

March 3, 2010

Money Market Fund Regulation

SEC Approves Rule Amendments Affecting Money Market Funds

SUMMARY

The Securities and Exchange Commission has adopted various amendments to rule 2a-7 and other rules relating to money market funds under the Investment Company Act of 1940. These amendments are the result in part of a “run” on a number of institutional taxable prime money market funds in September 2008 following the inability of the Primary Fund of The Reserve Fund to redeem its shares at \$1.00 per share and credit issues experienced by some money market funds in 2007-2008. These final amendments are similar in many respects to the money market fund rule proposals issued for comment by the SEC in June 2009.

The amendments (i) tighten the risk-limiting conditions of rule 2a-7, (ii) require money market funds to report their portfolio holdings and other information to the Commission on a monthly basis, and (iii) permit a distressed money market fund to suspend redemptions in order to allow for the orderly liquidation of fund assets. The principal elements of the amendments are the following:

- ***New liquidity requirements.*** Money market funds are prohibited from acquiring illiquid securities if, at the time acquired, the fund would have more than 5% of its total assets invested in illiquid securities. Taxable money market funds must maintain at least 10% of their assets in cash, demand deposits, U.S. Treasury securities, or assets readily convertible into cash within one day. All money market funds must maintain at least 30% of their assets in cash, demand deposits, U.S. Treasury securities, agency discount notes with remaining maturities of 60 days or less, or assets readily convertible into cash within five days.
- ***Repurchase agreements.*** Money market funds benefit from “look through” treatment when investing in repurchase agreements only if they are collateralized by cash items or Government securities, and the creditworthiness of repurchase agreement counterparties must be evaluated by the fund’s board of directors (or its delegate).
- ***Shortened maturity limits.*** The amendments impose a maximum 120-day weighted average life maturity limit on a money market fund’s portfolio, and reduce the maximum weighted average maturity of a money market fund’s portfolio from 90 to 60 days.

SULLIVAN & CROMWELL LLP

- **Lower limits on acquisition of “second tier” security investments.** Money market funds may invest only 3% of their total assets in second tier securities and may not invest more than 0.5% of their total assets in second tier securities of a single issuer.
- **NRSRO designation.** A money market fund’s board of directors must designate at least four nationally recognized statistical rating organizations (“NRSROs”) that the fund will use in determining whether the security is an eligible security, a rated security, a first tier security, and a second tier security.
- **Increased reporting requirements.** Money market funds must submit to the SEC new detailed monthly reports in addition to the current quarterly reports, and the SEC will make such reports available to the public 60 days after the end of the month to which the information relates. Additionally, money market funds are required to post their portfolio holdings on their websites within five days of the end of each month.
- **Permission to suspend redemptions.** In the event that a money market fund breaks the buck, or is at imminent risk of breaking the buck, its board of directors may suspend redemptions in order to allow for an orderly liquidation.
- **Transaction processing.** A money market fund’s transaction system must be able to process purchases and redemptions at a price other than one dollar per share.
- **Purchases by affiliates.** Affiliates of money market funds have expanded opportunities to purchase distressed securities from the funds without the need to obtain SEC staff no-action letters.

While these final rule amendments are similar in many respects to the rules proposed by the SEC in June 2009, they also differ in a number of important ways from the proposals. Significantly, the final rule amendments do not distinguish between “institutional” and other money market funds, and they also reduce — but do not eliminate — the ability of money market funds to invest in second tier securities. These and certain other differences between the proposed and final rule amendments are discussed below.

The rule amendments affect the duties of independent directors and trustees of money market funds in various respects, as highlighted below under “Implications for Independent Directors of Money Market Funds.”

The SEC continues to explore possible more significant changes to the regulation of money market funds, including whether money market funds should have floating rather than stabilized net asset values. The SEC expects to continue to work with members of the President’s Working Group on Financial Markets regarding these matters and to issue a release addressing this topic in the future.

SEC Commissioner Kathleen Casey voted against adoption of the rule amendments, commenting that in her view they do not go far enough to prevent future runs on mutual funds. Commissioner Casey believes that money market funds either should have access to emergency liquidity facilities and be regulated under the same rules as banks, or should have floating net asset values. She also believes that the rule amendments further embed inappropriate reliance on NRSRO ratings in the regulation of money market funds.

Unless otherwise noted below, the amendments to the rules are effective May 5, 2010, except that money market funds must comply with the amendments to rule 2a-7 related to portfolio quality, maturity, liquidity,

SULLIVAN & CROMWELL LLP

and repurchase agreements by May 28, 2010, although they are not required to dispose of securities owned, or to terminate repurchase agreements entered into, as of the time of the adoption of the amendments. The adopting release can be found at <http://www.sec.gov/rules/final/2010/ic-29132.pdf>. Sullivan & Cromwell's previous publication on the proposed money market reforms can be found at <http://www.sullcrom.com/publications/detail.aspx?pub=643>.

