

THE INVESTMENT LAWYER™

covering legal and regulatory
issues of asset management

ASPEN PUBLISHERS

Vol. 17, No. 4 • April 2010

The SEC Adopts Sweeping Money Market Fund Reforms

by Robert A. Robertson and Kevin K. Babikian

On February 23, 2010, the Securities and Exchange Commission (SEC) adopted new rules and amendments to rules under the Investment Company Act of 1940 (1940 Act) governing the regulation of money market mutual funds (money funds).¹ The amendments were proposed on June 30, 2009.²

The amendments are designed to:

- (i) Strengthen Rule 2a-7's risk limiting conditions, including the addition of a new liquidity requirement;
- (ii) Enhance portfolio information disclosure; and
- (iii) Improve fund operations.

The SEC believes the amendments will make money funds more resilient to certain short-term market risks and less likely to break the dollar. The compliance date for the new requirements is May 5, 2010, with limited specified exceptions.

Background

A global financial crisis swept across both Wall Street and Main Street alike as fast as the 21st Century's first credit boom began to unwind in 2007. Reverberations from the worsening credit crisis were amplified in 2008 after Lehman Brothers Holdings filed for Chapter 11 bankruptcy on September 15, 2008. The next day, The Reserve Primary Fund (Reserve), an institutional fund, became the second money fund in history to break the dollar.³ In the days after Reserve broke the dollar, investors withdrew nearly \$300 billion from money funds.⁴ Such extraordinary redemption requests impaired the ability of money funds to provide liquidity to redeeming investors.

During this period, the SEC Staff provided no-action relief allowing asset purchase and credit support arrangements to be implemented by money funds facing credit or liquidity challenges. The Department of the Treasury

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and the Federal Reserve Board also responded by announcing unprecedented primary and secondary market support programs designed to improve market liquidity and assist money funds.⁵

The severity of the financial crisis moved the SEC to consider money fund regulation reform and adopt the amendments discussed in this article.

Strengthening Rule 2a-7's Risk Limiting Conditions

The SEC adopted amendments that improve Rule 2a-7's portfolio quality standards, shorten the Rule's maturity limits, and strengthen the Rule's diversification requirements (collectively, the Rule's risk limiting conditions). The SEC also adopted new liquidity standards.

Improving Portfolio Quality

Rule 2a-7 limits the portfolio holdings of money 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 the requisite nationally recognized statistical rating organizations (NRSROs) or, if unrated, have been deemed to be of comparable quality to such securities. Certain eligible securities are considered to be "first tier securities" while others are considered to be "second tier securities."⁶

Investments in Second Tier Securities

The amendments tighten the existing requirements with respect to investments in second tier securities by:

- Reducing the amount of assets that a money fund is permitted to invest in second tier securities to three percent of the fund's total assets (down from the five percent currently permitted under Rule 2a-7);⁷
- Limiting a money fund's exposure to any single second tier issuer to 0.5 percent of the fund's total assets (instead of one percent or \$1 million, whichever is

greater, currently required by the Rule);⁸ and

- Shortening the permitted maturity of any second tier security to 45 days (from the 397 days generally permitted today).⁹

The SEC did not prohibit the acquisition of second tier securities as originally proposed, opting instead to further limit exposure to risks posed by such securities, in order to balance Rule 2a-7's policy objectives and investors' prospects of earning higher returns.¹⁰

Designation of NRSROs

The amendments impose *new requirements* on a money fund's board concerning the credit quality of portfolio investments. Specifically, the board must:

- Designate at least four NRSROs (Designated NRSROs) whose short-term credit ratings the fund will use when determining whether a security is an eligible security for purposes of Rule 2a-7;¹¹
- Determine at least once each calendar year that the Designated NRSROs issue credit ratings that are sufficiently reliable for such use by the fund; and
- Disclose the Designated NRSROs, including any limitations on the use of such designation, in the fund's statement of additional information (SAI) no later than December 31, 2010.

The new requirements are designed, among other things, to foster competition among existing NRSROs and encourage more NRSROs to enter the credit rating market.¹²

Cautioning against over-reliance on NRSRO ratings, the SEC stated that the Rule continues to require money fund boards (typically relying on fund advisers) to determine that portfolio investments at the time of acquisition present minimal credit risks based on factors pertaining to credit quality, *in addition to any rating assigned to such securities by an NRSRO*.¹³

Ratings of Asset Backed Securities

The amendments eliminate the requirement that asset backed securities (ABSs) must be

rated by an NRSRO in order to be an eligible security.¹⁴ However, as part of the minimal credit risk analysis, the board or adviser should continue to:

- Analyze the underlying ABS assets to ensure that they are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS;
- Analyze the terms of any liquidity or other support provided by the sponsor of the ABS; and
- Otherwise perform the legal, structural, and credit analyses required to determine that the particular ABS involves appropriate risks for the fund.¹⁵

Shortening Maturity Limits

Rule 2a-7 currently requires money funds to maintain a dollar-weighted average portfolio maturity that is appropriate to the objective of maintaining a stable NAV per share. Money funds may neither acquire instruments that have remaining maturities of greater than 397 calendar days, nor maintain a dollar-weighted average portfolio maturity of more than 90 days.

