

Money Market Fund Reform

July 15, 2009

On June 30, the Securities and Exchange Commission (SEC) released proposed changes to Rule 2a-7 under the Investment Company Act of 1940 (1940 Act) (Rule 2a-7), which is the rule governing money market funds.¹ The changes are designed largely to improve the stability of money market funds, particularly under adverse market conditions. However, the proposed amendments also include novel provisions that are specifically geared to the operations of funds that have “broken the buck” and funds that will liquidate. Some of the SEC’s proposals amend current Rule 2a-7 requirements, while others impose new requirements on money market funds.

Background

Three significant events relating to the current broad financial crisis caused investors, fund managers, and the government to take a hard look at the performance and safety of money market funds. First, the Reserve Primary Fund “broke the buck” when its shares fell below \$1.00 as a result of holdings of securities issued by Lehman Brothers. Second, numerous money market funds required financial support from their sponsors as a result of their holdings of securities issued by structured investment vehicles, or SIVs. Finally, extreme market conditions rendered illiquid many types of investments that had previously been believed to be highly liquid, which made it very difficult for many funds to satisfy a rush of redemption requests.

Shortly after these events, the SEC signaled to the industry that Rule 2a-7 may be subject to review to significantly strengthen the regulatory framework for money market funds. In March 2009, as a reaction to the turmoil in the money market fund industry and talk of Rule 2a-7 reform, the Investment Company Institute’s money market fund working group (the ICI Working Group) released recommendations to enhance existing money market fund regulations. The SEC’s proposed changes are substantially similar to the ICI Working Group’s recommendations, but there were some items in the ICI Working Group report that were not addressed in the SEC proposals and some SEC proposals that were not addressed in the ICI Working Group report. Certain notable topics in the SEC proposals that differ from the ICI Working Group report include:

- More rigid liquidity standards, including a ban on the purchase of illiquid securities, which was not addressed in the ICI Working Group report
- Requirements to maintain the operational ability to process purchases and redemptions at prices other than \$1.00 per share, which was not addressed in the ICI Working Group report
- A request for comment on the concept of a floating net asset value, which the ICI Working Group explicitly rejected

¹ Release [IC-28807](#) (June 30, 2009).

Discussion of SEC's Proposed Amendments

The SEC's proposed amendments to the rules governing money market funds would:

- Increase portfolio credit quality requirements
- Shorten portfolio maturity limits and modify testing methodologies
- Impose specific portfolio liquidity requirements
- Require "know your investor" procedures
- Require stress testing of portfolios
- Limit investment in repurchase agreements
- Enhance disclosure of portfolio information
- Provide money market funds and their boards of directors with options when dealing with situations in which market instability has had a detrimental impact on the stability of money market funds

Proposed Changes to Existing Rule 2a-7 Requirements

Increase Credit Quality

"Eligible securities" under Rule 2a-7 would be redefined to include only securities that have received the highest short-term debt ratings from the "requisite nationally recognized statistical rating organizations" (NRSROs). Currently, Rule 2a-7 allows limited investment in securities that have received the second highest short-term rating, so the proposed change would essentially ban investment in second-tier securities. Limited allowance would be made to permit retention of securities that are downgraded from first-tier to second-tier. With respect to long-term securities, a money market fund would be permitted to invest in a long-term security with a remaining maturity of 397 calendar days or less that has not received a short-term rating only if the security has received long-term ratings by "requisite NRSROs" in the highest two ratings categories (rather than one of the three highest rating categories).

Weighted Average Maturity

The maximum dollar-weighted average portfolio maturity would be reduced from 90 days to 60 days.

Proposed Changes Adding New Rule 2a-7 Requirements

Weighted Average Life

Money market funds would be required to adhere to a new maturity test, which would limit the weighted average life of their portfolio to no more than 120 days. In making this calculation, funds would look at the maturity of their investments without giving effect to maturity shortening provisions applicable to long-term floating or variable rate securities. Funds would not be able to shorten the maturity date on these securities to less than their nominal maturity based on the next date the interest rate on the instrument is reset. The effect of the restriction would be to limit the ability of a money market fund to invest in long-term securities that may expose a fund to interest rate and credit spread risk.

Portfolio Liquidity

Money market funds currently may not hold more than 10% of their portfolio in 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), although this requirement is imposed as part of the SEC's interpretation of the requirement that money market funds issue "redeemable securities." Under a newly proposed restriction, to be adopted as part of Rule 2a-7 rather than a revised interpretation of "redeemable security," money market funds would not be permitted to acquire illiquid securities and would be required to satisfy a general portfolio liquidity standard. In addition, money market funds would be required to maintain a specified portion of their portfolios in cash or securities that can be readily converted into cash within one business day (the one-day liquidity basket) and a specified portion of their portfolios in cash or securities that can be readily converted into cash within five business days (the weekly liquidity basket).

