Chapter 9

Money Market Funds*

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§ 9:1 Introduction

Money market funds are subject to comprehensive regulation under the federal securities laws. The Securities and Exchange Commission (SEC) has, over a period of more than thirty years,[1] developed and refined a complex regulatory scheme designed to limit a money market fund's underlying portfolio risk and impose strict operational and procedural requirements. Money market funds are also subject to specific disclosure and advertising rules that differ from those that apply to other registered investment companies.

In its most recent effort to enhance the ability of money market funds to maintain a $1 share price in the face of market events, such as the market illiquidity in the Fall of 2008 that threatened the ability of money market funds to meet redemptions, the SEC proposed amendments to Rule 2a-7 under the Investment Company Act of 1940, as

1. *See, e.g., In re* Scudder Cash Investment Trust, Investment Company Act Release No. 9992 (Nov. 7, 1977) (early example of an exemptive application filed by a money market fund to permit the use of the amortized cost method for valuing portfolio securities). *See also* Investment Company Act Release No. 9786 (May 31, 1977) (discussing the SEC's view on the appropriateness of certain methods utilized by money market funds to value debt securities); and *In re* Intercapital Liquid Asset Fund, Inc., et al., Investment Company Act Release No. 10,824 (Aug. 8, 1979) (example of an order granting exemptive relief to permit use of the amortized cost method of valuation).

amended (ICA),[2] and other changes to the regulatory scheme for money market funds in June 2009,[3] which were adopted in final form in February 2010 (the "2010 Amendments").[4] This chapter describes the laws and regulations governing money market funds in the wake of the 2010 Amendments and in the face of continuing efforts to further regulate money market funds.

§ 9:2 What Is a Money Market Fund?

A money market fund is an open-end investment company that is registered under the ICA and that has as its investment objective the generation of income and preservation of capital through investment in short-term, high-quality debt securities.[5]

Unlike other registered investment companies, money market funds seek to maintain a stable price per share of $1[6] through the

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2. 15 U.S.C. §§ 80a-1 to -64 (2009). All references to rules in this chapter are references to rules under the ICA unless otherwise noted. Certain of Rule 2a-7's provisions discussed in this chapter in connection with guarantees, demand features, and asset-backed securities do not apply to such instruments if they were issued on or before February 10, 1998. For a discussion of these "grandfather" provisions, see Investment Company Act Release No. 22,921, at section III.B.2 (Dec. 2, 1997).
3. *See* Money Market Fund Reform, Investment Company Act Release No. 28,807 (June 30, 2009) [hereinafter 2009 Proposing Release].
4. *See* Money Market Fund Reform, Investment Company Act Release No. 29,132 (Feb. 23, 2010) [hereinafter 2010 Adopting Release]. The SEC adopted: (i) amendments to Rules 2a-7 and 17a-9; (ii) new Rules 22e-3 and 30b1-7; and (iii) new Form N-MFP. The 2010 Amendments became effective on May 5, 2010.
5. Investment Company Act Release No. 21,837, at section I (Mar. 21, 1996). According to the Investment Company Institute (ICI), as of September 21, 2011, approximately $2.6 trillion was invested in money market funds. In comparison, approximately $3.5 trillion had been invested in money market funds in the summer of 2008. *See* Investment Company Institute, Money Market Mutual Fund Assets Historical Data, *available at* www.ici.org/research/stats.
6. The vast majority of money market funds seek to maintain a stable net asset value per share of $1, but a few may seek to maintain a stable net asset value per share of a different amount (*e.g.*, $10). For convenience, this chapter refers to a stable net asset value per share of $1. Where a money market fund is one series of an investment company with multiple series, the maintenance of a net asset value per share of $1 could result in disproportionate voting power in the hands of the shareholders of the money market fund with respect to matters required to be voted on by all series of the investment company, such as the election of directors. Accordingly, the SEC staff has permitted (although not required) investment companies to establish "dollar-based voting" in which each dollar of net asset value entitles a shareholder to one vote, as an alternative to the

use of either the amortized cost valuation method or the penny-rounding pricing method (discussed below).[7] This stable net asset value feature has contributed to the popularity of money market funds as a tool for cash management and, in the view of the SEC, has encouraged many investors to "view investments in money funds as an alternative to either bank deposits or checking accounts."[8] Accordingly, the policy goal of the SEC in regulating money market funds has historically been to limit the risk that a money market fund will be unable to maintain a stable price per share of $1 (that is, to limit the risk that a money market fund would "break the dollar").

The use of the amortized cost method or the penny-rounding method to compute a money market fund's current net asset value per share or price per share[9] requires exemptive relief from the ICA's pricing and valuation provisions,[10] which Rule 2a-7 provides. As a condition of providing this exemptive relief, however, Rule 2a-7 imposes the following on money market funds:

- requirements relating to oversight of the fund by its board of directors (a "Board");
- requirements relating to the implementation of specific compliance procedures;

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traditional "one share, one vote" rule. *See* Sentinel Group Funds, Inc., SEC No-Action Letter (pub. avail. Oct. 27, 1992), agreeing to not recommend enforcement action under section 18(i) of the ICA, which requires all shares issued by a registered investment company to be "voting securities."

7. The use of the amortized cost or penny-rounding method of valuation is not mandatory. A fund can hold itself out as a money market fund and value its securities on a mark-to-market basis, as long as it complies with the Risk Limiting Provisions of Rule 2a-7 (discussed below). The SEC stated in the 2010 Adopting Release that they were unaware of any money market fund that relied solely on the penny-rounding method of pricing as of February 2010. *See* 2010 Adopting Release, *supra* note 4, at n.180 and accompanying text.

8. Investment Company Act Release No. 21,837 at section I. The SEC staff has further recognized this concept by taking the position that, for purposes of determining whether an issuer is an "investment company" subject to the ICA, shares of a money market fund that relies on Rule 2a-7 to maintain a stable net asset value per share of $1 can be treated by the issuer as a "cash item" rather than an "investment security" for purposes of section 3(a)(1)(C) and Rule 3a-1. *See* Willkie Farr & Gallagher, SEC No-Action Letter (pub. avail. Oct. 23, 2000).

9. Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors. Under the penny-rounding method, a money market fund's market-based net asset value per share is rounded to the nearest cent. Rule 2a-7(a)(2) and (20).

10. *See infra* section 9:3.1.

- a complex array of portfolio maturity, quality and diversification requirements (referred to herein as Rule 2a-7's "Risk-Limiting Provisions"); and
- SEC reporting requirements.

In addition to tightening Rule 2a-7's existing Risk-Limiting Provisions, the 2010 Amendments introduced:

- a new category of Risk-Limiting Provisions that governs the liquidity of a money market fund's portfolio;
- new requirements that a fund disclose portfolio holdings information on its public website and report detailed portfolio holdings information to the SEC on a monthly basis; and
- a new requirement that a fund have the operational capacity to process purchase and redemption transactions at the fund's current market-based net asset value.

The 2010 Amendments also expanded the ability of affiliates to purchase securities from a fund and granted Boards the authority to suspend redemptions in anticipation of a liquidation of a fund.

§ 9:3 Rule 2a-7

§ 9:3.1 Exemption from Standard Valuation Procedures

The ICA requires registered investment companies to value portfolio securities for which market quotations are readily available at current market value and to value all other securities and assets at their fair value, as determined in good faith by the company's Board.[11] The SEC adopted Rule 2a-7 in 1983 in response to the proliferation of applications for exemptive relief by registered investment companies seeking permission to deviate from the standard valuation requirements in order to maintain a stable share price.[12]

Prior to the adoption of Rule 2a-7, the SEC had expressed the view that the portfolio valuation provisions of the ICA required a money market fund to (i) determine the fair value of short-term debt securities for which market quotations were not readily available by reference generally to current market factors, and (ii) calculate its price per share to an accuracy of within 0.10% (that is, $0.01 based on a share price of

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11. *See* ICA § 2(a)(41) (definition of "value") and Rule 2a-4. *See also* Rule 22c-1 (governing the pricing of redeemable securities for purposes of distribution, redemption, and repurchase).
12. Investment Company Act Release Nos. 12,206 (Jan. 29, 1982) (proposing release) and 13,380 (July 11, 1983) (adopting release) [hereinafter Release No. 13,380].

$10). The SEC had considered the use of the amortized cost method to determine the fair value of debt securities that mature in more than sixty days to be inconsistent with the ICA's valuation requirements, and had also concluded that the practice of rounding to the nearest $0.01 where a fund sought to maintain a $1 net asset value per share could have a dilutive effect on shareholders.[13] Accordingly, in the view of the SEC, without exemptive relief, the use of the amortized cost method or the penny-rounding method with respect to securities having a remaining maturity of more than sixty days is prohibited under the ICA. Rule 2a-7 provides exemptions that allow money market funds to operate outside the ICA mandates for valuing portfolio securities, provided that the Rule's requirements are met.

§ 9:3.2 Holding Out and Use of Names and Titles

Rule 2a-7 prohibits a registered investment company from the following actions without complying with Rule 2a-7's Risk-Limiting Provisions (discussed below):

- Holding itself out as a money market fund or as the equivalent of a money market fund in any document filed or transmitted pursuant to the ICA or in sales literature required to be filed under the ICA,[14] which includes sales literature filed with the Financial Industry Regulatory Authority (formerly the National Association of Securities Dealers, Inc.) in lieu of the SEC.[15]
- Using the term "money market" or a similar term in its name or in the title of any redeemable securities it issues.[16]

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13. *See* Investment Company Act Release No. 9786. In this release, the SEC stated that a registered investment company could value a debt security maturing in sixty days or less using amortized cost without the need for exemptive relief. The SEC subsequently stated, however, that this position could not be relied upon by a money market fund calculating the market-based net asset value per share of its portfolio for purposes of shadow pricing under Rule 2a-7. *See* Release No. 13,380, *supra* note 12, at text accompanying n.44. During the market illiquidity crisis in the Fall of 2008, the SEC staff took a temporary no-action position allowing money market funds to rely on Release 9786 for purposes of shadow pricing. *See* Investment Company Institute, SEC No-Action Letter (pub. avail. Oct. 10, 2008).
14. Rule 2a-7(b)(1).
15. *See* ICA § 24(b) and Rules 24b-2 and 24b-3 (governing the filing of sales material by registered investment companies).
16. Rule 2a-7(b)(2). Under the investment company "Names Rule," a fund with a name suggesting investment in certain types of securities must invest at least 80% of its assets in accordance with its name and adopt a conforming policy. Rule 35d-1. A generically named money market fund is not required to specifically adopt a policy to invest at least 80% of its assets in money market securities since Rule 2a-7 requires money market

- Using names that include terms such as "cash," "liquid," "money," "ready assets" or similar terms.[17]

§ 9:3.3 Board Findings and Procedures for Rule 2a-7 Reliance

[A] Required Board Findings

The use by a money market fund of either the amortized cost method or the penny-rounding method requires the fund's Board to determine initially in good faith that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, and that the fund will only do so as long as the Board continues to believe that the stable net asset value per share or price per share fairly reflects the fund's market-based net asset value per share.[18]

[B] Required Procedures: Funds Using the Amortized Cost Method

The Board of a money market fund that uses the amortized cost method to value portfolio securities must establish written procedures that are reasonably designed, taking into account current market conditions and the fund's investment objective, to stabilize the fund's

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funds to invest all of their assets in securities eligible for investment under Rule 2a-7. However, a money market fund with a name suggesting a focus on a certain type of money market security, such as the "XYZ U.S. Treasury Money Market Fund," would be required to adopt a policy under Rule 35d-1 to invest at least 80% of its assets in U.S. Treasury securities. *See* SEC, Frequently Asked Questions about Rule 35d-1, Question No. 13 (pub. avail. Dec. 4, 2001), *available at* www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm.

17. Rule 2a-7(b)(3).

18. Rule 2a-7(c)(1). The SEC has instituted and settled administrative proceedings against the portfolio manager of a money market fund based on allegations that, among other things, the portfolio manager willfully aided and abetted and caused violations of Rule 22c-1 by continuing to value two structured notes at amortized cost for purposes of calculating the fund's net asset value in the face of steep market declines for the two structured notes instead of tracking the deviation between amortized cost and market value by using market quotations or appropriate substitutes. The SEC stated that as a result, the fund sold and redeemed shares at the price of $1 per share when the fund was no longer eligible to rely on Rule 2a-7. The portfolio manager was barred from association with any broker, dealer, or investment company, and was ordered to pay a civil money penalty. *See In re* Michael P. Traba, Investment Company Act Release No. 23,952 (Aug. 19, 1999).

net asset value per share at a single value.[19] Among other things, these written procedures must provide for "shadow pricing" of the fund's portfolio and for periodic "stress testing" of money market fund portfolios.

[B][1] Shadow Pricing and Related Board Actions

The shadow pricing provisions of Rule 2a-7 require the Board of a money market fund that uses amortized cost to establish an appropriate and reasonable interval, based on market conditions, for the calculation of the deviation, if any, between the fund's net asset value per share based on currently available market quotations (or an appropriate substitute that reflects current market conditions) and the fund's net asset value per share calculated using the amortized cost method (the "Deviation").[20]

The Board must periodically review the amount of, and the methods used to calculate, the Deviation,[21] and the fund must maintain records of the Deviation and the Board's deliberations in connection with the Deviation.[22] In the event that the Deviation exceeds ½ of 1% (that is, the fund's per share net asset value on a mark-to-market basis is less than $0.995 or greater than $1.005), Rule 2a-7 requires the Board to promptly meet to consider what action, if any, should be taken to reduce the Deviation.[23] Moreover, regardless of the extent of the Deviation, Rule 2a-7 imposes on the Board a duty to take appropriate action whenever the Board believes that the Deviation may result in material dilution or other unfair results to investors or current shareholders.[24]

Although Rule 2a-7 establishes a ½ of 1% standard for mandatory Board deliberation, many money market funds have built a lower tolerance level into their procedures, requiring notification of a Deviation to be given to the Board whenever the Deviation exceeds some lower threshold.[25] For example, a fund's procedures might require that

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19. Rule 2a-7(c)(8)(i).
20. Rule 2a-7(c)(8)(ii)(A)(1). Market prices may not be readily available if a money market fund's portfolio securities become illiquid. In that case, it may be necessary to use fair valuation techniques to value such securities for purposes of calculating the Deviation. *See infra* section 9:3.5[D].
21. Rule 2a-7(c)(8)(ii)(A)(2).
22. Rule 2a-7(c)(8)(ii)(A)(3).
23. Rule 2a-7(c)(8)(ii)(B).
24. Rule 2a-7(c)(8)(ii)(C). Any action taken with respect to a Deviation in excess of ½ of 1% must be reported on the fund's Form N-SAR. Rule 2a-7(c)(10)(vii). *See* Form N-SAR, item 77N.
25. The SEC has recognized this practice. *See* 2010 Adopting Release, *supra* note 4, at n.10 and accompanying text.

the Board or a committee thereof be notified of any Deviation greater than ¼ of 1% (that is, where the per share net asset value on a mark-to-market basis is less than $0.9975 or greater than $1.0025) and be informed as to the investment adviser's proposed course of action in response to the Deviation.

Under normal circumstances, the shadow pricing requirement of Rule 2a-7 typically has been discharged by a weekly calculation of the Deviation by the fund's investment adviser, administrator, or pricing agent, and by quarterly review of the Deviation at regularly scheduled meetings of the fund's Board. Since the liquidity crisis in the Fall of 2008, many funds have begun to monitor the level of Deviation on a daily basis, whether formally under their procedures or informally through daily shadow pricing by the fund's adviser.

[B][2] Stress Testing[26]

The 2010 Amendments require the Board of a money market fund to adopt procedures that provide for the periodic stress testing of the fund's ability to maintain a stable net asset value per share upon the occurrence of certain hypothetical events, including, but not limited to: changes in short-term interest rates; increases in shareholder redemptions; and downgrades of, or defaults on, portfolio securities.[27] However, money market funds are not required to stress test their

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26. The requirement for periodic stress testing was based on a proposal described in ICI's 2009 money fund report ("ICI Report"). Many money market fund advisers had already implemented some version of stress testing for their funds by the time the ICI Report was published. *See* INVESTMENT COMPANY INSTITUTE, REPORT OF THE MONEY MARKET WORKING GROUP 75 (Mar. 17, 2009), *available at* www.ici.org/pdf/ppr_09_mmwg.pdf. The SEC staff has stated that they would not object if an investment adviser of a U.S. Treasury money market fund refrains from stress testing for downgrades or defaults if the Board makes a determination that these types of stress events are not relevant for the particular fund; provided that, the money market fund retains a record of the Board's determination and the basis for the determination for a period of at least six years, the first two in an easily accessible place. *See* Division of Investment Management: Staff Responses to Questions about Money Market Fund Reform (Nov. 24, 2010 revision) [hereinafter Amended Rule 2a-7 Q&A], *available at* http://sec.gov/divisions/investment/guidance/mmfreform-imqa.htm, Question III.A.1.

27. *See* new Rule 2a-7(c)(10)(v)(A). While the Board is required to adopt the stress testing procedures (responsibility for fulfilling this requirement cannot be delegated by the Board under Rule 2a-7(e)), the Board is not required to design the portfolio stress tests, and the procedures can be implemented by the fund's adviser. *See* 2010 Adopting Release, *supra* note 4, at text accompanying n.264. The SEC staff has provided guidance on how money market funds should stress test defaults. The staff has stated that, although changes in short-term interest rates and redemptions will likely affect a money market fund's entire portfolio, downgrades and

portfolios for the risk of breaking the dollar on the upside (for example, the risk that the market-based NAV of their securities will exceed $1.005).[28] Stress testing must be conducted at such intervals as the Board determines is appropriate and reasonable in light of current market conditions.

In the 2010 Adopting Release, the SEC stated that money market funds should incorporate "know your customer" evaluations into their stress testing procedures.[29] The SEC staff also has clarified that a money market fund should incorporate an evaluation of the liquidity needs of its shareholder base into its stress testing procedures.[30] To illustrate, the SEC staff stated that the testing of a money market fund's ability to maintain a stable NAV per share based upon specified hypothetical events should account for the fund's anticipated redemption activity for the relevant period, and that the investment adviser's assessment of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year should be based, in part, on the redemption activity that the investment adviser believes is reasonably likely to occur in the following year.[31]

The results of each stress test must be reported to the fund's Board at its next regularly scheduled meeting (sooner, if appropriate in light of the results).[32] The report must include: the date(s) on which the

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defaults are likely to be limited to an individual security or to a few specific securities; as such, stress tests should be designed to assist the fund's Board in assessing the effect of isolated stresses on a fund's shadow NAV, and if a downgrade or default of a portfolio holding is likely to have a significant effect on the fund's shadow NAV, so that the shadow NAV would deviate by more than one-half cent per share, the test should indicate the full extent of the loss a fund might be expected to incur as a result. *See* Amended Rule 2a-7 Q&A, Question III.A.3.

28. *See* Amended Rule 2a-7 Q&A, Question III.A.2.

29. *See* 2010 Adopting Release, *supra* note 4, at n.261 ("As discussed above, amended Rule 2a-7's new liquidity requirements require money market funds to evaluate their liquidity needs based on their shareholder base. . . . Money market funds should also incorporate this element in their stress testing procedures as appropriate."). For a discussion of Rule 2a-7's general liquidity requirement and "know your customer" procedures, see *infra* section 22:3.4[D][2][a].

30. *See* Amended Rule 2a-7 Q&A, Question III.B.1.