Weighted Average Maturity

The amendments shorten the maximum dollar-weighted average maturity (WAM) of a money fund's portfolio to 60 calendar days (from the current limit of 90 calendar days). The shortened maximum WAM is designed to further decrease the fund's exposure to risks related to longer term investments, such as higher levels of volatility, interest rate risk, liquidity risk and wider credit spreads. The compliance date for the maximum WAM limit is June 30, 2010.

Weighted Average Life

The amendments add a *new requirement* that limits the dollar-weighted average life maturity (WAL) of money fund investments to 120 calendar days. The WAL is calculated without regard to a security's interest rate reset dates.

Generally, the maturity of a portfolio security is considered to be the period remaining

until the date on which the principal must be repaid according to its terms (its final "legal" maturity). Rule 2a-7 contains exceptions from this general approach for specific types of securities, which are referred to as the Rule's "maturity shortening" provisions. Among these exceptions are provisions that allow a fund to treat a variable- or floating-rate security as having a maturity equal to the time remaining to the next interest rate reset date.¹⁶

The SEC used the example of a money 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 based on the federal funds rate. Using the reset dates, the portfolio would have a WAM of one day. In contrast, using a measurement that does not recognize resets, the portfolio would have a WAL of 365.5 days (that is, half of the portfolio would have a one day maturity and half would have a two-year maturity), which would be longer than the new 120-day limit.¹⁷

The new WAL requirement is designed to limit the spread risk associated with longer term adjustable rate securities, particularly in volatile markets. The compliance date for the new maximum WAL limit is June 30, 2010.

Maturity Limit for Government Securities

The amendments remove the provision from Rule 2a-7 that permits money funds relying exclusively on the penny-rounding method of pricing to acquire government securities with remaining maturities of up to 762 calendar days.

Diversification—Strengthening Repurchase Agreement “Look Through” Requirements

When a money fund enters into a repurchase agreement, the fund may “look through” the agreement for purposes of Rule 2a-7's diversification calculations (that is, the securities underlying the repurchase agreement may be considered to be held directly by the fund), provided the repurchase agreement is “collateralized fully.” Two rule amendments relate to a money fund's investments in repurchase agreements:

- For a repurchase agreement now to be deemed to be “collateralized fully,” the underlying collateral must consist of cash items or government securities; and
- A money fund board or adviser must evaluate the creditworthiness of all repurchase agreement counterparties in order to rely on the special look through treatment mentioned above.¹⁸

The amendments are designed to reduce the risk that a money fund incurs losses when protecting its interest in collateral underlying a repurchase agreement whose counterparty has defaulted.¹⁹ Prior to the amendments, the Rule permitted the equivalent of first tier securities (or unrated securities of comparable quality) to be included in the collateral.

Establishing New Liquidity Requirements

Currently, money funds are limited, under a long-standing SEC interpretive position, to investing no more than 10 percent of their assets in illiquid securities.²⁰ The liquidity requirements under Rule 2a-7 are designed to enable money funds to absorb large amounts of redemptions without having to sell securities into a declining market.²¹ See Table 1 below for an overview of the new requirements.

General Liquidity Requirement

The amendments require money funds to hold sufficiently liquid securities to meet foreseeable redemptions.²² To comply with this requirement, the SEC expects money funds

to adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify the risk characteristics of shareholders.²³ The SEC did not identify specific characteristics that should be addressed in the policies and procedures, although the SEC stated that it expects fund managers to consider, for example:

- Any recurring liquidity needs of shareholders; and
- Whether the liquidity needs of shareholders coincide in order to have greater liquidity at such times.²⁴

The SEC stated that, “in their consideration of these procedures and in the oversight of their implementation, fund boards should appreciate that, in some cases, fund managers’ interests in attracting additional fund assets may be in conflict with their overall duty to manage the fund in a manner consistent with maintaining a stable net asset value. We urge directors to consider the need for establishing guidelines that address this conflict.”²⁵

