

SEC Proposes to Modify Rule 2a-7 and Implement Other Regulatory Initiatives to Promote Stability of Money Market Funds

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July 23, 2009

OVERVIEW:

On June 30, 2009, the Securities and Exchange Commission (“SEC” or “Commission”) proposed for comment amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (“1940 Act”) and certain other regulatory initiatives to protect money market funds registered under the 1940 Act (each a “Fund”) and their investors during periods of market volatility.

BACKGROUND:

Rule 2a-7 regulates the activities of a Fund and provides parameters for the calculation of a stable net asset value (“NAV”). Consistent with the original premise that the value of a Fund’s investment in a liquid portfolio of high quality, diversified, short-term debt securities should remain constant from acquisition through maturity/sale, Rule 2a-7 permits a Fund to calculate its NAV by using the Amortized Cost Method or the Penny-Rounding Method. The Amortized Cost Method calculates a Fund’s NAV by valuing each portfolio security at cost and adjusting the cost to incorporate amortization of premium or accretion of discount. The Penny-Rounding Method values each portfolio security using its market value and rounds the calculated NAV to the nearest 1%.

In order to rely on either one of these methodologies, a Fund must satisfy various investment requirements relating to, portfolio, quality, maturity, and diversification set forth in Rule 2a-7. These portfolio parameters were incorporated into Rule 2a-7 in order to reduce the volatility of Fund portfolios necessary to substantiate a stable NAV calculation provided under these methodologies.

PROPOSED AMENDMENTS:

The SEC has proposed numerous revisions to rules under the 1940 Act to help sustain the viability of a Fund during periods of market volatility. These revisions take the form of both amendments to current rules as well as the introduction of several new regulations.

Many of the proposals focus on limiting the investment risk associated with a Fund by adopting stricter requirements for portfolio quality, maturity, liquidity, and diversification than those currently mandated by Rule 2a-7. The following chart summarizes each proposed amendment to Rule 2a-7 regarding these elements and compares the proposals to the corresponding current Rule 2a-7 requirements, as applicable. Defined terms set forth in the chart carry the meaning set forth in current Rule 2a-7.

Proposed Rule 2a-7 Amendment	Current Rule 2a-7 Requirement
Portfolio Quality	
<ul style="list-style-type: none"> Requires a Fund to invest only in First-Tier Securities. 	<ul style="list-style-type: none"> Requires a Fund to limit investments in non-Second-Tier Securities (Second -Tier Conduit Securities for tax exempt Funds) to 5% of total assets.
<ul style="list-style-type: none"> Requires a Fund to limit investments in long-term debt securities to those with a remaining maturity of 397 calendar days or less and that are rated in one of the two highest long-term rating categories by the requisite number of NRSROs. 	<ul style="list-style-type: none"> Requires a Fund to limit investments in long-term debt securities to those with a remaining maturity of 397 calendar days or less and that are rated in one of the three highest long-term rating categories by the requisite number of NRSROs.
<ul style="list-style-type: none"> Requires a Fund board of directors (“Board”) to consider whether or not a security continues to present minimal credit risk when the security ceases to be a First-Tier Security. 	<ul style="list-style-type: none"> Requires a Board to consider whether or not a portfolio security continues to present minimal credit risk when a security ceases to be a First-Tier Security or when a Fund investment adviser becomes aware that an unrated or Second-Tier Security receives an NRSRO rating below the second highest short-term rating categories for debt securities.
Portfolio Maturity	
<ul style="list-style-type: none"> Requires a Fund to maintain a dollar-weighted average maturity of 60 days or less. 	<ul style="list-style-type: none"> Requires a Fund to maintain a dollar-weighted average maturity of 90 days or less.
<ul style="list-style-type: none"> Requires a Fund portfolio to have a weighted average life maturity of 120 days or less without consideration of interest rate reset dates on variable and floating rate securities.¹ 	<ul style="list-style-type: none"> No similar requirement is currently in effect.
<ul style="list-style-type: none"> Requires a Fund utilizing the Penny-Rounding Method to limit purchases of Government securities to those with a remaining maturity of 397 calendar days or less. 	<ul style="list-style-type: none"> Requires a Fund utilizing the Penny-Rounding Method to limit purchases of Government securities to those with a remaining maturity of 762 calendar days or less.

¹ Under current Rule 2a-7, a Fund may utilize interest rate reset dates to calculate the maturity for certain securities under certain conditions.