THE NEWLY ADOPTED RULES

LIQUIDITY

The rule amendments aim to promote greater liquidity to allow a money market fund to meet increased redemption demands by investors. To do so, they impose objective minimum liquidity requirements, subjective "know your investor" requirements, periodic stress testing to determine whether increased liquidity is necessary, and a liquid collateral requirement for repurchase agreements.

Objective Minimum Liquidity Requirements

- ***Limits on Acquiring Illiquid Securities.*** Under the current rules, funds may maintain up to 10% of their assets in illiquid securities, defined as securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately their amortized cost value. Under the rule amendments, however, a fund cannot acquire illiquid securities if, immediately after the acquisition, the fund would have invested more than 5% of its total assets in illiquid securities. In addition, "illiquid securities" is newly defined as securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to them by the fund.
- ***Minimum Daily and Weekly Liquidity Requirement.*** Under the rule amendments, all *taxable* funds must hold at least 10% of their total assets in "daily liquid assets," which includes cash, demand deposits, U.S. Treasury securities, and other highly liquid assets that can be readily converted into cash within one day. In addition, *all* funds must hold at least 30% of their total assets in "weekly liquid assets," which includes cash, demand deposits, U.S. Treasury securities, agency discount notes with remaining maturities of 60 days or less, and other highly liquid assets that can be readily converted into cash within five days. The fund must comply with these standards at the time any new security is acquired. The proposed amendments had distinguished between "retail" and "institutional" funds, and would have imposed a higher liquidity requirement on institutional funds since the SEC believes that "institutional" funds require greater liquidity than "retail" funds. While the final rule amendments do not include such a distinction (the SEC states that it had "not identified an effective way at this time to distinguish between types of money market funds to achieve our purpose"), the SEC states that it intends to revisit this issue in the future.

General Liquidity Requirement/Know Your Investor Procedures. As proposed, and in addition to the minimum liquidity requirements, the rule amendments require a fund to hold additional assets in highly liquid securities sufficient to meet reasonably foreseeable redemptions and any commitments the fund has made to shareholders, such as undertakings to pay redemptions more quickly than seven days after acceptance of the redemption request. Depending upon the volatility of its cash flows, this new provision may require a fund to maintain greater liquidity than would otherwise be required by the new daily and weekly minimum liquidity requirements. In the release on the amendments, the SEC states that funds should adopt policies and procedures designed to assure that appropriate efforts are undertaken to

SULLIVAN & CROMWELL LLP

identify risk characteristics of shareholders, and specifically advises fund boards to make sure that advisers are monitoring for “hot money.” The SEC urges fund boards to consider the need for establishing guidelines to address the conflict that may exist between an adviser’s interests in attracting assets and its duty to manage the fund in a manner consistent with maintaining a stable net asset value.

RISK LIMITING

Periodic Stress Tests. As proposed, money market fund boards must approve procedures for periodic stress tests based on hypothetical market scenarios. The scenarios are intended to test the ability of a fund’s portfolio to sustain a stable net asset value per share in the event of various extreme circumstances. The scenarios must include an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and a widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates, commercial paper, and other types of securities held by the fund. The tests must be conducted at intervals the board deems appropriate in light of current market conditions. A report of each test must be given to the board at its next regularly scheduled meeting and more frequently, if appropriate, in light of the results. Such reports must include information specified in the amendments. The SEC states that the amendments do not specifically require fund boards to design the stress tests (many commentators had expressed concern that the rule proposals seemed to suggest such a duty).

Liquid Collateral for Repurchase Agreements. Under the current “look-through” treatment of repurchase agreements, a fund may treat a repurchase agreement as an acquisition of the underlying collateral for diversification purposes, and the underlying collateral may include securities rated in the highest rating category in addition to cash and Government securities. The rule amendments limit the availability of look-through treatment to those repurchase agreements that are fully collateralized by cash items or Government securities, and also impose a new requirement that the board or its delegate evaluate the creditworthiness of the counterparty even though the agreement is fully collateralized.

Portfolio Quality. Contrary to the SEC’s proposals, the final rule amendments do not limit money market funds to purchases of (i) the highest rated securities or (ii) unrated securities that the funds deem are of comparable quality to such securities. Instead, money market funds continue to be able to invest in securities that have been rated in either of the two highest short-term debt ratings categories or are comparable to securities that have been so rated. In addition, ratings must now be from each of the four NRSROs designated by the funds. Such investments — like all investments by a money market fund — may be made only after the fund’s board (or its delegate) has determined that the security presents minimal credit risk.

