

MEMO# 24148

February 24, 2010

SEC Adopts Changes to Money Market Fund Regulation

[24148]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 8-10
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 6-10
BOARD OF GOVERNORS No. 2-10
BROKER/DEALER ADVISORY COMMITTEE No. 8-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 6-10
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PRIMARY CONTACTS - MONEY MARKET FUNDS No. 1-10
SEC RULES MEMBERS No. 20-10
SMALL FUNDS MEMBERS No. 14-10
TRANSFER AGENT ADVISORY COMMITTEE No. 13-10 RE: SEC ADOPTS CHANGES TO
MONEY MARKET FUND REGULATION

The Securities and Exchange Commission has adopted amendments proposed last June to the rules governing money market funds, with several changes made in response to commenters—including those of ICI. [\[1\]](#) According to the SEC, the amendments are designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share. The Release also notes that the SEC is continuing to explore the possibility of more significant changes to the regulation of money market funds—some of which could transform the business and regulatory model on which money market funds have been operating for more than 30 years—and expects to issue a release addressing these issues and proposing further reform to money market fund regulation.

Portfolio Quality

The SEC's amendments further reduce the amount of credit risk a money market fund may assume by limiting the securities in which money market funds may invest. The amendments also address how NRSRO ratings are used in Rule 2a-7.

Second Tier Securities

The amendments place new limits on a money market fund's ability to acquire lower quality ("second tier") securities by (i) lowering the permitted percentage of a fund's "total assets" that may be invested in second tier securities from 5 percent to 3 percent and (ii) lowering the permitted concentration of its total assets in second tier securities of a single issuer from the greater of one percent or \$1 million to $\frac{1}{2}$ of 1 percent. In addition, money market funds will not be permitted to acquire any second tier security with a remaining maturity in excess of 45 days. The new limitations also apply to tax-exempt funds, which under the current rule are only subject to the issuer diversification requirement with respect to conduit securities that are second tier. In addition to the reduction in the ability of money market funds to acquire second tier securities of any particular issuer, the SEC also proportionately reduced by half the ability of a money market fund to acquire "demand features" or "guarantees" of a single issuer that are second tier securities from 5 percent to 2.5 percent of the money market fund's total assets.

According to the Release, the SEC believes that despite the fact that second tier securities present greater credit spread risk and trade in thinner markets, the amendments strike an appropriate balance between reducing the risk that money market funds will not be able to maintain a stable price per share and allowing fund investors to benefit from the higher returns that limited exposure to second tier securities can provide.

NRSROs

The amendments continue to limit a money market fund's investment in rated securities to those securities rated in the top two rating categories (or unrated securities of comparable quality). Although the Release notes the SEC's concern that references to NRSRO ratings in its rules may have inadvertently placed an "official seal of approval" on ratings that could adversely affect the quality of due diligence and investment analysis, it also notes that the SEC found no evidence that suggests that over-reliance on NRSRO ratings contributed to the problems that money market funds faced during the debt crisis. Indeed, the Release quotes various commenters, including ICI, that argued that NRSRO ratings act as a "floor" that keeps all money market funds operating at or above the same level.

To address lingering concerns regarding the role of NRSROs in Rule 2a-7, the amendments, however, shift responsibility to money market fund boards for deciding which NRSROs they will use in determining whether a security is an eligible security for purposes of the rule. Specifically, the amendments require that each money market fund's board of directors (i) designate four or more NRSROs, any one or more of whose short-term credit ratings the fund would look to under the rule in determining whether a security is an eligible security, a rated security, and whether it is a first tier or a second tier security, and (ii) determine at least once each calendar year that the designated NRSROs issue credit ratings that are sufficiently reliable for that use. In addition, funds must identify the designated NRSROs in the fund's statement of additional information ("SAI"). Under the amendments, funds may, but are not required to, consider (or monitor) the ratings of other NRSROs under other provisions of the rule.