Limitation on the Acquisition of Illiquid Securities

The amendments prohibit a money fund from acquiring an illiquid security if, immediately after the acquisition, the fund would have invested more than five percent of its total assets in illiquid securities.²⁶ The amendments define “illiquid security” to mean a security that cannot be sold or disposed of in the ordinary course of business within *seven calendar days* at approximately the value ascribed to it by the fund.²⁷

Table 1—New Liquidity Requirements Overview

All Money Funds	
<i>In General</i>	° Sufficiently liquid securities to meet “foreseeable” redemptions.
<i>Illiquid Securities Limit</i>	° Five percent maximum illiquid portfolio securities upon acquisition.
<i>Minimum Weekly Liquidity</i>	° 30 percent minimum portfolio securities convertible to cash in five days.
Taxable Money Funds—all of the above plus:	
<i>Minimum Daily Liquidity</i>	° 10 percent minimum portfolio securities convertible to cash in one day.

Minimum Daily and Weekly Requirements

The amendments require that, at a minimum, immediately after the acquisition of any security:

- *A taxable money fund* must have invested at least 10 percent of total assets in cash, US Treasury securities, and securities convertible into cash in *one business day*;²⁸ and
- *Each money fund* must have invested at least 30 percent of total assets in cash, US Treasury securities, agency discount notes with remaining maturities of 60 days or less,²⁹ and securities convertible into cash within *five business days*.³⁰

The amendments differ substantially from those originally proposed, which would have required a board to determine whether the fund is an “institutional fund” or a “retail fund” on the theory that institutional funds are subject to substantially larger redemption requests.³¹ As adopted, the amendments do not distinguish between institutional and retail funds. The same daily and weekly minimum liquidity requirements are imposed on both types of funds due primarily to the practical difficulty in distinguishing between them.³²

Stress Testing of Portfolios

As amended, Rule 2a-7 adds a *new requirement* on the board of a money fund to adopt procedures that provide for the periodic “stress testing”³³ of the fund’s portfolio in order to assess whether the fund could maintain its stable NAV per share upon the occurrence of specified hypothetical events, including but not limited to:

- A change in short-term interest rates;
- An increase in shareholder redemptions;
- A downgrade of, or a default on, portfolio securities; and
- The widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund.³⁴

The tests must be conducted at such intervals as the board determines are appropriate and reasonable in light of current market conditions.

The results of each “stress test” must be reported to the fund’s board at its next regularly scheduled meeting (or sooner, if appropriate in light of the results). The report must generally include:

- The date(s) on which the testing was performed;
- The magnitude of each hypothetical event that would cause the fund to break the dollar; and
- An assessment by the fund’s adviser of the fund’s ability to withstand events that are reasonably likely to occur within the following year.³⁵

Money funds must maintain records of the stress tests for six years, the first two years in an easily accessible place.³⁶

Enhancing Disclosure Requirements

The amendments relating to portfolio information disclosure fall under two categories: public Web site posting and reporting to the SEC. The amendments are designed to provide greater transparency to investors about the risks to which money funds are exposed, and to better equip the SEC with tools necessary to monitor and respond to market events impacting money funds.

Monthly Web Site Posting

The amendments require money funds to post information about their portfolio holdings on their Web sites no later than five business days after month’s end, which must remain accessible on the Web site for at least six months after posting. Currently, money funds are required to disclose their portfolio holdings only to the SEC and only on a quarterly basis (within 60 days after the end of the quarter). Funds must comply with the new Web site posting requirements no later than October 7, 2010. See Table 2 below for a summary of the new requirements.

Table 2—Fund Web Site Postings—*New Rule 2a-7(c)(12)*

<i>Fund Information (and Each Class Thereof)</i>	
• Dollar-Weighted Average Maturity (WAM)	• Dollar-Weighted Average Life (WAL)
<i>Information Regarding Each Portfolio Security</i>	
<ul style="list-style-type: none"> • Issuer's name • Category of investment (for example, Treasury debt; ABCP) • CUSIP number (if any) • Principal amount 	<ul style="list-style-type: none"> • Maturity date • Final legal maturity date • Coupon or yield • Amortized cost value
<i>Other Information</i>	
• Link to SEC Web site where most recent 12 months of publicly available information for the fund may be obtained	

Monthly Reporting to the SEC

New Rule 30b1-7 requires money funds to electronically report to the SEC (in an XML tagged data format), within five business days after month's end, more detailed portfolio holdings information on new Form N-MFP.³⁷ Information filed with the SEC on Form N-MFP will be made publicly available 60 days after the end of the month to which the information pertains. Funds must begin to file the new information on Form N-MFP no later than December 7, 2010.³⁸ See Table 3 on page 14 regarding information on the reporting requirements.

