

MEMO# 23604

July 2, 2009

SEC Proposes Changes to Money Market Fund Regulation

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TO: ACCOUNTING/TREASURERS MEMBERS No. 30-09
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BOARD OF GOVERNORS No. 6-09
BROKER/DEALER ADVISORY COMMITTEE No. 38-09
INVESTMENT COMPANY DIRECTORS No. 18-09
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 25-09
OPERATIONS MEMBERS No. 13-09
PRIMARY CONTACTS - MONEY MARKET FUNDS No. 3-09
SEC RULES MEMBERS No. 72-09
SMALL FUNDS MEMBERS No. 41-09
TRANSFER AGENT ADVISORY COMMITTEE No. 48-09 RE: SEC PROPOSES CHANGES TO
MONEY MARKET FUND REGULATION

The Securities and Exchange Commission has proposed amendments to rules that govern money market funds under the Investment Company Act of 1940.[\[1\]](#) Many of the proposed amendments are similar to recommendations from the ICI's Money Market Working Group report.[\[2\]](#) Specifically, the amendments would tighten the risk-limiting conditions of Rule 2a-7, require money market funds to disclose information monthly about their portfolio holdings on their websites and to the SEC, and permit a money market fund that has "broken the dollar" to suspend redemptions to allow for the orderly liquidation of fund assets. The SEC also is seeking comment on other potential changes to its regulation of money market funds, including whether money market funds should have "floating" rather than stabilized net asset values or require in-kind redemptions to satisfy certain large redemptions.

Comments on the proposal, which is summarized below, are due to the SEC on or before September 8, 2009.

Tighten the Risk-Limiting Conditions of Rule 2a-7

- Portfolio Quality: The SEC proposal would further limit the amount of credit risk to

which money market funds can be exposed by making the following changes.

- **Second Tier Securities:** Similar to the recommendation by the Money Market Working Group, the SEC proposal would raise credit quality standards by prohibiting money market funds from investing in “second tier securities.” Specifically, under the proposed amendments, money market funds could “acquire” only “eligible securities,” which would be re-defined to include securities receiving only the highest (rather than the highest two) short-term debt ratings from the “requisite NRSROs.”
- **Long-term Unrated Securities:** The SEC proposal would permit money market funds to acquire long-term unrated securities only if they have received long-term ratings in the highest two ratings categories (rather than the highest three) to more narrowly limit the credit risk to which a money market fund may be exposed.
- **Credit Reassessments:** In light of the proposed elimination of second tier securities from the definition of eligible security, the SEC has proposed to amend Rule 2a-7 so the only circumstance in which the fund’s board would be required to reassess whether a security presents minimal credit risks would be if, subsequent to its acquisition by the fund, the fund’s adviser becomes aware that an unrated security has received a rating from any NRSRO below the highest short-term rating category.
- **Portfolio Maturity:** The SEC is proposing changes to Rule 2a-7’s maturity limits in order to further limit the exposure of money market fund investors to certain risks, including interest rate risk.
 - **Weighted Average Maturity:** The SEC proposal would reduce the maximum weighted average portfolio maturity permitted by Rule 2a-7 to 60 days; the current limit is 90 days. The SEC has requested comment on whether a different weighted average maturity limit should apply, such as 45 days or 75 days (as recommended by the Working Group).
 - **Weighted Average Life:** As recommended by the Working Group, the SEC’s proposal would add to Rule 2a-7 a new maturity test that would limit the portion of a fund’s portfolio that could be held in longer term variable- or floating-rate securities. Specifically, the proposal would limit the weighted average life maturity of portfolio securities to 120 days. For purposes of calculating a fund’s weighted average life to maturity, the proposed rule would ignore interest rate resets although a security’s demand features could continue to be used in this calculation.
 - **Maturity Limit for Government Securities:** The SEC proposal would delete a provision of Rule 2a-7 that permits a 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.
 - **Maturity Limit for Other Portfolio Securities:** The SEC has requested comment on whether it should consider reducing the maximum maturity for individual non-Government securities acquired by a money market fund from 397 days to, for example, 270 days.
- **Portfolio Liquidity:** The SEC proposal would amend Rule 2a-7 to add new risk-limiting conditions designed to improve money market funds’ ability to meet significant redemption demands.
 - **Limitation on Acquisition of Illiquid Securities:** The SEC proposal would prohibit money market funds from acquiring securities unless, at the time of acquisition, they are liquid, i.e., securities that can be sold or disposed of in the ordinary

course of business within seven days at approximately their amortized cost value. The proposal would not prohibit funds from continuing to hold securities that become illiquid after their purchase.

