



SEC Approves Money Market Fund Reform to Better Protect Investors

On January 27, 2010, the Securities and Exchange Commission (the “SEC”) adopted rule amendments designed to significantly strengthen the regulatory requirements governing money market funds and better protect investors (the “Money Market Fund Reform”).¹ On February 23, 2010, the SEC released the final rule amendments that become effective on May 5, 2010, with compliance dates phased-in during 2010 and 2011.²

The Money Market Fund Reform is the result of a full-scale review of the money market fund regulatory regime commenced by the SEC in the wake of the financial crisis and the weaknesses revealed by the Reserve Primary Fund’s “breaking the buck” in September 2008.³ The adopted rule amendments are similar in form to the proposed amendments and represent a major first step by the SEC to stabilize money market funds during periods of economic distress.

Aiming at better protection for investors, the Money Market Fund Reform requires money market funds to maintain a portion of their portfolios in highly liquid instruments, reduce the long-term debt exposure of their portfolios and improve the quality of their portfolio securities. The final rule amendments also require monthly reporting of portfolio holdings to the SEC and permit suspension of redemptions if a fund “breaks the buck” to allow for the orderly liquidation of fund assets. Most notably, the SEC did not take any action on more far-reaching changes regarding a move to a floating net asset value (“NAV”) in place of the stable NAV of \$1 used by money market funds and mandatory satisfaction of redemption requests in excess of a certain size through in-kind redemptions. The SEC requested comment on these options in its proposing release.⁴ Most commenters, including the Investment Company Institute,⁵ expressed concern regarding a floating NAV, and many commenters expressed concern regarding mandatory in-kind redemptions. In light of these comments, and through the SEC staff’s work with the President’s Working Group on Financial Markets, the SEC continues to explore more fundamental changes to the money market fund regulatory regime.

This Alert provides an overview of the Money Market Fund Reform and its compliance dates and outlines the next steps regarding the regulatory framework for money market funds.

¹ See the press release announcing the adoption of the rule amendments, available at <http://www.sec.gov/news/press/2010/2010-14.htm>.

² Money Market Fund Reform, Release No. IC-29132 (Feb. 23, 2010), available at <http://www.sec.gov/rules/final/2010/ic-29132.pdf>.

³ For a discussion of the background for and an assessment of the SEC’s rule amendments, see our Client Alert, “SEC Proposes Rule Amendments to Strengthen the Regulatory Framework for Money Market Funds,” dated June 25, 2009, available at <http://www.mofo.com/files/Publication/328964c5-313f-44f2-82ce-a4549dadccbc/Presentation/PublicationAttachment/2e3f2e56-f38d-4f3b-b3d4-a7ff7a726828/090625SEC.pdf>.

⁴ Money Market Fund Reform, Release No. IC-28807 (Jun. 30, 2009), available at <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>.

⁵ The Investment Company Institute is the principal trade organization of the mutual fund industry, including money market funds. Note that, in connection with the adoption of the final rule amendments, the Investment Company Institute supported the SEC’s actions, while making clear it will continue to oppose a move to a floating NAV. See the press release regarding ICI Comments on SEC’s Money Market Fund Reforms, dated January 27, 2010, available at http://www.ici.org/pressroom/news/10_news_sec_mmf.

Money Market Fund Reform

The SEC adopted amendments to Rule 2a-7 and new rules under the Investment Company Act of 1940 governing money market funds. With a few important modifications, the adopted rule amendments are similar to those proposed by the SEC. The most significant rule amendments reflected in the Money Market Fund Reform are:

Portfolio Quality – The SEC determined not to eliminate money market funds’ ability to acquire so-called “Second Tier” securities as proposed by the SEC. Instead, the SEC amended Rule 2a-7 to further limit this ability by:

- lowering the permitted percentage of a fund’s total assets that may be invested in “Second Tier” securities from 5% to 3%;
- lowering the permitted concentration of its total assets in “Second Tier” securities of any single issuer from the greater of 1% or \$1 million to 0.5%; and
- prohibiting funds from buying “Second Tier” securities with a remaining maturity in excess of 45 days.

Rating agencies will continue to play a role in money market funds. Rule 2a-7 continues to impose minimum ratings requirements for eligible securities, but the credit rating cannot be the sole factor in the determination, because the rule also continues to require funds to perform an independent credit analysis of every security purchased. In addition, the SEC adopted a new requirement that funds designate each year at least four Nationally Recognized Statistical Rating Organizations (“NRSROs”) that the fund’s board considers to be reliable for purposes of satisfying the minimum ratings requirements. The fund may disregard ratings by any other NRSRO.

Portfolio Liquidity – The SEC adopted new daily and weekly requirements that money market funds maintain certain minimum percentages of their assets in cash or securities readily convertible into cash to pay redeeming investors. More specifically, amended Rule 2a-7 requires:

- all *taxable* money market funds to hold at least 10% of their total assets in “daily liquid assets” (cash, U.S. Treasury securities, or securities that convert into cash (e.g., mature) within one day); and
- *all* money market funds to hold at least 30% of their total assets in “weekly liquid assets” (cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week).

Moreover, amended Rule 2a-7 imposes a new general liquidity requirement mandating money market funds to hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions. Depending on the fund’s cash flow, this provision may require the fund to maintain greater liquidity than would be required by the daily and weekly minimum requirements discussed above. The SEC expects money market funds to develop “know your investor” procedures to identify investors whose redemption requests may pose risks, and, as part of these procedures, anticipate the likelihood of large redemptions.