Improving Fund Operations

The amendments³⁹ require money funds (or their transfer agents) to have 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 the fund's stable NAV or price per share).⁴⁰ The compliance date for this new requirement is October 31, 2011.

Suspension of Redemptions

A money fund's board (including a majority of independent directors) may determine that the deviation between the fund's amortized cost price per share and the market based NAV per share may result in material

dilution or other unfair results, and irrevocably approve the fund's liquidation. In this case, new Rule 22e-3 permits the fund to suspend redemptions and payment of redemption proceeds, provided that the fund first notifies the SEC of its decision to liquidate and suspend redemptions.⁴¹

In the event that a liquidating fund fails to devise or properly execute a plan of liquidation that protects shareholders, the SEC retains the authority to rescind or modify the relief provided by the new Rule. A money fund that intends to rely on the new Rule may need to disclose in its prospectus the circumstances under which it may suspend redemptions.⁴² The SEC stated that the amendments are designed to reduce the vulnerability of investors to the harmful effects of a run on a money fund.

Conclusion

The SEC Commissioners approved the amendments in a four to one vote. The one Commissioner who dissented suggested that the amendments did not go far enough in addressing such "fundamental" issues as reliance on NRSRO ratings, and that the SEC should reconsider in the future whether to take a more significant step in the direction of a floating rate NAV. Nevertheless, the present rule changes should sufficiently reduce the risk of investing in money funds, which retail and institutional investors have come to rely upon for their cash management needs.

Table 3—Reports to the SEC—*New Form N-MFP*

<i>Fund Information</i>	
<ul style="list-style-type: none"> • Securities Act file number • Adviser’s SEC file number • Name and file number of each sub-adviser • Accountant’s city and state • Administrator name(s) • Transfer agent’s CIK and SEC file numbers as applicable • Information regarding master-feeder funds, as applicable • Whether series is primarily used to fund insurance company separate accounts 	<ul style="list-style-type: none"> • Fund category (for example, Prime; Treasury; Single State) • Dollar-Weighted Average Maturity (WAM) • Dollar-Weighted Average Life (WAL) • Total value of portfolio securities at amortized cost • Total value of other assets • Total value of liabilities • Net assets • 7-day gross yield • Shadow price
<i>Information Regarding Each Fund Class</i>	
<ul style="list-style-type: none"> • EDGAR class identifier • Minimum initial investment • NAV per share 	<ul style="list-style-type: none"> • Net shareholder flow activity for prior month • 7-day net yield • Shadow price
<i>Information Regarding Each Portfolio Security</i>	
<ul style="list-style-type: none"> • Issuer’s name • Title of issue, including coupon or yield • CUSIP number (if any) • Category of investment (for example, Treasury debt; ABCP) • Information regarding repurchase agreements • Ratings category • Designated NRSROs • Maturity date • Final legal maturity date 	<ul style="list-style-type: none"> • Information regarding demand features • Information regarding guarantees • Information regarding other enhancements • Total principal amount • Total current amortized cost • Percentage invested in security • Explanatory notes • Whether security is illiquid • Value, including and excluding value of any capital support agreement

Notes

1. See *Money Market Fund Reform*, SEC Release No. IC-29132 (Feb. 23, 2010) (Adopting Release). The SEC adopted amendments to Rules 2a-7, 17a-9 and 30b1-6T; new Rules 22e-3 and 30b1-7; and new Form N-MFP (collectively, amendments). The amendments become effective May 5, 2010, which is the compliance date of each amendment, unless otherwise indicated below.
2. See *Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009) (Proposing Release).
3. “Breaking the dollar” colloquially refers to the market based net asset value per share of a money fund falling below the fund’s stable share price of typically \$1.00.
4. See Adopting Release, *supra* n.1, at p.6.
5. The Treasury announced the “Temporary Guarantee Program for Money Funds” in September 2008 (expired in September 2009). The Federal Reserve announced the

“Money Market Investor Funding Facility” in October 2008 (expired in October 2009). The Federal Reserve also announced the “Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility” in September 2008 and the “Commercial Paper Funding Facility” in October 2008 (each expired on February 1, 2010).

6. A first tier security is generally: any eligible 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 fund; or a “government security” (as defined in Rule 2a-7). A second tier security is any eligible security that does not qualify as a first tier security.

7. See amended Rule 2a-7(c)(3)(ii). This limitation applies to all money funds. In comparison, Rule 2a-7 currently limits such investments by tax-exempt funds only with respect to conduit securities. See Rule 2a-7(c)(3)(ii)(A) and (B).