Second Tier Securities. The rule amendments further limit the ability of money market funds to invest in “second tier securities.” They (i) lower the permitted percentage of a fund’s “total assets” that may be invested in second tier securities from 5% to 3% and (ii) lower the permitted concentration of a fund’s total

SULLIVAN & CROMWELL LLP

assets in second tier securities of a single issuer to 0.5%. In addition, money market funds are not permitted to acquire any second tier security with a remaining maturity in excess of 45 days.

Designated NRSROs. Under the amended rules, a fund's board of directors must designate "at least four" NRSROs that the fund will use in determining whether the security is an eligible security, a rated security, a first tier security, and a second tier security. In addition, the board must determine at least once each year that the designated NRSROs issue credit ratings that are sufficiently reliable for that use and the funds must also identify the designated NRSROs in their statements of additional information. The SEC notes in the release that the requirement to designate at least four NRSROs is intended to foster competition among NRSROs to develop a specialized service of providing short-term ratings to money market funds and improve independent credit ratings for purposes of rule 2a-7. The SEC notes that permitting the designation of only three NRSROs "would simply embrace the current market for ratings, which is dominated by three rating agencies." The release provides guidance to fund boards regarding the designation and annual evaluation of NRSROs, and indicates that the SEC anticipates that fund boards will have the benefit of the fund adviser's evaluation and recommendations in making the required designations and determinations. Money market funds must disclose the designated NRSROs in their statements of additional information by December 31, 2010.

Asset-Backed Securities. The rule amendments eliminate the requirement that an asset-backed security be rated by at least one NRSRO in order to be an eligible security that a money market fund may acquire. A money market fund may now acquire an unrated asset-backed security that otherwise meets the requirements of rule 2a-7, including those requirements that apply to unrated securities.

Portfolio Maturity. As proposed, the rule amendments further limit the maximum time within which a permissible investment may mature. This change is intended to limit a fund's exposure to interest rate risks, spread risks, and liquidity risks.

- **Weighted Average Life.** The rule amendments impose a restriction on a fund portfolio's weighted average life ("WAL"), prohibiting it from exceeding 120 days. The calculation of the WAL may include a security's demand features, although interest rate resets are not taken into consideration. The release notes that the WAL limitation restricts the extent to which a fund can invest in longer term securities that may expose it to spread risk. There is no current restriction on a money market fund's WAL.
- **Weighted Average Maturity.** The rule amendments reduce the maximum weighted average maturity ("WAM") of a fund's portfolio from the current 90 days to 60 days. The calculation of WAM, unlike that of WAL, takes into account interest rate resets. The SEC believes that the limit on the maximum WAM will result in money market funds that are more resilient to changes in interest rates that may be accompanied by other market shocks.
- **Remaining Maturity.** Lastly, the maximum remaining maturity permissible for an acquired government security is reduced from 762 to 397 days.

Fund portfolios must meet the new maturity limits by June 30, 2010.

SULLIVAN & CROMWELL LLP

DISCLOSURE

Public Website Posting. As proposed, the rule amendments institute a monthly electronic reporting requirement. For each security held, funds must post the issuer's name, the investment category, the CUSIP number, the principal amount, the maturity date as determined for purposes of calculating WAM, the final maturity date, the coupon or yield, and the amortized cost value, so that fund investors may monitor their investments. Funds must also post the WAM and the WAL of their portfolios within five business days after the end of the month, and this information must be maintained on the fund's website for no less than six months after posting. The compliance date for this new requirement is October 7, 2010.

Reporting to the Commission. Also as proposed, the SEC has created a new reporting form which must be completed and submitted monthly through EDGAR, and the reported information will then be compiled into a central database by the SEC. Funds must report the following:

- For each security held, the issuer's name, the issue's title, the CUSIP number, the investment category, the NRSROs designated by the fund for the security, the credit ratings given by each NRSRO, whether the security is first tier, second tier, unrated, or no longer eligible, the maturity date as determined for purposes of calculating WAM, the final maturity date, whether the instrument has certain enhancement features, the principal amount, the current amortized cost value, the percentage of the fund's assets invested in the security, whether the security is illiquid, and certain other information.
- Information about the fund's risk characteristics, such as the weighted average maturity of the fund's portfolio and its seven-day gross yield.
- The market-based values of each portfolio security and the fund's market-based net asset value per share, with separate entries for values that do and do not take into account any capital support agreements into which the fund may have entered.

This information must be filed within five business days after the end of the month. The first mandatory filing, for November 2010 month-end information, will be due on December 7, 2010. The SEC will make the reports filed with it publicly available 60 days after the end of the relevant month.

Contrary to its proposal, the SEC has not eliminated the current quarterly reporting requirement. However, the SEC will phase out the weekly reporting requirement instituted in September 2009 for any fund that has a market-based net asset value per share below \$0.9975 (such reports are not required after December 1, 2010).

