

SEC Adopts Money Market Fund Reforms

On February 23, 2010, the SEC issued a final rule release (Adopting Release) adopting important changes to the rules governing money market funds (MMFs) under the Investment Company Act of 1940. In a release issued June 30, 2009 that proposed the amendments (Proposing Release), the SEC stated that the proposed amendments were a step towards addressing the concerns that it identified when reviewing the regulation of MMFs following the market disruptions of the past several years, in particular, protecting MMF investors in times of financial market turmoil and lessening the possibility that the MMF industry would not be able to withstand stresses similar to those experienced in 2007 and 2008. The SEC was also concerned with reducing the systemic risk to which MMFs are exposed, in particular, the risk that a run on one MMF can lead to runs on other MMFs. Additionally, due to the vital role that MMFs play in the short-term capital markets, a role that has grown substantially during the previous decade, the SEC sought to preserve and improve the health of MMFs to help ensure that they will continue to be able to provide a source of short-term capital to the large number of businesses and state and local governments that finance current operations through the issuance of short-term debt.

Although many of the SEC's original proposals were adopted substantially as proposed (for further information on the proposed rules, please see our [July 7, 2009](#) alert), a number of significant changes were made. Consistent with the proposed rules, the final rules address three general areas of reform: tightening risk-limiting restrictions on MMFs, increasing disclosure requirements, and addressing operational considerations. The final rules are meant to reduce risks associated with the liquidity, credit quality, and maturity aspects of an MMF's portfolio and require MMFs to anticipate large redemptions, periodically test the stability of an MMF's net asset value (NAV), and designate at least four nationally recognized statistical rating organizations (NRSROs) whose credit ratings the MMF would look to for determining whether a security is an "eligible security" under Rule 2a-7. Additionally, the rules require monthly disclosure and SEC reporting of an MMF's investment portfolio. Although the amended rules continue to permit MMFs to maintain a stable \$1.00 NAV through the use of the amortized cost or penny rounding methods, the rules require monthly reporting to the SEC of an MMF's mark-to-market (or "shadow") NAV, with the information to be disclosed to the public after a 60-day delay. Lastly, the rules permit an MMF's board to suspend redemptions if it determines that the MMF's NAV per share is at imminent risk of falling below \$1.00 (*i.e.*, "breaking the buck") or the MMF's NAV per share has fallen below \$1.00, and provide more flexibility to allow affiliates to purchase distressed securities from an MMF to protect it from losses. The SEC indicated that money market fund reform is not finished and that it will consider further reforms in the future. See "Future Reform" below.

A brief summary of the final rules can be found below. The text of the final rules may be found at the SEC's website at: <http://www.sec.gov/rules/final/2010/ic-29132.pdf>.

Risk Limiting Restrictions on Money Market Funds

Portfolio Quality

Final Rule 2a-7 restricts an MMF from investing more than 3% of its total assets in "second tier securities," defined as securities with the second highest short-term debt rating from an NRSRO or securities determined by the MMF's board to be of comparable quality. The current limit is 5%. Although the

proposed amendments to Rule 2a-7 would have entirely prohibited MMFs from purchasing second tier securities, the SEC was persuaded by commenters that such a prohibition would not be justified on a cost-benefit basis, due to, among other reasons, the potential negative impact on the diversification of MMF portfolio holdings, the potential negative impact on issuers of second tier securities, and the availability of high-quality second tier securities that may provide a higher yield than first tier securities while still maintaining an appropriate risk profile. The final rule also restricts an MMF from investing more than 0.5% of its total assets in second tier securities issued by a single issuer, while Rule 2a-7 currently sets this limit at the greater of 1% of the MMF's total assets or \$1,000,000. Additionally, the final rule proportionately reduces by half the ability of an MMF to acquire "demand features" or "guarantees" of a single issuer that are second tier securities, lowering the limit from 5% to 2.5% of the MMF's total assets. Lastly, under the final rule, an MMF is restricted from buying second tier securities with a remaining maturity of more than 45 days, down from 397 days under the current rule.