31. *Id.*

32. The SEC staff has clarified that if, under normal market conditions, a money market fund's stress testing procedures require monthly testing and the fund's Board meets on a quarterly basis, a single report presenting data from each of the monthly stress tests conducted between meetings would satisfy Rule 2a-7(c)(10)(v). *See* Amended Rule 2a-7 Q&A, Question III.A.4. The SEC staff has encouraged such reports to present results (including results previously reported to the directors) in a manner that would facilitate directors' observation of trends in stress testing results. *Id.*

testing was performed; the magnitude of hypothetical events 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.[33]

[C] Required Procedures: Funds Using the Penny-Rounding Method

The Board of a money market fund that uses the penny-rounding method must take steps to assure, to the extent reasonably practicable, taking into account current market conditions, that the fund's price per share, rounded to the nearest 1%, will not deviate from the single price established by the Board.[34]

[D] Specific Procedures: All Funds

A money market fund that uses either the amortized cost method or the penny-rounding method to value portfolio securities must include in its procedures specific provisions with respect to the following, as applicable:

- ongoing review of a security's minimal credit risk if its maturity is determined by reference to a demand feature (discussed below);[35]
- periodic evaluation of any determination that a fund will not rely on a demand feature or guarantee (discussed below) in the determination of a portfolio security's quality, maturity, or liquidity;[36]
- periodic review of whether an interest rate formula for a variable or floating rate security, upon readjustment of the interest rate, can reasonably be expected to cause the security to have a market value that approximates its amortized cost value;[37] and

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33. *See* new Rule 2a-7(c)(10)(v)(B). Money market funds must maintain records of the stress testing for six years, the first two years in an easily accessible place. *See* amended Rule 2a-7(c)(11)(vii).
34. Rule 2a-7(c)(9).
35. Rule 2a-7(c)(10)(i).
36. Rule 2a-7(c)(10)(ii).
37. Rule 2a-7(c)(10)(iii). This requirement only applies where the security is not subject to a demand feature and the maturity of the security has been determined pursuant to the maturity rules for adjustable rate Government Securities, short-term variable rate securities, or short-term floating rate securities.

- periodic determination in the case of an asset-backed security (ABS)[38] of the number of 10% obligors (defined below) who are deemed to be the issuers of all or a portion of the ABS.[39]

In addition to the above procedures, the Board may find it advisable to consider putting in place a process requiring more frequent and more detailed minimal credit risk determinations during times of volatile and illiquid markets,[40] particularly if the issuers of securities held by the fund depend on access to the short-term debt markets to roll over or service their outstanding paper.

§ 9:3.4 The Risk-Limiting Provisions

As amended in 2010, Rule 2a-7 establishes four basic criteria with respect to the composition of a money market fund's portfolio: maturity, quality, diversification and liquidity.

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38. An asset-backed security is any fixed income security (other than a Government Security) issued by a special purpose entity. A special purpose entity is a trust, corporation, partnership, or other entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from qualifying assets, but does not include a registered investment company. Qualifying assets are financial assets, either fixed or revolving, that by their terms convert to cash within a finite period of time, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders. Rule 2a-7(a)(3). An example of an ABS would be an interest in a pool of credit card receivables issued by a trust. Investments in ABS are subject to special diversification requirements under Rule 2a-7. *See infra* section 9:3.4[C][1][c][iii].

39. Rule 2a-7(c)(10)(iv). However, if the Board, or its delegate, has determined at the time of acquisition that the ABS will not have or is unlikely to have any 10% obligors who are deemed to be the issuers of all or a portion of the ABS, and a record of this determination is maintained, then it is not required for the fund's procedures to mandate periodic determinations. "Acquisition" would include any purchase or subsequent rollover, but would not include the failure to exercise a demand feature. Rule 2a-7(a)(1).

40. For instance, a more detailed creditworthiness requirement might be included in the procedures governing certain types of instruments, such as collateralized debt obligations or structured investment vehicles. Likewise, a detailed "approved list" may be maintained to monitor whether a money market fund's securities continue to present minimal credit risk. As used in Rule 2a-7, the concept of "minimal credit risk" is separate from the credit rating status of the security and relates to whether an instrument is likely to default or become ineligible under the quality requirements during the period that the fund intends to hold the security. *See infra* section 9:3.4[B][2]. If the issuer of the instrument and the provider of any demand feature or guarantee (discussed below) are different parties, then the minimal credit risk determination may be required for each party.

[A] Maturity

[A][1] Portfolio Maturity

To reduce exposure to risks associated with long-term investments, including interest rate risk, Rule 2a-7 requires a money market fund to maintain a dollar-weighted average portfolio maturity that is appropriate to the objective of maintaining a stable net asset value per share;[41] provided, however, that a fund may not:

- acquire any instrument that has a remaining maturity of greater than 397 calendar days,[42] and provided further that, the fund may not acquire a Second Tier Security with a remaining maturity of greater than forty-five calendar days;[43]
- maintain a dollar-weighted average portfolio maturity (WAM) of more than sixty days;[44] and

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41. Rule 2a-7(c)(2).
42. Rule 2a-7(c)(2)(i). The 2010 Amendments removed the provision from Rule 2a-7 that permitted funds using the penny-rounding method of pricing to acquire Government Securities with extended maturities of up to 762 calendar days. As of February 2010, the SEC was unaware of any money market fund that relied solely on the penny-rounding method of pricing, or that held fixed-rate Government Securities with remaining maturities of two years or more. *See* 2010 Adopting Release, *supra* note 4, at n.180 and accompanying text. Since then, these securities have been subject to the same 397-day maximum maturity as other First Tier money market fund investments. *See* amended Rules 2a-7(c)(2)(i) and (ii).
43. Rule 2a-7(c)(3)(ii).
44. Rule 2a-7(c)(2)(iii). Many bond funds that seek generation of income as their objective have abandoned maturity measurement in favor of measurement of portfolio duration. Duration is a measure of the sensitivity of debt securities to changes in market interest rates based on the cash flow associated with a security, including pre-payments of principal prior to the security's maturity. However, Rule 2a-7 continues to impose a limit based on average dollar-weighted portfolio maturity, and therefore, duration measurement currently is not a permitted substitute for compliance with Rule 2a-7's maturity requirements. The 2010 Amendments shortened the maximum WAM of a money market fund's portfolio to sixty calendar days (from ninety calendar days). *See* amended Rules 2a-7(c)(2)(ii) and (iii). The shortened maximum WAM is intended to reduce the likelihood that a money market fund would break the dollar, by further decreasing a fund's exposure to risks related to longer term investments, such as higher levels of price volatility, interest rate risk, liquidity risk, and wider credit spreads. In the 2009 Proposing Release, the SEC noted that during the 2007–2009 financial crisis, money market funds with shorter maximum weighted average maturities had proven to be better equipped to satisfy significant demands for redemption because a larger portion of their securities matured on a more frequent basis, thus making available the cash needed to pay redeeming investors. *See* 2009 Proposing Release, *supra* note 3, at section II.B.1.

- maintain a dollar-weighted average life to maturity of more than 120 days.[45]

[A][1][a] Calculating Weighted Average Life[46]

The 2010 Amendments added a new requirement under Rule 2a-7 that limits the dollar-weighted average life to maturity (WAL) of a money market fund's investments to 120 calendar days, the calculation of which must be made without reference to the exceptions discussed in section 9:3.4[A][2] below regarding interest rate readjustments.[47] This requirement is intended to limit the spread risk associated with longer term adjustable rate securities, particularly in volatile markets, by focusing on the date on which a fund has a legal right to receive the principal amount of each instrument, whether through an instrument maturing or by exercising a demand feature.[48] The SEC concluded that a 120-day WAL strikes the correct balance between not significantly constraining the range of high quality, short-term debt securities in which money market funds may invest, and providing an appropriate amount of spread risk protection to money market funds and their investors.[49]

[A][2] Maturity of Portfolio Securities

Generally, the maturity of a portfolio security under Rule 2a-7 is the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount of the security must unconditionally be paid, or,

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45. Rule 2a-7(c)(2)(iii).
46. The 120-day WAL limit was recommended to the SEC in the ICI Report. *See* 2010 Adopting Release, *supra* note 4, at n.158 and accompanying text.
47. *See* amended Rule 2a-7(c)(2)(iii). In the 2009 Proposing Release, the SEC explained that the intended purpose of this more stringent method of calculating maturity (*i.e.*, not permitting the use of interest rate reset dates to shorten 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. *See* Proposing Release, *supra* note 3, at section II.B.2. The SEC staff has stated that, for purposes of calculating a money market fund's WAL under Rule 2a-7(c)(2)(iii), the fund may treat a short-term floating rate security that is subject to a demand feature as having a maturity equal to the period remaining until the principal can be recovered through demand (*i.e.*, the fund may treat a short-term floating rate security in the same manner as a short-term variable rate security). *See* SEC no-action letter to The Investment Company Institute (pub. avail. Aug. 10, 2010).
48. *See* 2010 Adopting Release, *supra* note 4, at section II.B.2.
49. *Id.*

in the case of a security that is called for redemption, the date on which the redemption payment must be made (the "final maturity").[50] However, Rule 2a-7 contains several specific exceptions to the general method for determining the maturity of a portfolio security which address, in part, the effect of demand features[51] and other maturity shortening devices,[52] as discussed below.

[A][2][a] Adjustable Rate Government Securities

A variable rate[53] Government Security[54] that has an interest rate readjustment at least once every 397 calendar days is deemed to have a maturity equal to the period remaining until the next interest rate

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50. Rule 2a-7(d). A security that is subject to a "mandatory tender feature" (*i.e.*, a feature providing that the principal amount of the security will be paid off on a specified date unless the holder affirmatively elects to remain invested) can be treated as having a maturity measured by reference to the payment date of the tender feature. Investment Company Act Release No. 21,837, at n.151. It should be noted that Rule 2a-7 does not contain a specific exception to the general method for determining the maturity of funding agreements (*i.e.*, insurance contracts between a fund and an insurance company). Funding agreements are generally illiquid and can present difficult valuation issues.

51. A demand feature must provide a legal right to sell the security, and mechanisms such as "Dutch auctions" and "best efforts" agreements by securities dealers to make a market in the security do not qualify as demand features. *See* Goldman, Sachs & Co., SEC No-Action Letter (pub. avail. Sept. 7, 1988) and Paul B. O'Kelly, Esq., SEC No-Action Letter (pub. avail. June 5, 1986) (stating that a dealer's undertaking to provide an auction mechanism or secondary market in a debt security is not the equivalent of a demand feature that can be used to shorten the maturity of a variable or floating rate debt instrument under Rule 2a-7).

52. While some variable and floating interest rates can be used to shorten the maturity of an instrument for most purposes under this Rule, compliance with the weighted average life requirement must be calculated without reference to interest rate adjustments. See *supra* section 9:3.4[A][1][a] regarding the new WAL requirements.

53. A variable rate security is a security providing for the adjustment of the interest rate on set dates and that, upon each adjustment until final maturity or until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost. Rule 2a-7(a)(31).

54. For purposes of the ICA, including Rule 2a-7, a "Government Security" is any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by the U.S. Congress, and any certificate of deposit for such securities. *See* ICA § 2(a)(16) and Rule 2a-7(a)(16).

adjustment.[55] A floating rate[56] Government Security is deemed to have a remaining maturity of one day.[57]

[A][2][b] Variable Rate Securities

A variable rate security, the principal amount of which is scheduled to be paid unconditionally in 397 calendar days or less, is deemed to have a remaining maturity equal to the shorter of the period until the next interest rate adjustment or until the principal amount can be recovered through exercise of a demand feature.[58] A variable rate security, the principal amount of which is scheduled to be paid in more than 397 calendar days and that is subject to a demand feature is deemed to have a maturity equal to the longer of the period until the next interest rate adjustment or until the principal amount can be recovered through exercise of the demand feature.[59]

[A][2][c] Floating Rate Securities

A floating rate security, the principal amount of which must be paid unconditionally in 397 calendar days or less, is deemed to have a

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55. Regarding a conforming change to Rule 2a-7(c)(2), see 2010 Adopting Release, *supra* note 4, at n.179 and accompanying text. There is no limitation on the maximum final legal maturity of adjustable rate government securities under Rule 2a-7, so long as there is an interest rate readjustment within the 397-day period specified in Rule 2a-7(d)(1). The SEC considered adopting a final maturity limit in the 2010 Adopting Release, but it determined that it had insufficient data to do so at that time. *See* 2010 Adopting Release, *supra* note 4, at n.182.
56. A floating rate security is a security that provides for an interest rate adjustment whenever a specified interest rate changes and that, at any time until final maturity or until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost. Rule 2a-7(a)(15).
57. Rule 2a-7(d)(1).
58. Rule 2a-7(d)(2). Prior to the 1996 amendments to Rule 2a-7, a short-term variable rate security's maturity was deemed to be the longer of the period remaining until the next interest rate adjustment or the date on which principal could be recovered through demand.
59. Rule 2a-7(d)(3). Although preferred stock is technically an equity security and may therefore not have a stated "maturity," under certain circumstances preferred stock with a resetting dividend rate and a demand feature may be treated as a variable rate security that is eligible for investment by a money market fund. *See* Merrill Lynch Investment Managers, SEC No-Action Letter (pub. avail. May 10, 2002); *see also* Eaton Vance Management, SEC No-Action Letter (pub. avail. June 13, 2008) (permitting the issuance of liquidity protected preferred shares eligible for purchase by money market funds).

maturity of one day.[60] A floating rate security, the principal amount of which is scheduled to be paid in more than 397 calendar days and that is subject to a demand feature is deemed to have a maturity equal to the period remaining until the principal amount can be recovered through exercise of the demand feature.[61]

[A][2][d] Repurchase Agreements

A repurchase agreement is deemed to have a maturity equal to the period remaining until the date on which the repurchase of the underlying securities is scheduled to occur. However, if the repurchase agreement is subject to a demand, the maturity may be deemed to be the notice period applicable to the demand for the repurchase of the securities.[62]

[A][2][e] Portfolio Lending Agreements

A portfolio lending agreement is deemed to have a maturity equal to the period remaining until the date on which the loaned securities are scheduled to be returned. However, if the portfolio lending agreement

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60. Rule 2a-7(d)(4). This conclusion by the SEC is based on the supposition that a floating rate security, by its nature, should always have a market value that approximates its amortized cost value. *See* Investment Company Act Release No. 21,837, at section II.F.

61. Rule 2a-7(d)(5).

62. Rule 2a-7(d)(6). Repurchase agreements entered into by money market funds must also comply with ICA § 12(d)(3) (prohibition on fund acquisition of an interest in a broker-dealer, underwriter, or investment adviser). To determine compliance with § 12(d)(3), Rule 5b-3 permits funds, subject to certain conditions, to treat a repurchase agreement as an acquisition of the underlying collateral. *See* Investment Company Act Release No. 25,058 (July 5, 2001) (codifying SEC staff no-action positions treating a repurchase agreement as an acquisition of the underlying collateral if the repurchase agreement is "Collateralized Fully," as defined under Rule 5b-3(c)(1)). As part of the 2010 Amendments, the SEC revised the definition of "Collateralized Fully" for purposes of Rule 2a-7's diversification requirements. The SEC also reintroduced the requirement that Boards or their delegates must evaluate the creditworthiness of all repurchase agreement counterparties, which had been included in SEC staff no-actions positions prior to 2001. *See infra* section 9:3.4[C][1][c][i]; *see also* Release No. 25,058, at section II.A.3. A fund's adviser, rather than the fund's Board, typically assumes primary responsibility for monitoring and evaluating the fund's use of repurchase agreements. *See, e.g.*, Investment Company Institute, SEC No-Action Letter (pub. avail. June 15, 1999). If the issuer of a repurchase agreement should default, the collateral will become part of the money market fund's portfolio. Accordingly, although a repurchase agreement may be collateralized by securities with a maturity of greater than 397 days, if such collateral should become part of the fund's portfolio as the result of a default, the collateral must be disposed of as soon as possible. Investment Company Act Release No. 12,206 (Jan. 29, 1982), at n.23.

is subject to a demand, the maturity is deemed to be the notice period applicable to the demand for the return of the loaned securities.[63]

[A][2][f] Money Market Fund Shares

Money market fund shares are deemed to have a maturity equal to the period of time within which the money market fund issuing the shares (the "acquired fund") is required to make payment upon redemption, or any shorter period of time agreed to in writing with the acquired fund.[64]

[B] Portfolio Quality

A second criteria for the composition of a money market fund's portfolio under Rule 2a-7 relates to portfolio quality. Rule 2a-7 limits the portfolio holdings of money market funds to securities that are denominated in U.S. dollars, that pose minimal credit risk to the fund, and that are "Eligible Securities" under Rule 2a-7.[65]

[B][1] U.S. Dollar Denominated Securities

For a security to qualify as U.S. dollar denominated under Rule 2a-7, all principal and interest payments must be payable to the holder in U.S. dollars under all circumstances. Further, the interest rate, principal amount to be repaid, and timing of payments related to the security must not vary or float with the value of a foreign currency, the rate of

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63. Rule 2a-7(d)(7). The SEC staff has developed guidelines that all registered investment companies should observe when engaging in securities lending transactions. Early SEC no-action letters developing the securities lending guidelines include State Street Bank & Trust Co. (pub. avail. Jan. 29, 1972); State Street Bank & Trust Co. (pub. avail. Sept. 29, 1972); Salomon Brothers (pub. avail. Sept. 29, 1972); Standard Shares, Inc. (pub. avail. Aug. 28, 1974); and Adams Express Co. (pub. avail. Oct. 20, 1979). For a more current discussion on the future of securities lending and potential regulatory solutions, see materials from an SEC roundtable held in September 2009. *See, e.g.*, Press Release, SEC, SEC Announces Panelists for Securities Lending and Short Sale Roundtable (Sept. 25, 2009), *available at* www.sec.gov/news/press/2009/2009-207.htm.

64. Rule 2a-7(d)(8). Many money market funds have disclosed that they intend to make payment upon redemption on either a same day or next day basis. Whether this disclosure is sufficient to create the contractual arrangement required under Rule 2a-7 will depend on the nature of the acquired fund's undertaking. For example, it would seem unlikely that a statement of mere intention of the acquired fund to provide same day redemption payment, without some binding commitment or undertaking by the acquired fund, would satisfy Rule 2a-7(d)(8)'s standard. In the absence of a binding commitment, the maturity of money market fund shares would be seven calendar days, the statutory period beyond which payment of a redemption may not be deferred in the absence of unusual circumstances. ICA § 22(e).