The Release notes that changes in the fund's designated NRSROs, however, may affect the ability of the fund to purchase a new security or rollover a current holding, and may require the fund to reassess promptly whether the security continues to present minimal creditworthiness and dispose of a current holding. This is because a new designation of an NRSRO (or a removal of a designated NRSRO) is now treated under the rule as the equivalent of a credit event requiring the fund board or adviser to consider the rating of the newly designated NRSRO (or preclude the consideration of a formerly designated NRSRO).

The Release explains that the amendments are designed, among other things, to foster greater competition among NRSROs (including smaller NRSROs that specialize in rating particular investments) to produce the most reliable ratings in order to obtain designation by money market fund boards. The Release further explains that a fund could designate an NRSRO with respect to short-term credit ratings for only certain types of issuers or securities. This would allow a fund, for example, to designate an NRSRO that specializes in securities issued by insurance companies or banks. The Release notes that this approach may further encourage new entrants among NRSROs that fund managers might not otherwise consider designating due to lack of confidence in ratings outside the NRSROs' areas of expertise

In addition, the Release explains that before designating an NRSRO and before making its annual determination, a board should have the benefit of the adviser's evaluation regarding the quality of the NRSRO's short-term ratings. According to the Release, the SEC would expect the adviser's annual evaluation to be based, among other things, on an examination of the methodology an NRSRO uses to rate securities, including the risks they measure, and the NRSRO's record with respect to the types of securities in which the fund invests, including asset backed securities. The reliability of a newly registered NRSRO could be evaluated based upon the quality and relevant experience of the personnel conducting the rating.

Asset Backed Securities

Based on an analysis of the role of NRSROs in the asset backed security ("ABS") market during 2007 and 2008, the amendments eliminate a requirement that an ABS be rated by at least one NRSRO in order to be an eligible security that a money market fund may acquire. As a consequence, funds may acquire an unrated ABS that otherwise meets the requirements of Rule 2a-7, including those requirements that apply to unrated securities.

The Release notes, however, that as part of the minimal credit risk analysis that any money market fund must conduct before investing in an ABS, the board of directors (or its delegate) should: (i) analyze the underlying ABS assets to ensure that they are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS under various market conditions; (ii) analyze the terms of any liquidity or other support provided by the sponsor of the ABS; and (iii) otherwise perform the legal, structural, and credit analyses required to determine that the particular ABS involves appropriate risks for the money market fund.

Portfolio Maturity

The amendments further reduce the exposure of money market fund investors to certain risks, including interest rate risk, spread risk, and liquidity risk.

Weighted Average Maturity

The amendments require that each money market fund maintain a dollar-weighted average portfolio maturity (“WAM”) appropriate to its objective of maintaining a stable net asset value or price per share, but in no case greater than 60 days. The Release explains that such a limit on the maximum WAM will result in money market funds that are more resilient to changes in interest rates that may be accompanied by other market shocks, and thus reduce the likelihood of a run and better protect money market fund investors.

Weighted Average Life

As recommended by the ICI’s Money Market Working Group, the amendments limit the dollar-weighted average life (“WAL”) to maturity of a money market fund’s portfolio to 120 calendar days. Unlike WAM, the WAL of a portfolio is measured without reference to any Rule 2a-7 provision that otherwise permits a fund to shorten the maturity of an adjustable-rate security by reference to its interest rate reset dates. [\[2\]](#) The WAL limitation thus restricts the extent to which a fund can invest in longer term securities that may expose a fund to spread risk.

Maturity Limit for Government Securities

The SEC is deleting a provision of Rule 2a-7 that has permitted a fund that relied 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. In its proposing release, the SEC had requested comment on whether it should impose a limitation on the maximum final legal maturity of adjustable-rate Government securities that money market funds are permitted to acquire, but only received two comments on this proposal. Although the amendments do not include any such limitation, the Release notes that in the future it may reconsider, after obtaining additional data, whether to limit the maximum maturity of adjustable-rate Government securities that can be held by money market funds.

Portfolio Liquidity

The amendments add new risk-limiting conditions to Rule 2a-7 designed to improve a money market fund’s ability to meet significant redemption demands.

