SEC Adopts Rule Amendments for Money Market Funds

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At an open meeting on January 27, 2010, the Securities and Exchange Commission voted 4 to 1 to adopt new rules, amendments to Rule 2a-7, and a new form under the Investment Company Act of 1940 governing money market funds. This Alert summarizes what is noteworthy about the new rules, amendments and new form based on the discussion at the open meeting.[1] The rules will be effective 60 days after publication in the Federal Register, and compliance will be phased in throughout the year.

I. Adopted Provisions

It appears that several amendments will be as proposed in June 2009,[2] but the SEC made important changes to some of its proposals and added additional amendments. Commissioners and staff members indicated that the provisions seek to reduce the risks associated with money market funds, to increase disclosure and help investors to understand the risks of these investments, and to decrease the vulnerability of money market funds and the U.S. economy to industry-wide redemptions and the inability to finance shareholder withdrawals. Chairman Schapiro and Commissioners Aguilar, Paredes, and Walter voted to approve the changes. Commissioner Casey voted against them.

The SEC voted to amend Rule 2a-7 to tighten the maturity and credit quality standards and add new liquidity standards by:

- Shortening the maximum weighted average maturity limit to 60 days, as proposed (the current limit is 90 days);
- Adding a new 120 day weighted average life restriction, which would limit money market funds' investment in longer-term floating rate securities;
- Reducing the amount of so-called "second tier" securities that a money market fund may hold to 3% of the fund's portfolio (the current limit is 5%), and limiting an interest in the second tier securities of one issuer to 0.5% (the current limit is 1% or $1 million); the SEC had proposed prohibiting investment in second tier securities;
- Shortening the remaining maturity limit for each second tier security to 45 days (the current limit is 397 days);

- Requiring at least 10% of a money market fund's assets to be liquid daily (cash, U.S. Treasury securities, or securities convertible to cash within one day), and 30% to be liquid weekly (cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities convertible to cash within one week);
- Reducing the maximum percentage of illiquid securities to 5% of a money market fund's assets and redefining "illiquid security" as a security that cannot be sold within seven days at carrying value (the current limit is 10%); the SEC had proposed prohibiting investment in illiquid securities; and
- Requiring money market fund managers to perform periodic "stress tests" on a fund's portfolio to determine the risk that the value would fall below $1 per share, causing the fund to "break the buck" in the event of a market shock, and report the results to the fund's board.

The SEC voted to require additional disclosures of portfolio information by:

- Requiring money market funds to post on their websites fund portfolio holdings monthly and maintain the information on the website for at least six months after posting; and
- Requiring money market funds to file a new Form N-MFP with the SEC at the end of each month containing detailed information about risk characteristics, yield, and portfolio holdings, including their market-to-market values. The SEC will make the information publicly available after 60 days and plans to build an interactive database of money market fund information. Currently, money market funds report this information to the SEC twice a year; the SEC makes it publicly available after 60 days.

The SEC voted to address large-scale redemptions from money market funds by:

- Requiring money market funds to have the capability to process purchases and redemptions at a price other than $1 per share;
- Permitting a money market fund board of directors to suspend redemptions and liquidate the fund if the fund is about to break the buck (the SEC must be notified beforehand that the fund will rely on this rule);
- Expanding the ability of affiliates to buy securities from a money market fund without having to seek no-action relief from the SEC staff if the purchase will be made to protect the fund from losses (the SEC must be notified when the affiliate relies on this rule); and
- Requiring money market funds to adopt "know your customer" procedures to identify investors that may make potentially large redemptions that pose risks to the money market fund, and to hold sufficient liquidity to be able to meet such redemptions (this may require funds with higher potential redemptions to hold more liquid instruments than required by the new liquidity standards).

The SEC did not change the requirement that a money market fund only invest in rated securities that are rated in the top two rating categories or unrated securities of comparable quality, and money market funds still must perform an independent credit analysis of every security purchased. But the SEC voted to require each money market fund's board of directors to designate at least four nationally recognized statistical rating organizations ("NRSROs") that the board considers to be reliable for use by the fund to satisfy the minimum ratings requirements. The fund may disregard ratings by any other NRSROs. The current requirement that money market funds invest in asset-backed securities only if they are rated by an NRSRO also will be eliminated.

Finally, the new rules require money market funds to invest in repurchase agreements only if the collateral consists of cash items or government securities (the current collateral requirement includes highly rated securities). The money market fund (or its adviser) also must evaluate the creditworthiness of the repurchase counterparty.

