

News Bulletin

June 25, 2009



SEC Proposes Rule Amendments to Strengthen the Regulatory Framework for Money Market Funds

On June 24, 2009, the Securities and Exchange Commission (the “SEC”) proposed rule amendments designed to strengthen the regulatory framework for money market funds to increase their resilience to economic stresses and reduce the risks of runs on the funds.¹

This alert provides a brief overview of money market funds and the SEC’s proposals to reform the regulation of these funds. It also assesses the SEC’s proposals against the recommendations included in the Treasury Department’s June 17, 2009 white paper on Financial Regulatory Reform (the “White Paper”) and the Investment Company Institute’s March 17, 2009 Report of the Money Market Working Group (the “Report of the Money Market Working Group”).

Background and Overview of the SEC’s Proposals

Money market funds, which serve as cash management vehicles for investors, reportedly account for \$3.8 trillion in investor assets and have traditionally been viewed as investments that are as safe as cash since they seek to maintain a stable net asset value (“NAV”) of \$1.00 per share. Last September, however, the stability of these investments came into question after the Reserve Primary Fund’s NAV fell below the level invested in the fund, an almost unheard of occurrence referred to as “breaking the buck.” This traumatic event resulted in the withdrawal of approximately \$300 billion from money market funds during the week of September 15, 2008 and prompted the Treasury Department to step in and institute a temporary program that guaranteed the funds held in these accounts.

To augment the Treasury Department’s temporary guarantee program, which is currently slated to expire on September 18, 2009, in late 2008 the Federal Reserve Board announced the establishment of a number of temporary credit and purchase facilities intended to provide liquidity to money market funds and the short-term debt markets generally. The most notable of these facilities are the Money Market Investor Funding Facility (“MMIFF”), the Commercial Paper Funding Facility (“CPFF”) and the Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”). These facilities have been deployed to various extents and with varying results, and in any event are all scheduled to expire by early 2010.²

In an effort to restore stability to money market funds on a more permanent basis, the SEC voted to propose changes on June 24 that would require money market funds to hold a portion of their portfolios in highly liquid investments, reduce their exposure to long-term debt and restrict their investments to only the highest quality portfolio securities. The proposals would also require monthly reporting of portfolio holdings, and allow suspension of redemptions if a fund “breaks the buck” to allow for the orderly liquidation of fund assets.

¹ This bulletin is based on information provided at the SEC’s open meeting and in the press release announcing the proposal.

² See our Client Alert, “Federal Reserve Announces Creation of Money Market Investor Funding Facility,” dated October 21, 2008, at <http://www.mofo.com/news/updates/files/081021FederalReserve.pdf>.

“These proposals are designed to increase the ability of money market funds to weather future economic storms,” said SEC Chairman Mary Schapiro. “The stability of money market funds in times of turmoil is enormously important both for investors and for the securities markets. The proposals would also improve the operations of money market funds and oversight of their investments during calmer times, which can further protect funds and increase public awareness of potential risks.”

The SEC's Proposals

Specifically, the SEC's proposals, if adopted, would strengthen the regulation of money market funds by:

- requiring that money market funds have certain minimum percentages of their assets in cash or securities that can be readily converted to cash, to pay redeeming investors;
- shortening the weighted average maturity limits for money market fund portfolios from 90 days to 60 days;
- limiting money market funds to investing in only the highest quality securities (i.e., eliminate their ability to invest in so-called “Second Tier” securities);
- requiring funds to stress test fund portfolios periodically to determine whether the fund can withstand market turbulence;
- requiring money market funds to report their portfolio holdings monthly to the SEC and post them on their websites;
- requiring funds to be able to process purchases and redemptions at a price other than \$1; and
- permitting a money market fund that has “broken the buck” and decided to liquidate to suspend redemptions while the fund undertakes an orderly liquidation of assets.

Assessment of the SEC's Proposals

The SEC's proposals were not generated in a vacuum. The federal financial regulators, including the SEC, the money market fund industry and others have been actively discussing appropriate steps to bolster the stability of money market funds since the precipitous market disruptions of September 2008. Most notably, the Investment Company Institute, the principal trade organization of the mutual fund industry, including money market funds, issued its comprehensive Report of the Money Market Working Group. Additionally, the White Paper, issued just last week, embodies the Obama Administration's far-reaching proposal to reform the entire financial services industry, and contains a specific set of recommendations for the future regulation of money market funds.

The SEC's proposals take significant steps in addressing the concerns raised over the stability of money market funds and address many of the recommendations made by the Treasury Department and the Investment Company Institute. First of all, by requiring money market funds to invest in highly liquid investments and shortening the weighted average maturity limit, the SEC's proposals are responsive to the Treasury Department's suggestion of improving the liquidity of money market funds and reducing the average maturity of the assets held in their portfolio. The SEC's inclusion of a requirement to stress test fund portfolios also follows a recommendation of the Investment Company Institute in its Report of the Money Market Working Group. Finally, the SEC's decision to include a proposal that permits the suspension of redemptions in extraordinary circumstances conforms to the Treasury Department's recommendations in the White Paper.

Despite following many of the recommendations of the Treasury Department and the Investment Company Institute, the SEC's proposals are not without controversy. Noticeably absent from the SEC's proposals is a firm stance that money market funds will continue to maintain a \$1 stable NAV. While money market funds have traditionally adhered to the \$1 stable NAV format, some commentators have argued that moving to a “floating NAV” format similar to that used by most other types of mutual funds, in which the NAV could vary depending on

the market value of the underlying fund assets, would remove the stigma of “breaking the buck” and provide for a more resilient marketplace.

The Investment Company Institute has opposed the “floating rate” NAV approach and has strongly advocated the preservation of a \$1 stable NAV. The Investment Company Institute has supported its position by arguing that the investment guidelines of most companies prevent them from investing their cash in pools with shifting values and also that a “floating NAV” would prevent state and local governments from using money market funds. The SEC has not taken a position on this issue. Rather, the SEC stated that it will seek comments on whether a floating NAV provides better protection to investors from runs on money market funds or whether the efficiency of the \$1 stable NAV is more beneficial to owners. By leaving this issue open for comment, the SEC’s proposals are likely to remain a controversial issue for the money market fund industry and will generate considerable discussion as the SEC considers whether to adopt a floating NAV.

The SEC is also requesting comments on other issues likely to generate debate, including whether money market funds should be required to satisfy redemption requests in excess of a certain size through in-kind redemptions—in other words, by distributing fund assets directly to investors. Also, the SEC is once again raising the question, originally raised in its prior proposals regarding credit rating agencies, of the role of the credit rating agencies in determining the suitability of assets for investment by money market funds.³

It should be noted that the SEC’s proposals are open for comment for 60 days after their publication in the Federal Register and are likely to be refined as they proceed through the administrative process. Assuming, however, that the SEC’s proposals are ultimately enacted in a form similar to these initial proposals, the new rules, with or without a floating NAV, would represent a major step by the SEC to stabilize money market funds during periods of economic distress.

For additional information on government actions, money market funds and the financial crisis generally, please see our Client Alerts and resources at [Financial Crisis—News and Resources](#) and [Regulatory Reform—News and Resources](#).

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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.

³ See our Client Alert, “SEC Adopts and Proposes Reforms Relating to Credit Ratings Agencies,” dated February 4, 2009, at <http://www.mof.com/news/updates/files/090204SECAadoptsandProposesReforms.pdf>.