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SPECIAL EDITION

SEC Provides Details on Amendments to Money Market Fund Rules

The SEC recently published its [formal release](#) (the “Adopting Release”) adopting significant amendments (the “Amendments”) to Rule 2a-7 and other rules under the Investment Company Act of 1940 (the “1940 Act”) that affect money market funds. The SEC approved the Amendments at its January 27, 2010 open meeting. This special edition of the *Alert* discusses the Amendments in detail. It reviews the principal changes to the 1940 Act’s money market fund rules, and discusses the new obligations the Amendments impose on money market fund boards of directors as well as the new policies the Amendments require funds to adopt. It also reviews the various compliance dates for the Amendments.

Summary of the Amendments

The Amendments reflect three categories of changes to the rules governing money market funds: (a) changes to Rule 2a-7’s risk limiting conditions governing a fund portfolio’s: (i) maturity, (ii) credit quality, (iii) diversification and (iv) liquidity, (b) changes relating to operational aspects of money market funds, and (c) new disclosure requirements.

(a) *Changes to Rule 2a-7’s Risk Limiting Conditions:*

Portfolio maturity

- A money market fund portfolio’s maximum permissible weighted average maturity is reduced from 90 days to 60 days. A money market fund continues to have an obligation to maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value or price per share.
- The Amendments impose a new requirement that a money market fund portfolio’s weighted average maturity, determined without reference to Rule 2a-7’s maturity shortening provisions based on periodic resets of interest rates, may not exceed 120 days. This measure is referred to as “weighted average maturity life.”
- The Amendments eliminate the ability of any money market fund to acquire “government securities” with remaining maturities of more than 762 days. Currently, a money market fund that does not use the amortized cost method may acquire those securities.

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Credit Quality

- The Amendments reduce the limit on a money market fund's holdings of "second tier" securities (generally, securities that have received short-term ratings in the second highest ratings categories, or, if unrated, their equivalent) from 5 percent of total assets to 3 percent of total assets.
- The Amendments reduce the amount a money market fund may hold in second tier securities of any one issuer to ½ of 1 percent of the fund's total assets from the greater of 1 percent of the fund's total assets or \$1 million.
- The Amendments reduce the maximum remaining maturity for a second tier security that a money market fund may acquire from 397 days to 45 days.
- The Amendments permit a money market fund to invest in asset-backed securities that are not rated by a Nationally Recognized Statistical Ratings Organization (each, an "NRSRO"). Currently, Rule 2a-7 allows a money market fund to invest in asset-backed securities only if they have received a rating from an NRSRO.

Diversification

- Under the Amendments, a money market fund may not acquire a second tier security if, immediately after the acquisition, the fund has invested in more than one-half of one percent of its total assets in the second tier securities of a single issuer. Thus, under the Amendments, taxable and tax exempt money market funds will be treated the same for the purposes of second tier securities issuer diversification. Currently, Rule 2a-7 prohibits (a) a taxable money market fund from acquiring a second tier security if, immediately after the acquisition, the fund would hold second tier securities of a single issuer in an amount that is more than the greater of one percent of the fund's total assets or \$1 million, and (b) a tax exempt money market fund from acquiring the second tier conduit securities (but not necessarily other types of securities) of a single issuer if, immediately after the acquisition, the fund would hold second tier conduit securities of that issuer in an amount that is more than the greater of one percent of the fund's total assets or \$1 million.
- The Amendments permit a "single state" money market fund (generally, a tax exempt fund that invests in securities that generate income exempt from income and other taxes of a single state) to invest up to 30 percent of its total assets in the securities of a single issuer, including up to 0.5 percent of its total assets in second tier securities of that issuer. Currently, a single state fund may invest more than 5 percent of its assets in a single issuer's securities only if they are first tier securities.
- Under the Amendments, a money market fund may not acquire any security subject to a demand feature (generally, a right granted to the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest) or guarantee, or a security, after giving effect to a demand feature or guarantee, that is a second tier security, if more than 2.5 percent of the fund's total assets are invested in securities subject to demand features and guarantees from the entity that provided the demand feature or guarantee. The current limit is 5 percent.

- The Amendments modify the conditions for a repurchase agreement to be deemed fully collateralized. (If a repurchase agreement is fully collateralized, a money market fund may look through the repurchase agreement and treat the underlying collateral as the securities held by the fund for diversification purposes.) Currently, the collateral may consist of cash, government securities, and securities rated in the highest rating category by the requisite number of NRSROs (or unrated securities of comparable quality). Under the Amendments, eligible collateral is limited to cash and government securities. The Amendments also add a requirement that the fund's board (or its delegate) evaluate the creditworthiness of the repurchase agreement counterparty.

