

**SEC PROPOSES NEW MONEY MARKET FUND RULES — SIGNIFICANT AREAS OF UNCERTAINTY REMAIN**

On June 30, 2009, the Securities and Exchange Commission (the “SEC”) proposed amendments to certain rules — particularly Rule 2a-7 — under the Investment Company Act of 1940 (the “Investment Company Act”) that govern money market funds.<sup>1</sup> The proposed rule amendments are designed to prevent future disruptions such as the crisis that struck money market funds last fall. The amendments would (i) tighten the risk-limiting conditions of Rule 2a-7 by, among other things, requiring funds to maintain a portion of their portfolios in instruments that can be readily converted to cash (with more stringent requirements for institutional funds), reducing the weighted average maturity of portfolio holdings, requiring periodic stress testing of fund portfolios, strengthening a fund board’s evaluation of Nationally Recognized Statistical Rating Organizations (“NRSROs”) and counterparties to repurchase agreements, and prohibiting funds from investing in “second tier securities;”<sup>2</sup> (ii) require money market funds to report their portfolio holdings monthly to the SEC; and (iii) permit a money market fund that has “broken the buck” (*i.e.*, repriced its securities below \$1.00 per share) to suspend redemptions to allow for the orderly liquidation of fund assets and require all funds to have the capacity to process redemptions at values other than \$1.00 per share. The SEC also is requesting comment on whether money market funds should (i) have “floating” rather than “stable” net asset values, or (ii) be required to satisfy redemption requests in excess of a certain threshold through in-kind redemptions.

**Significant Areas of Uncertainty**

Those proposed changes, as well as the SEC questions, have led to significant uncertainty as to the following key items:

- **Variable Pricing.** Will the SEC propose to prohibit use of the amortized cost method in a future rule proposal, thereby forcing money market fund net asset values (“NAVs”) to float?

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<sup>1</sup> *Money Market Fund Reform*, Investment Company Act Release No. 28807 (June 30, 2009) (Proposing Release), available at <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>.

<sup>2</sup> Rule 2a-7(a)(22) defines second tier security as any eligible security that is not a “first tier security.” Rule 2a-7(a)(12) defines first tier security as, among other things, any eligible security that, if rated, has received the highest short-term debt rating from the requisite NRSROs or, if unrated, has been determined by the fund’s board of directors to be of comparable quality.

- **Additional Board Responsibilities.** What impact will proposed additional responsibilities related to credit ratings, periodic stress testing, repurchase agreements, institutional funds, and transaction processing have on fund boards?
- **Suspending Redemptions.** Will the ability of a fund to suspend redemptions only after breaking the buck be sufficient, or should a fund's board have the power to suspend redemptions before the fund breaks the buck?
- **Redemptions In-Kind.** Will in-kind redemptions allow for an orderly liquidation of a fund that has broken the buck? What effect will in-kind redemptions have on institutional investors?
- **Institutional vs. Retail.** How will a board determine whether a money market fund is institutional or retail? Will the practical consequence of the proposed rules be to segregate retail and institutional investments?
- **Disclosure.** What amount of portfolio holdings and loss (realized and unrealized) information will have to be made available to the public?

## **Proposed New Rules and Rule Amendments under the Investment Company Act**

### **A. Portfolio Quality**

The SEC proposed to amend provisions of Rule 2a-7 in order to generally limit money market fund investments to securities rated in the highest NRSRO rating category. This rule proposal would prohibit the purchase of second tier securities but would not force money market funds to dispose of securities that become second tier securities after purchase. In light of this proposal, the SEC also proposed to amend Rule 2a-7 so that the only circumstance in which a fund's board of directors would be required to reassess whether a security continues to present minimal credit risks would be if, subsequent to an unrated security's acquisition by the fund, the fund's adviser becomes aware that such security has received a rating from any NRSRO below the highest short-term rating category.<sup>3</sup>

Rule 2a-7 permits money market funds to invest in an unrated long-term security with a remaining maturity of 397 or fewer calendar days unless the security has received a long-term rating from any NRSRO that is not within the NRSRO's three highest long-term rating categories. In conjunction with its proposal to prohibit investment in second tier securities in an effort to more narrowly limit a money market fund's risk exposure, the SEC also proposed to permit money market funds to acquire long-term unrated securities only if such securities have received ratings within the two highest long-term rating categories.

