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SEC Adopts Final Rule Amendments to Increase Resilience of Money Market Funds

On February 23, 2010, the Securities and Exchange Commission (the SEC), issued a final rule release adopting amendments to Rules 2a-7 and 17a-9 under the Investment Company Act of 1940 (the Act), which govern money market funds. The SEC also adopted other new rules and new Form N-MFP. The new rules and form (the Amendments) are designed to make money market funds more resilient to the types of economic stresses and market turmoil experienced in 2008.¹ The Amendments track substantially the money market rule amendments proposed by the SEC last June², and also incorporate many of the recommendations of the Investment Company Institute.³

As discussed in detail below, the Amendments further limit the risks money market funds may assume by, among other things, (1) increasing the credit quality of fund portfolios, (2) shortening portfolio maturity limits, (3) tightening liquidity requirements, (4) requiring "stress testing" of fund portfolios against economic shocks, (5) limiting the risks associated with investments in repurchase agreements, (6) enhancing disclosure of fund portfolio holdings, (7) requiring that money market funds have the capacity to process transactions at prices other than the fund's current net asset value, (8) expanding the exemption from prohibitions on affiliated transactions, and (9) providing an orderly means to wind down the operations of a fund that does break the buck or is danger of breaking the buck in order to protect shareholders from a run on fund shares. In addition, the SEC has indicated that it is still considering further reforms to money market funds in the future.

The Amendments become effective on May 5, 2010, and the compliance date for those aspects of the Amendments related to portfolio quality, maturity, liquidity, and repurchase agreements is May 28, 2010. The compliance dates for the remaining aspects of the Amendments are staggered throughout the year as discussed below.

I. PORTFOLIO QUALITY

Second Tier Securities. The Amendments further limit the extent to which a money market fund may invest in "second tier securities."⁴ In particular, the Amendments (1) reduce the permitted percentage of a fund's "total assets" that may be invested in second

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tier securities from five percent to three percent and (2) lower the permitted concentration of its total assets in second tier securities of a single issuer from the greater of one percent or \$1 million to one-half of one percent.⁵ In addition, the Amendments prohibit money market funds from acquiring any second tier security with a remaining maturity in excess of 45 days. In reducing these limits, the Adopting Release notes that second tier securities present greater credit spread risk and trade in thinner markets than first tier securities, which can lead to greater price volatility and illiquidity during times of financial market stress.

Beginning on May 5, 2010, a money market fund would be prohibited from purchasing a second tier security if such purchase would cause greater than 3% of the fund's total assets to be invested in second tier securities. However, a money market fund would not be required to sell second tier securities that it purchased prior to May 5, 2010 in order to bring its portfolio in compliance with the 3% limit until May 28, 2010.

Eligible Securities. The Amendments require a money market fund's board of directors to (1) designate four or more NRSROs whose short-term credit ratings may be used by the fund to determine whether a security is an eligible security, and (2) determine at least once each calendar year that the designated NRSROs issue credit ratings that are sufficiently reliable for that use. In addition, a money market fund must identify the designated NRSROs in its statement of additional information (SAI) no later than December 31, 2010. Once a money market fund's board has designated the NRSROs, the fund may look only to the designated NRSRO whenever it has to consider credit ratings. Acknowledging that a board's determinations with respect to NRSROs will "be a matter of judgment," the Adopting Release explains that the board's initial designation and subsequent annual determinations would normally be based on the recommendations of the fund adviser who has previously evaluated each NRSRO.

Asset-Backed Securities. The Amendments also eliminate the requirement that an asset-backed security (ABS) be rated by at least one NRSRO in order to be an eligible security that may be purchased by a money market fund. As a result, money market funds may now acquire an unrated

ABS that otherwise meets the requirements of Rule 2a-7.

II. PORTFOLIO MATURITY

Weighted Average Maturity. In order to make money market funds more resilient to changes in interest rates caused by market turbulence, the Amendments reduce the maximum dollar-weighted average portfolio maturity (WAM) that a money market fund may maintain from 90 days to 60 days. The Adopting Release states that a portfolio weighted towards securities with longer maturities increases the fund's exposure to interest rate risks, amplifies spread risk, and decreases the ability of the fund to pay redeeming shareholders.