8. See amended Rule 2a-7(c)(4)(i)(C). This limitation applies to all money funds.
9. See amended Rule 2a-7(c)(3)(ii).
10. See Adopting Release, *supra* n.1, at section II.A.1.
11. See new Rule 2a-7(a)(11).
12. See Adopting Release, *supra* n.1, at section II.A.2.
13. Emphasis added. See Rule 2a-7(c)(3)(i).
14. See Rule 2a-7(a)(10)(ii)(B).
15. See Adopting Release, *supra* n.1, at p.37.
16. See *id.*, at section II.B.2.
17. See Proposing Release, *supra* n.2, at p.48.
18. See amended Rule 2a-7(c)(4)(ii)(A). The SEC had eliminated this requirement in 2001 in light of amendments to relevant bankruptcy laws. See Proposing Release, *supra* n.2, at II.E.
19. See Adopting Release, *supra* n.1, at section II.D.
20. 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).
21. See Adopting Release, *supra* n.1, at section II.C.
22. See new Rule 2a-7(c)(5). The SEC explained that this may require money funds to maintain greater liquidity than what is required by the new daily and weekly liquidity minimums discussed below.
23. See Adopting Release, *supra* n.1, at p. 53.
24. See *id.*, at pp.52-53.
25. See *id.*, at p.53.
26. See new Rule 2a-7(c)(5)(i).
27. Emphasis added. See new Rule 2a-7(a)(19).
28. See new Rule 2a-7(a)(8).
29. Agency notes are generally government securities issued at a discount to the principal amount to be repaid at maturity, which have remaining maturities of 60 days or less. See new Rule 2a-7(a)(32)(iii).
30. See new Rules 2a-7(a)(32) and 2a-7(c)(5)(ii)-(iii). Demand deposits are included under cash, and repurchase agreements are included under securities convertible into cash in one or five business days, as applicable. The SEC excluded tax-exempt money funds from daily liquidity requirements. See Adopting Release, *supra* n.1, at p. 64.
31. See Proposing Release, *supra* n.2, at pp.52-68.
32. See Adopting Release, *supra* n.1, at p.60.
33. The stress testing requirement is based on a proposal described in the Investment Company Institute's money fund report. See ICI, "Report of the Money Market Working Group" (Mar. 17, 2009), available at www.ici.org/pdf/ppr_09_mmmwg.pdf.
34. See new Rule 2a-7(c)(10)(v)(A).
35. See new Rule 2a-7(c)(10)(v)(B).
36. See amended Rule 2a-7(c)(11)(vii).
37. See Proposing Release, *supra* n.2, at section II.F.2. In the Proposing Release, the SEC noted that information disclosed by a money fund to the SEC on a quarterly basis quickly becomes stale and thus limits the SEC's ability to respond to current market events, and that because the quarterly reports are not required to be submitted in an easily searchable format, the SEC has been unable to closely monitor individual money funds and the money fund industry in general (e.g., the SEC was unable to quickly determine which money funds held SIVs or Lehman paper during the recent credit crisis).
38. Funds may file trial data on a voluntary basis as early as October 7, 2010, which the SEC does not intend to make available to the public. Because the information that is required to be filed on Form N-MFP pursuant to new Rule 30b1-7 includes all information that funds with lower market based NAVs must provide to the SEC under temporary Rule 30b1-6, the amendments phase out Rule 30b1-6 and extend its expiration date to December 1, 2010 (i.e., after the filing of monthly reporting requirements under Rule 30b1-7 become mandatory on December 7, 2010). (Rule 30b1-6 imposes certain reporting requirements on a money fund with a market based NAV per share below \$0.9975.)
39. In addition to the changes discussed, the SEC adopted amendments to Rule 17a-9 that permit affiliates to purchase distressed securities (e.g., eligible securities that have defaulted) and other portfolio securities (e.g., non-defaulted eligible securities that are purchased for any reason) from affiliated money funds; provided that, the purchase price is paid in cash at the greater of its amortized cost value or market value, and with respect to a non-defaulted eligible security, any profit that is realized from a subsequent sale of the security is remitted to the fund. See amended Rules 17a-9(a)(1)-(2) and (b)(1)-(2). Prompt notice of any such purchase by an affiliate, promoter, or principal underwriter, including identification of the security, its amortized cost, the sale price, and the reasons for the purchase, must be emailed to the SEC. See amended Rule 2a-7(c)(7)(iii)(B).
40. See new Rule 2a-7(c)(13).
41. See Adopting Release, *supra* n.1, at section II.H.
42. See Adopting Release, *supra* n.1, at n.378.

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