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SEC Issues Proposed Exemptive Order Relating to Confirmation Requirements; Re-Proposes Amendments to Remove Certain Credit Ratings; Proposes Amendments to Issuer Diversification Requirements

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 20-14
BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 35-14
BROKER/DEALER ADVISORY COMMITTEE No. 40-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 18-14
MONEY MARKET WORKING GROUP
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 15-14
OPERATIONS MEMBERS No. 12-14
SEC RULES MEMBERS No. 34-14
TAX MEMBERS No. 23-14
TRANSFER AGENT ADVISORY COMMITTEE No. 50-14 RE: SEC ISSUES PROPOSED EXEMPTIVE ORDER RELATING TO CONFIRMATION REQUIREMENTS; RE-PROPOSES AMENDMENTS TO REMOVE CERTAIN CREDIT RATINGS; PROPOSES AMENDMENTS TO ISSUER DIVERSIFICATION REQUIREMENTS

In connection with the SEC's recent amendments to the rules that govern money market funds, [1] the SEC issued a related notice proposing exemptions from certain confirmation requirements for transactions effected in shares of floating NAV money market funds. [2] To implement the mandate of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC also has re-proposed amendments to Rule 2a-7 and Form N-MFP to address provisions that reference credit ratings. [3] In addition, the SEC is proposing to amend Rule 2a-7's issuer diversification provisions to eliminate an exclusion from these provisions that is currently available for securities subject to a guarantee issued by a non-controlled person. [4] A brief summary of these proposals is provided below.

Comments on the proposed exemptive relief are due August 19. Comments on the re-proposed amendments relating to credit ratings and the proposal relating to Rule 2a-7's issuer diversification provisions are due 60 days after the date of publication of the release in the Federal Register.

Proposed Exemptive Order Relating to Rule 10b-10 Confirmations

Rule 10b-10 under the Securities Exchange Act of 1934 addresses broker-dealers' obligations to confirm their customers' securities transactions. Under the rule, a broker-dealer generally must provide customers with information relating to their investment decisions at or before the completion of a securities transaction. The rule also provides an exception for certain transactions in money market funds that attempt to maintain a stable NAV and where no sales load or redemption fee is charged. The exception permits broker-dealers to provide transaction information to money market fund shareholders on a monthly basis (subject to certain conditions) in lieu of immediate confirmations for all purchases and redemptions of shares of such funds.

Among other things, the amendments to the rules governing money market funds require institutional prime and institutional tax exempt money market funds to sell and redeem shares based on the current market-based NAV. Because shares prices of these funds likely will fluctuate, absent exemptive relief, broker-dealers will not be able to continue to rely on the current stable NAV exception under Rule 10b-10 for transactions in floating NAV money market funds. Instead, broker-dealers will be required to provide immediate confirmations for all such transactions.

In the SEC's 2013 money market fund proposing release, the SEC requested comment on whether, if the SEC adopted the floating NAV requirement, broker-dealers should be required to provide immediate confirmations to all floating NAV money market fund investors. [5] Commenters (including ICI) urged the SEC not to impose such a requirement, arguing that there would be significant costs associated with broker-dealers providing immediate confirmations.

After consideration of the likely costs associated with requiring immediate confirmations for such transactions, the SEC is proposing to grant exemptive relief that would allow broker-dealers, subject to certain conditions, to provide transaction information to investors in any floating NAV money market fund operating pursuant to Rule 2a-7(c)(1)(ii) on a monthly basis in lieu of providing immediate confirmations.

Given that there will be price fluctuations in floating NAV money market funds, the SEC preliminarily believes that it may be necessary or appropriate in the public interest and consistent with the protection of investors to also require that broker-dealers provide immediate confirmations upon a customer's request. Accordingly, the SEC proposes that, to be exempt from the immediate confirmation requirements of Rule 10b-10, the broker-dealer must (i) notify the customer of its ability to request delivery of an immediate confirmation, consistent with the written notification requirements of Rule 10b-10, and (ii) not receive any such request from the customer. The release notes that this condition would provide investors with an option to receive confirmation information regarding a transaction at or before the completion of a securities transaction, while also providing relief to broker-dealers in circumstances where customers would not view this additional information as beneficial. The new condition is in addition to the existing requirements listed under the exemption for stable NAV money market funds under Rule 10b-10(b)(2) and (3).

