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New Proposed Changes for Money Market Funds

by Robert A. Robertson and Kevin K. Babikian

On June 30, 2009, the Securities and Exchange Commission (SEC) proposed for public comment amendments to the money market fund rule—Rule 2a-7 under the Investment Company Act of 1940.[1] The proposed amendments are designed to, among other things, tighten the Rule's risk-limiting conditions, and require money market funds to report their portfolio holdings monthly to the SEC. In addition, the SEC is seeking comment on other possible regulatory changes, including whether money market funds should, like other types of mutual funds, effect shareholder transactions at market-based net asset values (NAVs), rather than the current cost-based values. The comment period for the SEC's proposal ended on September 8, 2009.

Why Change the Rule Now?

In fall 2008, money market funds faced serious problems as the financial markets deteriorated. Lehman Brothers Holdings Inc. (Lehman Brothers) filed bankruptcy, which led to heavy redemptions from about a dozen money market funds that held Lehman Brothers debt securities. A Reserve Fund series, which held large positions in commercial paper issued by Lehman Brothers, experienced a run on its assets and announced that it would break the dollar.[2] These events led many investors, especially institutional investors, to redeem their holdings in other prime money market funds and move assets to Treasury or government money market funds. During the week of September 15, 2008, investors withdrew approximately $300 billion from prime (taxable) money market funds, or 14 percent of the assets held in those funds.[3]

Institutional money market funds experienced the heaviest redemptions during this time period. They had depleted cash positions, and redemptions threatened to force a fire sale of their portfolio

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securities. Fearing more redemptions, money market fund (and other cash) managers began to retain cash rather than invest in commercial paper or other short-term instruments. Short-term markets seized up, which hindered access to credit in short-term private debt markets. On September 19, 2008, the US Department of the Treasury and the Federal Reserve Board announced an unprecedented market intervention by the federal government to stabilize and provide liquidity to the short-term markets.

The SEC is now proposing changes to certain aspects of Rule 2a-7 because, "although the crisis money markets faced last fall has abated, the problems have not disappeared."[4]

Strengthening the Risk Limiting Conditions

The proposed amendments would tighten Rule 2a-7's credit quality standards, shorten the portfolio maturity standards, and introduce new liquidity standards.

Portfolio Quality

The Rule limits the portfolio holdings of money market funds to securities that are "Eligible Securities." Eligible Securities are generally short-term securities that, at the time of acquisition, have received the highest or second highest short-term debt ratings from a requisite nationally recognized statistical rating organization (NRSRO).

An Eligible Security at present is either a "first tier security" or a "second tier security." A first tier security is generally any security that has received the highest short-term debt rating from any two NRSROs (or an unrated security of comparable quality), a security that is issued by another registered money market fund, or a "government security." A second tier security is any security other than a first tier security.

The amendments generally would redefine rated Eligible Securities to mean investments in securities that are rated in the *highest* NRSRO rating category (instead of one of the two highest). The SEC stated that eliminating a money market fund's ability to invest in second tier securities is intended to reduce the possibility that money market funds would break the dollar.

Portfolio Maturity

The Rule currently requires money market funds to maintain a dollar-weighted average portfolio maturity that is appropriate to the objective of maintaining a stable NAV per share. In this regard, the Rule does not permit a fund to acquire instruments that have remaining maturities of greater than 397 calendar days or maintain a dollar-weighted average portfolio maturity of more than 90 days. This requirement is intended to reduce exposure to risks associated with long-term investments, including interest rate risk.

The amendments would shorten the maximum dollar-weighted average maturity of a fund's portfolio to 60 days from the current limit of 90 days. This is intended to decrease further the risks related to longer-term investments (for example, higher levels of volatility, interest rate risk, liquidity risk, and wider credit spreads). The SEC stated that during the recent financial crisis, money market funds with shorter maximum weighted average maturities had proven to be better equipped to satisfy significant redemption demands because a larger portion of their securities matured on a more frequent basis, thus making available the cash needed to pay redeeming investors.

The amendments also would add a new maturity test that would limit the "Average Weighted Life" maturity of money market fund investments to 120 days. This calculation would be required to be made without regard to a portfolio security's interest rate reset dates. The SEC explained that the intended purpose of this more stringent method of calculating maturity is to reduce fund exposure to the risks associated with longer-term securities and to enable money market funds to maintain a greater degree of stability during periods of market volatility.

In explaining the concept of the "Weighted Average Life" maturity, the SEC used the example of a money market fund with a portfolio consisting 50 percent of overnight repurchase agreements and 50 percent of two-year government agency floating-rate obligations that reset daily. Using the reset dates as permitted by the current Rule's maturity shortening provisions, the portfolio would have a weighted average maturity of one day. However, using a measurement that does not recognize resets, the portfolio would have a weighted average life of 365.5 days (that is, half of the portfolio would have a one-day maturity and half would have a two-year maturity). The Average Weighted Life limitation, according to the SEC, would provide an extra layer of protection for funds in particularly volatile markets.