65. Rule 2a-7(c)(3)(i).

interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than the U.S. dollar.[66] Although a money market fund may not acquire a security that is denominated in a foreign currency, it may acquire the securities of foreign issuers if the securities are denominated in U.S. dollars, assuming such securities are otherwise eligible for investment under Rule 2a-7.[67]

[B][2] Securities Presenting Minimal Credit Risk

A money market fund must limit its portfolio investments to securities that the Board determines present minimal credit risk.[68] This determination is in addition to Rule 2a-7's credit rating requirements (discussed below), and must be based on factors that impact the credit quality of the issuer in addition to any ratings assigned to the securities. Accordingly, it is not sufficient for a money market fund simply to rely on the ratings assigned to securities by rating agencies. Rather, the investment adviser should assemble and maintain a credit file for each issuer to support the determination that the security presents minimal credit risk to the fund.[69]

Rule 2a-7 permits the responsibility for determining minimal credit risk to be delegated by the Board.[70] As a matter of practice, Boards typically take advantage of this flexibility by delegating the responsibility

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66. Rule 2a-7(a)(27). In two SEC no-action letters, Five Arrows Short-Term Investment Trust (pub. avail. Sept. 26, 1997), and SSgA International Liquidity Fund (pub. avail. Dec. 2, 1998), the SEC staff stated that it would not recommend enforcement action if funds that invested only in debt securities denominated in a specified foreign currency (the Pound Sterling, Deutsche Mark, Canadian Dollar, and the Euro) held themselves out as money market funds and otherwise complied with the terms of Rule 2a-7. These funds seek to maintain a constant net asset value in their designated currency and only accept purchases and effect redemptions in that currency. This relief permitted the funds, in part, to consider Government Securities issued by the relevant foreign government to be "Government Securities" for purposes of complying with Rule 2a-7's diversification and maturity standards, subject to certain conditions.
67. For example, many money market funds hold securities of foreign banks that are denominated in U.S. dollars.
68. Rule 2a-7(c)(3)(i).
69. A written record of the determination that a portfolio security presents minimal credit risks, as well as the Designated NRSRO ratings (if any) used to determine the status of the security, must be maintained and preserved in an easily accessible place for a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed. Rule 2a-7(c)(11)(iii). "NRSRO" is an acronym for nationally recognized statistical rating organization.
70. *See infra* section 9:3.8.

to the fund's investment adviser. However, the Board remains ultimately responsible for the minimal credit risk determination and its oversight. This responsibility has been detailed by the staff of the SEC's Division of Investment Management in two interpretive letters.[71]

In these interpretive letters, the SEC staff emphasized that a money market fund's Board has a duty to make a minimal credit risk finding regardless of the credit ratings status of the security. The letters also stated that, in making the minimal credit risk determination, the Board should take into account the following considerations, as appropriate:

(1) macro-economic factors that might affect the issuer's or guarantor's current and future credit quality;

(2) the strength of the issuer's or guarantor's industry within the economy relative to economic trends;

(3) the issuer's or guarantor's market position within its industry;

(4) cash flow adequacy;

(5) the level and nature of earnings;

(6) financial leverage;

(7) asset protection;

(8) the quality of the issuer's or guarantor's accounting practices and management;

(9) the likelihood and nature of event risks;

(10) an assessment of the issuer's ability to react to future events, including a review of the issuer's competitive position, cost structure and capital intensiveness;

(11) an analysis of the issuer's liquidity, including bank lines of credit and alternative sources of liquidity to support its commercial paper;

(12) a "worst case scenario" evaluation of the issuer's ability to repay its short-term debt from cash sources or asset liquidations in the event the issuer's backup credit facilities are unavailable;

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71. *See* SEC no-action letters to The Investment Company Institute (pub. avail. Dec. 6, 1989), and to Investment Company Registrants (pub. avail. May 8, 1990).

(13) the length to maturity of the security; and

(14) the percentage of the fund's portfolio represented by securities of that issuer.

In addition, in light of recent events, the minimal credit risk determination should also take into account the depth of the market for the securities of the issuer in question, both historically and projected going forward. While a money market fund can invest up to 5% of its total assets in illiquid securities,[72] the absence of a robust secondary market for an issuer's securities can, in some instances, indicate problems with the creditworthiness of the issuer.

These determinations must be made by the Board, or its delegate, on an ongoing basis for each investment held by a fund. Whenever a credit event occurs with respect to a portfolio holding, the Board, or its delegate, must again determine whether the security continues to present minimal credit risk. All such determinations, and the reasons therefor, should be recorded in a memorandum or other written document maintained in the credit file for that security.

[B][3] Eligible Securities

At the time a money market fund acquires a security, the security must meet the definition of an "Eligible Security" under Rule 2a-7.[73] Determining whether a security is an Eligible Security involves different considerations for rated securities, unrated securities, and securities that are subject to guarantees and demand features.

[B][3][a] First Tier and Second Tier Securities

There are currently two tiers of Eligible Securities under Rule 2a-7: first tier and second tier. A "First Tier Security" is any Eligible Security that is:[74]

- a rated security (discussed below) that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations;
- an unrated security (discussed below) that is of comparable quality to a security meeting the requirements for a First Tier rated security, as determined by the Board, or its delegate;

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72. For a discussion of the liquidity restrictions imposed by the 2010 Amendments, see *infra* section 9:3.4[D].
73. The term "Eligible Security" is defined in Rule 2a-7(a)(12). As discussed below, a security that is subject to a guarantee is eligible if the guarantee meets the definition of an Eligible Security.
74. Rule 2a-7(a)(14).

- a security that is issued by a registered money market fund; or
- a Government Security.[75]

A "Second Tier Security" is any Eligible Security that is not a First Tier Security.[76] The distinction between a First Tier and a Second Tier security is significant because Rule 2a-7 imposes more restrictive diversification requirements (discussed below) on an Eligible Security based on whether the security is First or Second Tier.

The 2010 Amendments continue to permit money market fund investments in Second Tier Securities;[77] provided that, each Second Tier Security Acquired by the fund has a remaining maturity of forty-five calendar days or less,[78] and, immediately after the Acquisition of any Second Tier Security, the fund has not invested more than 3% of its total assets in Second Tier Securities,[79] and has not invested more than 0.5% of its total assets in the Second Tier Securities of any single issuer.[80]

[B][3][b] Rated Securities

A rated security[81] may be determined to be an Eligible Security under Rule 2a-7 if it has a remaining maturity of 397 calendar days or

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75. For the definition of "Government Security," see *supra* note 54.
76. Rule 2a-7(a)(24).
77. In comparison, the amendments proposed in 2009 would have effectively limited money market fund investments to the equivalent of First Tier Securities by removing Second Tier Securities from the definition of Eligible Securities. *See* proposed Rule 2a-7(a)(11)(iii) in the 2009 Proposing Release.
78. *See* amended Rule 2a-7(c)(3)(ii). For historical context, it should be noted that, immediately prior to the Lehman Brothers bankruptcy, Lehman paper qualified as a First Tier Security under the Rule.
79. *See* amended Rule 2a-7(c)(3)(ii). This limitation applies to all money market funds. In comparison, prior to the 2010 Amendments, Rule 2a-7 limited Second Tier investments by tax-exempt funds only with respect to conduit securities. *See* Rules 2a-7(c)(3)(ii)(A) and (B) prior to the 2010 Amendments.
80. *See* amended Rule 2a-7(c)(4)(i)(C).
81. To qualify as a rated security, the security (or a guarantee of that security) must have received a short-term rating from a Designated NRSRO, or have been issued by an issuer (or guarantor in the case of a guarantee) that has received a short-term rating from a Designated NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security (or guarantee). Rule 2a-7(a)(21)(i) and (ii). A security is not considered to be a rated security if it is subject to an external credit support agreement that was not in effect when the security was assigned its rating, unless the security has received a short-term rating reflecting the existence of the credit support agreement or the credit support agreement itself has received a short-term rating. Rule 2a-7(a)(21)(iii).

less, and it has received a rating from the Requisite NRSROs[82] that is in one of the two highest short-term rating categories.[83] As noted above, if the short-term rating that the security receives from the

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82. "Requisite NRSROs" means any two Designated NRSROs that have issued a rating with respect to a security or a class of debt obligations of the issuer of the security or, if only one Designated NRSRO has issued such a rating, that Designated NRSRO. Rule 2a-7(a)(23). For a discussion on SEC staff no-action relief providing funds with temporary relief from the NRSRO designation requirement, see *infra* section 9:3.4[B][3][e]. On May 23, 2007, the SEC approved rules to implement provisions of the Credit Rating Agency Reform Act of 2006 (enacted on Sept. 29, 2006, the "Rating Agency Reform Act"). *See* Exchange Act Release No. 55,857 (June 18, 2007). To introduce competition in the credit rating industry and thus promote greater rating reliability, the new rules require a credit rating agency that desires to hold itself out as an NRSRO to be registered with the SEC instead of obtaining no-action relief. Although the new rules were expected to increase the number of NRSROs to thirty (as of June 2007, S&P and Moody's had comprised 80% of the credit rating market, as measured by revenues), *see* Release No. 55,857 at section VIII.D., as of May 12, 2011, only the following ten rating agencies were registered with the SEC as NRSROs: A.M. Best Company, Inc.; DBRS Ltd.; Egan-Jones Rating Company; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Kroll Bond Rating Agency, Inc. (f/k/a LACE Financial Corp.); Moody's Investors Service, Inc.; Rating and Investment Information, Inc.; Realpoint LLC; and Standard & Poor's Ratings Services. *See* "Rating Agencies—NRSROs," *available at* www.sec.gov/answers/nrsro.htm. The SEC stated that "[b]ased on the uncertainty of how many credit rating agencies ultimately will register as NRSROs, the [SEC] intends to monitor for now how the NRSRO regulatory program impacts Rule 2a-7 and the [SEC's] other rules using the term "NRSRO." As the program develops, the [SEC] will evaluate whether modifications to these rules would be appropriate." *See* Release No. 55,857 at section IV. On May 18, 2011, the SEC proposed additional rules for NRSROs in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). *See* Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 64,154 (May 18, 2011). The NRSRO provisions in the Dodd-Frank Act augment the Rating Agency Reform Act of 2006. Among other things, the proposed rules target potential conflicts of interest and require NRSROs to release more information on how debt securities are assessed.

83. Within such short-term rating categories, there may be sub-categories or gradations indicating relative standing. Rule 2a-7(a)(12)(i).

In 2008, the SEC proposed to eliminate the use of NRSRO ratings in rules under the ICA, including Rule 2a-7. *See* 2009 Proposing Release, *supra* note 3, at II.A.3; *see also* Investment Company Act Release No. 28,327 (July 1, 2008). The rule amendments that the SEC adopted on February 2, 2009 did not eliminate the use of NRSRO ratings, but imposed additional requirements on NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies. *See* Exchange Act Release No. 59,342 (Feb. 2, 2009).

In the 2009 Proposing Release, the SEC once again sought comment on whether to modify provisions of Rule 2a-7 that incorporate minimum ratings by NRSROs to reflect changes made to the federal securities laws by

Requisite NRSROs is in the highest short-term rating category for debt obligations, then the security may further be classified as a First Tier Security.[84]

In March 2011, the SEC proposed to eliminate the use of NRSRO ratings in Rules 2a-7 and 5b-3 and Form N-MFP, and to replace them with more subjective standards of creditworthiness.[85] With respect to Rule 2a-7, the proposed amendments would impact the determination of whether a portfolio security is an Eligible Security and whether it is a First Tier or a Second Tier Security, the credit quality standards for portfolio securities with conditional demand features, requirements to monitor portfolio securities for ratings downgrades and other credit events, and the requirement to periodically stress test a fund's ability to maintain a stable NAV per share. As of September 26, 2011, these proposed amendments have not been adopted.

[B][3][c] Unrated Securities

An unrated security may be determined to be an Eligible Security only if the Board of the money market fund, or its delegate, determines that the security is of comparable quality to a rated Eligible Security,[86] provided that, an unrated security that had a remaining maturity of more than 397 calendar days when it was issued, but currently has a remaining maturity of 397 calendar days or less, cannot be determined to be an Eligible Security if it has received a long-term rating from any Designated NRSRO that is not within that Designated NRSRO's three highest long-term rating categories unless the security also has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories.[87]

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the Rating Agency Reform Act. *See* 2009 Proposing Release, *supra* note 3, at section II.A.3. In the 2010 Adopting Release, the SEC noted that, each time the SEC had solicited comments on this subject matter, a substantial majority of commenters had strongly supported retaining the references to NRSRO ratings in Rule 2a-7. *See* 2010 Adopting Release, *supra* note 4, at n.76 and accompanying text. As part of the 2010 Amendments, the SEC eliminated the only provision in Rule 2a-7 that limited money market funds to investing in a type of security only if it is rated, namely ABS.

84. On August 5, 2011, Standard & Poor's Ratings Services downgraded the *long-term* sovereign credit rating of the United States from "AAA" to "AA+," which had no effect on the ability of money funds to treat U.S. Government Securities as Eligible Securities and First Tier Securities.

85. *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29,592 (Mar. 3, 2011).

86. Rule 2a-7(a)(12)(ii). A written record of any comparable quality finding, including the rationale for the finding, should be included in the credit file for the issuer.

87. Within long-term rating categories, there may be sub-categories or gradations indicating relative standing. Rule 2a-7(a)(12)(ii). Prior to the 2010

As noted above, if the Board, or its delegate, further determines that an unrated security is of comparable quality to a security meeting the requirements for a First Tier rated security, then the security may also be classified as a First Tier Security.

[B][3][d] Securities Subject to Guarantees or Demand Features

The analysis of whether a security is an Eligible Security is more complex if the security is subject to a guarantee or a demand feature.

A "Guarantee" is an unconditional obligation of a person other than the issuer of the underlying security to pay the principal amount of the underlying security plus accrued interest when due or upon default.[88] Examples of Guarantees include letters of credit, financial guarantee (bond) insurance, and unconditional demand features (other than ones provided by the issuer of the securities), as discussed below.

A "Demand Feature" is a feature that permits the holder of a security to sell the security at an exercise price approximately equal to the amortized cost of the security plus any accrued interest at the time of exercise.[89] In the context of an ABS, a Demand Feature is a

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Amendments, Rule 2a-7 required ABS to be rated by at least one NRSRO in order to be an Eligible Security that a money market fund may acquire. The SEC had imposed this requirement in 1996 in part to facilitate the minimal credit risk analysis of fund advisers. *See* 2010 Adopting Release, *supra* note 4, at section II.A.3. The 2010 Amendments eliminated this requirement, thus permitting money market funds to acquire unrated ABS. The SEC cautioned in the 2010 Adopting Release, however, that as part of the minimal credit risk analysis required by Rule 2a-7, the Board or adviser should continue to: analyze the underlying ABS assets to ensure that they are properly valued and will provide adequate asset coverage for the cash flows required to fund the ABS under various market conditions; 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 presents appropriate risks for the money market fund. *See* 2010 Adopting Release, *supra* note 4, at n.131 and accompanying text. The SEC staff has clarified that, in performing the minimal credit risk evaluation for ABS, the board of a money market fund should consider all elements that are relevant to the analyses required to evaluate the ABS' risk (*i.e.*, the board need not consider other elements discussed in the 2010 Adopting Release that the board determines are not relevant for the particular investment). *See* Amended Rule 2a-7 Q&A, Question IV.B.1.

88. Rule 2a-7(a)(17).

89. Rule 2a-7(a)(9)(i). A Demand Feature must be exercisable either at any time on no more than thirty calendar days' notice, or at specific intervals not exceeding 397 calendar days and upon no more than thirty days' notice.

feature that permits the holder of the ABS to unconditionally receive principal and interest within 397 calendar days of making demand.[90]

An "Unconditional Demand Feature" is a Demand Feature that would be readily exercisable in the event of a default in payment of principal or interest on the underlying security.[91] Accordingly, an Unconditional Demand Feature (other than one provided by the issuer of the underlying security) is deemed to be a Guarantee under Rule 2a-7. In comparison, a "Conditional Demand Feature," which is defined simply as a Demand Feature that is not an Unconditional Demand Feature, is not a Guarantee under Rule 2a-7.[92]

The determination of whether a security that is subject to a Guarantee may be determined to be an Eligible Security (or a First Tier Security) under Rule 2a-7 may be based solely on whether the Guarantee itself is an Eligible Security or First Tier Security, as applicable.[93] In addition, with respect to a security that is subject to a Guarantee, the Guarantee must have received a rating from a Designated NRSRO[94] or the Guarantee must have been issued by a guarantor that has received a rating from a Designated NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee.[95] Also, with respect to a security that is subject to a Guarantee or Demand Feature, if the Guarantee or Demand Feature is permitted to be substituted with another Guarantee or Demand Feature, then the issuer of the Guarantee or Demand Feature, or some other entity (such as a securities

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90. Rule 2a-7(a)(9)(ii).
91. Rule 2a-7(a)(28).
92. Rule 2a-7(a)(6).
93. Rule 2a-7(c)(3)(iii).
94. For a discussion on SEC staff no-action relief providing funds with temporary relief from the NRSRO designation requirement, see *infra* section 9:3.4[B][3][e].
95. Rule 2a-7(a)(12)(iii)(A). This rating is not required, however, if the Guarantee is issued by a person that, directly or indirectly, controls, is controlled by, or is under common control with the issuer of the security (other than a sponsor of a special purpose entity with respect to an ABS), or the security is a repurchase agreement that is collateralized fully, or the Guarantee is itself a Government Security. Rule 2a-7(a)(12)(iii)(A)(1)–(3). In the 2009 Proposing Release, *supra* note 3, the SEC proposed changes regarding what it means for a repurchase agreement to be "Collateralized Fully." *See infra* section 9:3.4[C][1][c][i]. A fund may disregard a Demand Feature or Guarantee for all purposes under Rule 2a-7 if the fund is not relying on it to determine the quality, maturity, or liquidity of a portfolio security. Rule 2a-7(c)(5). A record of this determination must be made and maintained.

dealer), must have undertaken to promptly notify the holder of the underlying security in the event of such substitution or replacement.[96]

Securities that are subject to Conditional Demand Features face more stringent requirements to qualify as Eligible Securities (or First Tier Securities, as applicable). A security that is subject to a Conditional Demand Feature may be determined to be an Eligible Security (or First Tier Security, as applicable) under Rule 2a-7 only if the following four conditions are satisfied:

- First, the Conditional Demand Feature must be an Eligible Security (or First Tier Security, as applicable).
- Second, at the time the fund acquires the security, the Board, or its delegate, must have determined that the risk of circumstances resulting in the Conditional Demand Feature not being exercisable is minimal.[97]
- Third, the conditions limiting exercise must be able to be readily monitored by the fund or relate to the taxability of the interest payments on the security, or the terms of the Conditional Demand Feature must require that the fund will be given notice of the occurrence of the condition and will be given an opportunity to exercise the Demand Feature in accordance with its terms.[98]
- Fourth, the underlying security or any Guarantee of the security (or the comparable debt securities of the issuer or guarantor) must have either received a rating from the Requisite NRSROs in the two highest categories (short- or long-term, as applicable) or, if unrated, must have been determined by the Board, or its delegate, to be of comparable quality to a security that has been rated in the two highest categories by the Requisite NRSROs.[99]

[B][3][e] Designated NRSROs[100]

The 2010 Amendments imposed several new requirements on a money market fund's Board with respect to the fund's reliance on NRSROs:

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96. Rule 2a-7(a)(12)(iii)(B). Where this undertaking is not reflected in the offering circular or other documents relating to the underlying security, the fund should consider obtaining the undertaking in writing and include it in the credit file for the security.
97. A written record of this determination should be retained by the fund.
98. Rule 2a-7(c)(3)(iv)(B).
99. Rule 2a-7(c)(3)(iv).
100. The compliance date for the new requirements relating to the designation of NRSROs was originally December 31, 2010. However, the SEC staff has provided no-action relief from compliance with these new requirements in

(i) the Board must designate at least four NRSROs ("Designated NRSROs") on whose short-term credit ratings the fund will rely when determining whether a security is an Eligible Security for purposes of Rule 2a-7;[101] and

(ii) the Board must determine at least once each calendar year that the Designated NRSROs issue credit ratings that are sufficiently reliable for use by the fund.

In addition, the money market fund must disclose the Designated NRSROs, including any limitations on the use of such designation,[102] in the fund's statement of additional information.

In the 2010 Adopting Release, the SEC cautioned against over-reliance on NRSRO ratings, emphasizing that Rule 2a-7 continues to require money market fund Boards (typically this responsibility is delegated to the fund's adviser) to determine that portfolio investments "present minimal credit risks, which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by a Designated NRSRO."[103]

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light of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which requires the SEC to review its regulations that reference credit ratings and to modify regulations the SEC has identified to remove any reference to or requirement of reliance on credit ratings and substitute a standard of creditworthiness the SEC determines appropriate. *See* The Investment Company Institute, SEC No-Action Letter (pub. avail. Aug. 19, 2010). Until the SEC determines to modify Rule 2a-7 in accordance with section 939A of the Dodd-Frank Act, money market funds relying on this no-action letter must continue to comply with the obligations for determining and monitoring Eligible Securities set forth in Rule 2a-7 as in effect prior to May 5, 2010 (other than the limitation on holding unrated ABS rescinded by the 2010 rulemaking). *Id.* Stemming from the section 939A provision, the SEC proposed in March 2011 to eliminate the use of NRSRO ratings in Rules 2a-7 and 5b-3 and Form N-MFP, and to replace them with new more subjective standards of creditworthiness. *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29,592 (Mar. 3, 2011); *see also supra* section 9:3:4[B][3][b]. As of September 26, 2011, no further action has been taken on this proposal.

