# Money Market Fund Reforms on the Way

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On March 26, 2009, Treasury Secretary Timothy F. Geithner and Securities and Exchange Commission Chair Mary L. Schapiro testified before separate Congressional committees that the regulations applicable to money market funds ("MMFs") should be strengthened. Secretary Geithner stated before the House of Representatives Committee on Financial Services that

> the SEC should strengthen the regulatory framework around MMFs in order to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole ... less susceptible to runs.[1]

Chairman Schapiro's testimony before the Senate Committee on Banking, Housing and Urban Affairs, sounded the same theme, stating that the SEC would

> act quickly this spring to strengthen the regulation of money market funds by considering ways to improve the credit quality, maturity, and liquidity standards applicable to these funds. These efforts will be aimed at shoring up money market fund investments and mitigating the risk of a fund experiencing a decline in its normally constant $1.00 net asset value, a situation known colloquially as "breaking the buck."[2]

Neither Secretary Geithner nor Chairman Schapiro provided any specifics about the SEC's proposals. While the details of regulatory proposals for reform are in the process of being formulated, the industry has already published proposals of its own.

On March 18, 2009, the Investment Company Institute released the report (the "Report") of its Money Market Working Group (the "ICI Working Group").[3] The ICI Working Group was chaired by John J. Brennan, Chairman of The Vanguard Group, Inc., and included a wide range of senior executives from a number of major industry participants. Drawing on lessons learned by MMFs during the ongoing credit crisis, the Report provides many specific recommendations for reform that are based on two principles: (1) MMFs should be better positioned to withstand prolonged, extreme redemption pressures, and (2) any "run" on a MMF should be stopped immediately, with all shareholders treated fairly.[4]

Several of the specific recommendations can be implemented by MMFs without SEC action, and the ICI Working Group has urged their swift voluntary adoption by all ICI members.[5] According to press reports,[6] almost all of the largest industry participants have said they will voluntarily implement the recommendations before September 18, 2009, the expiration date for the Treasury's Temporary Guarantee Program for Money Market Funds (the "Guarantee Program"), assuming the Guarantee Program is extended beyond April 30, 2009.[7]

We believe it is unlikely that voluntary adoption by MMFs will stave off revisions to Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act"), and the Report calls for rule revisions to implement certain recommendations. Voluntary adoption may, however, help shape rule revisions, and we believe that the SEC will seriously consider revising Rule 2a-7 to include many of the Report's recommendations. Since senior members of the Obama administration have stated that MMFs as a group are systemically significant to the U.S. financial system, agencies that may be tasked with systemic risk regulation will undoubtedly be involved in those anticipated rule revisions.

The ICI Working Group's specific recommendations are as follows:

**Portfolio Liquidity**

- *Daily Liquidity Standard*. Rule 2a-7 should be amended to require taxable MMFs to hold at least 5% of their assets in securities "accessible" within one business day.[8]

- *Weekly Liquidity Standard*. The SEC should amend Rule 2a-7 to require all MMFs to hold at least 20% of their assets in securities "accessible" within seven business days.[9]

- *Stress Testing*. Rule 2a-7 should be amended to require that MMFs have procedures approved by their boards of directors that mandate regular "stress testing" of portfolios to assess their ability to meet assumed levels of credit risk, shareholder redemptions, and interest rate changes.

**Portfolio Maturity**

- *Weighted Average Maturity ("WAM")*. The SEC should amend Rule 2a-7 to reduce the maximum WAM for MMFs from 90 days to 75 days.

- *Spread WAM*. Rule 2a-7 should be amended to (a) add a new maturity limitation based only on a security's stated (or legal) final maturity date or the date on which a MMF may demand payment ("Spread WAM"), and (b) establish a maximum Spread WAM of 120 days.

**Credit Analysis**

- *New Products Committee*. Rule 2a-7 should be amended to require MMF advisers to establish a "new products" or similar committee to review and approve new structures prior to MMFs' investing in such structures.

– *Best Practices*. MMF advisers should consider and follow best practices set forth in Appendix I to the Report, as appropriate, when making minimal credit risk determinations.

– *Ratings*. Ratings requirements should be retained in Rule 2a-7 as a starting point for credit analysis.