Rather than prohibiting funds from purchasing *any* illiquid securities as proposed by the SEC, the SEC reduced the maximum percentage of illiquid securities of the fund’s total assets from 10% to 5%, thereby further limiting the ability of money market funds to purchase illiquid securities. The rule amendments also redefine “illiquid security” as a security that cannot be sold or disposed of within seven days at carrying value.

Portfolio Maturity – The SEC amended Rule 2a-7 to further restrict the maturity limitations on portfolios by shortening the maximum dollar-weighted average maturity (WAM) of a fund’s portfolio from 90 days to 60 days. In addition, the SEC adopted a new 120-day dollar-weighted average life (WAL) restriction, which, unlike the WAM, is measured without regard to any Rule 2a-7 provision that otherwise permits a fund to shorten the maturity of an adjustable-rate security by reference to its interest rate reset dates. The WAL restriction limits the

ability of a money market fund to invest in long-term floating rate securities that may expose the fund to spread risk.⁶

Periodic Stress Tests – Rule 2a-7 also imposes a new requirement that a fund adopt procedures providing for periodic “stress testing” of a portfolio’s ability to maintain a stable NAV in the event of shocks (e.g., interest rate changes, higher redemptions, or changes in credit quality of a portfolio). The amendment requires the performance of stress tests at such intervals as the fund’s board determines appropriate and reasonable in light of current market conditions. However, the rule does not specifically require the board to design the portfolio stress testing, as may have been suggested by the SEC’s proposed release.

Disclosure of Portfolio Information – New enhanced disclosure requirements for money market funds involve:

- *Monthly Website Posting* – Rule 2a-7 imposes a new requirement that funds post portfolio information on their websites, no later than the fifth business day of a month, and maintain the information on the website for at least six months; and
- *Monthly SEC Reporting* – New Rule 30b1-7 requires funds to file a new Form N-MFP, within five business days after the end of each month, with more detailed portfolio schedules, including the mark-to-market value of the fund’s net assets (i.e., shadow NAV), rather than the stable \$1 NAV at which shareholder transactions occur. The SEC will make the information publicly available after 60 days.

Processing Transactions at a Variable Price – The SEC amended Rule 2a-7 to include a new requirement that money market funds (or their transfer agents) have the capability to process purchases and redemptions at a price other than \$1. This requirement facilitates share redemptions, even under circumstances that require a fund to “break the buck.”

Suspension of Redemptions – The SEC adopted new Rule 22e-3, permitting a money market fund that has “broken the buck” or is about to “break the buck” and decides to liquidate the fund to suspend redemptions while the fund undertakes an orderly liquidation. The fund must notify the SEC prior to suspending redemptions.

Affiliate Purchases of Portfolio Securities – The SEC expanded the exemptive relief under Rule 17a-9 to permit an affiliate of a fund to purchase securities from the fund, for any reason, without first obtaining permission from the SEC, but under conditions that protect the fund from disadvantageous transactions. The fund must notify the SEC when it relies on the rule.

Repurchase Agreements – New amendments to Rule 2a-7 limit money market funds to investing in repurchase agreements collateralized by cash items or government securities (as opposed to the current requirement of highly rated securities) and reinstate the requirement that the fund evaluate the creditworthiness of the repurchase counterparty.

Compliance Dates

The Money Market Fund Reform becomes effective May 5, 2010, and the effective date is the compliance date if no other compliance date is specified. However, the SEC has phased in compliance dates for certain requirements as set forth below:

- *May 28, 2010* – portfolio quality, liquidity, stress testing and repurchase agreements requirements;⁷

⁶ Long-term adjustable-rate securities are more sensitive to credit spreads than short-term securities with final maturities equal to the reset date of the long-term security because of their longer exposure to the issuer’s credit risk, including deteriorating credit (widening spreads), or tightening liquidity conditions.

- *June 30, 2010* – weighted average maturity and weighted average life limits;
- *October 7, 2010* – website disclosure of portfolio information;
- *December 7, 2010* – Form N-MFP filing of detailed portfolio information;⁸
- *December 31, 2010* – designated NRSROs disclosure; and
- *October 31, 2011* – transaction processing at variable prices (other than \$1).

Next Steps

While the changes adopted by the SEC are largely consistent with expectations, SEC Chairman Mary Schapiro made it clear that the SEC's work is not yet complete. The SEC will continue to pursue "more fundamental changes to the structure of money market funds to further protect them from the risk of runs." Among those possible reforms are:⁹

- a floating NAV, rather than the stable \$1 NAV;
- mandatory in-kind redemptions for large redemptions;
- "real time" disclosure of shadow NAV;
- a private liquidity facility to money market funds in times of stress; and
- a possible "two-tiered" system of money market funds, with a stable NAV only for money market funds subject to greater risk-limiting conditions and possible liquidity facility requirements.

Accordingly, the focus is next on the SEC staff's continued evaluation and recommendations regarding these topics, in consultation with the President's Working Group on Financial Markets.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁷ However, funds are not required to dispose of portfolio securities owned, or terminate repurchase agreements already entered into, as of the time of adoption of the amendments to comply with the requirements of Rule 2a-7.

⁸ Funds filing information with the SEC pursuant to Rule 30b1-6T are no longer required to file this information after December 1, 2010.

⁹ See Speech by SEC Chairman: Statement on Money Market Funds Before the Open Commission Meeting, January 27, 2010, available at <http://www.sec.gov/news/speech/2010/spch012710mls-mmf.htm>.