Weighted Average Life. The Amendments also impose a new requirement that limits the dollar-weighted average life to maturity of a money market fund's portfolio to 120 calendar days. Unlike WAM, the weighted average life (WAL) of a portfolio is measured without taking into consideration interest rate reset dates that shorten the maturity of an adjustable-rate security. The SEC believes that the WAL limitation will provide an "extra layer of protection" for money market funds and their shareholders as it will require the fund's adviser to limit the spread risk associated with longer term adjustable-rate securities, which are more sensitive to credit spreads than short-term securities with final maturities equal to the reset date of the longer term security.

Money market fund portfolios must meet the new maximum WAM and WAL limits by June 30, 2010.

Maturity Limit for Government Securities. The Amendments eliminate a provision in Rule 2a-7 that previously permitted a fund that relied exclusively on the "penny-rounding" method of pricing to acquire government securities with remaining maturities of up to 762 days.⁶

III. PORTFOLIO LIQUIDITY

General Liquidity Requirement. The Amendments require money market funds to maintain a sufficient degree of liquidity necessary to meet reasonably foreseeable redemption requests and mitigate the risk that the fund will have to meet redemption requests by selling portfolio securities in a declining market. As discussed below, the Amendments require a fund

to impose certain minimum daily and weekly liquidity requirements. Based upon the volatility of the money market fund's cash flows and shareholder redemptions, however, a fund may be required to maintain greater liquidity than would otherwise be required by these minimum daily and weekly liquidity requirements. The Adopting Release states that both a money market fund's adviser and its board of directors must evaluate the fund's liquidity needs and protect the fund's shareholders accordingly. In order to evaluate the fund's liquidity needs, the adviser must consider the characteristics of the money market fund's investors and their likely redemptions (*e.g.*, meeting monthly or more frequent payroll requirements). In order to comply with this general liquidity requirement, the Adopting Release states that money market funds should adopt policies and procedures as part of their compliance program under Rule 38a-1 of the Act designed to ensure that appropriate efforts are undertaken to identify the risk characteristics of fund shareholders. Also, a money market fund's board of directors should make sure that the fund's adviser is monitoring for "hot money," remaining cognizant of the fact the adviser's interest in attracting additional fund assets may conflict with its overall duty to manage the fund in a manner consistent with maintaining a stable net asset value (NAV).

Limitation on Acquisition of Illiquid Securities. The Amendments further limit the ability of money market funds to purchase illiquid securities by restricting money market funds from purchasing illiquid securities if, after the purchase, more than 5% of the fund's portfolio would be illiquid securities, as opposed to the current limit of 10%.⁷

Minimum Daily and Weekly Liquidity Requirements. In addition to the general liquidity requirement discussed above, the Amendments require that money market funds maintain a portion of their portfolios in cash and securities that can readily be converted into cash. Specifically, the Amendments require all *taxable* money market funds to hold at least 10% of their total assets in "daily liquid assets"⁸ and *all* money market funds to hold at least 30% of their total assets in "weekly liquid assets."⁹ The Amendments, consistent with the SEC's earlier proposals, exempt tax-exempt money market funds from the daily liquidity requirements, largely

because these funds cannot engage in repurchase agreements and the supply of tax-exempt securities with daily demand features is extremely limited.

Stress Testing. The Amendments require the board of each money market fund to adopt procedures providing for periodic stress testing of the fund's portfolio. The procedures are required to provide for the periodic testing of the fund's ability to maintain a stable NAV in the wake of certain hypothetical events including (1) an increase in short-term interest rates, (2) an increase in shareholder redemptions, (3) a downgrade of or default on portfolio securities, and (4) a widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. The Amendments require that the board of directors receive reports of the results of the stress testing. The report must include (1) the date(s) on which the fund portfolio was tested; (2) the magnitude of each hypothetical event that would cause the money market fund to break the buck; and (3) an assessment by the fund's adviser of the fund's ability to withstand the events that are reasonably likely to occur within the following year.¹⁰

IV. REPURCHASE AGREEMENTS

Because money market funds invest a significant portion of their assets in repurchase agreements, the Amendments limit the risks associated with them. First, under the Amendments, a money market fund may only invest in repurchase agreements collateralized by cash items or Government securities in order to obtain the special treatment of those investments under the diversification provisions of Rule 2a-7.¹¹ Second, the Amendments reinstate the requirement (previously eliminated in 2001) that the money market fund's board of directors or its delegate evaluate the creditworthiness of the repurchase agreement's counterparty.