101. *See* new Rule 2a-7(a)(11). Responsibility for fulfilling this requirement cannot be delegated by the Board. *See* Rule 2a-7(e). A Designated NRSRO, as in the case of an NRSRO prior to the 2010 Amendments, may not be an affiliated person of the issuer of, or any insurer or provider of credit support for, the security. *See* amended Rule 2a-7(a)(11)(ii).

102. A Board may designate an NRSRO only with respect to certain types of securities or certain industries. *See* 2010 Adopting Release, *supra* note 4, at n.106 and accompanying text.

103. Emphasis added. *See* Rule 2a-7(c)(3)(i).

[C] Portfolio Diversification[104]

In addition to maturity and quality, a third criterion for the composition of a money market fund's portfolio under Rule 2a-7 concerns diversification.

Rule 2a-7 requires money market funds to be diversified with respect to securities issuers. The diversification requirements, which are designed to limit a money market fund's exposure to the credit risk of any single issuer, do not apply with respect to U.S. Government Securities (which are considered by the SEC not to present significant credit risk), or to securities that are subject to Guarantees issued by non-controlled persons (which instead are required to be diversified according to the diversification rules applicable to Guarantees)[105] or to shares of other money market funds that the Board or its delegate reasonably believes comply under the Rule's diversification requirements.[106]

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104. If a money market fund satisfies Rule 2a-7's diversification requirements, it is deemed to have satisfied the issuer diversification standards set forth in ICA § 5(b)(1). Rule 2a-7(c)(4)(v). However, compliance with Rule 2a-7's diversification requirements does not ensure that a money market fund will be in compliance with the diversification requirements under Subchapter M of the Internal Revenue Code of 1986, as amended ("Subchapter M"), which is generally necessary in order to avoid federal taxation at the fund level. For example, except for a repurchase agreement that is collateralized fully with Government Securities, the staff of the Internal Revenue Service (IRS) currently considers a repurchase agreement to be issued by the counterparty for purposes of determining compliance with Subchapter M's diversification requirements. (For a repurchase agreement that is collateralized fully with Government Securities, the IRS currently permits a look through the repurchase agreement to the Government Securities, if so elected by the fund. *See* Rev. Proc. 2004-28, 2004-22 I.R.B. 984.) In comparison, a money market fund may always look through to the underlying collateral for diversification purposes under Rule 2a-7 if the repurchase agreement meets certain conditions. Rule 2a-7(c)(4)(ii)(A). *See infra* section 9:3.4[C][1][c][i]. Another example where a money market fund may be in compliance with Rule 2a-7's diversification requirement but not with those of Subchapter M may arise where a fund holds a large percentage of its assets in securities issued by a single entity that are subject to Guarantees. Under certain circumstances, a fund may disregard the underlying issuer for Rule 2a-7 diversification purposes where the security is subject to a Guarantee issued by a non-controlled person. *See infra* section 9:3.4[C][2][b]. However, a fund may not be able to take a similar position under Subchapter M.

105. Rule 2a-7(c)(4)(i). Securities subject to Guarantees and Demand Features are subject to separate diversification requirements, which are discussed below.

106. *See* Rule 2a-7(c)(4)(ii)(E).

The diversification requirements vary depending on whether the fund is taxable or single state tax-exempt. Further, Rule 2a-7 establishes specialized diversification requirements for Second Tier Securities, ABS, and securities that are subject to Demand Features and Guarantees.

[C][1] Issuer Diversification

[C][1][a] General Diversification Requirements

The portfolio diversification requirements that apply to taxable and national funds differ from those that apply to single state funds.

[C][1][a][i] Taxable and National Funds

As used in Rule 2a-7, the term "Taxable Fund" refers to a money market fund that does not hold itself out as distributing income exempt from regular federal income tax.[107] In comparison, the term "National Fund" refers to a money market fund that holds itself out as distributing income exempt from regular federal income tax, although it does not hold itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state or subdivision, as applicable.[108]

Immediately after acquiring any security, a Taxable Fund or a National Fund must not have invested more than 5% of its total assets[109] in securities issued by the same entity.[110] This diversification requirement applies to 100% of the fund's total assets.[111] However, there is a temporary "safe harbor" from this diversification requirement that permits a Taxable or National Fund to invest up to 25% of its total assets in the First Tier Securities of a single issuer for up to three business days after the acquisition of the security. A fund may not utilize this safe harbor with respect to more than one issuer at any time.[112]

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107. A "Tax-Exempt Fund" under Rule 2a-7 is any money market fund that holds itself out as distributing income exempt from regular federal income tax. Rule 2a-7(a)(26).
108. *See, e.g.*, Investment Company Act Release No. 21,837, *supra* note 5, at n.4 and accompanying text.
109. Total assets means, with respect to a fund using the amortized cost method, the total amortized cost of all its assets, and with respect to any other fund, the total market-based value of its assets. Rule 2a-7(a)(27).
110. Rule 2a-7(c)(4)(i)(A).
111. For a diversified non-money market fund, the fund must not invest more than 5% of its assets in any issuer with respect to 75% of its assets.
112. The ability of a fund to rely on this temporary safe harbor will also depend on whether the investment is consistent with the investment policies set forth in the fund's registration statement, which may be more restrictive

[C][1][a][ii] Single State Funds

A "Single State Fund" under Rule 2a-7 is any money market fund that holds itself out as:

- distributing income exempt from regular federal income tax, and
- seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof.[113]

The general diversification requirements for a Single State Fund are not as stringent as the diversification requirements for Taxable and National Funds. Specifically, with respect to 75% of its total assets, immediately after acquiring any security, a Single State Fund may not have invested more than 5% of its total assets in securities issued by the same entity. Accordingly, Single State Funds have a permanent 25% safe harbor from the 5% issuer diversification standard.

[C][1][b] Diversification Requirements for Second Tier Securities

As noted above, Rule 2a-7 establishes specialized portfolio diversification requirements for Second Tier Securities. Immediately after acquiring a Second Tier Security, no money market fund, whether

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than Rule 2a-7. In a close case, the fund's Board may be able to interpret reliance as consistent with a fundamental policy. *See* Letter from Jack W. Murphy, Associate Director and Chief Counsel, SEC Division of Investment Management, to Amy B.R. Lancellotta, Associate General Counsel, Investment Company Institute (May 9, 1996) (response to questions relating to a fund's ability to comply with Rule 2a-7's diversification requirements), *available at* http://edgar.sec.gov/divisions/investment/noaction/1996/ici050996-2a7.pdf.

113. Rule 2a-7(a)(25). Any issuer of tax-exempt bonds (*e.g.*, states, municipalities, and their political subdivisions) may be deemed to be an "issuer" under ICA § 5(b)(1) (definition of "diversified company"). *See* Investment Company Act Release No. 9785 (May 31, 1977). For purposes of section 5(b)(1), a political subdivision would be deemed to be the sole issuer of a security if the assets and revenues of the subdivision (or agency, authority or instrumentality, as applicable) are separate from those of the government creating the subdivision and the security is backed only by the assets and revenues of the subdivision. Likewise, for purposes of section 5(b)(1), a nongovernmental user would be deemed to be the sole issuer if the assets and revenues of the nongovernmental user provide the only backing for the security (*e.g.*, an industrial development bond). *See* Investment Company Act Release No. 9785 (May 31, 1977). As noted above, if a money market fund satisfies Rule 2a-7's diversification requirements, it is deemed to have satisfied the issuer diversification standards set forth in ICA § 5(b)(1). *See* Rule 2a-7(c)(4)(v).

Taxable or Tax-Exempt, may invest more than 0.5% of its total assets in the Second Tier Securities of any single issuer.[114]

[C][1][c] Guidelines for Calculating Issuer Diversification

To facilitate the determination of whether a money market fund is in compliance with the issuer diversification requirements discussed above, Rule 2a-7 establishes guidelines for the treatment of repurchase agreements, refunded securities, Conduit Securities, ABS, and shares of other money market funds.

[C][1][c][i] Repurchase Agreements, Refunded Securities, and Conduit Securities[115]

When a money market 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 and the counterparty ignored), provided the repurchase agreement is "Collateralized Fully."[116] As amended in 2010, Rule 2a-7 defines "Collateralized Fully" by reference only to a portion of the

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114. *See* Rule 2a-7(c)(4)(i)(C). Prior to the 2010 Amendments, Rule 2a-7 imposed different requirements on Taxable Funds and Tax-Exempt Funds. With respect to Taxable Funds, Rule 2a-7 required that, immediately after acquiring a Second Tier Security, a money market fund may not have invested (i) more than 5% of its total assets in all Second Tier Securities held by the fund, and (ii) the greater of 1% of its total assets or one million dollars in Second Tier Securities issued by a particular issuer. *See* Rule 2a-7(c)(3)(ii)(A) and Rule 2a-7(c)(4)(i)(C)(1) prior to the 2010 Amendments. Although Tax-Exempt Funds were permitted to invest in Second Tier Securities to a greater extent than Taxable Funds, Rule 2a-7 still required that, immediately after acquiring a Second Tier Security, a Tax-Exempt Fund may not have invested (i) more than 5% of its total assets in conduit securities that were Second Tier Conduit Securities, and (ii) the greater of 1% of its total assets or one million dollars in Second Tier Securities issued by that issuer that were Second Tier Conduit Securities. *See* Rule 2a-7(c)(3)(ii)(B) and Rule 2a-7(c)(4)(i)(C)(2) prior to the 2010 Amendments.

115. A refunded security is defined as a debt security, the principal and interest payments on which are to be paid by Government Securities that have been irrevocably placed in an escrow account pursuant to an agreement between the issuer of the debt security and an unaffiliated escrow agent. Rule 2a-7(a)(22). The definition contains additional requirements with respect to the terms of the escrow arrangement.

116. Rule 2a-7(c)(4)(ii)(A). "Collateralized fully" in the case of a repurchase agreement means that the value of the securities collateralizing the repurchase agreement (less transaction costs if the seller defaults) is, and during the entire term of the repurchase agreement will remain, at least equal to the price paid to the seller plus the accrued resale premium on

definition of that term in ICA Rule 5b-3(c)(1), with the result that a money market fund is allowed to look through a repurchase agreement only where the collateral consists entirely of:[117]

(i) cash items; and

(ii) Government Securities.

In addition, in order for a money market fund to rely on the look through provision, the fund's Board must have evaluated the creditworthiness of the repurchase agreement counterparty to the repurchase agreement.[118] These amendments are intended to reduce the risk that a money market fund would incur losses when protecting its interests in collateral following a counterparty's default.[119] While a money market fund may enter into repurchase agreements collateralized by other types of securities, the fund must calculate compliance with the Rule's diversification requirement with respect to those investments by reference to the counterparty.

[C][1][c][ii] Refunded Securities and Conduit Securities[120]

With respect to the treatment of refunded securities, the acquisition of refunded securities is deemed to be the acquisition of the escrowed

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such price. Rule 2a-7(a)(5). The definition also contains custody requirements and, as discussed in this section, collateral requirements. If the repurchase agreement is not Collateralized Fully, the fund must consider the counterparty to be the issuer for purposes of diversification compliance. *See* 1991 Adopting Release, at n.31. Further, if the agreement (or portion thereof) is not Collateralized Fully, the agreement would be deemed to be an unsecured loan that itself would have to meet Rule 2a-7's quality requirements with respect to the 5% diversification test. *Id.*

117. *See* Rule 2a-7(a)(5).

118. *See* amended Rule 2a-7(c)(4)(ii)(A). The SEC had eliminated a similar requirement applicable to all repurchase agreements entered into by mutual funds in 2001, in light of amendments to relevant bankruptcy laws. *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25,058 (July 5, 2001), at nn.18–20 and accompanying text. The SEC had originally added the evaluation requirement to Rule 2a-7 in 1991 when diversification requirements were added to the Rule. *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18,005 (Feb. 20, 1991). Prior to that time, fund Boards were required to evaluate the creditworthiness of counterparties in accordance with Investment Company Act Release No. 13,005 (Feb. 2, 1983).

119. *See* 2010 Adopting Release, *supra* note 4, at section II.D.

120. A "Conduit Security" is a security issued by a municipal issuer involving an arrangement or agreement entered into, directly or indirectly, with a person other than a municipal issuer that provides for or secures repayment of the security. Rule 2a-7(a)(7). Industrial development bonds are common examples of Conduit Securities. By structuring the definition to identify

Government Securities.[121] With respect to a Conduit Security, the fund must look to the person ultimately responsible for payments of interest and principal on the security, rather than to the municipality, when measuring compliance with the Rule's diversification requirements.[122]

[C][1][c][iii] Asset-Backed Securities

Rule 2a-7 provides a complex procedure for determining diversification status with respect to investments by a money market fund in ABS.

As a general rule, an ABS that is acquired by a fund (the "primary ABS") is deemed to be issued by the special purpose entity that issued the ABS (that is, the trust, corporation, partnership, or other entity organized for the sole purpose of issuing the ABS).[123] This treatment permits a fund to disregard the identity of the sponsor of the ABS in determining compliance with Rule 2a-7's issuer diversification requirements. However, if the obligations of any issuer constitute 10% or more of the qualifying assets of the primary ABS, that issuer will be deemed to be the issuer of that portion of the primary ABS that is comprised of its obligations (such an issuer is referred to as a

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what is not a Conduit Security, the SEC intended to make it easier for a fund to identify a Conduit Security without obtaining a legal or other expert opinion. Rule 2a-7 applies diversification requirements to Second Tier Conduit Securities because these securities are not backed by revenues of an essential public facility or governmental taxing authority, and thus may be at greater risk of default. Rule 2a-7 provides that a Conduit Security does not include a security that is: (i) fully and unconditionally guaranteed by a municipal issuer; (ii) payable from a municipal issuer's general revenue (unless the revenue is pursuant to an agreement with a non-municipal entity providing for or securing repayment of the security); (iii) related to a project owned and operated by a municipal issuer; or (iv) related to a facility leased to and controlled by an industrial or commercial enterprise that is part of a public project owned and controlled by a municipal issuer.

A refunded security is defined as a debt security, the principal and interest payments on which are to be paid by Government Securities that have been irrevocably placed in an escrow account pursuant to an agreement between the issuer of the debt security and an unaffiliated escrow agent. Rule 2a-7(a)(22). The definition contains additional requirements with respect to the terms of the escrow arrangement.

121. Rule 2a-7(c)(4)(ii)(B). This provision codifies and updates a prior SEC staff position relating to escrowed securities. *See* T. Rowe Price Tax-Free Funds, SEC No-Action Letter (pub. avail. June 24, 1993) (permitting investment in a municipal bond refunded with escrowed U.S. Government Securities to be treated as an investment in U.S. Government Securities for purposes of determining compliance with the diversification requirements of section 5(b)(1)).

122. Rule 2a-7(c)(4)(ii)(C).

123. Rule 2a-7(c)(4)(ii)(D)(1).

"10% obligor"). For example, if 20% of the qualifying assets in a particular ABS asset pool is comprised of securities issued by one issuer (issuer A) and a money market fund invests 5% of its assets in securities issued by that ABS, the fund would be deemed to have 1% of its assets ($0.20^{124} \times 0.05^{125}$) invested in securities issued by issuer A, and 4% of its assets in securities issued by the ABS. This requirement is commonly referred to as the ABS "look-through" rule.[126]

Further, because the qualifying assets of a primary ABS may be comprised of securities issued by other ABS that are 10% obligors of the primary ABS (each, a secondary ABS), Rule 2a-7 requires a fund to look through each secondary ABS and treat any 10% obligor of a secondary ABS as a proportionate issuer of the primary ABS. However, money market funds are not required to look beyond a secondary ABS.[127] Due to the revolving nature of ABS qualifying assets, Rule 2a-7 requires a fund that holds an ABS to make periodic determinations of compliance with applicable diversification requirements and to maintain records of those determinations pursuant to written procedures.[128]

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124. The percentage of the pool that is represented by obligations of issuer A.
125. The percentage of the fund's assets invested in the securities issued by the ABS.
126. Rule 2a-7(c)(4)(ii)(D)(1)(i). This example assumes that there are no other 10% obligors of the primary ABS.
127. Rule 2a-7(c)(4)(ii)(D)(1)(ii). Rule 2a-7 provides an exception from this look-through requirement for a 10% obligor that is a special purpose entity and that does not issue its securities to any entity other than another specific ABS issuer (a "restricted special purpose entity"). Thus, a fund is not required to look through to restricted special purpose entities even if they have issued more than 10% of the qualifying assets comprising the primary ABS asset pool. Rule 2a-7(c)(4)(ii)(D)(2).
128. Rule 2a-7(c)(10)(iv) and (c)(11)(v). Rule 2a-7 provides that such periodic determinations are not required with respect to any ABS that a fund's Board, or its delegate, initially has determined will never have, or is unlikely to have, any 10% obligors. However, a record supporting this determination should be made. Under the ABS diversification requirements, if a 10% obligor is deemed to be the issuer of a portion of the ABS, the fund must also satisfy the Demand Feature and Guarantee diversification requirements, discussed below, with respect to any Demand Features or Guarantees to which the 10% obligor's obligations are subject. Rule 2a-7(c)(4)(ii)(D)(3). Some money market funds have chosen to avoid the complexities of the ABS look-through provisions by only acquiring ABS that do not have, and are not likely to ever have, 10% obligors.

[C][1][c][iv] Shares of Money Market Funds

A money market fund is permitted to acquire shares of another money market fund in excess of amounts otherwise permitted under Rule 2a-7's issuer diversification limitations if the Board of the acquiring fund reasonably believes that the acquired fund is in compliance with Rule 2a-7's issuer diversification requirements.[129]

[C][2] Demand Feature and Guarantee Diversification

[C][2][a] Diversification Requirements for Demand Features and Guarantees

In addition to conventional issuer diversification requirements, Rule 2a-7 imposes diversification requirements on securities that are issued by, or that are subject to Demand Features and Guarantees from, the same entity.[130] Rule 2a-7 applies the same diversification standards to a security that is issued by or subject to Guarantees (which, by definition, includes Unconditional Demand Features) as it does to Conditional Demand Features from the same entity. Moreover, these requirements apply uniformly to both taxable and tax-exempt money market funds. To prevent "double counting," however, Rule 2a-7 does not require a fund to satisfy the Demand Feature diversification standards with respect to a Demand Feature issued by

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129. Rule 2a-7(c)(4)(ii)(E). This treatment tracks ICA § 5(b), which permits a fund to exceed the ICA's diversification requirements with respect to investments in other investment companies. The determination of the maturity of investments in other money market funds is discussed above. Prior to the adoption of Rule 12d1-1 of the ICA in Investment Company Act Release No. 27,399 (June 20, 2006), the acquisition of shares of another money market fund was required to comply with restrictions contained in ICA § 12(d)(1) or be conducted pursuant to appropriate exemptive relief from those restrictions. The exception from Rule 2a-7's diversification standards, along with ICA § 12(d)(1)(E), permit a money market fund to be organized in a "master-feeder" structure. Effective as of July 31, 2006, Rule 12d1-1 provides an exemption from ICA § 12(d)(1), which allows funds to invest in shares of registered and unregistered money market funds in excess of the limits of ICA § 12(d)(1). Rule 12d1-1 also provides exemptions from ICA § 17(a) and Rule 17d-1 of the ICA (restrictions on a fund's ability to enter into transactions and joint arrangements with affiliated persons).