- Minimum Daily Liquidity Requirements: For the first time and similar to the Working Group's recommendation, the SEC proposal would require funds to have a minimum percentage of their assets in securities that can be readily converted to cash. Unlike the Working Group's recommendation, however, the SEC has proposed different liquidity requirements for retail and institutional money market funds.
 - Under the proposal, retail and institutional funds could not acquire any securities other than cash, U.S. Treasury securities or securities (including repurchase agreements) that mature or are subject to a demand feature exercisable and payable in one business day ("daily liquid assets") if, immediately after the acquisition, (i) the retail fund would have invested less than 5 percent of its total assets in daily liquid assets and (ii) the institutional fund would have invested less than 10 percent of its total assets in daily liquid assets. In contrast, the Working Group had recommended a daily liquidity requirement of 5 percent for all taxable money market funds.
 - Under the proposal, the fund's board would 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 would determine whether the money market fund is intended to be offered to institutional investors or has the characteristics of a fund that is intended to be offered to institutional investors, based on the (i) 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.
 - A retail fund would be defined as any money market fund that the board has not determined within the calendar year is an institutional fund.
 - Compliance with the daily liquidity test would be determined upon the acquisition of a security, and thus a fund would not have to dispose of less liquid securities (and potentially realize an immediate loss) if the portion of the fund held in highly liquid securities fell below five/ten percent as a result of redemptions. A fund could acquire only daily liquid assets, however, until the portfolio investments met the relevant daily liquidity test.
 - Similar to the Working Group's recommendation, tax exempt money market funds would be exempt from the minimum daily liquidity requirements.
- Minimum Weekly Liquidity Requirements: Under the proposal, retail and institutional funds could not acquire any securities other than cash, U.S. Treasury securities or securities (including repurchase agreements) that mature or are subject to a demand feature exercisable and payable in five business days ("weekly liquid assets") if, immediately after the acquisition, (i) the retail fund would have invested less than 15 percent of its total assets in weekly liquid assets and (ii) the institutional fund would have invested less than 30 percent of its total assets in weekly liquid assets. In contrast, the Working Group had recommended a weekly liquidity requirement of 20 percent for all money market funds. The weekly liquidity requirement would supplement the proposed daily

liquidity requirement.

- Similar to the daily liquidity requirement, compliance with the test would be determined upon the acquisition of a security.
- General Liquidity Requirement/"Know Your Investor" Procedures: The SEC's proposal also would require that a money market fund at all times hold highly liquid securities sufficient to meet reasonably foreseeable redemptions in light of its obligations under Section 22(e) of the Investment Company Act and any commitments the fund has made to shareholders, such as undertaking to pay redemptions more quickly than seven days. According to the Release, to comply with this condition, the SEC would expect money market funds to consider a number of factors that could affect the fund's liquidity needs. For example, a fund would have to understand the characteristics of its investors and their likely liquidity needs. The Release notes that because the obligation would be ongoing, a fund should adopt policies and procedures as required by Rule 38a-1, the "compliance rule" under the Investment Company Act, to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders, particularly those that hold securities through omnibus accounts, or access the fund through "portals" or through other arrangements that provide the fund with little or no transparency with respect to the beneficial shareholder.
- Stress Testing: Similar to the Working Group's recommendation, the SEC has proposed to require the board of each money market fund using the amortized cost method to adopt procedures providing for periodic stress testing of the fund's portfolio. According to the Release, the procedures would require testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events, including an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on a portfolio security, 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. The proposed amendments also would require that the board receive a report of the results of the testing at its next regularly scheduled meeting, which 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 a dollar.
- Diversification: The SEC has requested comment on whether it should further restrict the diversification limits of Rule 2a-7 relating to issuers and/or guarantors. Under the current rule, money market funds generally must limit their investments in the securities of any one issuer (other than Government securities) to no more than 5 percent of fund assets and limit their investments in securities subject to a demand feature or a guarantee to no more than 10 percent of fund assets from any one provider.
- Repurchase Agreements: Under Rule 2a-7, money market funds may treat the acquisition of a repurchase agreement as an acquisition of the collateral underlying the repurchase agreement for purposes of meeting the rule's diversification requirement, provided that the repurchase agreement is "collateralized fully," i.e., it, among other things, qualifies for an exclusion from any automatic stay of creditors' rights against the counterparty under applicable bankruptcy law. The SEC proposal would limit money market funds to investing in repurchase agreements collateralized by cash items or Government securities in order to obtain the special treatment noted above under the diversification provisions of Rule 2a-7. The SEC also proposes to require that the money market fund's board or its delegate evaluate the creditworthiness of the counterparty, regardless of whether the repurchase

agreement is collateralized fully.

