

# SEC Adopts Money Market Fund Reforms

Benjamin J. Haskin,  
Margery K. Neale  
and Ryan P. Brizek

WILLKIE FARR & GALLAGHER LLP

On February 23, 2010, the Securities and Exchange Commission ("SEC") adopted amendments to Rule 2a-7 ("Amended Rule 2a-7") under the Investment Company Act of 1940 ("ICA"), which governs money market funds.<sup>1</sup> The amendments were in response to the market turmoil that affected money market funds commencing in September 2008 after the Lehman Brothers Holdings bankruptcy. The SEC also amended or adopted other rules relating to money market funds and adopted Form N-MFP. These changes will likely have a significant impact on the market for short-term money market instruments.

Rule 2a-7 permits mutual funds to call themselves "money market funds" and employ amortized cost valuation for their portfolios (rather than market valuations) if a number of conditions are met, including conditions relating to specific portfolio quality, maturity and diversification tests. Amended Rule 2a-7 tightens portfolio quality and maturity standards and adds a number of new liquidity requirements, and also imposes new oversight obligations on fund boards of directors. The SEC also adopted a new rule that permits suspension of shareholder redemptions if a fund is in liquidation and imposed new detailed portfolio disclosure requirements. The SEC established aggressive compliance dates for the new and amended money market fund rules.

## Proposed New Rules and Rule Amendments Under the Investment Company Act of 1940

### A. Portfolio Quality

Amended Rule 2a-7 provides new limits regarding permissible money market fund investments in "second tier securities"<sup>2</sup> by:

- reducing the permitted percentage of a money market fund's total assets that may be invested in second tier securities to 3 percent from 5 percent;
- reducing the permitted concentration of a money market fund's total assets in second tier securities of a single issuer to 0.5 percent from the greater of 1 percent or \$1 million;<sup>3</sup> and
- prohibiting money market funds from acquiring any second tier security with a remaining maturity in excess of 45 days.

Amended Rule 2a-7 also imposes new requirements on money market fund boards (in consultation with the adviser) by requiring them to:

- designate four or more Nationally Recognized Statistical Rating Organizations ("NRSROs"), the short-term credit

ratings of any one or more of which the fund would consider in determining whether a security is an eligible security under the rule; and

- determine at least once each calendar year that the designated NRSROs issue credit ratings that are sufficiently reliable for that purpose.<sup>4</sup>

Finally, Amended Rule 2a-7 eliminates a requirement that an asset backed security ("ABS") be rated by at least one NRSRO in order to be an eligible security, thereby permitting a money market fund to acquire an unrated ABS that otherwise meets the requirements of Amended Rule 2a-7.

### B. Portfolio Maturity

Amended Rule 2a-7 reduces the exposure of money market fund investors to certain risks by further restricting maturity limitations that apply to portfolio holdings. The amendments:

- reduce the maximum weighted average maturity ("WAM") of a money market fund's portfolio to 60 days from 90 days;
- adopt a 120-day limit on the weighted average life ("WAL") of a money market fund's portfolio; and
- delete a provision from Rule 2a-7 that permitted money market funds that relied exclusively on the penny-rounding method of pricing to acquire government securities with extended maturities of up to 762 calendar days.

### C. Portfolio Liquidity

In order to require that money market funds maintain a sufficient degree of liquidity, Amended Rule 2a-7 contains the following new provisions:

- **General Liquidity Requirement.** Each money market fund must hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of its obligations under Section 22(e) of the ICA and any commitments the fund has made to shareholders. This effectively requires money market funds to develop policies and procedures to identify fund shareholders whose redemption requests may pose risks for the funds.

- **Limitation on Acquisition of Illiquid Securities.** A money market fund may not acquire illiquid securities if immediately after the acquisition the fund will have invested more than 5 percent of its total assets in illiquid securities. The previous limit was 10 percent.

- **Stress Testing.** A money market fund's board must adopt procedures providing for periodic stress testing of the fund's portfolio and maintain records of these stress tests for six years, keeping them in an easily accessible place for the first two years.

- **Daily Liquid Assets.** Daily liquidity standards require all taxable money market funds to hold at least 10 percent of their total assets in cash, direct obligations of the U.S. government, or securities that will mature, or that are subject to a demand feature that is exercisable and payable, within one business day.

- **Weekly Liquid Assets.** Weekly liquidity standards require all money market funds, including tax-exempt money market funds, to hold at least 30 percent of their total assets in (i) cash, (ii) direct obligations of the U.S. government, (iii)

government securities that are issued by a person controlled or supervised by and acting as an instrumentality of the U.S. government pursuant to authority granted by the U.S. Congress that (a) are issued at a discount to the principal amount to be repaid at maturity and (b) have a remaining maturity date of 60 days or less, or (iv) securities that will mature, or that are subject to a demand feature that is exercisable and payable, within five business days.