Liquidity

- The Amendments impose a new requirement that a money market fund must hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions. At a minimum, (a) each taxable money market fund must maintain at least 10 percent of its portfolio in cash, U.S. Treasuries and securities that convert to cash in one business day, and (b) each taxable or tax exempt money market fund must maintain at least 30 percent of its portfolio in cash, U.S. Treasuries, certain government securities with remaining maturities of 60 business days or less, and securities that convert to cash in five business days.
- The Amendments replace the 10 percent-limit on illiquid securities (generally, securities that the fund cannot sell in the ordinary course of business within seven days at approximately the value ascribed to them by the fund) previously articulated by the SEC staff with an express provision in Rule 2a-7 that prohibits a money market fund from purchasing any illiquid security if, after the purchase, more than 5 percent of the fund's portfolio consists of illiquid securities. Under the new limit, a money market fund using the amortized cost method will be able to treat as liquid a security that the fund can sell at a price that deviates from the security's amortized cost value only if the price approximates the market-based value that the fund has assigned to the security for purposes of determining the fund's shadow price.

(b) Changes in Operational Requirements

Stress Testing. The Amendments require a money market fund's investment manager to examine the fund's ability to maintain a stable net asset value in the event of market actions, large redemptions and other significant events. According to the Adopting Release, the purpose of requiring periodic stress tests is to determine how a fund will react under certain hypothetical situations, especially if those situations could cause the fund to "break-the-buck" by having its market-based price per share, or "shadow price," fall below \$0.995 per share. The Amendments require a fund's board to determine how frequently a fund should be stress tested; however, neither the Amendments nor the Adopting Release states that a fund's board must approve the design of the stress tests.

In the Amendments and the Adopting Release, the SEC identifies hypothetical situations that should be included in stress tests applied to a money market fund: (i) increases in short-term interest rates, (ii) increases in shareholder redemptions, (iii) ratings downgrades on portfolio securities, and (iv) changes in yield spreads between a benchmark and the commercial paper and other securities held by the fund. The Adopting Release, however, includes little guidance as to what other events a money market fund should consider. Under the Amendments, a money market fund's adviser is required to give the board each

year its assessment of the fund's ability to withstand the events that are reasonably likely to occur within the following year, as well as its ability to withstand more than one event occurring concurrently. The fund is required to keep these reports for at least six years, two years in an easily accessible place.

Portfolio Liquidity. The Amendments do not expressly require a money market fund to adopt policies and procedures to determine the amount of liquid securities that the fund should hold "to meet reasonably foreseeable shareholder redemptions." As a practical matter, however, a fund should have some process for assessing its shareholder liquidity needs on an ongoing basis. The Adopting Release states that this assessment should consider characteristics of the fund's investors, the likely liquidity needs of these investors, the concentration of the fund's shareholder base, and whether the fund accepts "hot" money. The Adopting Release also states that a money market fund board should consider whether to include guidelines to address the conflict of interest that the fund's investment manager may have with the fund with respect to attracting additional fund assets.

Selection of NRSROs. The Amendments require a money market fund's board to designate at least four NRSROs, at least one of which the fund must consider to determine whether a security will be deemed an "eligible security", first tier security, second tier security or a "rated security" for purposes of Rule 2a-7. The board also must determine at least once each calendar year thereafter whether the designated NRSROs issue credit ratings that are sufficiently reliable for the fund to continue using them. The Adopting Release states that a fund is permitted, but not required, to consider ratings from other NRSROs when determining whether a security is an eligible security. The Amendments require that no designated NRSRO may be an "affiliated person" of the money market fund, as defined in Section 2(a)(3) of the 1940 Act. The Adopting Release also states that before making any designation or determination, a board should have received from the fund's investment manager the manager's evaluation of the quality of the NRSRO's short-term ratings.

Calculation of Share Price at a Price Other than the Stable Share Price. The Amendments require that a money market fund have the capacity to redeem and sell its securities at a price based on the current net asset value per share calculated pursuant to Rule 22c-1 under the 1940 Act when such price does not correspond to the fund's stable share price.

