Money Market Fund Regulation

SEC Proposes Rule Amendments That Bring Money Market Funds Under Increased Regulation

SUMMARY

Money market funds depend on rule 2a-7 to value their assets in order to maintain a stable net asset value, ordinarily $1.00 per share.

In light of significant redemptions in September 2008 and the inability of the Reserve Primary Fund to redeem its shares at $1.00 per share, as well as credit issues experienced by some money market funds in the preceding year, on June 30, 2009, the Securities and Exchange Commission published a host of proposed amendments to rule 2a-7 and other rules governing money market funds under the Investment Company Act of 1940. If adopted, the proposals would (i) tighten the risk-limiting conditions of rule 2a-7, (ii) increase the number of disclosures that money market funds must make to the SEC and the general public and (iii) permit a money market fund whose net asset value per share falls below one dollar, or “breaks the buck,” to suspend redemptions in order to allow for orderly liquidation of fund assets. The principal elements of the SEC proposals are the following:

- **New liquidity requirements.** Money market funds would be prohibited from acquiring securities unless, at the time acquired, they are liquid (can be sold in the ordinary course within seven days at approximately their amortized cost value). Institutional money market funds must maintain at least 10% of their assets in cash, U.S. Treasury securities, or assets readily convertible into cash within one day. Furthermore, at least 30% of their portfolios must be liquid within one week. The minimum daily and weekly liquidity percentages for retail money market funds are 5% and 15%, respectively.

- **Repurchase agreements.** Money market funds would 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.

- **Shortened maturity limits.** The proposed rules 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.

- **Prohibition on acquisition of “Second Tier” security investments.** Money market funds may acquire only the highest rated securities.
Periodic stress test requirements. Money market funds must adopt procedures for mandatory periodic tests based on hypothetical market scenarios.

Increased reporting requirements. New detailed monthly reporting requirements to the SEC replace the current quarterly reportings. Additionally, money market funds are required to post their portfolio holdings on their websites each month.

Permission to suspend redemptions. In the event that a money market fund breaks 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 will have expanded opportunities to purchase distressed securities from money market funds without the need to obtain SEC staff no-action letters.

The SEC has solicited comment from interested parties on all aspects of the proposed rules. It is also seeking comment on other potential changes, including whether money market funds should have floating rather than stabilized net asset values, and what the role of rating agencies should be in relation to money market funds.

Comments on the proposals should be submitted on or before September 8, 2009.

THE NEW PROPOSED RULES

RISK LIMITING

Liquidity. The proposed rule amendments aim to promote greater liquidity to allow a money market fund (a “fund”) to meet an increase in 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. The new rules, however, limit funds to purchasing only liquid securities, defined as securities that can be sold or disposed of in the ordinary course of business within seven days at approximately their amortized cost value. The securities need only be liquid at the time of acquisition, so a security that later becomes illiquid does not need to be disposed of to satisfy this requirement.

Minimum Daily Liquidity Requirement. The proposed rules institute different minimum liquidity requirements for institutional and retail funds. Institutional funds must maintain at least 10% of their assets in cash or other highly liquid assets that can be readily converted into cash within one day. Retail funds are only required to maintain 5% of their assets in assets convertible to cash within one day. The proposal requires a fund board to determine, at least once per calendar year, whether the fund is an institutional or retail fund. To aid in this determination, the SEC has also proposed new definitions of the terms “retail fund” and “institutional fund.” Since the liquidity requirements apply...
only when securities are acquired, a fund is not required to dispose of assets if redemptions later drive its total liquid assets below the specified minimum percentage. Tax-exempt funds are exempt from the one-day liquidity requirement.

- **Minimum Weekly Liquidity Requirement.** As with the minimum daily liquidity requirement, the minimum weekly liquidity requirement also distinguishes between retail and institutional funds. Institutional funds may not invest in a security if, immediately after the acquisition, at least 30% of the portfolio’s total assets are not invested in “weekly liquid assets.” Retail funds must maintain at least 15% of their portfolio in “weekly liquid assets,” measured immediately after each security acquisition. “Weekly liquid assets” would be defined as U.S. Treasury securities, or securities that mature or are subject to a demand feature exercisable and payable within five business days. Tax-exempt funds must comply with the minimum weekly liquidity requirement.

**General Liquidity Requirement/Know Your Investor Procedures.** In addition to the minimum liquidity requirements, the proposed rules 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. The release states that funds should adopt procedures to know their investors, including identifying their risk characteristics, and their likely liquidity needs.

**Periodic Stress Tests.** Funds using the amortized cost method of valuation must adopt procedures for stress tests based on hypothetical market scenarios. The scenarios are intended to test the portfolio’s ability to maintain a stable net asset value per share. Some of the scenarios the SEC contemplates are: an increase in short-term interest rates, an increase in shareholder redemptions, and defaults on portfolio securities. The tests would be conducted at intervals the board deems appropriate in light of current market conditions, and a report of each test must be given to the board at its next regularly scheduled meeting.

**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. Under the proposed amendments, look-through treatment would be limited to only those repurchase agreements that are fully collateralized by cash items or government securities. Additionally, the board or its delegate must evaluate the creditworthiness of the counterparty even though the agreement is fully collateralized.

**Portfolio Quality.** The new rules aim to protect the quality of investments by allowing an investment fund to purchase only (i) the highest rated securities or (ii) unrated securities that a fund deems are of comparable quality to rated securities.