General Liquidity Requirement

The amendments require that each money market fund hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of its obligations under Section 22(e) of the Investment Company Act of 1940 and any commitments the fund has made to shareholders (the “general liquidity requirement”). Depending upon the volatility of its cash flows (particularly shareholder redemptions), this new provision may require a fund to maintain greater liquidity than would be required by the daily and weekly minimum liquidity requirements set forth in the rule and discussed below.

To comply with this general liquidity requirement, the Release notes the SEC’s expectation that money market fund managers consider factors that could affect the fund’s liquidity needs, including characteristics of a money market fund’s investors and their likely redemptions.

In addition, to comply with amended Rule 2a-7, the Release notes that pursuant to Rule 38a-1 under the Investment Company Act, money market funds should adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders. In other words, fund boards should make sure that the adviser is monitoring and planning for “hot money.” In their consideration of these procedures and in the oversight of their implementation, the Release notes that fund boards should appreciate that, in some cases, fund managers’ interests in attracting additional fund assets may be in conflict with their overall duty to manage the fund in a manner consistent with maintaining a stable net asset value. The Release urges directors to consider the need for establishing guidelines that address this conflict.

Limitation on Acquisition of Illiquid Securities

The amendments further limit a money market fund’s investments in illiquid securities (i.e., securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to them by the money market fund). Under amended Rule 2a-7, a money market fund cannot acquire illiquid securities if, immediately after the acquisition, the fund would have invested more than 5 percent of its total assets in illiquid securities. The SEC had proposed to prohibit funds from acquiring any securities that were, at the time of their acquisition, already illiquid. Based on commenters’ objections, including ICI, the SEC was persuaded that prohibiting funds from acquiring any illiquid securities may have undesirable consequences for money market funds. Thus, the amendments reduce by half the existing limit in order to strike a balance between the SEC’s concern regarding liquidity risk, i.e., a fund’s ability to satisfy redemption demands if it is holding illiquid securities, and funds’ concerns that they retain some ability to make investments in high quality illiquid securities. Also at the suggestion of commenters, the Release notes that the SEC would not treat as illiquid a security that could not be sold at amortized cost. Thus, under the amended rule, a money market fund using the amortized cost method will be able to treat as liquid a security that the fund can sell at a price that deviates from the security’s amortized cost value, as long as the price approximates the market-based value that the fund has ascribed to the security for purposes of determining its shadow price. Because the market-based value assigned by a money market fund to its securities is the measure that ultimately justifies the fund’s use of a stable net asset value, the Release notes that a money market fund should treat as illiquid any security that cannot be sold at a price approximating such market-based value.

Minimum Daily and Weekly Liquidity Requirements

The SEC is adopting new liquidity requirements that mandate each money market fund maintain a portion of its portfolio in cash and securities that can readily be converted into cash. More specifically, amended Rule 2a-7 requires all taxable money market funds to hold at least 10 percent of their total assets in “daily liquid assets” [\[3\]](#) and all money market funds to hold at least 30 percent of their total assets in “weekly liquid assets.” [\[4\]](#) A money market fund must comply with the daily and weekly liquidity standards at the time each security is acquired. Thus, a money market fund whose portfolio does not meet the minimum daily or weekly liquidity standards after acquisition is not in violation of the rule, but may not acquire any assets other than daily or weekly liquid assets.

In response to commenters’ concerns, including those of ICI, the SEC dropped its proposal to require funds to distinguish between retail and institutional funds for purposes of the liquidity requirements. Indeed, the Release acknowledges that after further consideration, the SEC has not identified an effective way at this time to distinguish between types of

money market funds for this purpose. Therefore, the amended rule applies the same minimum standards to both institutional and retail money market funds. The Release notes, however, that the SEC intends to consider revisiting its determination to apply the same minimum liquidity standards to all money market funds and reevaluate whether there is a workable objective definition that would accurately identify funds with lower liquidity needs and thus justify applying lower minimum standards to them.