– *Designated Rating Agencies*. The SEC should amend Rule 2a-7 to require MMFs to have board-approved procedures pursuant to which MMF advisers designate and disclose to shareholders at least three rating agencies that the advisers monitor to determine eligible securities and MMFs disclose the designated rating agencies.*

**Client Risk Assessment**

– *Know Your Clients*. The SEC should adopt rule amendments requiring MMFs to develop procedures for accepting shareholders so that MMFs either (a) understand the expected redemption practices and liquidity needs of their investors or (b) if this information is unavailable, mitigate potential adverse effects from such unpredictability.

– *Website Disclosure of Client Concentration*. The SEC should adopt rule amendments requiring MMFs to post on their websites monthly (a) the concentration levels of different types of clients, and (b) the risks this concentration may pose to the MMFs.[10]

**Ability to Suspend Redemptions to Prevent a Run**

– *Suspension of Redemptions in Exigent Circumstances without SEC Action*. The SEC should adopt a rule under Section 22(e) of the 1940 Act (a) permitting the board of a MMF that has broken a dollar, or reasonably believes it may be about to do so, to suspend fund redemptions (and purchases) for five business days; during which time the fund would address its net asset value by seeking credit support or otherwise, or would determine to suspend redemptions permanently and liquidate,[11] and (b) requiring prompt nonpublic notice to the SEC of any such suspension.*

– *Suspension of Redemptions in connection with Liquidation*. The SEC should adopt rules, similar to Rule 22e-3T which permits suspension of redemptions related to MMF liquidations under the Guarantee Program, that (a) would permit a MMF preparing to liquidate to announce a suspension of redemptions and its intention to liquidate, and (b) would require the board to approve the plan of liquidation and announce it to shareholders within five business days of the initial announcement.*

**Confusion About MMFs**

– *MMF Disclosure*. MMFs should reassess and revise if necessary the risk disclosures they provide to investors in light of recent events.[12]

– *Website Disclosure of Portfolio Holdings*. The SEC should adopt a rule requiring MMFs to provide website disclosure of all their portfolio holdings at least monthly, with a two day lag.

- *Prohibition Against Non-2a-7 Fund Suggesting that it is a MMF*. The SEC should adopt an anti-fraud rule under the Investment Advisers Act of 1940 which would make it a fraudulent or deceptive practice for any adviser (registered or not) to advise a fund that is not registered under the 1940 Act and that (a) uses "cash" or any similar word in its name (such as "money" or "liquid") or (b) holds itself out as seeking to maintain a stable net asset value, unless the fund complies with Rule 2a-7.

**Enhanced Government Oversight**

- *Nonpublic Reporting*. The money market industry should work with government to develop nonpublic reporting for MMFs and other institutional investors in the money market.*

- *SEC Staff Monitoring of Outliers*. The SEC should establish a formal program for its staff to monitor (a) any MMFs that have performance that clearly exceeds that of their peers during any month in order to determine the reasons for such performance, and (b) 10 other randomly selected funds each month.

**Government Resources**

- *Purchase of Distressed Securities by MMF Affiliates*. The SEC should expand Rule 17a-9 under the 1940 Act to permit a MMF affiliate to purchase portfolio securities that are eligible securities, including situations in which a portfolio security has defaulted, has been determined to no longer present minimal credit risks, or when the issuer of the security experiences an insolvency event.*

- *Notice to SEC of Purchases by a MMF Affiliate of Securities under Rule 17a-9*. Rule 2a-7 should be amended to require MMFs to provide the SEC with prompt, nonpublic notice when an affiliate of a MMF, among others, purchases a security that is no longer a Rule 2a-7 eligible security from a MMF pursuant to Rule 17a-9.*

**Government Programs**

- *Extension of Treasury Guarantee Program*. The Treasury Department should extend the Guarantee Program through September 18, 2009.

- *Permission to Use Amortized Cost for Shadow Pricing*. The SEC should delegate authority to its staff to reinstate the staff's October 2008 no-action letter permitting MMFs to use amortized cost for "shadow pricing" certain securities under specified market conditions in order to alleviate valuation difficulties that may arise when the market for very short-term instruments.

**Additional Enhancements**

- *Elimination of Second Tier Securities*. The SEC should amend Rule 2a-7 to eliminate

MMFs' current ability to invest up to 5% of their assets in second tier securities, as defined in the Rule.