Certain Purchases of Portfolio Holdings by an Affiliate without SEC Approval. The Amendments include changes to Rule 17a-9 under the 1940 Act, which permits an affiliated person, or an affiliated person of an affiliated person, to purchase from a money market fund, certain securities held by the fund without violating Section 17(a) of the 1940 Act. Section 17(a) generally prohibits principal transactions between a registered investment company and an affiliated person of the registered investment company. Prior to the Amendments, an affiliated person, or an affiliated person of an affiliated person, of a money market fund only could rely on Rule 17a-9 to acquire from a money market fund a portfolio security that was no longer an eligible security under Rule 2a-7. Under the Amendments, affiliated persons, and affiliated persons of affiliated persons, of a money market fund will be able to acquire any security held by a money market fund, including an eligible security, subject to certain limitations relating to the acquisition price and provided that, in the case of securities that are eligible securities and that have not defaulted, the acquirer remits to the fund any profit that it receives on the resale of the security. A fund that sells a security to an affiliated person, or an affiliated person of an affiliated person, is required to notify the SEC promptly.

Suspension of Redemptions. The Amendments include new Rule 22e-3 under the 1940 Act, which allows a money market fund to suspend redemptions for more than seven days if the board, including a majority of its disinterested directors, (a) makes a determination that the extent of the deviation in the fund's shadow price from the price per share based on the amortized cost method may result in a material dilution or other unfair result to existing fund shareholders and (b) acts irrevocably to liquidate the funds. Rule 22e-3 also requires a money market fund, when relying on the rule, to notify the SEC prior to suspending redemptions of the decision to suspend redemptions and liquidate. A registered investment company that invests in a money market fund pursuant to Section 12(d)(1)(E) of the 1940 Act, such as a feeder fund in a master-feeder arrangement or an insurance company separate account issuing variable insurance contracts, also may suspend redemptions in reliance on Rule 22e-3, provided that the money market fund has suspended redemptions in reliance on the Rule and the registered investment company also notifies the SEC.

(c) New Disclosure Requirements

Form N-MFP. Pursuant to new Rule 30b1-7 under the 1940 Act, a money market fund is required to file with the SEC by the fifth business day of each month, a report on Form N-MFP of portfolio holdings that is current as of the last business day of the previous month. The report includes not only information on the fund's portfolio holdings, but also the shadow price of each share class of the fund determined with and without the benefit of any capital support agreement. In addition, a fund must identify its designated NRSROs in Form N-MFP with respect to each of the fund's portfolio securities. Each Form N-MFP will become publicly available 60 days after the end of the month to which the information in the report relates.

Website Disclosure. The Amendments require that by the fifth business day of each month, a money market fund must disclose on its website a schedule of its investments as of the last business day of the prior month, and maintain the schedule on its website for at least six months. That schedule also must include the fund's calculations of weighted average maturity and weighted average maturity life, and it must include a link to the SEC's website to allow the investor to obtain copies of the fund's monthly Forms N-MFPs.

SAI Disclosure of Designated NRSROs. The Amendments require a money market fund to disclose in its statement of additional information ("SAI") its designated NRSROs and any limitation that the fund may have in using any designated NRSRO.

Compliance Dates

The Adopting Release indicates May 5, 2010 as the effective date for the Amendments and specifies compliance dates for the various elements of the Amendments as follows:

May 5, 2010	Amended portfolio diversification requirements and new stress testing procedures (although the Adopting Release is not clear as to the latter).
May 28, 2010	Amended requirements relating to (i) portfolio quality, (ii) maturity (other than weighted average maturity and weighted average maturity life), (iii) portfolio liquidity and (iv) repurchase agreements. (Rule 2a-7's portfolio liquidity requirements include the requirement that a money market fund maintain securities

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sufficiently liquid to meet reasonably foreseeable shareholder redemptions. This suggests that a fund should also begin complying with that requirement by May 28, 2010, although the Adopting Release is not clear on this point.)

June 30, 2010	Weighted average maturity and weighted average maturity life requirements.
October 7, 2010	Website disclosure requirements.
December 7, 2010	Requirement to file reports on Form N-MFP.
December 31, 2010	SAI disclosure of designated NRSROs.
October 31, 2011	Requirement that a fund be able to sell and redeem shares at a price other than \$1 per share.

The SEC has also extended from September 17, 2010 to December 1, 2010 the expiration date for Rule 30b1-6T under the 1940 Act, which is the temporary rule that requires a money market fund to report portfolio holdings to the SEC when the fund's shadow falls below \$0.9975.

* * *

Given their complexity, the SEC may issue an interpretative release or other guidance that clarifies certain aspects of the Amendments. The Adopting Release also notes several issues that the SEC is expected to address in additional rulemaking: the use of stable share prices, whether to apply the same liquidity standards to retail and institutional funds, and limitations on the maximum maturity of adjustable rate government securities that may be acquired by a money market fund. The *Alert* will address these developments as they occur.

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