The SEC requests comment on all aspects of the proposed exemptive order.

Removal of Certain References to Credit Ratings

In March 2011, the SEC proposed certain amendments related to the removal of credit rating references in Rule 2a-7 and Form N-MFP. In consideration of comments received on its initial proposal, the SEC is re-proposing amendments to replace references to credit ratings in Rule 2a-7 and to modify provisions in Form N-MFP that reference credit ratings.

Rule 2a-7

The re-proposed amendments would affect five elements of Rule 2a-7: (i) determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings downgrades and other credit events; and (v) stress testing.

Eligible Securities

The SEC's 2011 proposal would have eliminated the objective requirement that an eligible security be rated by an NRSRO or be of comparable quality while maintaining the distinction between first tier and second tier securities. First, the proposed revisions would have combined the eligible security and minimal credit risk determinations. Second, a security would be a "first tier security" (regardless of the ratings it has received from any credit rating agency) if the fund's board (or its delegate) determines that the issuer has the "highest capacity to meet its short-term financial obligations." As in the current rule, a money market fund would be required to invest at least 97 percent of its total assets in first tier securities. A second tier security would have been defined as a security that is determined to present minimal credit risk but does not satisfy the new subjective definition of "first tier security."

ICI's comment letter expressed concern that the SEC's 2011 proposed approach could be interpreted as raising the credit standards for first tier securities (because, if taken literally, the proposal did not seem to contemplate any variation in credit worthiness among issuers of first tier securities) and lowering them for second tier securities (by permitting a fund to invest in a security that would not have qualified under the rule's current standards). Instead, we recommended that the SEC combine the two criteria and require a single, uniform, very high standard of quality (e.g., securities generally comparable to securities rated in the highest short-term rating category, which would be first tier securities under the current rule).

After consideration of commenters' concerns, the re-proposal combines the two risk criteria into a single standard that is included as part of Rule 2a-7's definition of eligible security. Specifically, under the re-proposal an eligible security would be a security with a remaining maturity of 397 calendar days or less that the fund's board of directors (or its delegate) determines presents minimal credit risks, which determination includes a finding that the security's issuer has an "exceptionally strong capacity" to meet its short-term obligations. Also, because the re-proposal would eliminate the distinction between first and second tier securities, the SEC also is re-proposing to remove the current prohibition on funds investing more than 3 percent of their portfolios in second tier securities.

The release notes that the re-proposed determination is designed to retain a degree of credit risk similar to that in the current rule by allowing for gradations in credit quality

among securities that meet a very high standard of credit quality, while limiting a money market fund's investments in second tier securities to those the fund determines do not diminish the overall high quality of the fund's portfolio. The release also states that as a practical matter, the re-proposed standard would generally preclude firms from determining that securities rated "third tier" (or comparable unrated securities) would be eligible securities under Rule 2a-7.

The release clarifies that in determining whether a security presents minimal credit risks, a fund adviser could take into account credit quality determinations prepared by outside sources, including NRSRO ratings, that the adviser considers are reliable in assessing credit risk.

Proposed Minimal Credit Risk Factors

Although Rule 2a-7 does not set forth any specific factors that a board (or its delegate) should consider in determining minimal credit risks, the SEC staff has observed during money market fund examinations that most advisers to these funds evaluate some common factors that bear on the ability of an issuer or guarantor to meet its short-term financial obligations. Based on these observations, as well as recommendations made by ICI's Money Market Working Group, [6] the release sets forth a non-exhaustive list of factors that the SEC believes generally should be included as part of a minimal credit risk assessment. These include:

- the issuer's or guarantor's financial condition (i.e., analysis of recent financial statements, including trends relating to cash flow, revenue, expenses, profitability, short-term and total debt service coverage, and leverage (including financial leverage and operating leverage));
- the issuer's or guarantor's liquidity, including bank lines of credit and alternative sources of liquidity;
- the issuer's or guarantor's ability to react to future events, including a discussion of a "worst case scenario," and its ability to repay debt in a highly adverse situation; and
- the strength of the issuer's or guarantor's industry within the economy and relative to economic trends as well as the issuer's or guarantor's competitive position within its industry (including diversification in sources of profitability, if applicable).