Reliance on NRSROs

Although the Proposing Release requested comment on possible alternatives to Rule 2a-7's current requirements with respect to MMFs' reliance on credit ratings provided by NRSROs, the final rule continues to rely heavily on NRSRO ratings by, for example, continuing to define "eligible security" as a security that has been rated in either of the two highest short-term debt ratings categories. The final rule also adds a new requirement that the board of an MMF designate four or more NRSROs that the board determines provide reliable ratings for the purposes of determining whether a security is an eligible security under Rule 2a-7 and requires the MMF's board to determine annually that each designated NRSRO issues credit ratings that are "sufficiently reliable" for such use. For these purposes, the SEC acknowledged that an MMF's board will largely base its decisions on recommendations by the MMF's adviser; however, the Adopting Release states that the rule changes place the ultimate responsibility on MMF boards. According to the Release, MMF board designations and determinations will serve as a check on MMF advisers that may have conflicts of interest in selecting an NRSRO from which the adviser seeks a rating for the MMF or an NRSRO that may accommodate the MMF's investment in higher yielding, riskier securities. Requiring such designations will also, according to the SEC, foster greater competition among NRSROs to produce the most reliable ratings in order to obtain designation by MMF boards. The designated NRSROs must be disclosed in the Statement of Additional Information of an MMF's registration statement.

An MMF may look to only the designated NRSROs to determine whether a security is a rated security, whether a rated security is an eligible security, and whether it is a first tier or a second tier security. For example, if a security is rated as a first tier security by two NRSROs, only one of which is a designated NRSRO, and is rated as a second tier security by another designated NRSRO, the security is a "split-rated" security and thus must be considered a second tier security. Additionally, if a security or its issuer has not been rated by one of the designated NRSROs, the security is an "unrated security" under the final rule, and the MMF's adviser must determine that the security is comparable to a rated eligible security before the MMF can acquire the security. Subsequent to an MMF acquiring a security, the MMF's adviser must monitor only the ratings of designated NRSROs in determining whether a change in ratings requires the board to reassess the MMF's holding of that security. Changes in an MMF's designated NRSROs may affect the ability of an MMF to purchase a new security or roll over a current holding, may require the MMF to reassess promptly whether the security continues to present minimal credit risks, and may require an MMF to dispose of a current holding. A new designation of an NRSRO or a removal of a designated NRSRO is treated under the amended rule as the equivalent of a credit event requiring the MMF's board or adviser to consider the rating of the newly designated NRSRO. The amended rules allow a board to designate NRSROs only with respect to certain types of issuers or securities so that, for example, a board could designate an NRSRO that specializes in securities issued by insurance companies or banks.

The final rule eliminates the current requirement that an asset-backed security (ABS) be rated by an NRSRO to be an eligible security and requires only that an ABS meet the requirements of Rule 2a-7, including the unrated security requirements, in order to be an eligible security. The Adopting Release stated that before an MMF may

acquire an ABS, the MMF's board (or its delegate) should analyze the underlying ABS assets to ensure they are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS, analyze the terms of the liquidity or other support provided by the sponsor of the ABS, and conduct the credit, structural, and legal analyses required to determine whether the ABS involves appropriate risks for the MMF.

Portfolio Maturity

Consistent with the proposed amendments, final Rule 2a-7 shortens the maximum dollar-weighted average portfolio maturity (WAM) of MMFs from 90 days to 60 days. According to the Adopting Release, this change is intended to result in MMFs that are more resilient to changes in interest rates that may be accompanied by other market shocks and thus reduce the likelihood of a “run.” To calculate the WAM, an MMF may treat a variable- or floating-rate security as having a maturity equal to the time remaining to the security's next interest rate reset date rather than the time remaining to the security's actual maturity date. Therefore a 60-day limit would be calculated using such security's “shortened” maturity dates, according to the Adopting Release. The SEC noted that a 60-day limit is more consistent with current industry practice as well as with practice by European MMFs. For example, as noted in the Adopting Release, the Institutional Money Market Fund Association (IMMFA) funds, which manage a significant amount of stable value MMF assets in Europe, have been required to maintain a maximum WAM of 60 days since 2002, and recent proposals by the European Union's Committee of European Securities Regulators (EUCESR) to create common requirements for European MMFs would impose a maximum 60-day WAM for short-term MMFs.

