September 25, 2015

SEC Removes Credit-Rating References and Amends Issuer Diversification Requirements in Money Fund Rules

In a September 16, 2015 Release (the "Release"), the SEC completed its obligations under Section 939A of the Dodd-Frank Act by removing references to credit ratings from Rule 2a-7. Most notably, the Release removes credit ratings from Rule 2a-7's definition of "eligible security." In the process, the Release creates a uniform credit quality standard – "presents minimal credit risks to the fund" – for each security acquired by a money market fund. The Release also requires money market funds to adopt written procedures requiring a fund's adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

These changes and the other changes made by the Release are described below. The compliance date for all of the Release's changes is October 14, 2016.

Adoption of Uniform Credit Quality Standard

In its current form, Rule 2a-7 imposes two credit quality requirements with respect to the securities that a money market fund may acquire. First, an objective standard requires that each acquisition must be an eligible security, which is defined by reference to credit ratings provided by "nationally recognized statistical rating organizations" (each, an "NRSRO"). Second, a subjective standard requires that each acquisition, as determined by the fund's board (or its delegate), presents "minimal credit risks" to the fund. Minimal credit risks is not defined in Rule 2a-7.

Section 939A of the Dodd-Frank Act requires every federal agency, including the SEC, "to remove any reference to or requirement of reliance on credit ratings" from the agency's regulations, and "to substitute in such regulations such standard of credit-worthiness" as the agency determines appropriate. The Release gives effect to Section 939A by eliminating Rule 2a-7's references to credit ratings, including, most notably, by revising the credit quality elements in the definition of eligible security.[1] As revised, an eligible security is a security that "presents minimal credit risks to the fund." Because minimal credit risks is undefined, the Release codifies earlier SEC staff guidance regarding the credit quality factors that may be used to determine that a security presents minimal credit risks. Thus, with the Release's revisions, an eligible security is a security:

> that the fund's board of directors [or its delegate] determines presents minimal credit risks to the fund, which determination must include an analysis of the capacity of the security's issuer or guarantor (including for this paragraph the provider of a conditional demand feature, when applicable) to meet its financial obligations, and such analysis must include, to the extent appropriate, consideration of the following factors with respect to the security's issuer or guarantor: (A) Financial condition; (B) Sources of liquidity; (C) Ability to react to future market-wide and issuer- or guarantor-specific events, including ability to repay debt in a highly adverse situation; and (D) Strength of the issuer or guarantor's industry within the economy and relative to economic trends, and issuer or guarantor's competitive position within its industry.

The Release states that factors (A) through (D) codify into Rule 2a-7 the general credit analysis factors in prior SEC staff guidance that bear on minimal credit risks. The Release adds a fifth factor, regarding the price and/or yield of a

[1] In addition, the general portfolio quality requirement specified by Rule 2a-7 will no longer refer to securities that "the fund's board of directors determines present minimal credit risks . . . at the time of acquisition." Instead, as revised by the Release, the general portfolio quality requirement is securities that "at the time of acquisition are eligible securities."

security, and states that a minimal credit risks evaluation "may also include consideration of whether the price and/or yield of the security itself is similar to that of other securities in the fund's portfolio."

The Release notes that funds also may wish to consider whether factors unique to specific asset classes also should be included in minimal credit risks determinations, particularly if a fund invests significantly in one or more of the asset classes. The Release provides specific factors for various asset classes: municipal securities; conduit securities; other structured securities, such as VRDNs, tender option bonds, extendible bonds, "step-up" securities or other structures; and repurchase agreements. The revised definition of eligible security expressly refers to the Release for a discussion of these "additional factors that may be relevant in evaluating certain specific asset types."

Finally, the Release retains the 397-day maturity maximum in the definition of eligible security. Money market fund securities and government securities, both formerly first-tier securities, remain eligible securities through their express inclusion in the revised definition of eligible security. The Release deletes the definitions of "rated security," "unrated security," "first-tier security" and "second-tier security" (including the three-percent limitation on the latter) from Rule 2a-7.

Monitoring Minimal Credit Risks

Currently, Rule 2a-7 requires a money market fund's board (or its delegate) to reassess promptly whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and to take such action as it determines is in the best interests of the fund and its shareholders. In the Release, this requirement has been eliminated. In its place, money market funds must adopt written procedures that require a fund's adviser to provide ongoing reviews of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

- Frequency of Monitoring. The Release does not specify a frequency upon which monitoring must occur. However, the Release did state that "many funds today engage in daily monitoring of changes . . . and do so even on an hourly basis if there are rapidly changing events. We believe that this type of monitoring is consistent with the ongoing monitoring requirement adopted today."