In addition, the release suggests that a minimal credit risk evaluation could include an analysis of whether the price and/or yield of a security is similar to that of other securities in the fund's portfolio. The release also sets forth factors that advisers may take into account when evaluating minimal credit risks of particular asset classes. These include: municipal securities; conduit securities; asset backed securities (including asset backed commercial paper); other structured securities, such as variable rate demand notes, tender option bonds, extendible bonds or "step up" securities; and repurchase agreements. [7]

The release requests comment on the factors listed above, including whether the SEC should codify the factors as part of Rule 2a-7 (which is not part of the re-proposal).

Conditional Demand Features

Currently, a security subject to a conditional demand feature may be determined to be an eligible security or a first tier security if, among other things, (1) the conditional demand feature is an eligible security or a first tier security, and (2) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may

be, within the highest two categories from the requisite NRSROs or is a comparable unrated security. Under the 2011 proposal, the SEC would have removed the credit rating requirement and amend the provision to require that the fund's board (or its delegate) determine that the underlying security or any guarantee of such a security be of high quality and subject to very low credit risk.

ICI and other commenters urged the SEC to retain the requirement that a security subject to a demand feature has received at least a second tier rating to limit the risk that a demand feature might terminate if its underlying security receives a rating below investment grade.

The re-proposed standard differs in phrasing to more closely parallel the required finding in the SEC's re-proposed minimal risk determination. Under the re-proposal, a fund would have to determine that the conditional demand feature is an eligible security. A fund's board (or its delegate) also would have to evaluate the long-term risk of the underlying security and determine that it (or its guarantor) "has a very strong capacity for payment of its financial commitments." The release notes that this standard is similar to those articulated by credit rating agencies for long-term securities assigned the second-highest rating. It also explains that an issuer that the board (or its delegate) determines has a very low risk of default, and a capacity for payment of its financial commitments that is not significantly vulnerable to reasonably foreseeable events would satisfy the re-proposed standard. On the other hand, securities that are rated in the third-highest category for long-term ratings (or comparable unrated securities) would not satisfy the re-proposed standard for underlying securities.

To address commenters' concerns regarding the risks of a money market fund investing in securities whose eligibility as portfolio securities depends on a demand feature that would terminate if downgraded by a single rating category, the SEC is retaining the current Rule 2a-7 requirement that a security subject to a conditional demand feature is an eligible security only if at the time it is acquired the fund's board (or its delegate) determines that there is minimal risk that the circumstances that would result in the conditional demand feature terminating will occur, and that either (i) the conditions limiting the demand feature's exercise can be monitored, or (ii) the fund otherwise receives notice of the occurrence of a limiting condition and the opportunity to exercise the demand feature in accordance with its terms. [8]

Monitoring Credit Risks

Rule 2a-7 currently requires a money market fund board (or its delegate) promptly to reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as it determines is in the best interests of the fund and its shareholders. The 2011 proposal would have required the fund's board or its delegate to reassess if it becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that may suggest that the security is no longer a first tier or second tier security, as the case may be.

Most commenters, including ICI, asserted that the proposed standard was too vague and would be burdensome to administer. Instead, ICI and others recommended that the SEC eliminate the requirement for reassessing minimal credit risk when a security is downgraded by an NRSRO and include a general ongoing obligation to monitor the credit risks of portfolio securities, which would obviate the need for a separate requirement to identify specific triggers for reassessment. Consistent with this recommended approach,

the re-proposal would require each money market fund to adopt written procedures that require the fund adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

The release notes that ongoing monitoring of minimal credit risks would include the determination of whether the issuer of the portfolio security, and the guarantor or provider of a demand feature, to the extent relied upon by the fund to determine portfolio quality, maturity, or liquidity, continues to have an exceptionally strong capacity to repay its short-term financial obligations. The review would typically update the information that was used to make the initial minimal credit risk determination and would have to be based on, among other things, financial data of the issuer or provider of the guarantee or demand feature. The release also clarifies that funds could continue to consider external factors, including credit ratings, as part of the ongoing monitoring process. The release acknowledges that a specific requirement to monitor credit risk would essentially codify the current practices of fund managers, which are already explicit (and implicit) in several provisions of the rule.