V. DISCLOSURE OF PORTFOLIO INFORMATION

Public Web site Posting. In order to provide investors with more portfolio information and a better understanding of the current risks to which a fund is exposed, the Amendments require money market funds to disclose information about their portfolio holdings on their Web sites. In particular, the Amendments will require money market funds

to disclose monthly with respect to each security held: (1) the issuer; (2) the category of investment (*e.g.*, Treasury debt, government agency debt, asset backed commercial paper, structured investment vehicle note); (3) the CUSIP number (if any); (4) the principal amount; (5) the maturity date as determined under Rule 2a-7 for purposes of calculating WAM; (6) the final maturity date, if different from the maturity date previously described; (7) coupon or yield; and (8) the amortized cost value. The Amendments also require money market funds to disclose their overall WAM and WAL. The required portfolio information, current as of the last business day of the previous month, must be posted no later than the *fifth* business day of the month, and must be maintained on the fund's Web site for no less than six months after posting. ***The compliance date for public Web site disclosure is October 7, 2010.***

Reporting to the Commission. In addition to posting certain portfolio information on their Web sites as discussed above, the Amendments also require money market funds to provide certain information to the SEC on new Form N-MFP. Form N-MFP must include, with respect to each portfolio security held on the last business day of the prior month, the following information: (1) the issuer; (2) the title of the issue, including the coupon or yield; (3) the CUSIP number; (4) the category of investment; (5) the NRSROs designated by the fund, the credit ratings given by each NRSRO, and whether each security is first tier, second tier, unrated, or no longer eligible; (6) the maturity date as determined under Rule 2a-7; (7) the final legal maturity date; (8) whether the instrument has certain enhancement features; (9) the principal amount; (10) the current amortized cost value; (11) the percentage of the fund's assets invested in the security; (12) whether the security is illiquid; and (13) other material information. Form N-MFP also requires money market funds to provide certain additional information about a fund including, among other things, the fund's WAM and its seven-day gross yield. Money market funds are also required to report on Form N-MFP the market-based values of each portfolio security and the fund's market-based NAV, with separate entries for values that do and do not take into account any capital support agreements into which the fund may have entered.

Form N-MFP must be filed with the SEC within five business days after the end of each month and the information contained in Form N-MFP will be made available to the public 60 days after the end of the month to which the information pertains. ***Funds' first mandatory Form N-MFP filings will be due on December 7, 2010, for holdings as of the end of November 2010.***¹²

VI. PROCESSING OF TRANSACTIONS

The Amendments require that a money market fund (or its transfer agent) have the capacity to redeem and sell its securities at a price based on the fund's current NAV, including the capacity to sell and redeem shares at prices that do not correspond to the stable NAV. The purpose of this requirement is to facilitate the orderly processing of shareholder transactions, even under circumstances that require a fund to break the buck. ***In order to provide ample time for funds to change their systems to accommodate purchases and redemptions at the current NAV, the compliance date for processing transactions is October 31, 2011.***

VII. EXEMPTION FOR AFFILIATE PURCHASES

Expanded Exemptive Relief. The SEC is adopting an amendment to Rule 17a-9 under the Act that expands the exemption provided by the Rule from the Act's prohibition on affiliated transactions to permit affiliated persons to purchase from a money market fund a portfolio security that has defaulted, but that continues to be an eligible security, as long as the conditions of the Rule governing the purchase price are satisfied. Previously, the exemption was available only for the purchase of a portfolio security that was no longer an "eligible security." In order to rely on the amended Rule, the conditions require that the purchase price for the security be paid in cash and be equal to the greater of the security's amortized cost or its market value, including accrued interest. The Amendments also add a new provision to Rule 17a-9 that permits affiliated persons, under the same conditions as discussed above, to purchase other portfolio securities from an affiliated money market fund, for any reason, provided that such person promptly remits to the fund any profit it realizes from the later sale of the security.

New Reporting Requirement. The Amendments require a money market fund whose securities have been purchased by an affiliate in reliance on Rule 17a-9 to promptly e-mail the SEC with notice of the transaction and explain the reasons for the purchase.