Portfolio Liquidity

Money market funds are currently limited to investing no more than 10 percent of their assets

in illiquid securities.[5] The 10 percent requirement, however, is not explicitly part of the Rule. The proposed amendments would expressly incorporate a liquidity requirement into Rule 2a-7, restricting *all* portfolio investments to cash and securities that, at the time of acquisition, would be considered to be "liquid securities." The Rule would define "liquidity" to mean securities that can be sold or disposed of in the ordinary course of business within seven calendar days at approximately their amortized cost. The SEC stated that, in its view, it is critical for a money market fund to have sufficient liquidity in order to maintain a stable share price.

The amendments furthermore would require institutional and retail money market funds to satisfy new additional liquidity requirements. Immediately after the acquisition of any security, *all funds* would be required to have invested at least 15 percent (if a retail fund) or 30 percent (if an institutional fund) of total assets in cash, US Treasury securities, and securities convertible into cash within five business days. A *taxable fund* would be required to have invested at least 5 percent (if a retail fund) or 10 percent (if an institutional fund) of total assets in cash, US Treasury securities, and securities convertible into cash in one business day.

Money market funds also would be subject to an ongoing general requirement to hold highly liquid securities that would, upon sale, generate sufficient proceeds to meet reasonably foreseeable shareholder redemptions.

Disclosure of Portfolio Holdings

Money market funds presently are required to disclose their portfolio holdings on a *quarterly* basis. The proposed amendments would require funds to post updated information about their portfolio holdings on their websites on a *monthly* basis.

The amendments would also require money market funds, within two business days after the end of each month, to electronically file with the SEC information regarding detailed portfolio holdings and certain risk characteristics. The SEC would make such information publicly available two weeks after it is filed.

The SEC explained that these amendments would enable them to create a database of money market fund portfolio information that could be used to improve the SEC's ability to monitor the risk characteristics of individual money market funds and the money market fund industry in general, anticipate and respond to market events, and enhance the SEC's oversight of money market funds.

Processing Transactions

The Rule amendments would require a money market fund's board of directors to determine annually that the fund has the operational capacity to process shareholder purchase and redemption transactions electronically at a price based on the fund's current market-based NAV per share (that is, not merely at a price of $1.00 per share).

The SEC explained that the Reserve Fund lacked such operational capacity, and that this limitation had resulted in significant delays in satisfying redemption requests after the Reserve Fund broke the dollar in September 2008. The SEC noted that the inability of money market funds to price shares in accordance with market values has the potential to expose shareholders to unnecessary risks, including the risk that a fund may not meet its obligation to process redemption requests within seven days.

Affiliated Purchases of Portfolio Securities

The amendments would also expand the ability of an affiliate to purchase portfolio securities from a money market fund. Affiliates would be permitted to purchase distressed securities (for example, Eligible Securities that have defaulted) and other portfolio securities (for example, non-defaulted Eligible Securities that are purchased for any reason) from affiliated money market funds. The purchase price of an Eligible Security that has not defaulted would be required to be paid in cash at the greater of its amortized cost value or market value. Any profit that is realized from a subsequent sale of such a security would be required to be remitted to the fund.

A fund would be required to promptly notify the SEC by email of any such purchase and the reasons for the purchase.

Suspension of Redemptions

The SEC is also proposing a new rule that would permit the board of a money market fund

to suspend redemptions, upon email notification to the SEC, if the fund breaks the dollar and will be liquidated. In the event that a liquidating fund fails to devise or properly execute a plan of liquidation that protects shareholders, the SEC would retain the authority to rescind or modify the relief provided by the new rule. The goal of this rule is to reduce the vulnerability of investors to the effects of a run on money market funds and to minimize the potential for disruption of the securities markets.

Request for Comment—"Floating" NAVs

The SEC requested comment on other possible amendments to Rule 2a-7. Most importantly, the SEC requested comment on whether to eliminate the ability of money market funds to use the amortized cost method of pricing (that is, eliminate the ability to use a stable NAV per share). A money market fund NAV per share would "float" like other mutual funds.

While the $1.00 stable NAV per share enables money market funds to be low-risk cash management vehicles, the SEC observed that this creates the risk that there will be a run on money market funds that break the dollar. This may further reduce their share price and negatively impact remaining shareholders.

Conclusion

The SEC's proposals are generally sound in light of the unprecedented financial meltdown of 2008 and 2009. The SEC hopefully will not, however, find it necessary to pursue further the concept of a "floating" NAV for money market funds. Investors view these funds as safe, *stable* cash management investments, and the amortized cost method of pricing is a critical component of Rule 2a-7 living up to investor expectations.[6]

NOTES

1. *See Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009), available at *http://www.sec.gov/rules/proposed/2009/ic-28807.pdf.*

2. A money market fund "breaks the dollar" when the fund's market-based NAV per share falls below its stable share price of $1.00.

3. *See* Release No. IC-28807, *supra* n.1.

4. *See id*. For historical context, *see* Robert A. Robertson & Kevin K. Babikian, "Credit Support Options for Money Market Funds," *The Investment Lawyer*, Vol. 16 No. 1 (Jan. 2009).

5. *See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, SEC Release No. IC-17452 (Apr. 23, 1990).

6. *See* Robert A. Robertson & Bradley W. Paulson, "A Methodology for Mutual Fund Derivative Investments," *Stanford Journal of Law, Business & Finance* 237, 237-270 (1995).

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