130. Rule 2a-7(c)(4)(iii)(A). Accordingly, although these requirements are characterized as Demand Feature and Guarantee diversification, the requirements also relate to other securities issued by the entity providing the Demand Feature or Guarantee.

the same entity that issued the underlying security. Further, the Demand Feature and Guarantee diversification requirements do not apply to Demand Features or Guarantees that are Government Securities.[131]

Rule 2a-7's Demand Feature and Guarantee diversification requirements provide that, with respect to 75% of the fund's total assets, immediately after the acquisition of any Demand Feature or Guarantee or of any security subject to a Demand Feature or Guarantee, no more than 10% of the fund's total assets may be invested in securities that are issued by or subject to Demand Features or Guarantees from the entity that issued the Demand Feature or Guarantee. In addition, with respect to 100% of the fund's total assets:

- immediately after the acquisition of a second tier Demand Feature or Guarantee (or a security after giving effect to the Demand Feature or Guarantee), the fund may have no more than 2.5% of its total assets invested in securities issued by or subject to Demand Features or Guarantees from the entity that issued the second tier Demand Feature or Guarantee,[132] and
- immediately after the acquisition of a security subject to a Demand Feature or Guarantee, a fund may have no more than 10% of its total assets invested in securities issued by, or subject to Demand Features or Guarantees from, the same entity unless, with respect to any security subject to Demand Features or Guarantees from that entity (other than securities issued by the entity), the Demand Feature or Guarantee is issued by a non-controlled person.[133]

In other words, a money market fund can utilize the 25% non-diversification basket available under Rule 2a-7(c)(4)(iii) to exceed the

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131. Rule 2a-7(c)(4)(iii). Rule 2a-7's issuer diversification standards would apply to the underlying security. A Guarantee or Demand Feature that is a Government Security is not subject to the Guarantee, Demand Feature, or issuer diversification rules.

132. Rule 2a-7(c)(4)(iii)(B). Prior to the 2010 Amendments, this limitation was 5% of total assets.

133. Rule 2a-7(c)(4)(iii)(C). A Demand Feature or Guarantee issued by a non-controlled person is defined to mean a Demand Feature or Guarantee issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the Demand Feature or Guarantee. Rule 2a-7(a)(10)(i) and Rule 2a-7(a)(18)(ii). A Demand Feature or Guarantee issued by a sponsor of an ABS may be treated as issued by a "non-controlled person," and therefore eligible for inclusion in the 25% basket for Guarantees and Demand Features. Rule 2a-7(a)(10)(ii) and Rule 2a-7(a)(18)(ii).

10% diversification requirement applicable to securities issued by or subject to Demand Features or Guarantees from the same entity only with respect to first tier Demand Features or Guarantees issued by a non-controlled person.

[C][2][b] Guidelines for Calculating Demand Feature and Guarantee Diversification

Rule 2a-7 provides diversification guidelines for "fractional" and "layered" Demand Features and Guarantees.[134] The issuer of a fractional Demand Feature or Guarantee will be deemed to have issued the Demand Feature or Guarantee only with respect to that portion of the underlying security to which the Demand Feature or Guarantee applies.[135] Each issuer of a layered Demand Feature or Guarantee will be deemed to have issued the Demand Feature or Guarantee with respect to the entire principal amount of the underlying security.[136]

If a fund is not relying on a particular Demand Feature or Guarantee to determine the quality, maturity, or liquidity of a portfolio security, the fund may choose to disregard that Guarantee or Demand Feature for all purposes under Rule 2a-7, provided that such nonreliance is documented in the fund's records.[137] If the fund is not relying on the Guarantee for any purpose, the minimal credit risk determination with respect to the underlying security must be made independent of the Guarantee, notwithstanding a rating agency's use of the Guarantee to rate the security. However, if a fund is relying on separate Guarantees or Demand Features to satisfy one or more of Rule 2a-7's quality or maturity requirements, or to determine the liquidity of a portfolio security, each of these Guarantees or Demand Features will be subject to Rule 2a-7's Guarantee and Demand Feature diversification requirements.

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134. Fractional Demand Features or Guarantees are those that apply only to a portion of the principal value of the underlying security. Layered Demand Features or Guarantees are multiple Demand Features or Guarantees with respect to the same underlying security that are not contractually limited (*i.e.*, each applies to the entire underlying principal value of the obligation). Some ABS are supported by Guarantees that cover all losses up to the amount of expected loss likely to be experienced by the ABS. These are referred to as "first loss Guarantees" and may be treated as fractional Guarantees when calculating compliance with Rule 2a-7's Guarantee and Demand Feature diversification requirements. Investment Company Act Release No. 22,921 at section I.B.3.b.v (Dec. 2, 1997).
135. Rule 2a-7(c)(4)(iv)(A).
136. Rule 2a-7(c)(4)(iv)(B).
137. Rule 2a-7(c)(6). A memorandum or notation included in the credit file for the issuer would satisfy this requirement.

[D] Portfolio Liquidity

In addition to maturity, quality, and diversification, the 2010 Amendments added new liquidity requirements that apply to a money market fund's portfolio.

[D][1] Background

Prior to the 2010 Amendments, money market funds were limited, under a longstanding SEC interpretive position, to investing no more than 10% of their net assets in illiquid securities.[138] Although this requirement generally did not force a fund to liquidate any portfolio instrument where the fund would suffer a loss on the sale,[139] beginning in the summer of 2007, market events revealed a weakness in money market fund portfolios, as previously liquid Eligible Securities became illiquid and/or suffered market valuation declines, even in the absence of a downgrading or other credit event.

The global financial crisis beginning in 2007 effectively caused the secondary market for many structured investment vehicles (SIVs) that were tied to sub-prime mortgage assets to cease to exist, except at distressed prices. As a result, investments in SIVs threatened to seriously impact the ability of many money market funds to maintain a stable $1 share price. The SEC staff provided no-action relief to affiliated purchasers during the early stages of the crisis, permitting fund affiliates to support the stable net asset values of the funds through the use of various arrangements, including the purchase of fund portfolio securities that remained "Eligible Securities" under Rule 2a-7, but that had become less liquid investments.

The global financial credit crisis deepened in 2008 after Lehman Brothers Holdings Inc. ("Lehman Brothers") filed for Chapter 11 bankruptcy protection on September 15, 2008. The next day, the Reserve Primary Fund ("Reserve Fund"), which had held a $785 million position in Lehman Brothers debt, became the second money market fund in U.S. history to break the dollar. In the days after Reserve Fund broke the dollar, there was a run on prime money market funds, with

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138. *See* "Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145," Investment Company Act Release No. 17,452 (Apr. 23, 1990). In comparison, non-money market funds are subject to a 15% limitation on illiquid assets.

139. *See* Investment Company Act Release No. 13,380 at n.38 (July 11, 1983). Shareholders of the Reserve Fund subsequently received $0.99 per share in distributions from the liquidated fund. *See* Press Release, The Reserve, Reserve Primary Fund to Distribute $215 Million (July 15, 2010), *available at* www.ther.com/pdfs/Primary%20Distribution_71510.pdf.

nearly $300 billion being withdrawn from those funds as a result of a "flight to quality."[140] The combination of these extraordinary redemption requests during a period of market illiquidity seriously impaired the ability of many prime money market funds to meet redemptions through ordinary means.[141] Numerous funds sought to sell portfolio securities at the same time in a market where there was little liquidity. As a result, the gap between the market-based net asset value of many funds and their dollar share price increased dramatically. During this period, the SEC staff provided no-action relief allowing asset purchase and credit support arrangements to be implemented for money market funds facing credit or liquidity challenges. The Department of the Treasury ("Treasury") and the Federal Reserve Board also implemented several programs in an effort to improve market liquidity and assist money market funds.[142]

[D][2] Portfolio Liquidity Requirements

The 2010 Amendments imposed three new liquidity requirements that are intended to increase the likelihood that a money market fund will be able to meet a heavy volume of redemptions during times of market turmoil without having to sell securities into a declining market.[143]

[D][2][a] General Liquidity Requirement/Know Your Customer Procedures

Rule 2a-7 now requires a money market fund to hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions,[144] in light of the fund's statutory obligation to pay redemption proceeds within seven calendar days of receiving a redemption order under

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140. *See* 2010 Adopting Release, *supra* note 4, at n.14 and accompanying text.
141. The liquidity difficulties encompassed many types of short-term securities and were not limited to Lehman paper. While some funds held debt securities issued by Lehman Brothers, others did not.
142. The Treasury announced the "Temporary Guarantee Program for Money Market 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 in February 2010).
143. *See* 2010 Adopting Release, *supra* note 4, at section II.C.
144. *See* new Rule 2a-7(c)(5). The SEC explained in the 2010 Adopting Release that this general mandate may require money market funds to maintain greater liquidity than what is required by the new daily and weekly liquidity minimums, which are discussed below.

section 22(e) of the ICA,[145] as well as under any commitments regarding payment on redemption that the fund has made to fund shareholders. To comply with this requirement, the SEC stated its expectation that a money market fund will adopt "Know Your Customer" policies and procedures designed to ensure that appropriate efforts are undertaken to identify the risk characteristics presented by the fund's shareholder base.[146]

In the 2010 Adopting Release, the SEC did not identify specific characteristics that should be addressed in a money market fund's policies and procedures, although the SEC stated that it expects fund management and Boards to consider such factors as whether shareholders have recurring liquidity needs, the concentration of the fund's shareholder base, and whether the liquidity needs of shareholders coincide.[147] These and other factors that affect a money market fund's liquidity needs should be taken into account in determining and monitoring those needs.

The SEC also identified a potential conflict of interest, stating 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.[148]

The SEC stated that a volatile or more concentrated shareholder base would require a fund to maintain greater liquidity than a stable shareholder base consisting of thousands of retail investors.[149]

In seeking to implement the type of "Know Your Customer" procedures called for by the 2010 Adopting Release, money market fund sponsors have developed several approaches to identify shareholder accounts that are most likely to redeem material amounts of shares on a frequent basis. Many sponsors have relied initially on an analysis of past redemption data, and have supplemented that

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145. Section 22(e) restricts the ability of any fund to delay payment on redeemed shares for more than seven calendar days.
146. The SEC explained in the 2010 Adopting Release that the 2010 Amendments did not expressly incorporate this requirement into Rule 2a-7 since such procedures are generally required by Rule 38a-1 under the ICA. *See* 2010 Adopting Release, *supra* note 4, at n.198.
147. *See* 2010 Adopting Release, *supra* note 4, at text accompanying nn.196–97.
148. *See id.* at text accompanying n.199.
149. *See id.* at text accompanying n.197.

information with such other available data as the identity and redemption patterns of: (i) shareholders that own more than a certain percentage of a fund's portfolio; (ii) shareholder accounts who share a common decision maker; and (iii) accounts that evidence wide swings in account balances maintained over a period of time. Sponsors may also take into account such other data regarding underlying accountholders as can be obtained from institutions that maintain omnibus account arrangements with a fund.[150] From such data, sponsors have identified accounts that present a material risk of redemption, and have considered the holdings of those accounts when determining the level of a fund's reasonably foreseeable redemptions. Sponsors have also typically established procedures to identify and monitor those accounts going forward, and to analyze new accounts as they are opened. The establishment and maintenance of these procedures is part of an evolving process, and new standards and sources of data may well develop as the industry gains experience with these matters.

[D][2][b] Overall Limitation on the Acquisition of Illiquid Securities

The 2010 Amendments prohibit a money market fund from acquiring an illiquid security if, immediately after the acquisition, the fund would have invested more than 5% of its total assets in illiquid securities.[151] The amendments define an "illiquid security" as any 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.[152]

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150. Omnibus account arrangements can present particular challenges for money market fund sponsors in that, omnibus account agreements may not require an institution that maintains an omnibus account to provide data regarding the identity of and redemption patterns and other data regarding the beneficial owners of the account. In such cases, the fund sponsor may be required to rely on the voluntary cooperation of the omnibus account holder and/or make certain assumptions regarding the average account size and redemption frequency of the beneficial owners of the account based on such data as is available.

151. *See* new Rule 2a-7(c)(5)(i). In comparison, the amendments originally proposed in 2009 would have prohibited money market funds from acquiring any illiquid securities.

152. Emphasis added. *See* new Rule 2a-7(a)(19). "Approximately" signals that a security would not be deemed to be illiquid simply because it could not be sold at amortized cost. *See* 2010 Adopting Release, *supra* note 4, at text accompanying n.210. If a security could be sold at approximately the market-based value used to shadow price the security, it could be treated as a liquid security. *See* 2010 Adopting Release, *supra* note 4, at n.210.

[D][2][c] Minimum Daily and Weekly Requirements

The 2010 Amendments require that, at a minimum, immediately after the acquisition of any security:[153]

(i) a taxable money market fund must have invested at least 10% of its total assets in "Daily Liquid Assets," that is, cash, U.S. Treasury securities, and securities convertible into cash in one business day;[154] and

(ii) all money market funds must have invested at least 30% of total assets in Weekly Liquid Assets, that is, cash, U.S. Treasury securities, agency notes with remaining maturities of sixty days or less,[155] and securities convertible into cash

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153. The SEC staff has stated that a money market fund may choose any reasonable time for determining its Total Assets, Daily Liquid Assets, and Weekly Liquid Assets for purposes of compliance with Rule 2a-7, provided that: (a) the determinations are made at least once every Business Day; and (b) the fund consistently makes the determinations at the same time or times. *See* Amended Rule 2a-7 Q&A, Question II.3. The SEC staff has also stated that although a money market fund should use the Total Assets, Daily Liquid Assets and Weekly Liquid Assets most recently computed, the fund should take into account its use of Daily or Weekly Liquid Assets to acquire assets when determining whether a subsequent acquisition complies with the Daily or Weekly Liquid Asset requirement. The SEC staff provided the following example to illustrate: if a fund acquires longer term securities with a value of $10 million using available cash balances, the $10 million should be subtracted from the fund's Daily Liquid Assets when evaluating whether a subsequent acquisition on the same day would be in compliance with the Daily or Weekly Liquid Asset requirement. *Id.*

154. *See* new Rule 2a-7(a)(8). The SEC staff has stated that, in a master-feeder structure, a taxable money market fund that is a feeder fund, investing solely in securities issued by a master fund in reliance on section 12(d)(1)(E) of ICA, cannot look through to the portfolio of the master fund for purposes of compliance with the Daily Liquid Asset requirement. *See* Amended Rule 2a-7 Q&A, Question II.5. Citing to Equity Securities Trust, Series 4, SEC No-Action Letter (Jan. 19, 1994) and The Thai Fund, Inc., SEC No-Action Letter (Nov. 30, 1987), the SEC staff has clarified that a feeder fund can comply with the Daily Liquid Asset requirement by investing in a master fund that guarantees redemptions in one day or by holding 10% of its Total Assets in cash or in other Daily Liquid Assets that are not deemed to be investment securities for purposes of section 12(d)(1)(E), such as U.S. Treasury securities. *Id.*

155. Agency notes are Government Securities issued at a discount to the principal amount to be repaid at maturity. *See* new Rule 2a-7(a)(32)(iii). The SEC staff has stated that, during periods of market stress, a money market fund can treat non-interest bearing agency notes purchased at or above face value as Weekly Liquid Assets, and that whether an agency note will qualify as a Weekly Liquid Asset ultimately depends on whether the

(whether by maturity or through exercise of a demand feature) within five business days.[156]

The amendments are intended to facilitate the ability of money market funds to satisfy redemption requests during times of market turmoil.[157]

§ 9:3.5 Downgrades and Defaults of Portfolio Securities

In addition to the Risk-Limiting Provisions, Rule 2a-7 establishes specific procedures that must be followed in the event a portfolio security is downgraded or a default or certain other events occur with respect to a portfolio security.

[A] Downgrades

A money market fund's Board is required to promptly reassess whether a security continues to present minimal credit risk, and must

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note is issued without an obligation to pay additional interest on the principal amount, so that income earned, if any, is solely the difference between the amount paid at issuance and the principal amount payable upon maturity. *See* Amended Rule 2a-7 Q&A, Question II.2.

156. *See* Rule 2a-7(a)(32). A money market fund may not rely on the maturity shortening provisions of Rule 2a-7(d)(1) through (d)(8) in interpreting the definitions of "Daily Liquid Assets" and "Weekly Liquid Assets," and that the term "mature" in these definitions should be understood to mean only the date on which the principal amount must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made. *See* Amended Rule 2a-7 Q&A, Question II.1. The SEC staff has stated that if a money market fund sells a security to a creditworthy buyer and the proceeds from the sale are due unconditionally within one (in the case of a Daily Liquid Asset) or five (in the case of a Weekly Liquid Asset) Business Days, the requirement for the fund's Daily and Weekly Liquid Assets to include securities that can readily be converted to cash within one or five Business Days would be satisfied. *See id.*, Question II.4.

157. The amendments differ substantially from those originally proposed by the SEC, which would have required a money market fund's Board to determine at least annually whether the fund is an "institutional fund" (*e.g.*, among other things, based on such factors as the fund's minimum initial investment requirements), and would have imposed higher liquidity requirements on institutional funds (10% daily liquid assets and 30% weekly liquid assets) as compared to retail funds (5% daily liquid assets and 15% weekly liquid assets), on the basis that institutional funds can be subject to substantially larger redemption requests. *See* 2009 Proposing Release, *supra* note 3, at nn.218–27 and accompanying text. As adopted, the amendments do not distinguish between institutional and retail funds, but rather impose the same daily and weekly minimum liquidity requirements on both types of funds, in recognition of the inherent difficulties in distinguishing between institutional and retail money market funds. *See* 2010 Adopting Release, *supra* note 4, at n.227 and accompanying text.

take such action as it deems to be in the best interests of the fund and its shareholders, upon the occurrence of either of the following:

(i) a portfolio security ceases to be First Tier (either because it is no longer rated in the highest rating category by the Requisite NRSROs or, in the case of an Unrated Security, because the Board, or its delegate, has determined that the security is no longer comparable to a First Tier Security); or

(ii) the fund's investment adviser becomes aware that any Unrated Security or Second Tier Security held in the fund's portfolio has been given a rating by any Designated NRSRO that is below the second highest short-term rating category.[158]

However, this reassessment is not required if the fund disposes of the security (or it matures) within five business days of the event requiring reassessment.[159]

[B] Securities Subject to Demand Features

Rule 2a-7 requires that if, after giving effect to a downgrade, more than 2.5% of a money market fund's total assets are invested in Second Tier Securities that are issued by or subject to Demand Features from a single institution, the fund must reduce its investments in such securities to no more than 2.5% of its total assets by exercising the Demand Feature at the next exercise date. However, the fund will not be required to eliminate its excess positions if the Board or its delegate determines that disposing of the securities would not be in the best interests of the fund.[160]

[C] Defaults and Other Events Requiring Disposition

Rule 2a-7 requires a money market fund to dispose of a portfolio security as soon as practicable, consistent with achieving an orderly disposition of the security,[161] if:

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158. Rule 2a-7(c)(7)(i)(A). This obligation of the Board may be delegated to the fund's investment adviser or officers. *See infra* section 9:3.8.

159. Rule 2a-7(c)(7)(i)(B).

160. Rule 2a-7(c)(7)(i)(C). Prior to the 2010 Amendments, the limitation under this sub-section was 5%, instead of the 2.5% limit required under the amended Rule.