VIII. FUND LIQUIDATION

The SEC has adopted new Rule 22e-3, which exempts money market funds from Section 22(e) of the Act to permit them to suspend redemptions and postpone payment of redemption proceeds in order to facilitate an orderly liquidation of the fund. In particular, new Rule 22e-3 permits a fund to suspend redemptions and payment of redemption proceeds if (1) 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 NAV may result in material dilution or other unfair results; (2) the board, including a majority of disinterested directors, has irrevocably approved the liquidation of the fund; and (3) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions. New Rule 22e-3 is intended to protect investors from the harmful effects of a run on the fund. Also, the Proposing Release conditioned the Rule's relief on a fund breaking a dollar and re-pricing its shares. The rule as adopted gives the fund's board of directors the discretion to determine whether to suspend redemptions because the extent of the deviation between the fund's amortized cost price per share and its shadow price would result in material dilution or other unfair results to shareholders. Finally, new Rule 22e-3 gives the SEC the power to rescind or modify the relief provided by the Rule and require the money market fund to resume honoring redemptions if, for example, a liquidating fund has not devised or is not executing a plan of liquidation that sufficiently protects fund shareholders.

IX. TECHNICAL NOTE REGARDING SHAREHOLDER VOTES AND AMENDMENTS TO REGISTRATION STATEMENTS

If a money market fund has in place a policy that can only be changed by shareholder vote that is less restrictive than the Amendments require (*e.g.*, maintaining a WAM of no greater than 90 days),

the Amendments provide that a money market fund is not required to hold a shareholder vote to comply with the more restrictive provisions. In addition, the Amendments permit a money market fund to amend its registration statement to reflect the fund's compliance with the Amendments pursuant to Rule 485(b) under the Securities Act of 1933, so long as the other changes in the fund's post-effective amendment meet the conditions for immediate effectiveness.

¹ See Money Market Fund Reform, SEC Release No. IC-29132 (Feb. 23, 2010), available on the SEC's Web site at <http://www.sec.gov/rules/final/2010/ic-29132.pdf> (the Adopting Release).

² See Money Market Fund Reform, SEC Release No. IC-28807 (June 30, 2009), available on the SEC's Web site at <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf> (the Proposing Release).

³ 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.

⁴ Second tier securities are eligible securities that, if rated, have received other than the highest short-term debt rating from the requisite Nationally Recognized Statistical Rating Organization (NRSRO) or, if unrated, have been determined by the fund's board to be of comparable quality. See Amended Rule 2a-7(a)(24) (defining "second tier security").

⁵ In addition to reducing the ability of money market funds to acquire second tier securities of any particular issuer, the Amendments also proportionately reduce by half the ability of a money market fund to acquire "demand features" or "guarantees" of a single issuer that are second tier securities from 5% to 2.5% of the money market fund's total assets. See Amended Rule 2a-7(c)(4)(iii)(B).

⁶ Rule 2a-7 otherwise permits money market funds to acquire government securities with remaining maturities of up to 397 days.

⁷ The Amendments define the term "illiquid security" as a security that cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.

⁸ See Amended Rule 2a-7(a)(8) (defining "daily liquid asset" to mean (i) cash; (ii) direct obligations of the U.S. Government; and (iii) securities that will mature or are subject to a demand feature that is exercisable and payable within one business day).

⁹ See Amended Rule 2a-7(a)(32) (defining "weekly liquid asset" to mean (i) cash; (ii) direct obligations of the U.S. Government; (iii) Government securities issued

by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States, that are issued at a discount to the principal amount to be repaid at maturity and have a remaining maturity of 60 days or less; and (iv) securities that will mature or are subject to a demand feature that is exercisable and payable within five business days).

¹⁰ The Amendments require money market funds to maintain records of these stress tests for six years, the first two years in an easily accessible place. See Amended Rule 2a-7(c)(11)(vii).

¹¹ The special treatment allows money market funds to consider the acquisition of the repurchase agreement as an acquisition of the underlying collateral for diversification purposes. Under the Amendments, securities with the highest rating, or unrated securities of comparable credit quality, will no longer be acceptable collateral.

¹² The SEC amended temporary Rule 30b1-6T so that the rule, which requires any money market fund with a market-based NAV below \$0.9975 to provide the SEC with a weekly report containing portfolio and valuation information, expires on December 1, 2010, rather September 17, 2010.

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