The final rule also imposes a maximum 120-day dollar-weighted average life to maturity (WAL). Unlike the WAM, the WAL of a portfolio is measured without reference to any Rule 2a-7 provisions that otherwise permit an MMF to shorten the maturity of an adjustable-rate security by reference to its interest rate dates, *i.e.*, without using a security's “shortened” maturity dates.¹ Rule 2a-7 does not currently impose a WAL restriction on an MMF's portfolio, meaning that an MMF is not required to consider a variable- or floating-rate security's actual maturity date. The final rule therefore limits the current ability of an MMF to invest in longer term adjustable-rate securities. The new WAL requirement is intended to limit the spread risk (*i.e.*, the risk associated with widening credit spreads) to which an MMF may be exposed, which is greater for longer-term adjustable-rate securities. The Adopting Release noted that the IMMFA recently adopted changes to its code of conduct that will require a maximum 120-day WAL, and that recent proposals by the EUCESR would also impose a maximum 120-day WAL for short-term MMFs.

Portfolio Liquidity

The amendments to Rule 2a-7 impose new limitations on an MMF's ability to acquire illiquid securities as well as new daily, weekly, and general liquidity requirements. The final rule defines the term “illiquid security” as any security that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the MMF. According to the Adopting Release, the ascribed value is determinative because this value is the measure that ultimately justifies the MMF's use of a stable NAV. Therefore an MMF should treat as illiquid any security that cannot be sold at a price approximating its market-based value, as determined by the fund, rather than look to its amortized cost to make this determination. The final rule prohibits an MMF from acquiring an illiquid security if, after purchase, more than 5% of the MMF's total assets would be comprised of illiquid securities. Although the amendments lower Rule 2a-7's current 10% limitation on illiquid securities, the proposed rule would have prohibited the acquisition of illiquid securities altogether.

The new rules also require MMFs to keep specified percentages of their portfolios in securities that are readily convertible to cash. The final rule requires *taxable* MMFs to hold at least 10% of their assets in “daily liquid assets.”

¹ For purposes of both the WAM and WAL limitations, cash balances have a maturity of one day.

which include cash (including demand deposits), direct obligations of the U.S. Government,² and securities (including repurchase agreements) that are convertible into cash within one business day, and requires *all* MMFs to hold at least 30% of their assets in “weekly liquid assets,” which include cash, direct obligations of the U.S. Government, agency discount notes with remaining maturities of 60 days or less, and securities that are convertible into cash within five business days. An MMF must be in compliance with the liquidity standards immediately after a security is acquired. Tax-exempt MMFs are not subject to the daily liquidity requirements.

The proposed rule would have imposed different daily and weekly liquidity requirements on “retail” MMFs and “institutional” MMFs. However, lacking support from the industry and lacking an effective way to distinguish between those types of MMFs, the SEC instead adopted a single threshold for all taxable MMFs and another threshold for all MMFs. The SEC did indicate a willingness to revisit the topic in a subsequent rulemaking.

The daily and weekly liquidity requirements notwithstanding, the final rule adopts, as proposed, a general liquidity requirement that an MMF hold sufficient liquid assets to meet reasonably foreseeable shareholder redemptions in light of the MMF’s obligations under Section 22(e) of the 1940 Act and any commitments the MMF has made to its shareholders (such as an agreement to pay redemption proceeds within a set number of days). Although amended Rule 2a-7 does not specifically require the adoption of policies and procedures related to the general liquidity requirement, in the Adopting Release the SEC stated that it believes that MMFs are required by Rule 38a-1 to develop “know your investor” policies and procedures that allow them to identify investors whose redemption requests may pose risks for the MMF, and that an MMF’s board should make sure that the MMF’s adviser is monitoring and planning for “hot money.” The SEC further emphasized that MMF boards should appreciate the potential conflicts between an MMF’s adviser’s interest in attracting additional fund assets and its duty to manage the MMF in a manner consistent with maintaining a stable NAV. The SEC also suggested that MMFs take steps to identify the risk characteristics of shareholders investing through omnibus accounts or portals, such as making contractual arrangements with their financial intermediaries to better monitor client profiles.