161. Rule 2a-7(c)(7)(ii). Any action taken with respect to defaulted securities or events of insolvency must be reported on the fund's Form N-SAR. Rule 2a-7(c)(11)(viii). In addition, a fund must report on Form N-SAR any securities it holds on the final day of the relevant reporting period that are not Eligible Securities. *Id.*

- there is a default with respect to the portfolio security (other than an immaterial default that is unrelated to the financial condition of the issuer), or
- the portfolio security ceases to be an Eligible Security, or
- a determination is made by the Board or its delegate that the portfolio security no longer presents minimal credit risk, or
- an event of insolvency[162] occurs with respect to the issuer of the portfolio security or the provider of any Demand Feature or Guarantee.

However, the fund will not be required to dispose of the portfolio security if the Board determines that such course of action would not be in the best interests of the fund.[163]

[D] Responding to Issues in Less Liquid Markets

Valuing portfolio securities for which market quotations are not readily available presents a challenge that money market funds may face in less liquid markets. To facilitate the good-faith determination by a Board, or its delegate, of the fair value[164] of portfolio securities trading in a less liquid market, the services of third party pricing

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162. An event of insolvency with respect to a person is defined as: (1) an admission of insolvency, the application by a person for the appointment of a trustee or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; (2) the institution of similar proceedings by another person against the person which are not contested; or (3) the institution of similar proceedings by a government agency responsible for the activities of the person, whether or not contested by the person. Rule 2a-7(a)(13). An instrument subject to a Demand Feature or Guarantee is not deemed to be in default, and an event of insolvency with respect to the issuer is not deemed to have occurred, if: (1) the Demand Feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest, or (2) the provider of the Guarantee is continuing, without protest, to make payments as due on the instrument. Rule 2a-7(c)(7)(iv).

163. Responsibility for this determination cannot be delegated by the Board. *See* Rule 2a-7(e). In making this determination, a Board should consider "any and all factors that it believes to be material in assessing whether retention of a security is in the best interests of a fund." In addition to illiquidity in the marketplace for a security, a Board may take the existence of insurance against payment defaults, issuer insolvencies, and other credit-related events into consideration in making the determination. *See* ICI Mutual Insurance Company, SEC No-Action Letter (pub. avail. July 27, 1998).

164. *See generally* ICA § 2(a)(41).

vendors may be utilized and quotes may be obtained from brokers. However, a Board ultimately remains responsible for the pricing of its funds.

Where market events affect the valuation of a significant portion of a fund's portfolio, the level of Deviation can increase to an extent that can become problematic. Even if the fund is not in danger of breaking the dollar share price, it may be difficult for the fund to meet redemptions by selling portfolio securities that have become thinly traded. Several options may be available to a money market fund sponsor seeking to support a money market fund. In the past, funds have taken one or more of the following steps, some of which may require relief under the ICA:[165]

- In the case of a smaller money market fund, the investment adviser or an affiliate could purchase shares of the fund, which would reduce the level of Deviation and provide cash to meet redemptions.[166]
- The investment adviser of the money market fund or one of its affiliates could agree to purchase portfolio securities from the money market fund for cash at their amortized cost.[167]
- The investment adviser of the money market fund could provide a Guarantee to the fund in the form of a capital support agreement or similar arrangement.[168]

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165. In many cases, the options that are available to a Board, or its delegate, for supporting a money market fund may require no-action relief under ICA § 12(d)(3) (generally making it unlawful for any registered investment company to acquire any security issued by, or any interest in the business of, any broker-dealer, any person engaged in the business of underwriting, or an investment adviser of an investment company, or an investment adviser registered under the ICA), § 17(a)(1) (generally making it unlawful for any affiliated person of a registered investment company, or an affiliated person of such person, acting as principal, to knowingly sell any security or other property to the registered investment company), and § 17(d) (generally making it unlawful for any affiliated person of a registered investment company, or any affiliated person of such a person, acting as principal to effect any transaction in which the registered investment company is a joint or joint and several participant with such person in contravention of rules and regulations adopted by the SEC).

166. A share purchase does not require regulatory relief.

167. *See, e.g.*, 1784 Funds, SEC No-Action Letter (pub. avail. July 17, 1995) (use of Standby Purchase Agreement allowing money market fund's investment adviser or affiliate to purchase certain securities from the fund necessary to prevent the deviation between the fund's market-based net asset value per share and the fund's amortized cost net asset value per share from exceeding ½ of 1%); *see also infra* section 9:4.

168. *See, e.g.*, SEI Daily Income Trust—Prime Obligation Fund, SEC No-Action Letter (pub. avail. Nov. 8, 2007), and SEI Daily Income Trust—Money

- The investment adviser of the money market fund or one of its affiliates could engage in reverse repurchase agreements with the fund, effectively allowing the fund to borrow against its portfolio securities to meet redemptions.[169]
- The Board, or its delegate, could ensure that the money market fund has access to a line of credit or other credit facility from an affiliated bank[170] or from an unaffiliated bank with affiliated payment obligations.[171]

Market Fund, SEC No-Action Letter (pub. avail. Nov. 9, 2007) (capital support agreement entered into by money market fund and affiliate to prevent losses realized upon ultimate disposition of securities from causing money market fund's market-based net asset value per share to fall below a minimum permissible net asset value specified in the capital support agreement by obligating affiliate to make a cash contribution to the money market fund, up to a maximum amount specified in the capital support agreement); *see also* Wells Fargo Funds Trust, SEC No-Action Letter (pub. avail. Feb. 13, 2008); Dreyfus Cash Management Plus, Inc., SEC No-Action Letter (pub. avail. Oct. 20, 2008); Russell Investment Company, SEC No-Action Letter (pub. avail. Oct. 24, 2008); The Hartford Mutual Funds, Inc., Hartford Series Fund, Inc., SEC No-Action Letter (pub. avail. Feb. 17, 2009); and ING Funds Trust, ING Investors Trust, ING Series Fund, Inc., SEC No-Action Letter (pub. avail. Feb. 19, 2009) (capital support agreement between money market fund and affiliate to limit potential losses resulting from default by issuer of commercial paper and to prevent any downgrade in money market fund rating by committing affiliate to make specified cash contributions to the money market fund to cover all losses realized on a specific portion of the commercial paper).

169. *See, e.g.*, Dreyfus Cash Management, SEC No-Action Letter (pub. avail. Sept. 25, 2008).

170. *See, e.g.*, STI Classic Funds, SEC No-Action Letter (pub. avail. Oct. 26, 2007) (issuance by an affiliated bank of an irrevocable standby letter of credit deemed to be a First Tier Security, pursuant to which money market fund would continue to hold the illiquid securities and value them based on the letter of credit but would transfer them to the affiliated bank in consideration of any amounts paid to the money market fund under the letter of credit). It should be noted that many lines of credit typically require notification for accessing lines of credit to be provided by around 2:00 P.M., although money market funds would not usually know whether they will need to access funds from their lines of credit until around 4:00 P.M. Accordingly, advisers of money market funds should take steps to ensure that they can meet the notification cut-off times for accessing funds from their lines of credit if necessary to meet redemptions of fund shares.

171. *See, e.g.*, Overland Express MMF, SEC No-Action Letter (pub. avail. July 7, 1995) (issuance by an unaffiliated bank of a first tier credit enhancement in the form of irrevocable standby letters of credit pursuant to a Credit Enhancement Agreement setting forth certain rights and obligations of the parties in the event of one or more draws by money market fund against a letter of credit in the event principal and interest are not received by the final maturity date of the securities and in certain other circumstances).

- The money market fund and any other funds in the same fund complex could seek to obtain an inter-fund lending exemptive order from the SEC (or rely on such an order if one has been previously obtained).[172]
- The money market fund could enter into a put agreement with an affiliate obligating the affiliate to purchase certain securities for cash at amortized cost at a future date.[173]
- The investment adviser or its affiliate could make a cash infusion into the fund.[174]

[E] Notice to the SEC

A money market fund must promptly notify the SEC,[175] by electronic mail directed to the Director of Investment Management or the Director's designee, of any:

- Default or Event of Insolvency with respect to the issuer of one or more portfolio securities (other than an immaterial default unrelated to the financial condition of the issuer) or any issuer of a Demand Feature or Guarantee to which one or more portfolio securities is subject, and the actions the money market fund intends to take in response to such event, where immediately before default, the securities (or the securities subject to the Demand Feature or Guarantee) accounted for 0.5% or more of the money market fund's total assets.[176] *Or*
- Purchase of a security from the fund by an affiliated person, promoter, or principal underwriter of the fund, or an affiliated

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172. Although inter-fund lending orders have been issued by the SEC, *see, e.g.*, Pioneer Bond Fund, et al., Investment Company Act Release No. 28,144 (Feb. 5, 2008), their high administrative costs (*e.g.*, independent committee requirements; specific standards of use; market rate acquisition requirements; etc.) may make them less than ideal for use by some money market funds.
173. *See, e.g.*, Centennial Money Market Trust, SEC No-Action Letter (pub. avail. Sept. 17, 1999) (put agreement executed by money market funds and affiliate pursuant to which money market funds have the right to sell to the affiliate, at a price equal to the amortized cost plus accrued interest, a portion of funding agreements owned by the money market funds in an amount such that the deviation between the market value of the money market fund's assets, after giving effect to the put agreement as to such portion of the applicable funding agreement, and the amortized cost of the money market fund's assets does not equal or exceed $0.003 per share).
174. A cash infusion, being a "gift" of cash to the fund, does not require regulatory relief.
175. Either of these two notices likely will trigger an inquiry from the SEC staff and result in an on-site inspection of the fund.
176. Rule 2a-7(c)(7)(iii)(A).

person of such a person, in reliance on Rule 17a-9 under the ICA, including identification of the security, its amortized cost, the sale price, and the reasons for such purchase.[177]

§ 9:3.6 Disclosure of Portfolio Information on Public Website

The 2010 Amendments require funds to disclose fund portfolio information on public website postings.[178] Prior to the 2010 Amendments, money market funds were required to disclose their portfolio holdings to the SEC on a quarterly basis (within sixty days after the end of the quarter). While some fund groups posted portfolio information on their websites, that disclosure was made on a purely voluntary basis. The 2010 Amendments require each money market fund to post information about its portfolio holdings on a public website on a

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177. Rule 2a-7(c)(7)(iii)(B). The exemptive relief provided by Rule 17a-9 has been expanded. *See* 2010 Adopting Release, *supra* note 4, at section II.G.1.

178. *See* new Rule 2a-7(c)(12). The 2010 Amendments also require the disclosure of fund portfolio information in reports filed with the SEC. The SEC staff has clarified that the website disclosure requirement described in Rule 2a-7(c)(12) applies equally to an open-end management investment company that is registered under the ICA and regulated as a money market fund under Rule 2a-7, and that offers and sells its shares only to registered investment companies that are part of the same "group of investment companies," as that term is defined in section 12(d)(1)(G)(ii) of the ICA. *See* Amended Rule 2a-7 Q&A, Question V.B.1. The SEC staff took the view that a money market fund that is registered under the ICA only (*i.e.*, the fund offers and sells its securities without registration under the Securities Act, in reliance on Rule 506 of Regulation D under the Securities Act and/or section 4(2) of that Act) will not be deemed to violate the prohibition on general solicitation and advertising in Rule 502(c) of Regulation D by reason of complying with Rule 2a-7(c)(12), as long as it limits the information posted on its website to the information required by Rule 2a-7(c)(12) and does not otherwise use its website to sell securities or in a manner that conditions the market for sales of its securities. *See id.*, Question V.G.1. The staff explained that because Rule 506 is a safe harbor that provides objective standards on which an issuer can rely to meet the requirements of the section 4(2) exemption, a fund following this guidance regarding the use of the information posted on its website should be deemed to comply with the section 4(2) exemption, if it otherwise complies with Rule 506. *Id.* Likewise, with respect to an unregistered money market fund, the SEC staff has stated that the fund will not be deemed to violate the prohibition on general solicitation and advertising by posting information on its website in compliance with Rule 2a-7(c)(12) (*e.g.*, for purposes of permitting registered investment companies to invest in the fund under Rule 12d1-1 in excess of the limits set forth in section 12(d) of the ICA), as long as the fund posts only the information required by the Rule and does not use its website to offer or sell securities or in a manner that is deemed to be general solicitation or advertising for offers or sales of its securities. *See id.*, Question V.F.1.

monthly basis no later than five business days after the end of each month.[179] The posted information must remain accessible on the website for at least six months after posting. These amendments are intended to provide greater transparency to investors regarding the risks to which money market funds are exposed.

The amendments require the WAM and WAL of each money market fund to be posted on the website.[180] With respect to each security held by the fund, the amendments specify certain information that must be posted on the website, including, for each portfolio security: the issuer's name; category of investment (for example, Treasury debt; commercial paper); CUSIP number; principal amount; maturity date; final legal maturity;[181] coupon or yield; and amortized cost value. Importantly, a fund's market-based net asset value per share is not required to be included in the website disclosure.[182] In addition, the amendments require the fund's website to contain a link to an SEC website where the most recent twelve months of publicly available information filed by the fund may be obtained.[183]

§ 9:3.7 Recordkeeping

Rule 2a-7 requires that money market funds maintain and preserve written records of the following:[184]

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179. A money market fund that is a feeder fund in a master-feeder structure must either disclose the master fund's portfolio holdings in its monthly website posting or provide a link to the master fund's website disclosure of portfolio holdings. *See* Amended Rule 2a-7 Q&A, Question V.D.1.

180. Rule 2a-7(c)(12)(i). The SEC staff has clarified that a money market fund's WAM and WAL should be provided on the same web page with the required listing of the securities held by the fund as of the last Business Day of the month. *See* Amended Rule 2a-7 Q&A, Question V.E.1.

181. The SEC staff has clarified that a security's final legal maturity date should be the same as the date used to calculate the fund's WAL. *See* Amended Rule 2a-7 Q&A, Question V.H.1. *See* 2010 Adopting Release, *supra* note 4, at n.154.

182. Rule 2a-7(c)(12)(ii).

183. Rule 2a-7(c)(12)(iii). The SEC staff has stated that a money market fund cannot satisfy this requirement by creating a general link to (i) the website http://sec.gov/ or (ii) the web page on the SEC's website where a user can "Search for company filings" (*i.e.*, http://sec.gov/edgar/searchedgar/webusers.htm). *See* Amended Rule 2a-7 Q&A, Question V.C.1. On the other hand, a money market fund can satisfy this requirement by creating a link to a fund specific web page on the SEC website that contains links to (at least) each of the fund's most recent twelve monthly Form N-MFP filings. *See id.*, Question V.C.2.

184. These records must be made available for inspection by the SEC in accordance with ICA § 31(b). Rule 2a-7(c)(11)(vi).

- the Board's considerations and actions taken in the discharge of its responsibilities under Rule 2a-7;[185]
- the determination that a security presents minimal credit risk, as well as a record of any ratings used to determine a security's status as an Eligible Security, First Tier Security, or Second Tier Security;[186]
- the determination regarding the deviation, if any, between the market value and the amortized cost value of any adjustable rate security that does not have a Demand Feature;[187]
- the determination regarding the number of 10% obligors deemed to be the issuers of all or a portion of an ABS, and certain specific information in connection therewith;[188]
- the determination that the fund is not relying on a Demand Feature or Guarantee to determine the quality, maturity, or liquidity of the underlying security;[189] and
- reports provided to the Board on the results of Stress Tests conducted under the Rule.[190]

Further, Rule 31a-1 under the ICA requires, in part, that each fund maintain records identifying:

(1) each portfolio security by its legal name;

(2) any liquidity or credit enhancements associated with a security; and

(3) any coupons, accruals, maturities, puts, calls, or any other information necessary to identify, value, and account for each security.[191]

§ 9:3.8 Delegation of Board Responsibilities

Rule 2a-7 permits a money market fund's Board to delegate most day-to-day responsibilities under Rule 2a-7 to the fund's investment

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185. Rule 2a-7(c)(11)(ii).
186. Rule 2a-7(c)(11)(iii). This record should include the basis upon which the credit quality of an unrated security is determined to be comparable to an Eligible Security.
187. Rule 2a-7(c)(11)(iv).
188. Rule 2a-7(c)(11)(v).
189. Rule 2a-7(c)(11)(vi).
190. Rule 2a-7(c)(11)(vii). For a discussion of the new stress testing requirements, see *supra* section 9:3.3[B][2].
191. Rule 31a-1(b)(1).

adviser or officers, provided the Board adopts guidelines and procedures to govern the exercise of the delegated authority and exercises oversight to assure that the procedures are being followed.[192] Thus, for example, the Board may delegate responsibility for approving purchases of unrated or single-rated securities, for the determination that a security presents minimal credit risk, and for credit reassessments in the event of downgrades where a portfolio security ceases to be First Tier, or where an unrated or Second Tier portfolio security has been given a rating by a Designated NRSRO below the second highest short-term category. However, Rule 2a-7 specifically prohibits the Board from delegating any of its responsibilities for the following:

- the designation of at least the four Designated NRSROs whose credit ratings will be used by the fund to determine whether a security is an Eligible Security, and the determination at least once each calendar year that such Designated NRSROs issue credit ratings that are sufficiently reliable for use by the fund;[193]
- the determination that the use of amortized cost or penny-rounding pricing procedures is in the best interests of the fund and its shareholders, and that either procedure may be continued only so long as share prices so determined fairly reflect market-based prices;[194]
- the determination that the fund should continue to hold securities subject to default, securities that are no longer Eligible Securities or that no longer present minimal credit risk, or securities whose issuer has experienced an event of insolvency;[195]
- the establishment of the fund's written procedures to stabilize the fund's net asset value or price per share;[196]
- the implementation of shadow pricing and the consideration of action where the Deviation exceeds ½ of 1%;[197]

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192. Rule 2a-7(e).
193. For a discussion on SEC staff no-action relief providing funds with temporary relief from the NRSRO designation requirement, see *supra* section 9:3.4[B][3][e].
194. Rule 2a-7(c)(1).
195. Rule 2a-7(c)(7)(ii).
196. Rule 2a-7(c)(8)(i) and Rule 2a-7(c)(9).
197. Rule 2a-7(c)(8)(ii)(A), (B).

- the determination of whether the Deviation may result in material dilution or other unfair results to investors or existing shareholders, and the appropriate action to be taken, if any;[198] and
- the initial approval of Stress Testing procedures and the periodic review of the money market fund's ability to maintain a stable net asset value per share based upon specific hypothetical events.[199]

§ 9:4 Buyouts of Problematic Securities

As originally adopted, Rule 17a-9 under the ICA updated and codified SEC staff positions taken in the aftermath of the 1994 Orange County bankruptcy and in other circumstances where securities were in default or had become ineligible under Rule 2a-7.[200] Prior to the 2010 Amendments, Rule 17a-9 provided a limited exemption to permit affiliates of a money market fund to purchase a portfolio security from the fund only if that security had ceased to be an Eligible Security under Rule 2a-7. The purchase price, equal to the greater of the amortized cost of the security or its market price (in each case, including accrued interest), was required to be paid in cash.

