

# ADVISORY

## SULLIVAN & WORCESTER LLP INVESTMENT MANAGEMENT ADVISORY

### SEC Proposes Rule Amendments to Strengthen Regulatory Framework for Money Market Funds

On June 24, 2009, the Securities and Exchange Commission (the "SEC") voted unanimously to propose rule amendments designed to strengthen the regulatory framework for money market funds by increasing the resilience of such funds to the market turmoil experienced in the recent financial crises (the "Proposed Rule")<sup>1</sup>. The Proposed Rule incorporates many of the recommendations (discussed in detail below) of the Investment Company Institute's (the "ICI") "*Report of the Money Market Working Group*" (the "ICI Report")<sup>2</sup> published in March. Specifically, the Proposed Rule is intended to reduce the risk of shareholder "runs" on money market funds, which occurred last fall when the Reserve Primary Fund's net asset value fell below \$1.00 per share or "broke the buck." The Proposed Rule would amend Rule 2a-7 under the Investment Company Act of 1940, as amended (the "Act") by increasing the liquidity requirements and reducing the risk profiles of money market funds, as well as requiring money market funds to disclose certain information more frequently and permit a money market fund to suspend redemptions in the event it breaks the buck.

In particular, the Proposed Rule would bolster the regulatory framework for money market funds by:

- Requiring money market funds to hold certain minimum percentages of their assets in cash or securities that can be readily converted into cash to pay redeeming investors. In addition, money market funds would be prohibited from holding illiquid securities (they are currently permitted to hold up to 10% in illiquid securities).
- Shortening the weighted average maturity limits for money market fund portfolios from 90 days to 60 days.
- Limiting money market funds to investing only in the highest quality securities by eliminating their ability to invest in so-called "Second Tier" securities. Currently, money market funds are permitted to invest up to 5% of their assets in Second Tier securities.

<sup>1</sup> See Money Market Fund Reform, SEC Release No. IC-28807 (June 30, 2009), available on the SEC's website at <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>

<sup>2</sup> See INVESTMENT COMPANY INSTITUTE, REPORT OF THE MONEY MARKET WORKING GROUP (Mar. 17, 2009), available at [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf)

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- Requiring money market funds to “stress test” fund portfolios periodically to determine whether the fund can withstand market turbulence.
- Requiring money market funds to report their portfolio holdings monthly to the SEC and post such holdings on their websites, as opposed to the current requirement of quarterly disclosure.
- Requiring money market funds to have the operational capacity to process purchases and redemptions at a price other than \$1.00.
- Permitting a money market fund that has “broken the buck” and decided to liquidate to suspend redemptions while the fund undertakes an orderly liquidation of assets.

The Proposed Rule would also require money market funds to adopt “Know Your Investor” procedures to determine which investors might present a risk to the fund if they redeemed their investment.

While the vote to propose the rule amendments was unanimous, Commissioner Troy A. Paredes voiced concern with respect to two aspects of the amendments. First, he questioned whether the elimination of Second Tier securities as a permissible investment is necessary in light of the fact that he is “not aware of any causal link between Second Tier securities and the stresses money market funds came under last year.” Second, he expressed reservations about requiring money market funds to disclose their “shadow NAV,” which is the money market fund’s market-based net asset value per share and may differ from the \$1.00 NAV the fund is required to maintain. Commissioner Paredes is concerned that disclosure of a money market fund’s shadow NAV might spur redemptions if investors see that a money market fund’s NAV has fallen, and might actually put pressure on a fund to break the buck when investors redeem who otherwise would not have done so had the shadow NAV not been disclosed. In addition to seeking comments on the Proposed Rule, the SEC is also seeking public comment on whether to move to a “floating NAV” in lieu of the stable \$1.00 share price which is currently required. In response, the ICI has stated that it “continues to strongly oppose a move to floating NAVs because such a change would be so unpopular with investors that it would likely push them into riskier, less-regulated products.”