### D. Repurchase Agreements

In order to obtain special "look-through" treatment for investments in repurchase agreements under the diversification provisions of Amended Rule 2a-7, money market funds will be limited to investing in repurchase agreements collateralized by cash items or government securities, and a fund's board or its delegate must evaluate the creditworthiness of a repurchase agreement's counterparty. Previously, money market funds could receive this diversification treatment for repurchase agreements collateralized by high-grade corporate securities as well.

### E. New Disclosures

Amended Rule 2a-7 requires certain portfolio information, current as of the last business day of the previous month, to be posted to a fund's website no later than the fifth business day of the month. Portfolio information must be maintained on a fund's website for no less than six months after posting.

New Rule 30b1-7 requires money market funds to file electronically with the SEC on new Form N-MFP within five business days after the end of each month certain information with respect to each portfolio security held on the last business day of the prior month. The information contained in such reports will be available to the public 60 days after the end of the month to which the information pertains.

The SEC adopted as final Rule 30b1-6T, a temporary rule that requires the weekly filing of portfolio information by money market funds in certain circumstances. The expiration date of Rule 30b1-6T was extended until December 1, 2010, which corresponds with the first filing of portfolio information on Form N-MFP required by new Rule 30b1-7.

Further, a money market fund will be required to disclose its designated NRSROs in its statement of additional information ("SAI").

### F. Processing of Transactions

Amended Rule 2a-7 requires a fund (or its transfer agent) to have the capacity to redeem and sell its securities at a price based on the fund's current net asset value per share, including the capacity to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share.

### G. Exemption for Affiliate Purchases

Rule 17a-9 under the ICA permits money market funds to dispose of distressed securities quickly during times of market stress under certain circumstances. Amended Rule 17a-9 expands the ability of fund affiliates to purchase securities from a fund, subject to a number of conditions (including a clawback of any profits realized by the affiliate on a subsequent sale of the security). A money market fund whose securities have been purchased by an affiliated person in reliance on Rule 17a-9 must provide the SEC with prompt notice by electronic mail of the transaction and the reasons for the purchase.

### H. Fund Liquidation

The SEC adopted new Rule 22e-3, which exempts money market funds from Section 22(e) of the ICA, to permit these funds to suspend redemptions and postpone payment of redemption proceeds to facilitate the *permanent* termination of a money market fund in an orderly manner.

### Compliance Dates

The amendments to Rules 2a-7, 17a-9 and 30b1-6T, new Rules 22e-3 and 30b1-7, and new Form N-MFP become effective May 5, 2010. **The compliance date is May 5, 2010, except for certain amendments with the compliance dates listed in Figure 1 below.**

<sup>1</sup> Money Market Fund Reform, *Inv. Co. Act Rel. No. 29,132* (Feb. 23, 2010). Available at <http://www.sec.gov/rules/final/2010/10-29132.pdf>.

<sup>2</sup> Second tier securities are eligible securities that, if rated, have received other than the highest short-term debt rating from the requisite Nationally Recognized Statistical Rating Organizations or, if unrated, have been determined by the fund's board to be of comparable quality.

<sup>3</sup> Amended Rule 2a-7 also proportionately reduces by half the authority of a money market fund to acquire "demand features" or "guarantees" of a single issuer that are second tier securities to 2.5% from 5% of the money market fund's total assets.

<sup>4</sup> A fund may designate only credit rating agencies that are unaffiliated with the issuer of, or insurer or credit support provider for, a particular security and are registered as NRSROs with the SEC under the Securities Exchange Act of 1934 ("Exchange Act"). See Exchange Act Section 15E.

Figure 1

Compliance Date	Amendments
May 28, 2010	Amendments to Rule 2a-7 related to portfolio quality, maturity, liquidity, and repurchase agreements (except for requirements relating to the new maximum WAM and WAL limits and the designation of NRSROs).
June 30, 2010	New maximum WAM and WAL limits.
October 7, 2010	Public website disclosure.
December 7, 2010	Form N-MFP filings.
December 31, 2010	Designated NRSROs must be disclosed in a money market fund's SAI.
October 31, 2011	Funds must be able to process transactions at prices other than stable net asset value.

Benjamin J. Haskin and Margery K. Neale are Partners in Willkie's Asset Management Group in Washington, DC and New York, N.Y. respectively. Ryan P. Brizek is an Associate in the Asset Management Group in Washington, DC.

Please email the authors at [bhaskin@willkie.com](mailto:bhaskin@willkie.com), [mneale@willkie.com](mailto:mneale@willkie.com) or [rbrizek@willkie.com](mailto:rbrizek@willkie.com) with questions about this article.