Client Alert

September 24, 2015

SEC Adopts Further Revisions to Rule 2a-7

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The SEC recently adopted rule amendments removing credit rating references in Rule 2a-7 and Form N-MFP. Issuer diversification provisions were also amended to eliminate a current exclusion for securities subject to a guarantee issued by a non-controlled person.

ELIGIBLE SECURITIES AND MINIMAL CREDIT RISK DETERMINATIONS

As amended, the definition of "eligible security" in Rule 2a-7 will require a "single uniform minimal credit risk finding, based on the capacity of the issuer or guarantor of a security to meet its financial obligations." According to the SEC, eliminating references to NRSRO ratings from Rule 2a-7 is not intended to change the current risk profile of money market funds, nor should it change fund boards' evaluation of minimal credit risk.

In order to maintain similar risk profiles to those of current money market portfolios, the revised rule codifies general credit analysis factors that fund boards (and their designees) should use to determine if a security presents minimal credit risk. Such evaluation should not be limited to the risk profile of a security in isolation, but rather should be considered in light of a fund's other holdings. Accordingly, the SEC said that such evaluation could include: (i) an examination of correlation of risk among securities held; (ii) credit risk associated with market-wide stresses; or (iii) specific security credit or liquidity disruptions.

The SEC acknowledged that eliminating the floor provided by NRSRO ratings could result in a fund taking on additional credit risk in an attempt to increase yield. To address this concern, the SEC codified certain factors that it expects a fund board (or its designee) to consider when evaluating credit risk, noting that they "should assist fund boards by serving as objective and verifiable tools to rely on in the absence of NRSRO ratings." The factors include:

- The issuer's or guarantor's financial condition;
- The issuer's or guarantor's sources of liquidity;
- The issuer's or guarantor's ability to react to future market-wide and issuer- or guarantor-specific events, including the ability to repay debt in highly adverse situations; and
- The strength of the issuer's or guarantor's industry within the economy and relative to economic trends, and the issuer's or guarantor's competitive position within its industry.

Although not required by the amended rule, the SEC also suggested that an analysis of counterparty relationships, to the extent that funds have the information available, would assist fund boards when making minimal credit risk determinations.

The adopting release includes guidance related to how each of these general factors could be evaluated. While not codified, these asset-specific factors should be carefully considered by money market funds and their boards since they will doubtless form a basis for SEC staff to evaluate whether registrants are complying with the revised rule. Notably, however, the SEC clarified that the factors codified in the amended rule and the guidance in the release are not exhaustive, since additional factors may be relevant depending on the type of security analyzed. Accordingly, money market funds and their boards should carefully consider whether other credit related factors are pertinent to their overall obligation to determine "minimal credit risk."

The revised rule also clarifies that the uniform standard for determining minimal credit risk will also apply to conditional demand features and underlying securities or guarantees.

The amended rule will also require money market fund advisers to monitor minimal credit risk determinations. While the amended rule does not specify the frequency with which such monitoring should occur, the SEC said that it should occur on a "regular and frequent basis." As an example, the SEC noted its understanding that many funds currently monitor market changes and issuer-specific events on a daily basis. Nothing in the amended rule should give rise to an adviser changing that practice.

Issuer Diversification

The amended rule eliminates an exclusion to the issuer diversification requirements for securities subject to guarantees issued by non-controlled persons. Thus, a money market fund that invests in any security subject to a guarantee will have to comply with the following, irrespective of who provides the guarantee:

- Securities subject to a guarantee (or a demand feature) provided by any one guarantor may not exceed 10 percent of a fund's total assets; and
- Securities issued by any one issuer may not exceed 5 percent of the total assets of a fund.

COMPLIANCE DATE

Money market funds, their boards, and their advisers must comply with the amended rule by October 14, 2016. Consistent with their obligations under Rule 38a-1, before that date money market funds and their boards must adopt revised compliance policies "reasonably designed" to ensure that a money market fund will comply with the new credit quality and diversification obligations under Rule 2a-7. The SEC noted that this compliance date coordinates with the previously adopted changes to Rule 2a-7 related to floating net asset value, liquidity fees, and redemption gate provisions. While it sounds like a long lead time, fund groups are already grappling with the changes to policies, procedures, and systems required to implement the broader changes to Rule 2a-7. This is one more thing to add to the list, and it won't make the task any easier.

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