During the 2007–2009 financial crisis, many fund groups obtained no-action relief from the SEC staff to permit the purchase of securities that remained "Eligible Securities," but which nevertheless had become

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198. Rule 2a-7(c)(8)(ii)(C).
199. Rule 2a-7(c)(10)(v)(A).
200. *See, e.g.*, Lehman Brothers Daily Income Fund, SEC No-Action Letter (pub. avail. July 7, 1995) (permitting the purchase of Orange County notes by an affiliated person of a fund at par value plus accrued interest); *see also* Liquid Green Trust, SEC No-Action Letter (pub. avail. Dec. 19, 1991) (permitting the purchase of defaulted commercial paper by an affiliated person of a fund). For a discussion of other options available to a Board, or its delegate, to support a money market fund, see *supra* section 9:3.5[D]. The Internal Revenue Service held in a Technical Advice Memorandum (TAM 200247004 (July 29, 2002)) that contributions by an investment adviser to money market funds to avoid having the funds break a dollar were deductible by the adviser because the payments were primarily made to protect, maintain, and preserve the adviser's business. The Treasury subsequently issued regulations under section 263 of the Internal Revenue Code that specifically include an example that allows an investment adviser of a money market fund to deduct payments made by the adviser to the fund for the purpose of avoiding a net asset value of less than $1 per share. The example indicates that the payment was made to preserve the reputation of the adviser and that it was not made in exchange for any ownership interest in the fund. *See* Example 6 of Treas. Reg. § 1.263(a)-4(*l*).

difficult to sell in the market.[201] Such no-action relief was required prior to the 2010 Amendments since Rule 17a-9 did not provide express relief to permit an affiliate to purchase a security that remained an Eligible Security, even if that presented potential pricing issues due to illiquidity or other market events.[202]

As amended, Rule 17a-9 permits affiliates to purchase a security from the portfolios of affiliated money market funds; provided that: (1) in the case of a portfolio security that has ceased to be an Eligible Security, or that has defaulted (other than an immaterial default unrelated to the financial condition of the issuer), the purchase price must equal the greater of the amortized cost of the security or its market price, including interest, and must be paid in cash;[203] and (2) in the case of any other portfolio security, in the event that the purchaser thereafter sells the security for a higher price than the purchase price paid to the money market fund, the purchaser must promptly pay to the fund the amount by which the subsequent sale price exceeds the purchase price paid to the fund.[204] Prompt notice of any purchase under Rule 17a-9 by an affiliate, including identification of the security, its amortized cost, the sale price, and the reasons for the purchase, must be given to the SEC by email.[205]

§ 9:5 Industry Concentration

Section 8(b)(1)(E) of the ICA requires a recital of a fund's policy concerning "concentrating investment in a particular industry or

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201. *See, e.g.*, TD Asset Management USA Funds Inc.—TDAM Money Market Portfolio, SEC No-Action Letter (pub. avail. Dec. 31, 2007) (purchase by adviser from money market fund of certain credit-linked certificates at amortized cost including accrued and unpaid interest satisfying Rule 17a-9 requirements except for credit-linked certificates continuing to constitute an Eligible Security); Dreyfus Money Funds, SEC No-Action Letter (pub. avail. Oct. 20, 2008) and MainStay VP Series Fund—MainStay VP Cash Management Portfolio, SEC No-Action Letter (pub. avail. Oct. 22, 2008); *see also supra* section 9:3.5[D].
202. Rule 17a-9 creates no legal obligation for any affiliate to make purchases permitted by the Rule. In addition, affiliates whose securities are publicly traded may have an obligation to disclose the contribution in their financial statements and also, perhaps, on reporting forms under the Securities Exchange Act of 1934.
203. *See* amended Rule 17a-9(1).
204. *See* amended Rule 17a-9(2). A portfolio security that has ceased to be an Eligible Security or that has defaulted is not subject to this new "claw-back" provision, since the state of such securities would invariably serve as an objective indication that the security is distressed, and the purchase of such securities would be in the best interests of the fund. *See* 2010 Adopting Release, *supra* note 4, at text following n.369.
205. *See* amended Rule 2a-7(c)(7)(iii)(B).

group of industries."[206] This recital must be included in a fund's registration statement. Neither a definition of "concentration" nor an industry classification system is contained in the ICA or in any rules thereunder. However, the staff of the SEC has taken the position that a fund will be concentrated if it invests 25% or more of its assets in a particular industry.[207] A fund generally may not change its policy with respect to concentration of investments unless such change is approved by shareholders.[208]

Further, funds may not elect to concentrate pursuant to management's investment discretion.[209] The SEC has, however, recognized an exception from this rule that permits money market funds to declare a policy with respect to industry concentration that reserves freedom of action to concentrate their investments in Government Securities (as defined in the ICA) and in certain instruments issued by domestic banks (which may include U.S. branches of foreign banks or foreign branches of U.S. banks in certain circumstances).[210] In order for a money market fund to take advantage of this position, the fundamental policy on industry concentration contained in its registration statement should reserve the ability to concentrate in Government Securities and domestic bank instruments. Further, additional disclosure should be included in the fund's Statement of Additional Information regarding "the type and nature of the various instruments in which the [fund] intends to invest and the criteria used . . . in evaluating and selecting such investments."[211]

§ 9:6 Disclosure and Advertising Standards

In addition to the requirements applicable to money market funds under Rule 2a-7, the SEC's rules and forms also impose certain disclosure and advertising standards on money market funds that

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206. The requirement of choosing a concentration policy is also reflected in Item 2(b) of Form N-1A.
207. The SEC has stated that "25% is an appropriate benchmark to gauge the level of investment concentration. . . ." *See* Investment Company Act Release No. 23,064 (Mar. 13, 1998).
208. *See* § 13(a)(3) of the ICA.
209. *See* Investment Company Act Release No. 9011 (Oct. 30, 1975).
210. *See* Guide 19 to Form N-1A, Investment Company Act Release No. 13,436 (Aug. 12, 1983) [hereinafter Guide 19]. Although the Guides were removed from Form N-1A in connection with the 1998 amendments to the form, the authors are aware of no authority issued by the SEC or its staff indicating that this portion of Guide 19 no longer accurately reflects the staff's position with respect to industry concentration. *See* Investment Company Act Release No. 23,064 (Mar. 13, 1998).
211. Guide 19, *supra* note 210.

are in addition to or different from those applicable generally to registered investment companies.[212]

§ 9:6.1 Disclosure

[A] Form N-1A

Form N-1A,[213] the disclosure form applicable to all registered open-end management investment companies, requires that a money market fund[214] disclose in the narrative risk disclosure section of its prospectus that an investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and that, although the fund seeks to preserve the value of shareholder investments at a net asset value per share of $1, it is possible to lose money by investing in a money market fund.[215]

Other prospectus disclosure rules specific to money market funds include the following:

(1) unlike other funds, money market funds are not required to provide a "management discussion of fund performance";[216]

(2) in addition to providing a table in the prospectus showing average annual total return for the past one, five, and ten calendar years, a money market fund may either provide the fund's seven-day yield as of the end of the most recent calendar year or provide a toll-free or collect telephone number for

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212. This discussion focuses only on disclosure and advertising requirements unique to money market funds. Other disclosure and advertising requirements generally applicable to registered investment companies in most cases are equally applicable to money market funds.

213. 17 C.F.R. § 274.11A.

214. As defined in Form N-1A, an open-end management investment company registered under the ICA that holds itself out as a money market fund and meets the maturity, quality, and diversification requirements of Rule 2a-7. Form N-1A, General Instructions—Definitions.

215. Form N-1A, Item 2(c)(1)(ii). Prior to amendments to Form N-1A effective in 1998, the Form required that disclosure relating to these points be placed on a money market fund's prospectus cover page. As a result of the amendments, a money market fund may continue to place this disclosure on the cover page of its prospectus, but is not required to. In addition, prior to the 1998 amendments, a single-state fund that was not diversified as to 100% of its assets was required to make prospectus cover page disclosure that the fund might be riskier than other money market funds because of its concentration in relatively fewer issuers. This requirement has been eliminated. However, to adequately disclose the principal risks of investing in a single-state money market fund, it may be necessary to provide disclosure to this effect in the fund's prospectus.

216. Form N-1A, Item 5. A non-money market fund must provide this discussion in the prospectus or in the fund's annual report to shareholders.

investors to obtain the fund's current seven-day yield. Further, although Form N-1A now mandates disclosure of certain performance information on an after-tax basis in fund prospectuses, the after-tax disclosure requirements do not apply to money market funds;[217]

(3) a money market fund is not required to disclose in its prospectus whether it may engage in active and frequent trading to achieve its principal investment strategies,[218] and may omit the fund's portfolio turnover rate generally required in the financial highlights section of the prospectus;[219] and

(4) a money market fund need not disclose information identifying and describing the persons primarily responsible for the day-to-day management of the fund's investment portfolio.[220]

With respect to rules specific to money market funds in shareholder reports, a money market fund is exempt from including a portfolio schedule, provided that this information is filed with the SEC on Form N-CSR and is provided to shareholders upon request, free of charge.[221]

[B] Form N-MFP

The 2010 Amendments introduced a new Rule 30b1-7, which requires every registered open-end management investment company, or series thereof, that is regulated as a money market fund under Rule 2a-7[222] to electronically file with the SEC a monthly report of portfolio holdings on new Form N-MFP[223] (in an XML-tagged data

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217. Form N-1A, Item 2(c)(2)(iii).
218. Form N-1A, Item 4, Instruction 7.
219. Form N-1A, Item 9, Instruction 4(c).
220. Form N-1A, Item 6(a)(2), Instruction 1.
221. Investment Company Act Release No. 26,372 (Feb. 27, 2004).
222. The SEC staff has stated that, because Rule 30b1-7 requires every registered fund that is regulated as a money market fund under Rule 2a-7 to file Form N-MFP with the SEC, all funds subject to Rule 2a-7, including those that do not use the amortized cost method or penny-rounding method (*i.e.*, a fund that only meets the conditions of Rules 2a-7(c)(2)-(5)), must file Form N-MFP. *See* Division of Investment Management: Staff Responses to Questions about Rule 30b1-7 and Form N-MFP (July 29, 2011 revision) [hereinafter Rule 30b1-7 Q&A], *available at* http://sec.gov/divisions/investment/guidance/formn-mfpqa.htm, Question I.A.1.
223. The information required to be filed on new Form N-MFP pursuant to Rule 30b1-7 includes all information that funds with market-based net asset values below $0.9975 were required to provide to the SEC under temporary Rule 30b1-6T, which the SEC had adopted in September 2009 on an interim final basis. *See* Disclosure of Certain Money Market Fund Portfolio Holdings, Investment Company Act Release No. 28,903 (Sept. 18,

format), current as of the last business day of the previous month,[224] no later than the fifth business day of each month.[225] Form N-MFP is divided into two parts: Part I, "Information about the Fund," and Part II, "Schedule of Portfolio Holdings."[226]

2009); *see also* 2010 Adopting Release, *supra* note 4, at section II.E.3. Rule 30b1-6T required a money market fund to provide weekly portfolio and valuation information to the SEC if its market-based net asset value per share fell below $0.9975 on any business day. Rule 30b1-6T expired on December 1, 2010. The SEC's adoption of Rule 30b1-7 is intended to create a central database of money market fund portfolio holdings, and to enhance the SEC's oversight of money market funds and the SEC's ability to respond to market events. *See* 2010 Adopting Release, *supra* note 4, at section II.E.2.

224. The SEC staff has indicated that it would not object if a money market fund that compiles portfolio holdings information as of the last calendar day of the month reports that information on Form N-MFP current as of a day in the month on or after the last business day of the month. *See* Rule 30b1-7 Q&A, Question I.B.1.

225. Rule 30b1-7(a). The information provided on Form N-MFP is made available to the public, but such availability is delayed until sixty days after the end of the month to which the information pertains. *See* Rule 30b1-7(b). As discussed above, more recent but less detailed information about money market fund portfolio holdings must be made available on fund websites within five business days after the end of the month. When the SEC introduced Rule 30b1-7, it anticipated that the public disclosure of monthly market-based NAVs would cause funds to take steps to resolve issues that may raise concerns with investors and analysts. *See* 2010 Adopting Release, *supra* note 4, at text following n.337.

226. *See* Form N-MFP, *available* at www.sec.gov/about/forms/formn-mfp.pdf. The technical specifications (schema) for Form N-MFP are available on the SEC website at www.sec.gov/info/edgar/formn-mfp-xml-techspecs.htm. The SEC staff has stated that a money market fund that is registered under the ICA only (*i.e.*, the fund offers and sells its securities without registration under the Securities Act, in reliance on Rule 506 of Regulation D under the Securities Act and/or section 4(2) of that Act) will not be deemed to violate the prohibition on general solicitation and advertising in Rule 502(c) of Regulation D when the fund files Form N-MFP with the SEC and the SEC makes the information available to the public through the SEC's website, so long as it limits the information in Form N-MFP to the required information and does not otherwise use the Form N-MFP filing to offer its securities publicly or to condition the market for the offering of its securities. *See* Form N-MFP Q&A, Question II.G.1. The staff has explained that because Rule 506 is a safe harbor that provides objective standards that an issuer can rely on to meet the requirements of the section 4(2) exemption, a fund following this guidance regarding the use of Form the N-MFP filing should be deemed to comply with the section 4(2) exemption, if it otherwise complies with Rule 506. *Id.* A money market fund that is a feeder fund in a master-feeder structure is not required to disclose the master's portfolio holdings in its Form N-MFP filing; rather, it should disclose the securities that it holds (*i.e.*, the investment in the master fund). *See id.*, Question II.F.

Under Part I, a fund must provide the following information about itself: Securities Act file number; the name and SEC file number of the fund's investment adviser, and if applicable, sub-adviser; information about the fund's independent public account, administrator, if any, and transfer agent; information about its master-feeder structure, if applicable; whether the fund is primarily used to fund insurance company separate accounts; the fund's category (that is, treasury, government/agency, prime, single state fund, or other tax-exempt fund);[227] WAM and WAL;[228] total value of portfolio securities at amortized cost, total value of other assets[229] and liabilities, and net assets; seven-day gross yield; and shadow price.[230] Additionally, the fund must provide the following information for each of its classes: EDGAR class identifier; minimum initial investment; net assets; NAV per share; net shareholder flow activity; seven-day net yield;[231] and shadow price.[232]

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227. Funds must indicate which of these categories most closely identifies them—no other categories may be used. *See* Form N-MFP Q&A, Question II.C.1.

228. A money market fund that is a feeder fund in a master-feeder structure should determine its WAM and WAL for Items 11 and 12 of Form N-MFP in accordance with Rule 2a-7(d)(8). *See* Form N-MFP Q&A, Question II.F.2.

229. The SEC staff has stated that cash holdings with banks should be included with the "total value of other assets" under Item 14 of Form N-MFP and not in the Schedule of Portfolio Securities under Part II of Form N-MFP. *See* Form N-MFP Q&A, Question II.E.

230. A money market fund that is a feeder fund in a master-feeder structure should determine the market value of the underlying security (*i.e.*, the market value of the master fund shares held). If the master fund redeems its shares at $1 per share and the feeder fund reasonably believes that the master fund's shadow NAV is not less than $0.995, then the current market value of each share would be $1. The total value of the security held would be equal to the product of $1 and the number of master fund shares held. *See* Form N-MFP Q&A, Question II.F.2.

231. The SEC staff has stated that a tax-exempt money market fund that holds taxable paper should not adjust the gross yield to reflect federal income taxes that would be imposed on the taxable paper, and that a state tax-exempt money market fund that holds paper from out of state should not adjust the gross yield to reflect state-level taxes that would be imposed on the out-of-state paper. *See* Form N-MFP Q&A, Question II.E.

232. The SEC staff has stated that if a money market fund has classes of shares and its dividend and accounting policies assure that there will be no deviation between the market-based NAVs of the classes of shares offered by the fund, the fund may use the same shadow NAV for each class without a separate calculation. *See* Form N-MFP Q&A, Question II.B.1. A money market fund that is a feeder fund in a master-feeder structure should determine the market value of the underlying security (*i.e.*, the market value of the master fund shares held). If the master fund redeems its shares at $1 per share and the feeder fund reasonably believes that the

Under Part II, a fund must report, with respect to each portfolio security held on the last business day of the prior month: the issuer's name; the issue's title; the security's CUSIP, if any;[233] the category of investment (for example, Treasury debt; commercial paper; certificate of deposit); whether the security is a repurchase agreement;[234] whether the security is a rated First Tier Security, rated Second Tier

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master fund's shadow NAV is not less than $0.995, then the current market value of each share would be $1. The total value of the security held would be equal to the product of $1 and the number of master fund shares held. *See id.*, Question II.F.2.

233. If a CUSIP is not provided, the form asks for other unique identifiers of the security and the CIK of the issuer, if any. *See* Form N-MFP, Items 28–30. In the absence of a CUSIP, if a security is assigned a "dummy" CUSIP (*i.e.*, a random series of digits used internally to identify a particular security), the "dummy" CUSIP should be provided as the other unique identifier. *See* Form N-MFP Q&A, Question II.E.

234. If the security is a repurchase agreement, a fund must indicate whether it is treating the acquisition of the repurchase agreement as the acquisition of the underlying securities (*i.e.*, collateral) for purposes of portfolio diversification under Rule 2a-7, and it must provide additional information regarding the collateral underlying the repurchase agreement. *See* Form N-MFP, Item 32. The SEC staff has stated that if a security is a repurchase agreement and the fund is not treating the acquisition of the repurchase agreement as the acquisition of the underlying securities for purposes of portfolio diversification under Rule 2a-7, the fund must still describe the securities subject to the repurchase agreement. *See* Form N-MFP Q&A, Question II.E. Likewise, funds must describe the securities that are subject to repurchase agreements, even if some repurchase agreements are wholly or partially collateralized by equity securities. The SEC staff has stated that for equity securities, a fund may provide: the filing date instead of the maturity date; "N/A" for coupon or yield; "Other Instrument" for category of investments and a description of the type of equity security (*e.g.*, common, preferred, etc.); and "0.00" for the principal amount. *Id.* If there are more than fifty issuers of the collateral securities, and the fund's board (or its delegate) is not relying on the collateral to make its determination that a repurchase agreement presents minimal credit risks to the fund, the fund may provide the following information *in lieu* of the information required by Items 32a-f: (i) for Item 32a, the fund should select the appropriate range (51–100; 101–500; 501–1,000; or more than 1,000) of the number of issuers of the underlying securities; (ii) for Item 32b, the fund should provide the latest maturity date if the collateral is composed of debt securities; (iii) for Item 32c, the fund should indicate "N/A"; (iv) for Item 32d, the fund should respond "Other Instrument" and provide a brief description of the standard for eligibility of collateral under the repurchase agreement; and (v) for Items 32e and 32f, the fund may provide the information in the aggregate for all of the underlying securities. *Id.* If a security that is subject to a repurchase agreement is a zero coupon bond, the fund could indicate "zero coupon" and not include the yield under Item 32c. *Id.*

Security, an Unrated Security, or no longer an Eligible Security; the name of each Designated NRSRO of the fund and the credit ratings given by them;[235] the maturity date;[236] the final legal maturity date;[237] whether the security has a demand feature, a guarantee, or any other enhancements;[238] the total principal amount;[239] the total current amortized cost;[240] the percentage of the fund's net assets invested in the security;[241] explanatory notes; whether the security is an Illiquid Security; and the market-based value of the security,[242]

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235. As noted above, the SEC staff has issued a no-action letter indicating that they would not recommend enforcement action if a money market fund board does not designate NRSROs, as required under Rule 2a-7, before the SEC has completed the review of Rule 2a-7 required by the Dodd Frank Act and has made any modifications to the Rule. Until then, no fund must respond to Items 34 and 34a of Form N-MFP; alternatively, a fund may respond with "N/A." For Items 37b-c, 38b-c and 39c-d, a fund should respond "N/A" or "none." *See* Form N-MFP Q&A, Question II.E.

236. A money market fund that is a feeder fund in a master-feeder structure should determine the maturity date of the master fund shares it holds in accordance with Rule 2a-7(d)(8). *See* Form N-MFP Q&A, Question II.F.2.

237. A security's final legal maturity date should be the same as the date used to calculate the fund's WAL. *See* Form N-MFP Q&A, Question II.E; *see also* 2010 Adopting Release, *supra* note 4, at n.154. In response to Item 36 of Form N-MFP, the final legal maturity date for shares of a money market fund that is a master fund in a master-feeder structure should be the same as the maturity date reported in Item 35 of Form N-MFP. *See id.*, Question II.F.2.