EXPANDED EXEMPTION FOR AFFILIATE PURCHASES

As proposed, amendments to rule 17a-9 create more opportunities for fund affiliates to purchase distressed securities from the fund without obtaining no-action relief. The new amendments allow fund affiliates to purchase eligible securities from funds under two new circumstances. First, the amendments permit an affiliate to acquire a portfolio security that has defaulted, even though the security continues to be an eligible security. Second, a new provision of the rule allows an affiliate to purchase other securities for cash at the greater of amortized cost value or market value, if it remits any profit of a later sale of the

SULLIVAN & CROMWELL LLP

security back to the fund. The fund is obligated to give the SEC prompt notice via e-mail of a purchase under the amended rule, along with the reasons for the purchase.

ORDERLY AND EFFICIENT LIQUIDATION

In order to allow for orderly liquidations of distressed money market funds, the rule amendments (i) require a fund's transaction system to be capable of handling purchases and redemptions at a price other than one dollar and (ii) permit a fund's board of directors to suspend redemptions if the fund breaks the buck.

- **Transaction System.** The rule amendments require a money market fund (or its transfer agent) to have the capacity to redeem and sell the fund's securities at a price based on the current net asset value per share (*i.e.*, the fund must be able to process transactions in an orderly fashion if it breaks the buck). Contrary to the proposed rule, the rule amendment does not require the fund's board to formally determine that the fund has such capacity. Funds must comply with this new requirement by October 31, 2011.
- **Suspension of Redemptions.** Amended rule 22e-3 permits a fund to suspend redemptions if (i) the fund's board, including a majority of disinterested directors, determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results, (ii) the board, including a majority of disinterested directors, irrevocably approves liquidation, and (iii) the fund notifies the SEC of its decision via e-mail prior to liquidating. The SEC may rescind or modify the suspension, after appropriate notice and hearing, if the fund has not devised or is not properly executing its plan of liquidation. The amended rule also allows a conduit fund, such as an insurance company separate account, a unit investment trust, or a feeder fund in a master feeder arrangement, to suspend redemptions if a money market fund in which all of its assets are invested has also suspended redemptions. Contrary to the proposed rule, a fund need not actually break the buck or re-price its securities before it suspends redemptions pursuant to this rule.

IMPLICATIONS FOR INDEPENDENT DIRECTORS OF MONEY MARKET FUNDS

The rule amendments expand the number of specific duties imposed upon money market fund directors or trustees. These new duties are:

- The designation of at least four NRSROs for purposes of measuring the credit risk of the fund's securities, and an annual evaluation of the reliability of each NRSRO's credit ratings.
- An evaluation of the seller's creditworthiness if a repurchase agreement is to be treated as an acquisition of the underlying security.
- The approval of procedures for stress testing conducted at intervals to be determined by the board, and the receipt of reports following such tests.
- The irrevocable approval of liquidation of the fund, including by a majority of the fund's investors, if the fund determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results.

Of these four new duties, the first, third, and fourth are not delegable. In addition, money market fund boards will be asked to approve amendments to rule 2a-7 procedures and to approve or amend various other compliance policies and procedures as a result of the rule amendments.

SULLIVAN & CROMWELL LLP

The SEC had originally proposed, but did not adopt, rule amendments requiring fund boards to determine that the fund (or its transfer agent) has the capacity to redeem and sell securities at the current net asset value and whether or not a fund is an “institutional” fund.

FURTHER REFORM

The SEC states in the release that it continues to explore more significant changes to the regulation of money market funds in light of comments it received following its proposals in June 2009. These additional, more fundamental potential regulatory changes include the following:

- ***Floating Share Price*** – should money market funds sell and redeem shares at floating prices rather than a stable share price? As noted above, Commissioner Casey voted against adopting the new amendments in part because she is of the view that, if the funds are not subject to banking regulation, the SEC should require them to sell and redeem shares at floating prices.
- ***Liquidity Requirements*** – should there be different minimum liquidity requirements for “retail” and “institutional” funds?

The SEC states in the release that it expects to issue a new release addressing these issues and proposing further reform to money market regulation. At the open meeting at which the final amendments were approved, SEC Chairman Mary Schapiro stated that other possible reforms include mandatory redemptions-in-kind for large redemptions (such as those made by institutional investors), “real time” disclosure of shadow net asset values, a private liquidity facility to provide liquidity to money market funds in times of stress, a possible “two-tiered” system of money market funds, with a stable net asset value only for money market funds subject to greater risk-limiting techniques and possible liquidity facility requirements, and “several other options being discussed with the President’s Working Group [on Financial Markets].”

* * *

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; rishj@sullcrom.com) or Alison Alifano (+1-212-558-4896; alifanoa@sullcrom.com) in our New York office.

CONTACTS

New York

John E. Baumgardner, Jr.	+1-212-558-3866	baumgardnerj@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com

Washington, D.C.

Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Paul J. McElroy	+1-202-956-7550	mcelroy@sullcrom.com
