SEC Proposes Money Market Reforms

The Securities and Exchange Commission is proposing several amendments and new regulations (Amendments) to rules governing money market funds (MMFs). The proposals are summarized below, along with certain of the SEC's more significant requests for comment.

Portfolio Quality

The Amendments would redefine "eligible securities" to include only securities with the highest short-term debt ratings from the "Requisite NRSROs" (and unrated securities determined to be of comparable quality), eliminating MMFs' ability to invest in second-tier securities. Consistent with this approach, the Amendments would require an MMF's board to reassess whether an unrated security continues to present minimal credit risks only if the MMF's adviser becomes aware that such security has received a rating below the highest short-term rating category.

The Amendments would permit an MMF to acquire a long-term security that has a remaining maturity of 397 calendar days or less and that lacks a short-term rating only if the security has received a long-term rating in one of the highest two rating categories. The current rule allows such investments unless the security has received a long-term rating below the three highest rating categories.

Portfolio Maturity

The Amendments would impose new weighted average portfolio maturity limits of 60 days (calculated using portfolio securities' interest reset dates) and 120 days (calculated without regard to such interest reset dates). The former limit reflects a reduction from 90 days; the latter limit is new. The Amendments also would eliminate the ability of MMFs that rely exclusively on the penny-rounding method of pricing to acquire Government securities with remaining maturities of up to 762 days.

Portfolio Liquidity

The Amendments would prohibit an MMF from acquiring any illiquid security and would impose certain new daily, weekly and general liquidity requirements. The Amendments would require that at least 5% of a taxable retail MMF's assets, and at least 10% of a taxable institutional MMF's assets, consist of cash, direct obligations of the U.S. Government and securities for which the MMF has a contractual right to receive cash within one business day. The Amendments also would require that at least 15% of a retail MMF's assets, and at least 30% of an institutional MMF's assets, consist of cash, direct obligations of the U.S. Government and securities for which the MMF has a contractual right to receive cash within five business days. All such percentages would be measured at the time of purchase, though the SEC requests comment regarding whether the daily liquidity requirement should be ongoing.

An MMF's board would be required to determine at least annually whether the MMF is a retail fund or an institutional fund based on the nature of the record owners of the MMF's shares, the MMF's minimum initial investment requirements and the historical and expected cash flows from purchases and redemptions. Tax-exempt MMFs would not be subject to the daily liquidity requirements. The Amendments also would require that an MMF at all times hold liquid securities sufficient to meet reasonably foreseeable redemptions in light of Section 22(e) and any commitments the MMF has made to pay redemptions more quickly than seven days. Although the Amendments do not specifically require policies and procedures, the release states that an MMF should adopt policies and procedures to ensure that appropriate efforts are undertaken to identify the risk characteristics of its shareholders—particularly those investing through omnibus accounts or portals.

In addition to the foregoing liquidity requirements, the Amendments would require written procedures for periodic "stress testing"—at intervals the MMF board determines to be reasonable—of the MMF's ability to maintain a stable net asset value per share based upon specified hypothetical events, which must 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 written procedures also must provide for a report to the MMF's board 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.

Miscellaneous Matters

Portfolio Holdings Disclosure. The Amendments would require an MMF to post its schedule of investments, current as of the last business day of a month, on its website no later than the second business day of the following month, and to maintain such information on the website for at least 12 months. The Amendments also would require an MMF to file a portfolio holdings report disclosing information about each portfolio security, current as of the last business day of a month, with the SEC no later than the second business day of the following month. The Amendments make corresponding changes to current quarterly portfolio holdings disclosure requirements to avoid duplicative disclosure obligations.

Transaction Processing. In order to ensure that an MMF has the operational capacity to continue to process investor transactions in an orderly manner at a net asset value below $1.00 (commonly termed "breaking the buck"), the Amendments would require an MMF board to determine in good faith, at least once per calendar year, that the MMF (or its transfer agent) has the capacity to redeem and to sell the MMF's shares at a price based on a net asset value per share other than $1.00.

Repurchase Agreements. The Amendments would permit MMFs to "look through" repurchase agreements for purposes of Rule 2a-7's diversification requirements only for repurchase agreements that are collateralized by cash items or Government securities. Additionally, regardless of whether a repurchase agreement is collateralized fully, the Amendments would require an MMF board (or its delegate) to evaluate the creditworthiness of the counterparty.

Affiliate Purchases

The Amendments would expand the scope of Rule 17a-9, which permits an affiliate of an MMF to purchase portfolio securities from the MMF in certain circumstances, to permit an affiliate to purchase from the MMF an eligible security that has defaulted (excluding certain immaterial defaults) in accordance with the requirements of that rule. The Amendments also would permit an affiliate of an MMF to purchase non-defaulted portfolio securities from the MMF for cash at the greater of amortized cost value or market value, so long as such affiliate promptly remits to the MMF any profit it realizes from the later sale of the security. An MMF would be required to provide prompt notice to the SEC of such affiliated purchases and the reasons therefor.

Fund Liquidation

Proposed Rule 22e-3 generally would allow an MMF that breaks the buck to suspend redemptions to facilitate an orderly liquidation if the MMF's board approves the MMF's liquidation and the MMF provides notice to the SEC. The SEC could rescind or modify the ability to suspend redemptions in certain instances to protect MMF shareholders. The proposed rule would extend similar relief to an open-end fund that owns shares of an MMF that has suspended redemptions pursuant to the proposed rule.

Other Requests for Comment

The proposing release contains a number of requests for comment that relate to the Amendments. It also contains two broad, conceptual requests for comment. The first request is for comments on whether to eliminate MMFs' ability to use the amortized cost method of valuation in favor of a floating net asset value. The second request is for comments on whether to require MMFs to satisfy redemption requests in excess of a certain threshold size through in-kind redemptions.

For more information regarding the SEC's proposed money market reforms, please contact your Ropes & Gray attorney or one of the attorneys with Ropes & Gray's Investment Management practice.

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