238. The SEC staff has stated that if a fund is not relying on a demand feature or guarantee to determine the quality, maturity, or liquidity of the security, the fund does not have to provide the information required by Items 37 and 38 for that demand feature or guarantee. *See* Form N-MFP Q&A, Question II.E. A money market fund that is a feeder fund in a master-feeder structure should respond "N" (no) to each item under Items 37 to 39 of Form N-MFP. *See id.*, Question II.F.2.

239. A money market fund that is a feeder fund in a master-feeder structure should report the principal amount of the master fund securities held by the feeder fund. *See* Form N-MFP Q&A, Question II.F.2.

240. A money market fund that is a feeder fund in a master-feeder structure should provide the amortized cost for the master fund shares if the feeder fund uses the amortized cost method of valuation; otherwise, it should indicate "N/A". *See* Form N-MFP Q&A, Question II.F.2.

241. The SEC staff has stated that if a fund is using the amortized cost method of valuation, the percentage of the fund's net assets invested in the security should be based on amortized cost. *See* Form N-MFP Q&A, Question II.E.

242. A money market fund that is a feeder fund in a master-feeder structure must determine the current market value of the security. If the master fund redeems its shares at $1 per share and the feeder fund reasonably believed that the master fund's shadow NAV is not less than $0.995, then the current market value of each share would be $1, and the total value of the security held would be equal to the product of $1 and the number of master fund shares held. *See* Form N-MFP Q&A, Question II.F.2.

including and excluding the value of any capital support agreement.[243]

§ 9:6.2 Advertising

Rule 482 under the Securities Act of 1933, as amended (the "Securities Act"), generally governs a fund's use of "omitting prospectus" advertising,[244] and Rule 34b-1 under the ICA generally governs any sales literature addressed to or intended to be circulated to prospective investors. Under both Securities Act Rule 482 and ICA Rule 34b-1, a money market fund must include a legend in its marketing materials stating that the fund is not insured and that it is possible to lose money investing in the fund.[245]

All advertising materials presenting yield information must contain a quotation of a money market fund's yield computed in accordance with the standardized formula set forth in Form N-1A.[246] Further:

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243. Disclosure of the market values for each security required by Items 45 and 46 must be as of the last Business Day of the month. *See* Form N-MFP Q&A, Question II.A.1. The SEC staff has clarified that the value of a capital support agreement that does not relate to a particular security should not be reflected in the value of any particular security; rather, the value of the support agreement itself (if any, as of the date of valuation) should be disclosed on Form N-MFP, such that each item in Part 2 of Form N-MFP is completed for the capital support agreement, as a separate security. *See id.*, Question II.D.1. If the capital support agreement has a value less than its maximum value (or no value) as of the date of valuation, the capital support agreement should be listed at its current value (or as having a value of zero). *Id.* If an affiliate has agreed to provide sufficient capital up to a maximum to bring a fund's NAV to $.995, such that the value of the capital support agreement will be determined only at such time as a loss is determined, then the value of the support agreement is the amount necessary to bring the fund's shadow NAV up to $.995; in comparison, if the fund's shadow NAV is $.995 or above, then the support agreement has no value for purposes of Form N-MFP. *See id.*, Question II.D.2.

244. Rule 482 provides that advertising meeting the conditions of that rule will be deemed to be a prospectus under section 10(b) of the Securities Act, and thereby permitted for use pursuant to section 5(b)(1) of the Securities Act.

245. Rule 482(b)(4) and Rule 34b-1(a). An additional legend (i) identifying either a toll-free (or collect) telephone number or a website where an investor may obtain performance data, and (ii) disclosing that performance data represents past performance and that current performance may be lower or higher than the performance data quoted, must also be included prominently on advertising or sales literature that contains performance data. Rule 482(b)(3).

246. Rule 482(e)(1) and Rule 34b-1(b)(1)(ii)(A). For instructions on standardized performance calculations for registered investment companies, see Item 21 of Form N-1A.

- quotations of current yield[247] must identify the length of, and the date of the last day in, the base period used in computing the quotations;[248]
- quotations of effective yield may be included in an advertisement or sales literature only if those quotations are accompanied by quotations of the fund's current yield for the same base period, presented in equal prominence with the effective yield presentation;[249]
- quotations of tax-equivalent yield or tax-effective yield in advertisements or sales literature must be accompanied by a quotation of current yield for the same base period, presented in equal prominence with the tax-equivalent or tax-effective yield calculation, and must state the income tax rate used in the calculation;[250] and
- quotations of total return in money market fund advertisements or sales literature are permitted only if they are accompanied by quotations of current yield, with the quotations adjacent to each other and shown in the same type size, and, if there is a material difference between total return and yield, there must be a statement that the yield quotation more closely reflects the current earnings of the fund.[251]

§ 9:7 Suspension of Redemptions

When the Reserve Primary Fund broke the dollar in September 2008, the fund applied to the SEC and obtained an order permitting

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247. "Current yield" for a money market fund is based on income received on a hypothetical investment over a given seven-day period (less expenses accrued during the period), and then "annualized" (*i.e.*, assuming that the seven-day yield would be received for fifty-two weeks, stated in terms of an annual percentage return on the investment). "Effective yield" for a money market fund is calculated in a manner similar to that used to calculate current yield, but when annualized, the income earned is assumed to be reinvested. Effective yield will be slightly higher than the current yield because of the compounding effect of this assumed reinvestment. Only investment income may be included in the yield of a money market fund.
248. Rule 482(e)(1)(i) and Rule 34b-1(b)(1)(ii)(A). Rule 482 generally requires that all performance information must be of the most recent practicable date considering the type of investment company and the media through which the data will be conveyed.
249. Rule 482(e)(1)(ii) and Rule 34b-1(b)(1)(ii)(A). A fund may advertise its current yield without including its effective yield.
250. Rule 482(e)(1)(iii) and Rule 34b-1(b)(1)(ii)(B).
251. Rule 482(e)(2) and Rule 34b-1(b)(1)(ii)(C).

the fund to suspend the right of redemption of its outstanding redeemable securities and to postpone payment for shares that were submitted for redemption for which payment was not made in order to allow for orderly liquidation.[252]

As part of the 2010 Amendments, the SEC adopted Rule 22e-3, which authorizes a money market fund to suspend redemptions and payment of redemption proceeds, if: (a) the fund's Board (including a majority of independent directors) determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results; and (b) the Board irrevocably approves the liquidation of the fund. The Rule also requires that the fund must notify the SEC by electronic mail of its decision before redemptions are suspended.[253] 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. According to the SEC, a money market fund that intends to be able to rely on the new Rule may need to update its prospectus to disclose the circumstances under which it may suspend redemptions.[254]

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252. *See In re* The Reserve Fund, Investment Company Act Release No. 28,386 (Sept. 22, 2008) (order). Because immediate action was required under the circumstances, the SEC issued the order before it provided an opportunity for interested persons to request a hearing, which was subsequently provided in a notice of application on October 24, 2008. *See* The Reserve Fund, Investment Company Act Release No. 28,465 (Oct. 24, 2008) (notice). Other Reserve funds also obtained a similar order from the SEC on October 24, 2008. *See* Reserve Municipal Money-Market Trust, et al., Investment Company Act Release No. 28,466 (Oct. 24, 2008) (order). On November 25, 2009, Reserve received an order from U.S. District Court for the Southern District of New York that provided for a *pro rata* distribution of Reserve's remaining assets. *See* Press Release, The Reserve, Court Issues Order Regarding Securities and Exchange Commission's Proposed Plan for Distribution of Reserve Primary Fund's Assets (Nov. 27, 2009), *available at* http://ther.com/pdfs/Press%20Release_Primary%20Liquidation%20Order_112709_FINAL.pdf.

253. *See* 2010 Adopting Release, *supra* note 4, at section II.H. Temporary Rule 22e-3T under the Treasury's guarantee program for money market funds had provided a similar exemption for funds that participated in that program. The SEC adopted Rule 22e-3T a few days after Reserve broke the dollar and received an order from the SEC to suspend redemptions and postpone payments in the midst of a run on the fund. Rule 22e-3 replaced Rule 22e-3T, which expired in October 2009.

254. *See* 2010 Adopting Release, *supra* note 4, at n.378.

§ 9:8 Processing of Purchases and Redemptions[255]

As amended, Rule 2a-7 requires money market 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 net asset value per share (*i.e.*, not merely at the fund's stable net asset value or price per share).[256] Funds must have this ability in place no later than October 31, 2011.

§ 9:9 Ongoing Developments

§ 9:9.1 PWG Report

On October 21, 2010, the PWG released its long-awaited report on "Money Market Fund Reform Options" (the "Report").[257] The Report stated that the large scale redemptions of money market fund shares in September 2008 underscored the vulnerability of the financial system to systemic risk because the cash needs of money market funds seeking to meet redemptions exacerbated strains in short-term funding markets, which in turn threatened the broader economy. Although the Report acknowledged that the SEC's adoption of amendments to the regulatory structure governing money market funds in 2010 was an important "first-step" in making money market funds more resilient and less risky, it recommended that more be done to address systemic risks and the structural vulnerabilities of money market funds to "runs." To that end, the Report presented several possible

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255. *See* new Rule 2a-7(c)(13).

256. The SEC has noted that the inability of money market funds to price shares in accordance with market values potentially exposes shareholders to unnecessary risks, such as the risk that a fund may not meet its obligation to process redemption requests within seven days. *See* 2009 Proposing Release, *supra* note 3, at section II.G. In the 2009 Proposing Release, the SEC explained that Reserve lacked such operational capacity, and that this limitation resulted in significant delays in satisfying redemption requests after Reserve broke the dollar.

257. *See* Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options (Oct. 2010), *available at* www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf. In 2009, the Department of the Treasury ("Treasury") had proposed that the PWG prepare a report on fundamental changes needed to address systemic risk and to reduce the susceptibility of money market funds to runs. *See* Department of the Treasury, Financial Regulatory Reform: A New Foundation (2009), *available at* www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

reform options for consideration by the Financial Stability Oversight Council (FSOC) that was established in 2010 by the Dodd-Frank Act and asked the FSOC to pursue those most likely to reduce money market funds' susceptibility to runs:[258]

- floating net asset values;
- privately sponsored emergency liquidity vehicles;
- mandatory redemptions in-kind;
- insurance for money market funds;
- a two-tier system providing enhanced protections for stable NAV money market funds;
- a two-tier system reserving stable NAV money market funds solely for retail investors;
- regulating stable NAV money market funds as special purpose banks; and
- enhancing constraints on unregulated money market funds substitutes.

Although the Report discussed various reform options for the FSOC to consider, it did not recommend any particular reform. Many had expected the Report to propose that money market funds adopt floating NAVs—a proposal strongly resisted by the mutual fund industry and issuers of short-term debt, among others.[259] Not only did the Report acknowledge several concerns with the floating NAV option, it also spoke favorably about an industry-supported plan to provide money market funds with access to a privately sponsored emergency liquidity vehicle.

§ 9:9.2 SEC Roundtable

On May 10, 2011, the SEC held a webcast roundtable discussion regarding money market funds and systemic risk, which was moderated by Director Eileen Rominger and Associate Director Robert

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258. To assist the FSOC with its analysis of these options, the SEC solicited public comment on the Report. *See* President's Working Group Report on Money Market Fund Reform, Investment Company Act Release No. 29,497 (Nov. 3, 2010). Comments were due January 10, 2011.

259. *See* Group of Thirty, Financial Reform: A Framework for Financial Stability (2009), *available at* www.group30.org/pubs/reformreport.pdf. This publication criticized money market funds, specifically expressing disapproval of the amortized cost pricing concept. The report was a product of a study done by the G30, which at the time was led by Paul Volcker, now the chairmen of the President's Economic Recovery Advisory Board and an advisor to the PWG.

Plaze.[260] Participants included the SEC Commissioners, FSOC representatives, academics, and professionals from the investment management industry. During the three-hour roundtable, the moderators and participants engaged in a discussion of the money market fund industry generally and the systemic risk inherent in the industry specifically. The informal nature of the roundtable permitted the participants to offer their thoughts and opinions on such issues as the factors that led to the run on money market funds in 2008 and the potential consequences of implementing proposed changes to address systemic risk.

With respect to the potential for money market funds to pose systemic risk to broader markets, the participants discussed what makes money market funds vulnerable to runs, and how the role of money market funds in the short-term funding market should be viewed through the prism of systemic risk analysis. With respect to regulatory options and their implications, the participants discussed whether floating NAV would reduce money market funds' susceptibility to runs and how they expected investors' behaviors to change. The participants then discussed the strengths and weaknesses of hybrid approaches to regulation, including a private liquidity bank (providing liquidity), mandatory reserve/capital requirements (withstanding credit events),[261] and liquidity fees (capital provided by managers or third parties).

§ 9:9.3 ICI Summit

On May 16, 2011, the ICI held its 2011 Money Market Funds Summit, which was divided into four panels. The first panel, entitled "Money Markets Today: Moving Past the Financial Crisis," included a discussion of such topics as an evaluation of the money markets since the financial crisis, the impact of low interest rates on short-term investing, the role of the money markets in corporate cash management, the importance of the money markets to the U.S. Treasury, state and local governments, among others, and the impact of Basel III and Tri-Party Repo reforms. Topics covered during the second panel, entitled "Understanding the Global Money Market Fund Industry," included an evaluation of cash management alternatives to money market funds and changes in money market fund rating criteria. The

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260. For a recording of the webcast, a copy of the unofficial transcript, and related materials, see SEC, Roundtable Discussion on Money Market Funds and Systemic Risk Page, *available at* http://sec.gov/spotlight/mmf-risk.htm.

261. For a discussion of some of the capital support proposals that have been suggested by industry members and others, see *Money Market Funds—What's Next?*, 18 INV. LAW. (June 2011).

third panel, entitled "Money Market Fund Regulatory Changes Post Financial Crisis," concentrated on the regulatory changes that the recent crisis created, the changes to Rule 2a-7 that ensued, and the impact on portfolio management decisions. The last panel, entitled "What's Next for Money Market Funds," discussed options for possible further reforms. The Summit emphasized the importance of money market funds to 35 million American households and thousands of corporate and government clients, that investors continue to trust money market funds as a secure and diversified option for their cash despite a challenging environment and near zero yields, and that Stable NAV is an indispensable, core characteristic of money market funds.

§ 9:9.4 FSOC 2011 Annual Report

On July 26, 2011, FSOC issued its 2011 Annual Report.[262] The Dodd-Frank Act requires the FSOC to make annual recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; to promote market discipline; and to maintain investor confidence.[263] To fulfill these requirements, the FSOC recommended in its report, among other things, to:

> Implement structural reforms to mitigate run risk in money market funds. When the SEC adopted new rules for money market funds (MMFs) in February 2010, it noted that a number of features still make MMFs susceptible to runs and should be addressed to mitigate vulnerabilities in this market. To increase stability, market discipline, and investor confidence in the MMF market by improving the market's functioning and resilience, the Council should examine, and the SEC should continue to pursue, further reform alternatives to reduce MMFs' susceptibility to runs, with a particular emphasis on (1) a mandatory floating net asset value (NAV), (2) capital buffers to absorb fund losses to sustain a stable NAV, and (3) deterrents to redemption, paired with capital buffers, to mitigate investor runs.[264]

The report stated that the run on money market funds in 2008 added considerably to market stress during the financial crisis, and that some of the key features of money market funds that made them susceptible to runs remain today.[265] The report also stated that:

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262. *See* Financial Stability Oversight Council, 2011 Annual Report, *available at* www.treasury.gov/initiatives/fsoc/Pages/annual-report.aspx.
263. *See id.* at 11.
264. *See id.* at 13.
265. *See id.* at 50.

> One of the key factors that contributed to the financial crisis was insufficient analysis and management of liquidity risk by participants in short-term money markets. During the crisis, weaknesses in the liquidity risk profiles of financial institutions became evident and required a significant expansion of government support that went well beyond the traditional safety net extended to regulated depository institutions. . . . Exposure of these weaknesses has given financial institutions and market participants a better understanding of the vulnerabilities in these markets and, in particular, of the importance of liquidity risk management.[266]

§ 9:10 Conclusion

For more than thirty years, money market funds have been successful financial intermediaries, making short-term capital from investors available to a broad range of corporate and government borrowers. Recent market illiquidity has emphasized that money market funds present investment risks, which need to be fully disclosed to, and understood by, investors. Such disclosure, combined with more stringent investment standards, as suggested by the Investment Company Institute and ultimately adopted by the SEC, should ensure that the success of money market funds will be able to continue.

The SEC and other agencies that participate in the President's Working Group on Financial Markets are continuing to examine the money market fund model to determine if further changes are necessary. In her introductory remarks at the open meeting related to the 2010 Amendments, SEC Chairman Schapiro pledged that the SEC will continue to pursue more fundamental changes to the structure of money market funds to protect them from the risk of broad-based, large-scale redemptions.[267] Possible reforms under

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266. *See id.* at 86. Under section 113 of the Dodd-Frank Act, the FSOC can recommend that agencies tighten rules to reduce risk not only at banks, but also at non-bank financial institutions; however, section 113 does not specify how the FSOC intends to apply the criteria set forth therein when analyzing whether a particular company should be designated as a systemically important financial institution (SIFI). *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, Letter from the ICI, to the FSOC (Feb. 25, 2011), *available at* www.ici.org/pdf/24994.pdf. Consequently, some commenters have suggested that certain money market funds should be designated as SIFIs. *Id.* In its letter, the ICI has carefully explained why such designation would not be an appropriate regulatory tool for further strengthening the resilience of money market funds to severe market distress. *Id.*

267. Section 2(c) of the ICA requires the SEC to consider whether any potential rulemaking will promote efficiency, competition and capital formation, in addition to considering whether the rulemaking is consistent with the public interest and the protection of investors.

consideration include: replacing the stable $1 share price with a floating net asset value; requiring money market funds to satisfy large redemption requests through in-kind redemptions; requiring money market funds to disclose "shadow NAV" on a real-time basis; creating a private liquidity facility to provide liquidity to funds during times of stress; and creating a two-tiered system for money market funds, with a stable net asset value permitted only for money market funds subject to greater risk-limiting provisions and liquidity facility requirements.[268]

The current regulatory environment facing money market funds is perhaps best summarized in the following remark that ICI's Chairman Edward C. Bernard made at the 2011 ICI summit:

> It's been thirty-two months, to the day, since the Reserve Primary Fund broke the dollar, and we've been working nearly every day since then toward finding the balance that Secretary Geithner described (referring to Secretary Geithner's statement at ICI's General Membership meeting in May 2011 that the challenge is to figure out how to bring a little bit more resilience into the money market funds system without depriving the economy of the broader benefits that money market funds provide). Our industry and our financial regulators have devoted enormous resources to the hunt for solutions. We've considered a wide range of ideas, but there's still no consensus on any proposal that will give us all comfort that we can take the next step, without undermining the significant economic and investor benefits that money market funds provide. That's true even after the President's Working Group and the Securities and Exchange Commission's Roundtable.

As the debate on further reforms to money market funds persists, the industry continues to play a critical role in the U.S. economy, providing short-term funding to corporate issuers, state and local governments, and the U.S. government. The importance of this role, and the potential negative consequences of taking the wrong regulatory steps, must be taken into account by the SEC[269] and others as they work through any possible changes to the regulatory structure.

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268. *See* Mary L. Schapiro, Statement on Money Market Funds at the Open Commission Meeting (Jan. 27, 2010), *available at* http://sec.gov/news/speech/2010/spch012710mls-mmf.htm.

269. Chairman Shapiro reiterated this pledge at the SEC's 2011 money market funds roundtable, stating that "more needs to be done to better protect money market funds and the broader financial system from the destablizing risk that can result from a broad money market fund run." *See* SEC, Unofficial Transcript: Roundtable on Money Market Funds and Systemic Risk (May 10, 2011), *available at* http://sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm.