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SEC Proposes Amendments to Money Market Fund Rule

July 2008
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On June 11, 2008, the Securities and Exchange Commission (the "SEC") approved the initial two of three sets of proposed amendments relating to the use of Nationally Recognized Statistical Rating Organizations ("NRSROs") in the SEC's rules and forms. In general, these first two proposed amendments are designed to avoid conflicts of interest and increase transparency in the credit rating process. A copy of the SEC release that sets forth the first two amendments can be viewed at http://sec.gov/rules/proposed/2008/34-57967.pdf. (For more information, see the July 2, 2008 Capital Markets and Securities Law News Bulletin.)

On June 25, 2008, the SEC approved the third set of proposed amendments, which would amend four rules under the Investment Company Act of 1940 (the "1940 Act") and one rule under the Investment Advisers Act of 1940 (the "Proposed Amendments"). A copy of the Proposed Amendments can be viewed at http://www.sec.gov/rules/proposed/2008/ic-28327.pdf. This Client Alert describes the proposed changes to Rule 2a-7 under the 1940 Act and briefly summarizes the potential impact of the Proposed Amendments on the regulation of money market funds.

"Eligible Securities" Under Rule 2a-7: A Brief Overview

Currently, a money market fund registered under the 1940 Act may only acquire securities that (1) the fund's board has determined present minimal credit risks and (2) are classified as "eligible securities." In determining whether a given security presents minimal credit risks, the focus of the analysis must be based on factors pertaining to credit quality in addition to credit ratings assigned by NRSROs.

Generally, Rule 2a-7 provides that a security is an "eligible security" if it has a remaining maturity of 397 days or less and is rated in one of the two highest short-term rating categories by two NRSROs. A security that is rated by only one NRSRO must be rated in one of the two highest short-term rating categories by the rating NRSRO and must meet certain other maturity and quality requirements established by the rule. Rule 2a-7 imposes additional requirements for assessing the eligibility of unrated securities, securities with demand features or guarantees, asset-backed securities or unrated securities that are comparable in priority and quality to other rated obligations of the same issuer.

The Proposed Amendments to Rule 2a-7

In its proposing release dated July 1, 2008, the SEC noted that the Proposed Amendments are designed to completely eliminate Rule 2a-7's express references to NRSRO ratings in determining the eligibility of securities. As the general rationale for the Proposed Amendments, the SEC indicated its concern that the use of NRSRO ratings as a definitive criterion for determining the eligibility of investment securities may have implied a seal of approval on the accuracy and merit of such ratings. In its proposing release, the SEC noted that "there is a risk that investors interpret the use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities."

The Proposed Amendments would eliminate Rule 2a-7's reliance on NRSROs in determining whether a security is an "eligible security" in four principal ways.

- First, the Proposed Amendments would completely eliminate references to NRSRO ratings in determining whether a security is an "eligible security." As a result, the fund's board (or its delegate) would not only make the determination that a portfolio security presents minimal credit risks but would also be required to assess whether the security is an "eligible security." In making this determination, the board (or its delegate) would classify the security as a "First Tier Security" or "Second Tier Security" for purposes of the rule's diversification requirements. While NRSRO ratings would likely remain a factor in this determination, such ratings would no longer play as definitive a role in assessing eligibility.
- Second, the Proposed Amendments would formally limit the percentage of a money market fund's portfolio that can be invested in illiquid securities to 10 % of the fund's total assets. This limitation would codify the current standard set forth in previous SEC Staff releases pertaining to limitations on a money market fund's ability to hold illiquid securities. The Proposed Amendments would further limit a fund to holding securities that are "sufficiently liquid to meet reasonably foreseeable shareholder redemptions," a requirement that could lead a fund to conclude that it must stay well below the 10 % limit. In addition, the Proposed Amendments would apply the 10 % test immediately after the acquisition of *any* security, so a fund that exceeds the 10 % limit due to liquid holdings becoming illiquid would not be permitted to acquire *any* security until it reduces the percentage of illiquid holdings to less than 10 % of its total assets. Although the language of the proposed rule appears to preclude a fund from gradually working its percentage down by buying liquid securities with new money, the proposing release states that the requirement would not compel a fund to sell a portfolio security where the fund would suffer a loss on the sale.
- Third, the Proposed Amendments would change the events that would trigger the requirement that a money market fund's board reassess whether a portfolio security continues to present minimal credit risks. Currently, if a portfolio security is downgraded by an NRSRO, or in the event of a default by a portfolio security comprising more than ½ of 1 % of a fund's total assets, Rule 2a-7 requires the fund's board to reassess whether the security continues to present minimal credit risks. Under the Proposed Amendments, the board would be required to reassess minimal credit risks if the fund's investment adviser becomes aware of any information that suggests that a security may no longer present minimal credit risks. This board responsibility would continue to be non-delegable.
- Fourth, the Proposed Amendments would require that a money market fund promptly notify the SEC if an affiliate of the fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an "eligible security," pursuant to Rule 17a-9 under the 1940 Act.

Conclusion

If adopted, the Proposed Amendments may present additional challenges to money market fund boards and investment advisers. At minimum, the Proposed Amendments would replace certain objective criteria with subjective judgments based on factors that are likely to vary from fund to fund and adviser to adviser. The Proposed Amendments would make similar changes to other rules, such as those relating to the quality of the collateral for repurchase agreements and a fund's ability to purchase municipal securities in an affiliated underwriting. As a result of the Proposed Amendments, compliance policies, including those pertaining to determining eligibility, classifying "eligible securities" as "First Tier Securities" or "Second Tier Securities," valuing money market fund portfolio securities, reporting portfolio securities that may no longer present minimal credit risks to a board and reporting transactions effected pursuant to Rule 17a-9 to the SEC, may need to be adopted or revised.

Comments on the Proposed Amendments should be received by the SEC on or before September 5, 2008. If you have questions or wish to consult with us regarding potential comments, please do not hesitate to contact a member of Morrison & Foerster's Investment Management Practice Group.