Periodic Stress Tests

Final Rule 2a-7 adds a requirement that an MMF’s board adopt written procedures that provide for periodic stress testing of the MMF’s portfolio to be conducted at intervals the MMF’s board determines to be appropriate and reasonable in light of current market conditions. The stress tests must assess an MMF’s ability to maintain a stable NAV per share based on specified hypothetical events that include at least the following: a change in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark the MMF has selected for overnight interest rates and commercial paper and other types of securities held by the MMF. The MMF’s board must receive reports on the results of such testing, as well as an assessment by the MMF’s adviser of the MMF’s ability to withstand events reasonably likely to occur within the following year (including concurrent occurrences of these events). The reports must also include the dates on which the MMF’s portfolio was tested and the magnitude of each hypothetical event that would cause the MMF to break the buck. The SEC noted that the final rule does not specifically require the board to design the stress tests and stated that each board may consider the extent to which it wishes to become involved in the design of the stress tests.

Repurchase Agreements

Final Rule 2a-7, consistent with the proposed amendments, allows an MMF to “look through” the repurchase agreement counterparty and instead consider the underlying collateral for purposes of determining compliance with Rule 2a-7’s diversification requirements only when the collateral consists of cash items or Government securities.

² The list of securities that are “direct obligations of the U.S. Government” does not include all Government Securities as such term is defined in the 1940 Act. For example, many agency securities are not direct obligations of the U.S. Government.

This amendment eliminates the ability of an MMF to look through when the collateral is highly rated, non-Government securities. Furthermore, to take advantage of the look through treatment, the MMF's board or its delegate must evaluate the creditworthiness of the counterparty to the repurchase agreement, even if the repurchase agreement is fully collateralized by cash or Government securities.

Increased Disclosure Requirements

Monthly Website Posting

The amendments to Rule 2a-7 add a requirement that an MMF post portfolio holdings information, current as of the last business day of the previous month, on its website no later than the fifth business day of each month (rather than, as proposed, the second business day of each month). With respect to each security held, an MMF will be required to disclose (i) the name of the issuer; (ii) the category of investment (*e.g.*, Treasury debt, government agency debt, asset backed commercial paper, structured investment vehicle note, repurchase agreement); (iii) the CUSIP number; (iv) the principal amount; (v) the maturity date as determined under Rule 2a-7 for the purposes of calculating WAM; (vi) the final maturity date; (vii) coupon or yield; and (viii) the amortized cost value. The MMF must also disclose the overall WAM and WAL of its portfolio. The rule requires an MMF to maintain such information on its website for at least six months, shortening the proposed rule's requirement of 12 months.

Monthly Reporting to the SEC

In addition to the monthly website posting requirement, new Rule 30b1-7 requires an MMF to file with the SEC on new Form N-MFP a detailed portfolio holdings report disclosing information about each portfolio security current as of the last business day of the previous month, no later than the fifth business day of each month (rather than, as proposed, the second business day of each month). MMFs must report on Form N-MFP the following information for each security held: (i) the name of the issuer; (ii) the title of the issue, including the coupon or yield; (iii) the CUSIP number; (iv) the category of investment; (v) the NRSROs designated by the MMF, the credit ratings given by each NRSRO, and whether each security is first tier, second tier, unrated, or no longer an eligible security; (vi) the maturity date as determined under Rule 2a-7, taking into account the maturity shortening provisions of Rule 2a-7(d); (vii) the final legal maturity date, taking into account any maturity date extensions that may be effected at the option of the issuer; (viii) whether the instrument has certain enhancement features (*e.g.*, a "demand feature" or "guarantee"); (ix) the principal amount; (x) the current amortized cost value; (xi) the percentage of the MMF's assets invested in the security; (xii) whether the security is an illiquid security (as defined in amended Rule 2a-7(a)(19)); and (xiii) "Explanatory notes" (*i.e.*, any other information that may be material to other disclosures related to the security). The report must also include information about the MMF, including the MMF's WAM, WAL and seven-day gross yield. In addition, this monthly report must include market-based values for each portfolio security as well as the MMF's market-based (*i.e.*, "shadow") NAV per share, in each case with separate entries for values that do and do not take into account any capital support agreements.