The specified percentage of assets required to be held in each “basket” varies depending on new money market fund classifications, which divide funds into “retail” and “institutional” categories. Institutional money market funds typically maintain a greater portion of their assets in cash and overnight repurchase agreements than retail funds, which reflects the greater liquidity needs of these funds. These greater needs were demonstrated last fall, when institutional funds were subject to substantially greater redemption pressure than retail funds. The proposed changes would require a money market fund’s board of directors (or its delegate) to determine annually whether the fund is an institutional or retail money market fund for purposes of meeting the liquidity requirements. In particular, the board of directors would make the determination based on (i) the nature of the record owners of fund shares, (ii) the fund’s minimum initial amount of investment in the fund, and (iii) historical cash flows. Any fund not determined to be an institutional fund would be deemed to be a retail fund. The general liquidity scheme, therefore, would be as follows:

	Retail	Institutional
Daily Liquidity Requirement (does not apply to tax-exempt funds)	5%	10%
Weekly Liquidity Requirement (applies to tax-exempt funds)	15%	30%

In addition to the daily and weekly liquidity requirements, a money market fund would be subject to the general liquidity requirement that it always hold highly liquid assets sufficient to meet foreseeable redemptions. Pursuant to the general liquidity requirement, funds must develop “know your investor” procedures so that they would either (i) understand the expected redemption practices and liquidity needs of their investors or (ii) if this information is unavailable, mitigate potential adverse effects from such unpredictability.

Stress Testing

To further address liquidity risks that money market funds face, the board of directors of each money market fund using the amortized cost method would be required to adopt procedures providing for periodic stress testing of the fund’s portfolio. The procedures would require testing of the fund’s ability to maintain a stable net asset value per share based upon certain hypothetical events and would require the board of directors to receive a report of the results of such testing.

Repurchase Agreements

Money market funds would only be permitted to invest in repurchase agreements collateralized by cash items or government securities, and the board of directors (or its delegate) would be required to evaluate the creditworthiness of the counterparty even when the repurchase agreement is fully collateralized.

Processing of Transactions

Each money market fund’s board of directors must determine at least annually that the fund (or its transfer agent) has the capacity to redeem and sell its securities at a price based on the current net asset value per share. This proposed amendment would allow money market funds to “break the buck” and continue to process investor transactions at prices that do not correspond to a stable net asset value or price per share.

Proposed Changes to Other Rules Under the 1940 Act

Exemption for Affiliated Purchases

The SEC’s proposal would revise Rule 17a-9 under the 1940 Act to permit affiliated persons of a money market fund to purchase any portfolio security from the fund for cash at the greater of the security’s amortized cost value or market value. In the case of a security that continues to be an “eligible security” or has not defaulted at the time of purchase, the affiliated person would be required to promptly remit to the fund any profit it realizes from the

later sale of the security. A money market fund would be required to notify the SEC, via electronic mail, of any purchase made by an affiliated person in reliance on Rule 17a-9.

Suspension of Redemptions

As proposed, a new Rule 22e-3 under the 1940 Act would permit a money market fund to suspend redemptions upon breaking a buck, if the board approves liquidation of the fund. This new rule is designed to facilitate an orderly liquidation of the fund. Prior to suspending redemptions, the fund must notify the SEC of its decision to liquidate and suspend redemptions.

Disclosure of Portfolio Information

Proposed Rule 30b1-6 under the 1940 Act would require money market funds to post their portfolio holdings each month on their websites and to provide the SEC with a monthly electronic filing of portfolio holdings information on Form N-MFP.

Solicitation for Public Comments

In addition, the SEC is seeking comments on the following issues:

1. Whether the use of the amortized cost method of valuation should be eliminated.
2. Whether money market funds may satisfy redemption requests in excess of a certain size through in-kind redemptions.
3. Whether Rule 2a-7 should continue to include NRSRO references.
4. Whether money market funds should evaluate risks involving investments in asset-backed securities.
5. Whether the maximum maturity for nongovernment securities must be reduced.
6. Whether the diversification limits of Rule 2a-7 should be tightened to protect money market funds against too much exposure to one issuer or guarantor.
7. Whether an industry concentration limitation should be added to Rule 2a-7.
8. Whether fund directors should be permitted to temporarily suspend redemptions during certain exigent circumstances other than liquidation of the fund.
9. Whether SEC rules should include conditions regarding treatment of shareholders in a liquidation (e.g., fund assets to be distributed on a pro rata basis).

If the SEC issues final rules similar to the proposals, money market funds would have to update their disclosure, operational, board reporting, and compliance policies and procedures. It is unclear what the implications of the SEC's final rules will be for boards of directors. The new rules may give them, or their delegates, more authority in overseeing money market funds' activities and may require them to review additional reports related to the money market funds' investments and investors.

Comments on the SEC's proposals are due by September 8, 2009.

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