II. Comments and Issues Raised at the Open Meeting

Chairman Schapiro stated that the enhanced cash reserve requirements will enable money market funds to meet higher redemptions during a crisis, and allowing the suspension of redemptions will make them less vulnerable to runs and will decrease the need to sell distressed assets quickly at lower prices to meet higher redemptions. She also noted that the disclosure regime will enable better monitoring of money market funds' investments and risks, and will help investors to understand that money market funds may not always maintain a stable net asset value. Commissioner Walter said that the amendments will enhance protections for money market fund investors by enabling funds to better withstand market crises using new tools. Commissioner Paredes noted the delay in providing fair market values to the public and that money market funds may continue to invest in second tier securities when he indicated his support for the changes, and Commissioner Aguilar said that the amendments decrease the likelihood of another crisis by making money market funds safer investments, and align funds' ability to maintain a net asset value of $1.00 per share with investors' expectations that $1 invested means $1 upon withdrawal.

Commissioner Casey argued that these provisions did not adequately address the issues posed by Rule 2a-7. In her view, without further changes, money market funds will continue to be susceptible to runs and investors may continue to believe that the funds are guaranteed by the U.S. government. Although she recognized that Chairman Schapiro has endorsed considering additional measures, Commissioner Casey could not support these provisions in isolation because she could not be certain whether the SEC will have an opportunity to take further action. She recommended a fundamental rethinking of the regulation of money market funds, including either requiring a dedicated liquidity facility and regulating money market funds like banks, or requiring money market funds to have a floating net asset value. Requiring a floating net asset value would increase the transparency of money market fund holdings, she explained, and would reduce the likelihood of an industry-wide run when a more aggressive fund breaks a buck after substantially increasing risk to obtain additional yield.

Commissioner Casey also challenged the decision to wait 60 days to publicly disclose the net asset values on a mark-to-market basis. Commissioner Aguilar was concerned that real-time disclosure could cause needless runs based on mark-to-market values that could be interpreted many ways given the differences in valuing underlying investments. Commissioner Casey stated that more fundamental changes are required if the time delay is necessary because providing the information in real time would cause a run. Commissioner Walter did not think that more frequent disclosure would undermine the utility of money market funds, and stated that the SEC should not withhold this information from investors because disclosure is the cornerstone of functional, efficient markets and an informed investor is a better investor.

Commissioner Casey also expressed concern that the amendments further embed the use of ratings and may give ratings a more prominent role in money market funds by requiring boards to designate four NRSROs and continuing to impose minimum ratings requirements for eligible securities. She said that the SEC needed to move in a different direction to decrease inappropriate investor and regulatory reliance on credit ratings, and discussed problems associated with the use of ratings. Commissioner Walter said that she shared many concerns about the use of ratings, but believed that ratings are a necessary condition of Rule 2a-7 and for investment in certain securities. Chairman Schapiro also said that she agreed with some of Commissioner Casey's concerns about this issue, but noted that money market funds are still required to conduct an independent credit analysis for each security.

Chairman Schapiro and several Commissioners stated that the reforms the SEC adopted were a "first step" and the SEC will continue to consider additional changes, including:

- Requiring money market funds to have market-based, floating net asset values, like any other type of mutual fund, rather than using stable net asset values. The SEC asked for comment on this option in connection with the proposed rule amendments, and most commenters expressed concerns. As discussed above, Commissioner Casey indicated her support.
- Requiring real time disclosure of the money market fund's floating net asset value. Commissioner Casey indicated her support for this option and Commissioners Walter and Aguilar indicated that they look forward to considering this issue further, but Commissioner Paredes expressed his support for the 60-day delay.
- Requiring money market funds to satisfy large redemption requests in-kind. The SEC asked for comment on this option in connection with the proposed rule amendments, and many commenters expressed concerns.
- Requiring a private liquidity facility to assist funds during a crisis. As discussed above, Commissioner Casey expressed her support for this measure.
- Creating a two-tier system imposing different requirements based on a money market fund's risk. For example, Chairman Schapiro mentioned only allowing money market funds to maintain a stable net asset value if they meet certain risk-limiting conditions and liquidity facility requirements. Additionally, SEC staff members explained that the new liquidity requirements were based on the amount of liquidity that was necessary in 2008 for redemptions from institutional money market funds. They found that retail money market funds may require less liquidity, but they determined that complying with two sets of requirements was not operationally feasible for funds. The staff members expressed interest in revisiting this issue.

Chairman Schapiro also mentioned that the SEC may consider additional options being discussed with the President's Working Group. Commissioner Aguilar recommended that any future actions should ensure that retail investors are able to continue to participate in and benefit from money market funds, and that the economic attractiveness of money market funds is preserved so that assets currently invested in money market funds are not reinvested in unregistered vehicles. He also recommended that the SEC consider regulatory reforms for unregistered vehicles.

The SEC's action was largely consistent with expectations. The focus will now turn to the forthcoming report of the President's Working Group on money market funds and the next phase of rulemaking, which apparently will address floating net asset values.

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[1] A webcast of the open meeting can be viewed here. *See also* the SEC press release regarding the adopted provisions, which can be viewed here.

[2] WilmerHale's summary of the June 2009 proposal can be viewed by visiting our Investment Management Industry News Summary.

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