- Related Recordkeeping. Currently, money market funds are required to retain a written record of each determination that a portfolio security is an eligible security, including the determination that it presents minimal credit risks. The Release acknowledges that the new requirement to conduct ongoing reviews of minimal credit risks could result in burdensome recordkeeping requirements. Accordingly, the amended recordkeeping rule regarding the minimal credit risks reviews requires a record of a determination only when the security is first acquired, and at such later times (or upon such events) as the fund's board (or its delegate) determines that the adviser must reassess whether a security presents minimal credit risks.

Conditional Demand Features

Rule 2a-7 limits money market funds' acquisitions to securities with remaining maturities of no more than 397 days. However, a long-term security subject to a conditional demand feature (an "underlying security") currently may be deemed to be an eligible security if, among other things, (i) the conditional demand feature is an eligible security; and (ii) the underlying security (or its guarantee) has received certain credit ratings from an NRSRO. Thus, in its current form, Rule 2a-7 requires analysis of both the conditional demand feature and the underlying security's (or guarantee's) credit aspects.

The Release deletes the references to credit ratings and NRSROs. In the case of conditional demand features, a fund's board (or its delegate) must determine that both the conditional demand feature and the underlying security (or guarantee) are eligible securities.

Stress-Testing Clarification

Money market funds currently must adopt written procedures providing for stress-testing their portfolios upon the occurrence of various hypothetical events, including "[a] downgrade . . . of particular portfolio security positions."

The Release replaces "downgrade" with "An event indicating or evidencing credit deterioration, such as a downgrade."

Exclusion from the Issuer Diversification Requirement

Currently, Rule 2a-7 requires a money market fund's portfolio to be diversified with respect to both the issuers of the securities it acquires and the providers of guarantees related to those securities. In general, taxable money market funds must limit their acquisitions of the securities of any one issuer to no more than 5 percent of a fund's total assets, but excluding government securities and "securities subject to a guarantee issued by a non-controlled person" (the "Guaranteed Securities Exclusion"). In addition to these *issuer* diversification provisions, taxable money market funds must limit their investments in securities subject to a guarantee from any single *guarantor* to no more than 10 percent of a fund's total assets. Relying on the Guaranteed Securities Exclusion, a fund could invest a significant portion of its portfolio in securities issued by the same entity, provided the securities were guaranteed by different non-controlled guarantors, and guarantees by a single guarantor did not have a value exceeding 10 percent of the fund's total assets.

The Release precludes the occurrence of this scenario by eliminating the Guaranteed Securities Exclusion from the 5 percent diversification requirement. As revised by the Release, Rule 2a-7 requires each taxable money market fund that invests in securities subject to a guarantee to comply with both the 5 percent issuer diversification requirement as well as the 10 percent guarantor diversification requirement (unless, as unaffected by the Release, the fund's board determines that a fund is not relying on the guarantee).

Form N-MFP

Currently, in their monthly Form N-MFP filings with the SEC, money market funds must disclose, with respect to each portfolio security (and any guarantee, demand feature, or other enhancement associated with the portfolio security), the name of each "designated NRSRO" for the portfolio security and the rating assigned to the security. In 2010, the SEC staff issued a no-action letter to the effect that the staff would not object if a fund did not designate NRSROs (and did not make related disclosures in its statement of additional information) before the SEC had modified Rule 2a-7 in accordance with Section 939A of the Dodd-Frank Act. The Release marks the completion of these SEC's modifications. Therefore, money market funds will be required to disclose the NRSRO ratings that the fund's board (or its delegate) considered, if any, in making its minimal credit risks determination for a given security, along with the name of the agency that provided the rating.

Compliance Date

The compliance date for the Release's changes is October 14, 2016, which is the same as the final compliance date for the SEC's 2014 money market reform's floating net asset value, liquidity fee, and redemption gate provisions.

In view of the fact that the Release's compliance date coincides with the final compliance date for the SEC's 2014 money market reforms, the Release may complicate money market funds' compliance with both. At a minimum, it seems likely that written Rule 2a-7 procedures will have to be redrafted to incorporate the Release's changes. In addition, new written procedures may have to be drafted and implemented to comply with the Release's mandatory ongoing reviews of portfolio securities' credit quality.

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