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<sup>3</sup> In order for a security to be categorized as unrated, neither the security nor the issuer or guarantor of such security can have a short-term credit rating.

In addition, the SEC sought comment on whether to modify provisions of Rule 2a-7 that incorporate minimum credit ratings by NRSROs in order either to (i) remove ratings requirements from the rule entirely or (ii) require a money market fund's board to designate three (or more) NRSROs that the fund would look to for all purposes under Rule 2a-7 when determining whether a security is an eligible security, thereby theoretically creating competition among NRSROs. At the SEC's open meeting, Commissioner Kathleen Casey was in favor of reducing investor reliance on NRSROs. Commissioner Luis Aguilar strongly disagreed, and found credit ratings to be an important "external determination" of the quality of a security, which complements the "internal determination" made by a fund's board in consultation with the fund's investment adviser. Treatment of credit ratings and rating agencies will be a topic visited by the SEC in the coming periods in connection with Rule 2a-7 and other regulatory initiatives.

## **B. Portfolio Maturity**

The SEC proposed changes to Rule 2a-7's maturity provisions to limit further the exposure of money market funds to certain risks, including interest rate risk. In order to achieve this objective, the SEC proposed to:

- reduce the maximum weighted average portfolio maturity permitted by the Rule to 60 days;<sup>4</sup>
- institute a new portfolio maturity test that would limit the weighted average life maturity of portfolio securities to 120 days;<sup>5</sup>
- delete a provision of Rule 2a-7 that permits a money market fund that relies exclusively on the penny-rounding method of pricing to acquire government securities with remaining maturities of up to 762 days, rather than the 397-day limit otherwise provided by the rule;<sup>6</sup> and
- reduce the maximum maturity for individual non-government securities acquired by a money market fund from 397 days to a shorter period (*e.g.*, 270 days).

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<sup>4</sup> Rule 2a-7 currently requires a maximum weighted average portfolio maturity of 90 days. *See* Rule 2a-7(c)(2)(iii).

<sup>5</sup> The weighted average life of a portfolio would be measured without regard to a security's interest rate reset dates, which would limit the extent to which a fund could invest in longer-term securities that might expose a fund to interest rate spread risk and credit spread risk.

<sup>6</sup> The SEC noted that it is not aware of any money market fund that relies solely on the penny-rounding method of pricing.

### C. Portfolio Liquidity

In order to address liquidity risks, the SEC proposed to amend Rule 2a-7 to add new risk-limiting conditions designed to improve money market funds' ability to meet significant redemption requests.

- Illiquid Securities. The new risk-limiting conditions would preclude funds from acquiring illiquid securities, *i.e.*, securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately their amortized cost value.
- One-Day Liquidity. Such conditions also would require each taxable money market fund to invest the following percentage of assets in cash, U.S. Treasury securities, or securities that the fund can reasonably expect to convert to cash within a day:
  - 5% for retail funds or
  - 10% for institutional funds.<sup>7,8</sup>
- Five-Day Liquidity. Each taxable money market fund would be required to invest the following percentage of assets in either U.S. Treasury securities or securities (including repurchase agreements) that mature, or are subject to a demand feature exercisable and payable, within five business days:
  - 15% for retail funds or
  - 30% for institutional funds.
- Investor Characteristics. The directors of a money market fund would be required to understand the characteristics of the fund's investors (*i.e.*, retail versus institutional) and such investors' likely liquidity needs in order to ensure that the fund holds securities sufficient to meet reasonably foreseeable redemptions in light of its obligations under Section 22(e) of the Investment Company Act.