- *Clarification of Board Oversight Role*. Rule 2a-7 should be amended to provide for appropriate board oversight and to remove inappropriate board involvement in the investment process; for example, investments would be limited to those that the adviser determines (subject to board oversight) present minimal credit risks, rather than those that the board determines present minimal credit risk.*

The recommendations of the ICI Working Group are accompanied by its evaluation of various proposals for MMF reform advanced by others, such as funds' permitting their net asset value to float, funds' becoming special purpose banks with capital requirements and deposit insurance, requiring separate funds for retail and institutional investors or requiring that redemptions be made in kind in certain circumstances.[13] The Report rejects each of these alternatives,[14] arguing that any MMF reforms should not fundamentally alter or compromise the attractiveness of MMFs to investors and concluding that the recommendations of the ICI Working Group far better address current MMF concerns than other reform proposals.

* This recommendation requires SEC action before it can be fully implemented.

[1] Testimony by Timothy F. Geithner before the U.S. House of Representatives Committee on Financial Services (Mar. 26, 2009) at 9, available here.

[2] Testimony by Mary L. Schapiro before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Mar. 26, 2009) at 10, available here.

[3] Investment Company Institute, Report of the Money Market Working Group (March 17, 2009), available here.

[4] Report at 3.

[5]*See* Memorandum from John J. Brennan, Chairman of the ICI Working Group to John V. Murphy, Chairman, Board of Governors of the ICI, included with the Report.

[6] Mark Jewell, Industry Recommends Money Market Fund Safeguards, the *Washington Post* (March 17, 2009).

[7] The Guarantee Program is scheduled to expire on April 30, 2009; however, the Treasury has the option to extend it through September 18, 2009. For more information on the Guarantee Program, see the WilmerHale Investment Management Industry News Summary, dated September 19, 2008, available here; and the WilmerHale Investment Management Industry News Summary, dated November 28, 2008, available here.

[8] For purposes of the daily test, accessible securities include (a) cash, (b) Treasury securities, or (c) other securities and repurchase agreements that mature, or are subject to a demand feature exercisable, in one business day.

[9] For purposes of the weekly test, accessible securities include (a) cash, (b) Treasury securities, (c) certain other U.S. government securities, or (d) other securities and repurchase agreements that mature, or are subject to a demand feature exercisable, in seven business days.

[10] These recommendations regarding client risk are related to the recommendations concerning liquidity and stress testing because of the ICI Working Group's belief that MMFs with a better understanding of their clients' needs will be better able to position their portfolios to meet redemption requests. Report at 6.

[11] For reference, Appendix J to the Report is a checklist for suspending redemptions and liquidating a MMF.

[12] The Report provides a number of examples of the type of disclosure that may be considered, such as: (a) MMFs can break, and have in the past broken a dollar, and may do so in the future; (b) Shareholders should not rely on or expect a MMF affiliate to take action to prevent the MMF from breaking a dollar; (c) Credit quality of portfolio securities can change rapidly in certain market environments and the default of a single holding could have the potential to cause significant net asset value deterioration. See Report at 92.

[13] The Report makes specific reference to the proposals included in the report of a working group of the Group of Thirty, Financial Reform: A Framework for Financial Stability (January 15, 2009), available here. See also the WilmerHale Client Alert addressing that report entitled The Beginning of the End of Money Market Funds? (January 16, 2009), available here.

[14] These concerns include (a) investor rejection of floating net asset value funds and investing instead in unregulated vehicles; (b) significant accounting and tax challenges posed by capital requirements that would offer little protection against market-wide events that could lead to substantial redemptions; (c) potential market volatility and fundamental change to the operation of the money market if broad federal insurance of MMFs attracted investments from other vehicles and bank deposits to MMFs; (d) little benefit that would be derived from limited federal insurance; (e) impracticality of private insurance because insurance companies do not have the capital to support MMF insurance; (f) impracticality of requiring that retail and institutional investors be in separate funds and potential disadvantage to each client type; and (g) potential aggravation of difficult market conditions if securities are required to be distributed in kind and the recipients of the securities seek to sell them. Report at 8 and Section 8 generally.