Stress Testing

The recently adopted amendments to Rule 2a-7 require funds to test their ability based on certain hypothetical events, including a downgrade of particular portfolio security positions, to maintain weekly liquid assets of at least 10 percent and to minimize principal volatility (and, for stable NAV money market funds, the fund's ability to maintain a stable price per share). The 2011 proposal would have replaced the reference to ratings downgrades with the requirement that money market funds stress test their portfolios for an adverse change in the ability of a portfolio security issuer to meet its short-term obligations. Commenters, including ICI, urged the SEC not to eliminate the reference to a downgrade in the stress testing conditions.

In response to these comments, the SEC has re-proposed to require that money market funds stress test for an event indicating or evidencing credit deterioration of particular portfolio security positions, each representing various exposures in a fund's portfolio. The re-proposed amendments would describe the type of hypothetical event that funds should use for testing and include a downgrade or default as examples of that type of event. Thus, the release notes that funds could continue to test their portfolios against a potential downgrade or default in addition to any other indication or evidence of credit deterioration they determine appropriate and that might adversely affect the value or liquidity of a portfolio security.

Form N-MFP

With respect to each portfolio security, money market funds must disclose on Form N-MFP the name of each designated NRSRO for the portfolio security and the rating assigned to the security. The 2011 proposal would have eliminated items in the form that require disclosure of the ratings of the securities in the portfolio. Similar to the stress testing requirement discussed above, commenters objected to removing rating disclosures in Form N-MFP.

In response to these comments, the re-proposal would require that each money market fund disclose, for each portfolio security: (i) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO's services, as well as the name of the agency providing the rating; and (ii) any other NRSRO rating that the fund's board (or its delegate) considered in making its minimal credit risk determination, as well as the name of the

agency providing the rating.

Issuer Diversification Proposal

Generally, money market funds must limit their investments in the securities of any one issuer of a first tier security to no more than 5 percent of total assets and their investments in securities subject to a demand feature or a guarantee to no more than 10 percent of total assets from any one provider. Notwithstanding the 5 percent issuer diversification provision, Rule 2a-7 does not require a money market fund to be diversified with respect to issuers of securities that are subject to a guarantee by a non-controlled person. This exclusion could allow, for example, a fund to invest a significant portion or all of the value of its portfolio in securities issued by the same entity if the securities were guaranteed by different non-controlled person guarantors such that none guaranteed securities with a value exceeding 10 percent of the fund's total assets.

By diversifying solely against the guarantor, the release suggests that the fund could be relying on the guarantors' credit quality or repayment ability, not the issuer's. It also would create a highly concentrated portfolio that would be subject to substantial risk if the single issuer in whose securities it had invested were to come under stress or default. In consideration of the SEC's reform goal of limiting concentrated exposure of money market funds to particular economic enterprises (i.e., new amendments that require money market funds to limit their exposure to affiliated groups, rather than to discrete issuers [9]), the re-proposal would require each money market fund that invests in securities subject to a guarantee (whether or not the guarantor is a non-controlled person) to comply with both the 10 percent diversification requirement for the guarantor as well as the 5 percent diversification requirement for the issuer. As a result, except for the special provisions regarding single-state money market funds, no money market fund non-government portfolio security would be excluded from Rule 2a-7's limits on issuer concentration. The release also notes that very few money market funds (less than 2 percent) rely on the issuer diversification exclusion for securities subject to a guarantee by a non-controlled person.

The SEC requests comment on all aspects of this proposal.

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endnotes

[1] Money Market Fund Reform; Amendments to Form PF, SEC Release No. IC-31166 (July 23, 2014) ("Release"), which is available at http://www.sec.gov/rules/final/2014/33-9616.pdf.

[2] The proposed exemptive order is available at http://www.sec.gov/rules/exorders/2014/34-72658.pdf.

[3] The re-proposed amendments to remove credit rating references are available at http://www.sec.gov/rules/proposed/2014/ic-31184.pdf.

[4] The proposed amendments relating to the issuer diversification provisions are available at http://www.sec.gov/rules/proposed/2014/ic-31184.pdf.

[5] See Money Market Fund Reform; Amendments to Form PF, SEC Release No. IC-30551 (June 5, 2013) at 352-353, available at http://www.sec.gov/rules/proposed/2013/33-9408.pdf

[6] See Appendix I of the Investment Company Institute, Report of the Money Market Working Group (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[7] See Release at 22-25.

[8] See 2a-7(d)(2)(iii)(B).

[9] See Rule 2a-7(d)(3)(ii)(F).