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<sup>7</sup> The proposed amendments would require that a money market fund's board determine, no less frequently than once each calendar year, whether the fund is an institutional money market fund for purposes of meeting the liquidity requirements. In particular, the fund's board of directors would determine whether the money market fund is intended to be offered to institutional investors, based upon: (i) the nature of the record owners of fund shares; (ii) minimum amount required to be invested to establish an account; and (iii) historical cash flows resulting, or expected cash flows that would result, from purchases and redemptions. Under the provision, a fund offered through two classes, a majority of whose shares are held by retail investors, should nonetheless be deemed to be an institutional fund by the fund board if the cash flows from purchases and redemptions and the portfolio management required to meet liquidity needs based on those cash flows are more characteristic of an institutional money market fund than of a retail fund. *See* Proposing Release, *supra* note 1, at 61-62.

<sup>8</sup> Under the proposed rules, tax-exempt money market funds would be exempt from daily liquidity requirements.

- Stress Testing. The board of directors of a money market fund using the amortized cost method would be required to adopt procedures providing for periodic stress testing of such fund's portfolio.<sup>9</sup>

#### **D. Diversification**

Generally, money market funds must limit their investments in the securities of any one issuer (other than government securities) to no more than five percent of fund assets. They must also generally limit their investments in securities subject to a demand feature or a guarantee to no more than ten percent of fund assets from any one provider. The SEC sought general comments on whether it should propose more restrictive diversification limits under Rule 2a-7, and whether it should propose industry concentration limitations under the Rule.

#### **E. Repurchase Agreements**

With respect to repurchase agreements, the SEC proposed to (i) limit special treatment under the diversification provisions of Rule 2a-7 to money market funds investing in repurchase agreements collateralized only by cash items or government securities and (ii) require that a money market fund's board of directors or its delegate evaluate the creditworthiness of the counterparty, regardless of whether the repurchase agreement is fully collateralized.

#### **F. Disclosure of Portfolio Information**

Under the proposal, Rule 2a-7 would be amended to require money market funds to disclose information about their portfolio holdings on their websites no later than two business days after the end of a month. Specifically, a fund would be required to disclose the fund's schedule of investments identifying, among other things, the issuer, the title of the issue, the principal amount of the security and the security's current amortized cost.<sup>10</sup> The amendments would require a fund to post the information on its website for at least twelve months. Money market funds also would be required to provide the SEC with a monthly electronic filing of more detailed portfolio holdings information under proposed Rule 30b1-6.<sup>11,12</sup>

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<sup>9</sup> The proposal would require that stress tests be conducted at intervals that the board of directors determines appropriate and reasonable in light of current market conditions, which is the approach that Rule 2a-7 currently takes with respect to the frequency of shadow pricing. Funds would be required to maintain records of the stress testing for six years, in an easily accessible place for the first two years.

<sup>10</sup> The fund's schedule of investments is prescribed by Rules 12-12 to 12-14 of Regulation S-X.

<sup>11</sup> The portfolio information would be filed with the SEC on new Form N-MFP no later than the second business day of each month. See Proposing Release, *supra* note 1, at 81-82.

<sup>12</sup> To avoid duplicative disclosure obligations, the SEC also proposed to amend Rule 30b1-5 to exempt money market funds from the requirement to file their schedules of investments pursuant to Item 1 of Form N-Q, a quarterly schedule of portfolio holdings of management investment companies. See Proposing Release, *supra* note 1, at 85-86.

The SEC also requested comment on whether it should require money market funds to post their market-based NAV per share and the market-based prices of their portfolio securities.<sup>13</sup> This request for comment concerning shadow-pricing was not a formal rule proposal.

### **G. Exemption for Affiliate Purchases**

The SEC proposed to amend Rule 17a-9, which provides an exemption from Section 17(a) of the Investment Company Act, to permit affiliated persons of a money market fund to purchase distressed portfolio securities from the fund. Under the proposed amendment, a money market fund could sell a portfolio security that has defaulted to an affiliated person, even if the security continues to be an eligible security. In addition, an affiliated person would be permitted to purchase portfolio securities that have not defaulted from an affiliated money market fund for cash at the greater of their amortized cost value or market value, provided that such person promptly remits to the fund any profit it realizes from the later sale of any such security. The SEC also proposed a related amendment to Rule 2a-7 that would require that funds report all such transactions to the SEC.