### **Comparison of ICI Recommendations to Proposed Rule**

Set forth below is a discussion of the ICI Report’s major recommendations along with a comparison of those recommendations to the amendments proposed by the SEC in the Proposed Rule:

1. The ICI had recommended 5% daily liquidity for taxable money market funds and 20% weekly liquidity for all money market funds. The liquidity requirements set forth in the Proposed Rule are more restrictive in that taxable institutional money market funds must maintain 10% daily liquidity and 30% weekly liquidity. Taxable retail money market funds would be subject to 5% daily liquidity and 15% weekly liquidity. The Proposed Rule would exempt tax exempt funds from the minimum daily liquidity requirements. Therefore, the Proposed Rule follows the ICI’s recommendation of 5% daily liquidity for retail funds, but is more restrictive by requiring 10% daily liquidity for institutional funds. The ICI’s recommendation of 20% weekly liquidity is greater than what the Proposed Rule sets forth for retail funds (15%) but is less than what the SEC proposed for institutional funds (30%).
2. The ICI had recommended that the maximum average portfolio maturity be shortened from 90 days to 75 days. The Proposed Rule is actually more restrictive in that it would require a maximum average portfolio maturity of 60 days. In addition, the Proposed Rule is consistent with the ICI’s recommendation of requiring money market funds to have a “weighted average life” portfolio maturity not exceeding 120 days.
3. The Proposed Rule is consistent with the ICI’s recommendation to prohibit money market funds from investing in Second Tier securities.
4. The ICI had recommended that money market fund advisers perform periodic stress tests in order to evaluate the fund’s ability to maintain a stable NAV in the event of market turmoil. The Proposed Rule is consistent with the ICI’s recommendation.
5. The ICI had recommended that advisers should address “client risk” by adopting “know your client” procedures. The Proposed Rule includes the ICI’s recommendation regarding “know your client” procedures, but did not include the ICI’s recommendation to post client concentration levels on a money market fund’s website.

6. The ICI had recommended that money market funds be required to both post their portfolio holdings on their websites and disclose such holdings to the SEC monthly. The Proposed Rule is consistent with the ICI's recommendations. The Proposed Rule does not, however, address the ICI's recommendations that (i) the SEC staff monitor money market funds who significantly outperformed their peers and (ii) the SEC staff randomly monitor ten money market funds each month to determine whether their portfolio holdings fit within their risk profile.

7. The ICI had recommended that a money market fund's board of directors could suspend redemptions if the fund were to "break the buck" and liquidate. The ICI had also recommended that the money market fund's board could suspend redemptions for up to five-days if the fund has "broken" or is about to "break the buck." The Proposed Rule would implement the former recommendation, but not the latter.

8. The ICI had recommended that exemptive Rule 17a-9 under the Act be expanded to permit an affiliate of a money market fund to purchase an "eligible security" from the fund, as this would give affiliates of money market funds the ability to provide support to the funds without triggering the prohibitions against transactions between affiliates found in Section 17 of the Act. Currently, under Rule 17a-9 a security must no longer be an eligible security for an affiliated person of a money market fund to purchase such security. The Proposed Rule is consistent with the ICI's recommendation.

9. The ICI had recommended that money market fund advisers establish a "new products" committee to evaluate and approve new structures. The ICI had also recommended that money market fund advisers follow "best practices" for determining minimal credit risk. The Proposed Rule does not address these recommendations.

10. The ICI had recommended that money market funds should improve their prospectus disclosure to clearly spell out risks and avoid the use of "boilerplate" disclosure. The ICI had also recommended that the SEC adopt a new rule under the Investment Advisers Act of 1940 applicable to advisers of unregistered funds, designed to reduce investor confusion about funds that appear to be money market funds, but which do not comply

with the risk-limiting provisions applicable to money market funds. The Proposed Rule does not address these recommendations.

The comment period on the Proposed Rule expires on September 8, 2009.