Stress Testing

The amendments require a money market fund's board of directors to adopt procedures providing for periodic stress testing of the money market fund's portfolio. Under the amended rule, a fund must adopt procedures that provide for the periodic testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events. These include an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. Unlike the proposal, the stress testing requirement is applicable to all money market funds that employ either the amortized cost method of valuing portfolio securities or the penny-rounding method of pricing fund shares.

Because different tests may be appropriate for different market conditions and different money market funds, the Release notes the SEC's belief that the funds are better positioned to design and modify their stress testing systems and have not included more specific criteria in the rule. The amendment requires the testing to be done at such intervals as the fund board of directors determines appropriate and reasonable in light of current market conditions. This is the same approach that Rule 2a-7 takes with respect to the frequency of shadow pricing. The SEC urges funds, however, to adopt thresholds for testing frequency based, in part, on the amount of the deviation of the fund's market-based net asset value per share from its amortized cost value per share similar to many funds' thresholds for more frequent shadow pricing. Thus, the Release notes that if a fund's shadow net asset value per share decreased to less than \$0.9975, the SEC would expect the fund to conduct stress tests at least every week, even if the fund stress tests less frequently under normal conditions. The rule does not, however, specifically require the board to design the portfolio stress testing, as may have been suggested by the SEC's proposing release.

The amended rule also requires that the board receive a report of the results of the stress testing at its next regularly scheduled meeting, and more frequently, if appropriate, in light of the results. The report must include: (i) the date(s) on which the fund portfolio was tested; and (ii) the magnitude of each hypothetical event that would cause the money market fund to break the buck. The report also must include an assessment by the fund's adviser of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year.

Repurchase Agreements

As proposed, the amendments limit money market funds to investing in repurchase agreements collateralized by cash items or Government securities in order to obtain special treatment of those investments under the diversification provisions of Rule 2a-7. The

Release notes that this change is designed to reduce the risk that a money market fund would experience losses upon the sale of collateral in the event of a counterparty's default.

The SEC also is reinstating the requirement that it eliminated in 2001 that the money market fund's board of directors or its delegate evaluate the creditworthiness of the repurchase agreement's counterparty in order for the fund to take advantage of the special look-through treatment under Rule 2a-7's diversification provisions. The Release notes that the effect of this amendment is to require a fund adviser, as delegate, to determine that the counterparty is a creditworthy institution, separate and apart from the value of the collateral supporting the counterparty's obligation under the repurchase agreement.

Disclosure of Portfolio Information

Public Website Posting

The amendments require money market funds to disclose information about their portfolio holdings each month on their websites. Unlike the proposal that would have required a fund to disclose the fund's schedule of investments as prescribed by Rules 12-12 through 12-14 of Regulation S-X, the information required to be disclosed is listed in the amended rule. [5] The SEC was persuaded by commenters, including ICI, that the information specified in Regulation S-X would include information that would not be helpful to investors. Instead, the Release notes that investors will continue to have access to the more detailed information required by Regulation S-X in the fund's quarterly Form N-CSR and Form N-Q filings. The Release states that the revisions more closely tailor the required information to the needs of money market fund investors and others who seek information about fund holdings through internet websites.

The amended rule requires funds to post the portfolio information, current as of the last business day of the previous month, no later than the fifth business day of the month. As proposed, a fund would have been required to post the portfolio information on its website no later than the second business day of the month. The SEC extended the time in response to commenters, including ICI, that asserted that the second business day deadline would not provide funds with enough time to compile, review, and post the required portfolio information accurately. The amended rule also requires the portfolio information to be maintained on the fund's website for no less than six months after posting. In response to concerns expressed by commenters, the SEC reduced the maintenance period from the proposed twelve months.

Reporting to the SEC

The SEC has adopted a new rule requiring money market funds to provide the SEC a monthly electronic filing of more detailed portfolio holdings information. According to the Release, the information will permit the SEC to create a central database of money market fund portfolio holdings, which will enhance its oversight of money market funds and its ability to respond to market events. New Rule 30b1-7 requires money market funds to report portfolio information on new Form N-MFP within five business days after the end of each month. As proposed, Form N-MFP must be filed electronically through EDGAR in XML tagged date format. Information reported to the SEC will be available to the public on a 60-day delay.