(footnote continued)

based on the: (i) nature of the record owners of the fund’s shares; (ii) minimum initial investment requirements; and (iii) historical cash flows that have resulted or expected cash flows that would result from purchases and redemptions. Proposed rule 2a-7(a)(24) would define a “retail fund” as any fund other than an institutional fund.
**Second Tier Securities.** The new rules prohibit investments by funds in “second tier securities” by modifying the current definition of “eligible securities.” Under the new definition, only securities that have received the highest (rather than the highest two) short-term debt ratings from the requisite rating agencies are deemed eligible securities. If an eligible security is downgraded, the fund would have to dispose of the security as soon as practicable consistent with achieving an orderly disposition of that security.

**Unrated Securities.** Notwithstanding the new definition of eligible security, a fund may still acquire an unrated security if the fund’s board of directors concludes that it is of comparable quality to a rated security. Additionally, a fund may also acquire long-term unrated securities if the securities have received long-term ratings in the highest two ratings categories; under the current rules, a long-term unrated security may be acquired if it has long-term ratings in the highest three categories.

**Downgrades.** If an eligible rated security is downgraded below first tier after its purchase, the fund must dispose of the security as soon as practicable consistent with achieving an orderly disposition of that security, unless the fund’s board of directors finds that such disposal would not be in the best interests of the fund. If the fund becomes aware that any rating agency has given a previously unrated security a rating below the highest short-term rating category, the fund must reassess whether the security continues to possess minimal credit risk.

**Portfolio Maturity.** The proposals aim to increase investment quality by limiting the maximum time within which an investment may mature. This move is intended to limit a fund’s exposure to interest rate risks in particular.

- **Weighted Average Life.** The proposals impose a new restriction on a fund portfolio’s weighted average life, prohibiting it from exceeding 120 days. The calculation of the weighted average life may include a security’s demand features, although interest rate resets are not taken into consideration.
- **Weighted Average Maturity.** The proposals decrease the maximum weighted average maturity of a fund’s portfolio from the current 90 days, down to 60 days.
- Lastly, the maximum remaining maturity permissible for an acquired Government security would be 397 days.

**DISCLOSURE**

The proposed rules would eliminate the current quarterly reporting requirement and replace it with a monthly electronic reporting requirement. The electronic report is due to the SEC within two business days after the end of each month. The SEC has created a new proposed reporting form, which would be completed and submitted by the fund, and then compiled into a central database by the SEC. The SEC expects to make the reports filed with it publicly available within two weeks after their filing. Additionally, funds must post their portfolio holdings, along with their schedule of investments on their websites each month, so that fund investors may monitor their investments. This information must be posted within two business days after the end of each month.
ORDERLY & EFFICIENT LIQUIDATION

In order to allow for an orderly liquidation, the proposed rules (i) require a fund’s transaction system to be capable of handling purchases and redemptions at a price other than one dollar, (ii) create more opportunities for affiliates to purchase distressed securities from the fund without obtaining no-action relief, and (iii) permit a fund’s board of directors to suspend redemption if the fund breaks the buck.

- **Transaction System.** Under proposed rule 2a-7(c)(1), the board must determine in good faith, at least once per year, that the fund (or its transfer agent) has the capacity to redeem and sell its securities at a price based on the current net asset value per share (i.e., the fund can process transactions in an orderly fashion if it breaks the buck). This new board responsibility would be non-delegable under the proposed rule.

- **Affiliate Purchases.** Proposed amendments to rule 17a-9 would allow fund affiliates to purchase eligible securities from funds under two new circumstances. First, the amendments would 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 would allow 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 security back to the fund. The fund is obligated to give the SEC prompt notice of a purchase under the new rule, along with the reasons for the purchase.

- **Suspension of Redemptions.** Proposed rule 22e-3 permits a fund to suspend redemptions if it has broken the buck, the board of directors approves liquidation, and 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 proposed rule would also allow a conduit fund, such as an insurance company separate accounts 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.

SEC COMMENT SOLICITATION

The SEC has solicited comment from interested parties on all aspects of the proposed rules. In addition, it is seeking comment on the following issues:

- **Floating Share Price** – should funds sell and redeem shares at floating prices rather than a stable share price?

- **Credit Rating Agencies** – what role, if any, should credit rating agencies play in fund regulation? Should the SEC require fund boards to designate certain rating agencies that they will use to evaluate securities during and after their purchase? Are there better alternatives to the role that credit rating agencies play?

- **Asset-Backed Securities** – how might the risk posed by asset-backed securities be better addressed?

- **In-kind redemptions** – should funds be required to satisfy large redemption requests through in-kind redemptions as opposed to monetary payments?

Comments are due by September 8, 2009.

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CONTACTS

<table>
<thead>
<tr>
<th>New York</th>
<th>Phone Number</th>
<th>Email Address</th>
</tr>
</thead>
<tbody>
<tr>
<td>John E. Baumgardner, Jr.</td>
<td>1-212-558-3866</td>
<td><a href="mailto:baumgardnerj@sullcrom.com">baumgardnerj@sullcrom.com</a></td>
</tr>
<tr>
<td>Donald R. Crawshaw</td>
<td>1-212-558-4016</td>
<td><a href="mailto:crawshawd@sullcrom.com">crawshawd@sullcrom.com</a></td>
</tr>
<tr>
<td>Jillian Danielle Eng</td>
<td>1-212-558-4651</td>
<td><a href="mailto:engi@sullcrom.com">engi@sullcrom.com</a></td>
</tr>
<tr>
<td>Frederick Wertheim</td>
<td>1-212-558-4974</td>
<td><a href="mailto:wertheimf@sullcrom.com">wertheimf@sullcrom.com</a></td>
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