The information reported on Form N-MFP, which will be filed via the EDGAR system, will be made available to the public 60 days after the end of the month to which the information pertains. MMFs are currently required to report schedules of investments quarterly and shadow NAVs only semiannually, with such reports generally available to the public within 60 days after the end of the reporting period. The SEC acknowledged commenters' concerns about the possible destabilizing effects on MMFs of requiring disclosure of the market-based values of portfolio securities and of MMF NAV per share; however, the SEC concluded that shareholders will benefit from knowing this information, because it will help investors make better informed decisions, indicate the extent to which an MMF is managing its portfolio to maintain a stable NAV, and indicate the risks in an MMF's portfolio. In addition, reports on Form N-MFP will, according to the SEC, provide it with information it can use to create a database with which it can better oversee the activities of MMFs. The first mandatory filing will be due on December 7, 2010 for holdings as of the end of November 2010. However, the SEC staff will accept non-public "trial data" starting on

October 7, 2010 in order to give MMFs the opportunity to develop reporting procedures. The SEC stated that it does not intend to make the trial data public.

Phasing Out Weekly Reporting by Certain MMFs

The SEC is amending temporary Rule 30b1-6T so that the rule, which requires any MMF with a shadow NAV below \$0.9975 per share to provide the SEC with a weekly report containing portfolio and valuation information, will expire on December 1, 2010 rather than September 17, 2010. The extension of Rule 30b1-6T ensures that there is no gap between the expiration of the rule and the compliance date for new Rule 30b1-7.

New Operational Considerations

Processing of Transactions

Similar to the proposed amendments, the amendments to Rule 2a-7 require an MMF or its transfer agent to have the capacity to process purchases and redemptions at a price based on an NAV per share other than \$1.00. Basically, the SEC wants to ensure that an MMF has the operational capacity to process investor transactions in an orderly manner even if the MMF breaks the buck. The proposed amendments would have required an MMF's board to determine that the MMF had such capacity, but the SEC decided that the focus of the rule should be on the MMF's ability to process transactions rather than on the board's determination of that ability.

Purchases by Affiliates

Consistent with the proposed amendments, final Rule 17a-9 is amended to allow an affiliate of an MMF to purchase from the MMF an otherwise eligible security that has defaulted. Under the current rule, an affiliate may purchase a security only if it is no longer an eligible security (*e.g.*, a security that has been downgraded). Under the amended rule, the purchase price must be paid in cash and be equal to the greater of the security's amortized cost or its market value, including accrued interest. Additionally, the final rule permits an affiliate of an MMF to purchase other (*i.e.*, eligible) securities from the MMF for cash at the greater of amortized cost or market value, so long as such affiliate promptly remits to the MMF any profit it realizes from the later sale of the security. These amendments are intended to permit MMFs to dispose of distressed securities (*e.g.*, securities depressed in value as a result of market conditions or other events) quickly during times of market stress. An amendment to Rule 2a-7 requires the MMF to promptly notify the SEC by e-mail of such affiliated purchases and include identification of the security, its amortized cost, the sale price and the reasons for such purchase.

Fund Liquidation

To facilitate the orderly liquidation of an MMF, final Rule 22e-3 permits an MMF to suspend redemptions if (i) the MMF's board, including a majority of disinterested directors, determines that the deviation between the MMF's amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results to investors or existing shareholders; and (ii) the MMF's board, including a majority of the disinterested directors, has irrevocably approved the liquidation of the MMF. In a deviation from the proposed rule, the SEC added the requirement that an MMF's board's approval of a liquidation be irrevocable, but allowed MMF boards to make a determination to rely on this rule in order to liquidate an MMF prior to the MMF actually breaking the buck and repricing its shares. The result is that an MMF's board must make the same determination that it would make it if were deciding to break the buck pursuant to current Rule 2a-7(c)(7)(ii)(C) (which allows the board, if it believes that the extent of any deviation from an MMF's amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, to cause an MMF to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results). While an MMF will not be required to request an order from the SEC to suspend redemptions, the final rule requires an MMF to notify the SEC before relying on this rule. The SEC could rescind or modify the ability to suspend