The new rule and form are substantially similar to what was proposed, with a few exceptions. Most significantly, the information includes the market-based values of each portfolio security and the fund's market-based net asset value per share, with separate entries for values that do and do not take into account any capital support agreements into which the fund may have entered. The Release notes that as a collateral effect, the SEC expects that the public disclosure of monthly market-based net asset values may have the effect of discouraging a fund's portfolio manager from taking risks that might reduce the fund's market-based net asset value.

The information also includes a requirement that funds provide a description of the collateral subject to a repurchase agreement, including the issuer, maturity date, coupon or yield, the principal amount, to the nearest cent, and the value of the collateral, to the nearest cent.

Phase-out of Weekly Reporting by Certain Funds

The SEC also adopted as final Rule 30b1-6T, the temporary rule that requires the weekly filing of portfolio information by money market funds that have a market-based net value per share below \$0.9975. As adopted, the only change to the rule is the expiration date, which will now expire on December 1, 2010 and correspond with the first filing of portfolio information required by new Rule 30b1-7. The last date that funds will be required to file information under Rule 30b1-6T therefore will be on November 30, 2010.

Processing of Transactions

The amendments require that a fund (or its transfer agent) have the capacity to redeem and sell its securities at a price based on a 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. According to the Release, this amendment will require that shareholder transactions be processed in an orderly manner, even under circumstances that require a fund to "break a dollar." Based on concerns expressed by commenters that the issue is operational in nature and need not directly involve the board, the SEC changed the focus of the rule to the fund's ability to process transactions, rather than the board's determination regarding that ability as proposed.

Exemption for Affiliate Purchases

The SEC adopted an amendment to Rule 17a-9 under the Investment Company Act to expand the circumstances under which certain affiliated persons can purchase portfolio securities from a money market fund. The amendment expands the exemption provided by the rule from the Act's prohibition on affiliated transactions to permit affiliated persons to purchase from a money market fund a portfolio security that has defaulted (excluding an immaterial default unrelated to the financial condition of the issuer), but that continues to be an eligible security, as long as the conditions of the rule governing the purchase price are satisfied. These conditions require that the purchase price is paid in cash and is equal to the greater of the security's amortized cost or its market value, including accrued interest.

The amendment also adds a new provision to the rule that will more broadly permit

affiliated persons, under the same conditions as discussed above, to purchase other portfolio securities from an affiliated money market fund, for any reason, provided that such person promptly remits to the fund any profit it realizes from the later sale of the security. According to the Release, in these circumstances there may not be an objective indication that the security is distressed and thus that the transaction is clearly in the interest of the fund. Therefore, as proposed, the SEC has added the “claw back” requirement to eliminate incentives for fund advisers and other affiliated persons to buy securities for reasons other than protecting fund shareholders from potential future losses. The Release explains that the amendment is intended to enable advisers to address acute credit or liquidity problems in a money market fund portfolio by purchasing securities from the fund that would be difficult or impossible to sell on the open market at or near their amortized cost.

The SEC also is adopting an amendment to Rule 2a-7 that requires a money market fund whose securities have been purchased by an affiliated person in reliance on Rule 17a-9 to provide the SEC with prompt notice by electronic mail of the transaction and the reasons for the purchase. According to the Release, such reasons might include, for example, that the fund’s adviser expected that the security would be downgraded, that due to the decreased market value of the security the fund was at risk of breaking the dollar, or that the fund was experiencing significant redemption requests and wished to avoid a “fire sale” of assets to satisfy such requests.

Fund Liquidation

The SEC adopted new Rule 22e-3, which exempts money market funds from Section 22(e) of the Investment Company Act, to permit them to suspend redemptions and postpone payment of redemption proceeds in order to facilitate an orderly liquidation of the fund. The rule permits a fund to suspend redemptions and payment of redemption proceeds if (i) the fund’s board, including a majority of disinterested directors, determines that the deviation between the fund’s amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions. The rule applies to securities tendered for redemption but not yet priced at the time the fund begins to rely on the rule.