### **H. Fund Liquidation**

The SEC proposed new Rule 22e-3, which would exempt money market funds from Section 22(e) to permit them to suspend redemptions in order to facilitate an orderly liquidation of the fund. Under proposed new Rule 22e-3, any money market fund could suspend redemptions upon breaking the buck if the board, including a majority of its independent directors, approves liquidation of the fund.<sup>14</sup> The SEC also requests comment on whether it should (i) include a provision in Rule 22e-3 that would permit fund directors to temporarily suspend redemptions during certain exigent circumstances other than liquidation of the fund, or (ii) include conditions in any rule regarding the treatment of shareholders in a liquidation, such as whether fund assets should be distributed on a pro rata basis.

### **I. Processing of Transactions**

Finally, in the event a fund breaks the buck, the proposed amendments would require money market funds to have the operational capacity to continue to process investor transactions in an orderly manner. Rule 2a-7 would be amended to require that a money market fund's board determine in good faith, no less frequently than once each calendar year, that the fund (or its transfer agent) has the capacity to redeem and sell fund shares at prices based on the current NAV per share.

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<sup>13</sup> See Proposing Release, *supra* note 1, at 78.

<sup>14</sup> Proposed Rule 22e-3(a) would permit a money market fund to suspend redemptions if: (i) the fund's current price per share, calculated pursuant to Rule 2a-7(c), is less than the fund's stable NAV per share; (ii) its board of directors, including a majority of directors who are not interested persons, approves the liquidation of the fund; and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions, by electronic mail directed to the attention of the Director of the Division of Investment Management or the Director's designee.

## **Floating Net Asset Value and In-Kind Distributions**

While not proposing amendments that would implement either proposal, the SEC requested comment as to whether its rules should be amended to allow for a floating NAV or in-kind distributions.

### **Floating Net Asset Value**

The SEC sought comment on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation, thereby forcing fund NAVs to float. As opposed to a stable NAV, which appears to promise a dollar-for-dollar withdrawal of a person's investment, a floating NAV would cause such investor's personal investment in the fund to fluctuate like an investment in a regular mutual fund.

At the SEC's open meeting, SEC staff members noted that a stable NAV makes money market funds susceptible to a run and favors investors who redeem first over other investors in the fund. The SEC staff members saw a floating NAV as an option to prevent these problems from occurring. It should be noted, however, that none of the Commissioners spoke strongly in favor of a floating NAV. Commissioner Troy Paredes, in particular, noted that a floating NAV creates a "different kind of product" and such creation could negatively impact U.S. companies, states and municipalities that rely on money market funds for short-term borrowing purposes.

The SEC requests comment on whether or not a floating NAV would increase or decrease stability in money market funds and the broader financial system.

### **In-Kind Redemptions**

If the SEC chooses to retain a stable NAV for money market funds, it is interested in exploring other methods of reducing the risks and unfairness posed by significant sudden redemptions, such as requiring funds to satisfy redemption requests in excess of a certain size through in-kind redemptions. In-kind redemptions would lessen the impact of large redemptions on remaining money market fund shareholders and would require the redeeming investor to bear part of the cost of its liquidity needs. During the SEC's open meeting, Commissioner Elisse Walter supported the idea of in-kind redemptions because they provide an option for maintaining a stable NAV. If such a proposal is made, the SEC expects to set the threshold above which in-kind redemptions are required sufficiently high so that it could reasonably expect that such an investor would be in the position to assume ownership of such securities.

Alternatively, the SEC noted that a board of directors could cause a money market fund to assess a redemption fee under Rule 22c-2 to impose some of the fund's costs in meeting shareholders' liquidity needs on the redeeming shareholders.

**Request for Comment**

The proposing release solicits comment on the potential scope, effects, and costs of these rule proposals. The deadline for commenting on these proposals is September 8, 2009.

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If you have any questions concerning the foregoing or would like additional information, please contact Burton Leibert (212-728-8238, bleibert@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), or the Willkie attorney with whom you regularly work.

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