redemptions in certain instances to protect MMF shareholders. The new rule extends similar relief to a conduit fund (*i.e.*, a fund that invests in an MMF in reliance on Section 12(d)(1)(E) of the 1940 Act) that owns shares of an MMF that has suspended redemptions pursuant to the new rule. Rule 22e-3 replaces Rule 22e-3T, which expired on October 18, 2009.

Compliance Dates; Going Forward

The final rules take effect on May 5, 2010, and MMFs must comply with the amended rules on and after such date, except as stated below. Amendments to Rule 2a-7 pertaining to portfolio quality, liquidity, maturity, and repurchase agreements must be complied with by May 28, 2010. MMFs must meet the new maximum WAM and WAL limits by June 30, 2010. The compliance date for the new public website disclosure requirements is October 7, 2010, and MMFs do not need to disclose their designated NRSROs until December 31, 2010. MMFs or their transfer agents must have the capacity to redeem and sell securities at a price equal to their current NAV per share (including at prices that do not correspond to the stable NAV or price per share) by October 31, 2011. According to the SEC, MMFs that have fundamental policies that require a shareholder vote to be changed as a result of the amendments do not need to seek shareholder approval merely to cause the policies to be consistent with the amendments, as long as any existing policy is less restrictive than the amendments and does not conflict with the amendments.

Although members of the SEC staff have indicated in the past that it would be desirable if investment company boards generally could focus less on routine matters that can be handled by fund advisers, the amendments the SEC adopted impose a number of new requirements on MMF boards. For example, in addition to their current responsibilities, going forward, boards will be required to designate and make determinations regarding NRSROs each year; adopt new “know your investor” procedures; adopt stress testing procedures, determine the intervals at which tests should be conducted, and review the reports on the results of each stress test conducted; and evaluate (or delegate the evaluation of) the creditworthiness of each counterparty to a repurchase agreement where “look through” treatment is desired. Boards will need to think carefully about how to balance these new duties along with their existing responsibilities.

Future Reform

The SEC adopted the final rules by a vote of 4 to 1, with Commissioner Kathleen L. Casey dissenting, stating that the amendments do not go far enough to reform current money market fund rules. Two of her primary concerns, both of which were echoed by other commissioners, were that the amended rules do not require MMFs to use a floating NAV, which would “unyoke” MMFs from one another, and that monthly shadow NAV information on a 60-day delay is insufficient to alert investors to the risks of investing in MMFs. Commissioner Casey also commented that she believes that the continued use of NRSROs is ineffective and runs counter to the lessons learned from the recent financial crisis that exposed the dangers of relying on NRSROs’ ratings. Using NRSROs, she noted, continues to leave the system “open for gaming.”³

The SEC has emphasized its commitment to further money market fund reform, noting that it plans to propose further reforms in the future. Chairman Mary L. Schapiro highlighted several priorities for the SEC to consider going forward, including (i) moving to a floating NAV; (ii) mandatory redemptions-in-kind for large redemptions; (iii) real-time disclosure of shadow NAVs; (iv) requiring MMFs to arrange for private liquidity facilities to provide liquidity to MMFs in times of stress; and (v) a possible “two-tiered” system of MMFs, with a stable NAV allowed only for MMFs subject to greater risk-limiting conditions.

If you would like to learn more about the issues raised in this alert, please contact your usual Ropes & Gray adviser.

³ Legislative reform proposed by the United States House of Representatives also has the potential to affect MMFs’ reliance on NRSROs. The Wall Street Reform and Consumer Protection Act of 2009, approved by the House of Representatives on December 11, 2009, would, if adopted, remove statutory references to credit ratings from certain sections of the 1940 Act and other Federal securities laws, and require applicable Federal agencies, including the SEC, to remove any references to credit ratings in their regulations.