Unlike the proposal, the rule is not conditioned on a fund breaking a dollar and re-pricing its shares. Rather, the rule permits a money market fund’s board to suspend redemptions if the fund is about to break the dollar and decides to liquidate the fund. The Release notes that the revised condition provides the fund directors with the appropriate amount of discretion to act in the interest of shareholders.

The rule also allows a conduit fund (i.e., a fund that invests in a money market fund) to rely on the rule if the money market fund in which it invests has suspended redemptions under the rule. The SEC anticipates that this provision will be used principally by insurance company separate accounts issuing variable insurance contracts and by funds participating in master-feeder arrangements.

The rule also permits the SEC, after appropriate notice and opportunity for hearing, to rescind or modify the relief provided by the rule (and thus require the fund to resume

honoring redemptions) if, for example, a liquidating fund has not devised, or is not properly executing, a plan of liquidation that protects fund shareholders.

Compliance Dates

Portfolio Requirements

Except as indicated below, the compliance date for amendments to Rule 2a-7 related to portfolio quality, maturity, liquidity, and repurchase agreements is May 28, 2010. Funds are not required to dispose of portfolio securities owned, or terminate repurchase agreements entered into, as of the time of adoption of the amendments to comply with the requirements of the rule as amended. Fund portfolios must meet the new maximum WAM and WAL limits by June 30, 2010.

Designation of NRSROs

Each fund must disclose the designated NRSROs in its SAI no later than December 31, 2010. Fund boards are free to take advantage of the rule amendments any time after the effective date.

Disclosure and Reporting of Portfolio Information

- Website disclosure. The compliance date for public website disclosure is October 7, 2010.
- Reporting to the SEC. All money market funds must begin filing information on Form N-MFP pursuant to Rule 30b1-7 no later than December 7, 2010. Funds filing information with the SEC pursuant to Rule 30b1-6T will no longer be required to file this information after December 1, 2010.

Beginning October 7, 2010, SEC staff will be able to receive trial data from funds, on a voluntary basis, pursuant to the requirements of Rule 30b1-7. According to the Release, they will use these voluntary submissions and the experiences of funds during this period to make adjustments to their filing system and provide guidance to funds. The Release notes that the SEC does not intend to make these trial submissions public.

Processing of Transactions

Funds must comply with the new requirement to be able to process transactions at prices other than stable net asset value no later than October 31, 2011.

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[Attachment](#)

endnotes

[1] See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010) (“Release”), which is available on the SEC’s website at <http://sec.gov/rules/final/2010/ic-29132.pdf>. For your reference, attached is a redline

showing the amendments to Rule 2a-7.

[2] The Release also clarifies that for purposes of the WAM and WAL limitations, cash balances have a maturity of one day.

[3] A daily liquid asset includes cash (including demand deposits), Treasury securities, and securities (including repurchase agreements) for which a money market fund has a legal right to receive cash in one business day.

[4] A weekly liquid asset includes the same assets as noted above (except that the fund would have had to have the right to receive cash in five business days rather than one). The SEC also was persuaded by commenters, including ICI, to include Government agency discount notes as weekly liquid assets based on their relative liquidity during times of extreme market stress. Thus, the definition also includes agency discount notes with remaining maturities of 60 days or less.

[5] The amended rule requires funds to disclose monthly with respect to each security held: (i) the name of the issuer; (ii) the category of investment (e.g., Treasury debt, government agency debt, asset backed commercial paper, structured investment vehicle note); (iii) the CUSIP number (if any); (iv) the principal amount; (v) the maturity date as determined under Rule 2a-7 for purposes of calculating weighted average maturity; (vi) the final maturity date, if different from the maturity date previously described; (vii) coupon or yield; and (viii) the amortized cost value. In addition, the amendments require funds to disclose their overall WAM and WAL of their portfolios.