Investment Management E-news

February 8, 2010

SEC Approves Money Market Fund Reforms

At the January 27, 2010 open meeting (the "Meeting") of the U.S. Securities and Exchange Commission (the "SEC"), the SEC adopted new rules and amendments to existing rules (the "New Rules") under the Investment Company Act of 1940, as amended (the "Act"), intended to strengthen the regulatory framework governing the money market fund industry in response to weaknesses revealed during the financial crisis of 2008. The New Rules, representing the SEC's "important first step in [its] efforts to strengthen the money market regime," have a three-fold design to better protect investors by reducing risks associated with money market funds, enhancing fund disclosure to both the SEC and investors, and improving fund operations. Future reforms are likely.

Reducing Fund Risks

The New Rules amend the risk limiting restrictions of Rule 2a-7 under the Act with respect to the quality, maturity, and liquidity of money market fund portfolio holdings including as follows:

Improved Liquidity

Currently, money market funds are not subject to minimum liquidity requirements. The New Rules impose the following liquidity requirements:

- Daily Requirement: At least 10% of assets held by taxable money market funds must be in cash, U.S. Treasury securities, or securities that can be converted into cash within one day.
- Weekly Requirement: At least 30% of assets held by all money market funds must be in cash, U.S. Treasury securities, certain other government securities with remaining maturities of no more than 60 days, or securities that can be converted into cash within one week.

In addition, the New Rules restrict money market funds from having more than 5% of their portfolios invested in illiquid securities (reduced from the current 10% limit), and redefine as "illiquid" any security that cannot be sold or disposed of within seven days at carrying value.

Higher Credit Quality

The New Rules limit investment in lower quality securities by money market funds by prohibiting them from investing:

- more than 3% (reduced from the current limit of 5%) of their assets in second-tier securities.
- more than 0.5% (reduced from the current limit of greater of 1% or $1 million) of their assets in the second-tier securities of any single issuer.
- in second-tier securities that mature in more than 45 days (reduced from the current 397-day limit).

Shorter Maturity Limits

The New Rules shorten the average maturity limits for money market funds by:

- imposing a new maximum 120-day weighted average life maturity of a money market fund's portfolio;
- reducing the maximum weighted average maturity of a money market fund's portfolio from 90 days to 60 days.

"Know Your Investor" Procedures

As a new requirement, money market funds must develop procedures to anticipate risky redemption requests, including large redemptions, and hold an amount of liquid securities sufficient to meet such redemption requests.

Periodic Stress Tests

The New Rules add a new mandate for money market fund managers to conduct periodic evaluations of their funds' ability to maintain a stable net asset value ("NAV") in the event of "shocks" including interest rate changes, increased redemptions, changes in the credit quality of the funds' portfolios, and other disruptive events.

Nationally Recognized Statistical Rating Organizations ("NRSROs")

Money market funds must continue to perform an independent credit analysis of every security they purchase which must be rated in the one of the top two rating categories (or unrated but of comparable quality); however, as a new requirement, intended in part to improve securities ratings provided by NRSROs, the board of directors of a money market fund must designate each year at least four NRSROs whose ratings the fund's board considers to be reliable. The New Rules also eliminate the current requirement that money market funds invest only in those asset-backed securities that have been rated by an NRSRO.

Repurchase Agreements

The New Rules continue to permit money market funds to "look through" issuers of repurchase agreements to the underlying collateral securities for diversification purposes, but only if the collateral for such agreements is cash or government securities, and the money market fund has evaluated the creditworthiness of the repurchase counterparty.

Enhancing Fund Disclosure

The New Rules require money market funds to increase disclosure of their portfolio holdings to investors and the SEC. Money market funds must post their portfolio holdings on their Web sites each month, which postings must be maintained for at least six months. Money market funds also must file with the SEC reports containing detailed portfolio schedules and “shadow” NAV or mark-to-market value of fund net assets. The contents of these reports will be made public 60 days after the filing date.

Improving Fund Operations

The New Rules seek to minimize losses to investors by reducing the vulnerability of money market funds to “runs” and facilitating share redemptions if money market funds “break the buck” (i.e., when NAV falls below $1 per share). The New Rules require that money market funds and their administrators have the ability to process electronic transactions at prices other than $1 per share. In addition, boards of directors of money market funds are permitted to suspend redemptions and decide to liquidate if a fund is about to “break the buck,” with prior notice to, rather than prior approval from, the SEC. Finally, the New Rules also increase the ability of affiliates of money market funds to purchase distressed assets from the funds in order to protect the funds from suffering losses, with notice to, rather than prior individual approval from, the SEC.

Timing of Compliance

The New Rules will become effective 60 days after they are published in the Federal Register and mandatory compliance with some of the New Rules will be phased in during the year. The SEC has not yet posted the text of the final rules on its website. Therefore, the information contained in this alert is based upon statements made by the SEC and its staff at the Meeting and the press release issued by the SEC following the Meeting. We will notify you of any significant deviations from or additions to the information above following publication of the final rules.

Future Reform Possible

In her opening statement at the Meeting, Chairman Mary Schapiro noted that “[The SEC’s] work... is not yet complete” and the Staff is actively considering and reviewing additional potential reforms, including:

- moving to the use of a floating NAV instead of a stable NAV of $1 per share;
- requiring redemptions-in-kind for large redemptions;
- requiring “real time” disclosure of shadow NAV;
- requiring a private liquidity facility; and
- moving to a two-tiered system of money market funds permitting the use of a stable NAV only for those funds subject to greater levels of risk limitations and liquidity facility requirements.

Chairman Schapiro also noted that other proposals are being discussed by the President's Working Group. We will inform you of any new rules or rule proposals as they are adopted.

For more information, please feel free to contact your Butzel attorney, the authors listed below or other attorneys of the Investment Management Practice Group.

Robert A. Hudson 313 225 7019 hudson@butzel.com

Robert I. Jones 212 818 1872 jones@butzel.com

Jennifer E. Powell 248 593 3023 powell@butzel.com