Enhance Disclosure of Portfolio Securities

- **Public Website Posting:** Similar to the Working Group's recommendation, the SEC is proposing to amend Rule 2a-7 to require money market funds to disclose information about their portfolio holdings each month on their websites. Specifically, a fund would be required to disclose the fund's schedule of investments, as prescribed by Rules 12-12 to 12-14 of Regulation S-X, identifying, among other things, the issuer, the title of the issue, the principal amount of the security, and its current amortized cost. The fund would be required to post the information no later than the second business day of the month, current as of the last business day of the previous month, and would have to maintain the information on the website for at least twelve months.
 - As part of its proposal, the SEC is not proposing that money market funds also post their market-based net asset value per share and the market-based prices of their portfolio securities, although it is requesting comment on whether this or other information also should be disclosed.
- **Reporting to the SEC:** The SEC is proposing 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 would enable the SEC to create a central database of money market fund portfolio holdings, which would enhance its oversight of money market funds and its ability to respond to market events. Under proposed Rule 30b1-6, money market funds would file a monthly portfolio holdings report on new Form N-MFP no later than the second business day of each month, current as of the last business day of the previous month. Form N-MFP, which would be filed through EDGAR in an XML tagged data format, would require money market funds disclose a number of items enumerated in the Release; however, it would not require funds to provide market-based values. The SEC also notes that it expects to make the portfolio reports available to the public two weeks after their filing. Notably, the proposal would not require that this data be provided in XBRL format, although it has asked for comment on all aspects of the proposed portfolio reporting requirement.
- **Amendments to Rule 30b1-5:** To avoid unnecessarily duplicative disclosure obligations, the SEC is proposing 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. The Release notes, however, that the SEC is not proposing to exempt money market funds from the controls and procedures and certification requirements of Form N-Q.

Improve Money Market Fund Operations

- **Processing of Transactions:** The proposal would require that all money market funds be able to process purchases and redemptions electronically at a price other than \$1 per share. Specifically, the proposal would require that each fund's board determine in good faith, at least once each calendar year, 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. The proposed amendment also clarifies that this capacity includes the capacity to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share.
- **Exemption for Affiliate Purchases:** The SEC proposal would 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. Currently, under Rule 17a-9 a security must no longer be an eligible

security for an affiliated person of a money market fund to purchase the security. Under the proposed amendment, a money market fund could sell a portfolio security that has defaulted (other than an immaterial default unrelated to the financial condition of the issuer), to an affiliated person, even though the security continued to be an eligible security. In addition, the proposal would add a new provision to Rule 17a-9 that would permit affiliated persons, for any reason, to purchase other portfolio securities (e.g., eligible securities that have not defaulted) from an affiliated money market fund for cash at the greater of its amortized cost value or market value, provided that such person promptly remits to the fund any profit it realizes from the later sale of the security. The proposal also would require 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 of the transaction via electronic mail and the reasons for the purchase.

- **Fund Liquidation:** Similar to the Working Group's recommendation, the SEC is proposing a new rule that 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. The new rule would replace Rule 22e-3T, a temporary rule that provides a similar exemption for money market funds participating in the Treasury Department's Temporary Guarantee Program for Money Market Funds. Specifically, proposed Rule 22e-3 would permit all money market funds to suspend redemptions upon breaking a buck, if the board, including a majority of independent directors, approves liquidation of the fund, in order to liquidate in an orderly manner, and the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions by electronic mail. The proposed rule also contains an additional provision that permits the SEC 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 shareholders. Under this provision, the SEC may modify the relief "after appropriate notice and opportunity for hearing," in accordance with Section 40 of the Investment Company Act. The proposed rule also would provide a limited exemption from Section 22(e) for certain conduit funds (such as insurance company separate accounts issuing variable insurance contracts or funds participating in master-feeder arrangements) that invest, pursuant to Section 12(d)(1)(E) of the Investment Company Act, all of their assets in a money market fund that suspends redemption in reliance on the proposed rule.
 - The SEC also is requesting comment on whether it should include a provision in proposed Rule 22e-3 that would permit fund directors to temporarily suspend redemptions during exigent circumstances other than liquidation of the fund (similar to the Working Group's recommendation). The SEC also is requesting comment on whether the proposed rule should include conditions regarding the treatment of shareholders in a liquidation, or permit or require a fund board to recognize that investors will have different preferences for liquidity and capital preservation (e.g., by offering shareholders the choice of redeeming their shares immediately at a reduced net asset value per share that reflects the fair market value of fund assets).

Request for Comment

The SEC is seeking comment on all aspects of the rules and amendments proposed in its Release. In addition, the SEC is seeking comment on the following issues: whether money market funds should be required to have a floating share price; whether credit ratings agencies' ratings should be removed from Rule 2a-7 or, alternatively, whether fund boards

should designate certain rating agencies that they will use to evaluate securities for purchase and to monitor securities after purchase; whether the SEC should amend Rule 2a-7 to address risks with respect to investment in asset backed securities; and whether money market funds should be required to use in-kind redemptions to satisfy redemption requests in excess of a certain size.

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ENDNOTES

[1] See Money Market Fund Reform, SEC Release No. IC-28807 (June 30, 2009) (“Release”), which is available on the SEC’s website at <http://sec.gov/rules/proposed/2009/ic-28807.pdf>.

[2] The Working Group report is available on the Institute’s website at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

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