Proposed Amendment	Current Rule 2a-7 Requirement
Portfolio Liquidity	
<ul style="list-style-type: none"> Requires a Fund to acquire only those securities that are deemed to be “liquid” at the time of their purchase. Defines “liquid” securities as those that can be sold or disposed of in the ordinary course of business within 7 days at approximately their amortized cost. 	<ul style="list-style-type: none"> No similar requirement is currently in effect. Section 22(e) requires a Fund to satisfy redemption requests within seven days which has been interpreted by the SEC to limit a Fund’s investment in illiquid securities to 10% or less of total assets.²
<ul style="list-style-type: none"> Requires a Fund to limit a purchase to “daily liquid assets” if, as a result of the purchase, “daily liquid assets” would comprise less than 5% of total assets of a taxable “retail fund” (10% of total assets for taxable “institutional fund”).³ Defines “institutional fund” as a Fund that the Board determines at least once each calendar year to be offered primarily to institutional investor or has characteristics of such a Fund.⁴ Defines a “retail fund” as a Fund that the Board determines at least once each calendar year to be other than an “institutional fund.” Defines “daily liquid assets” as (i) cash (including demand deposits); (ii) securities (including repurchase agreements) for which the Fund has a contractual right to receive cash within 1 business day either because the security will mature or the Fund can exercise a demand feature; or (iii) U.S. Treasury securities. 	<ul style="list-style-type: none"> No similar requirement is currently in effect.
<ul style="list-style-type: none"> Requires a Fund to limit a purchase to “weekly liquid assets” if, as a result of the purchase, a “retail fund” would invest less than 15% of total assets (30% of total assets for an “institutional fund”) in “weekly liquid assets.” Defines “weekly liquid assets” to equal “daily liquid assets” but for the maturity requirement which would be 5 business days instead of the 1 business day for “daily liquid assets.” 	<ul style="list-style-type: none"> No similar requirement is currently in effect.

² Valuation and Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 July 18, 1983]], *supra* note 3 at nn.37-38 and accompanying text; Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)], *supra* note 19, at n.21 and accompanying text.

³ No similar liquidity requirements are being proposed for tax-exempt Funds.

⁴ According to the SEC, the Board must consider the following factors when determining the appropriate designation for the Fund: (i) the nature of the record owners of the Fund shares; (ii) the minimum amount required to establish an account; and (iii) the historical cash flows, resulting or expected cash flows that would result, from purchases and redemptions.

Proposed Amendment	Current Rule 2a-7 Requirement
Portfolio Liquidity (cont.)	
<ul style="list-style-type: none"> Requires a Fund to maintain “highly liquid assets” to satisfy its obligation to redeem shares within 7 business days pursuant to Section 22(e) of the 1940 Act and any commitments to redeem shares under a more expedited basis.⁵ 	<ul style="list-style-type: none"> No similar requirement is currently in effect.
<ul style="list-style-type: none"> Requires a Board whose Fund utilizes the Amortized Cost Method to adopt procedures to evaluate its ability to maintain a stable NAV by stress testing its portfolio using hypothetical conditions including increases in short-term interest rates or shareholder redemptions, downgrades of or defaults on portfolio securities, and the widening or narrowing of spreads between yields on a benchmark selected by a Fund and representative of overnight interest rates and securities in which the Fund invests. 	<ul style="list-style-type: none"> No similar requirement is currently in effect.
Diversification	
<ul style="list-style-type: none"> Requires investments in repurchase agreements to be limited to those collateralized by cash/cash equivalents and Government securities. 	<ul style="list-style-type: none"> Requires repurchase agreements to be fully collateralized in order for a Fund to be able to look through to the underlying collateral for purposes of satisfying the diversification requirements of the Rule.
<ul style="list-style-type: none"> Requires the Board or its delegate to evaluate the creditworthiness of each Fund counterparty to a repurchase agreement. 	<ul style="list-style-type: none"> No similar requirement is currently in effect.

While the above proposed updates to Rule 2a-7 are primarily intended to stabilize risk and enhance a Fund’s ability to maintain a stable NAV, an additional amendment to the rule is proposed to secure the timely processing of redemptions in the unlikely event that a Fund is unable to maintain a stable NAV. Specifically, this amendment requires a Board to annually determine that each Fund for which it provides oversight has the capability to process shareholder transactions at current NAV, including a NAV that is not the stable NAV. The practical effect of this proposal is that each Fund will be obligated to maintain procedures to process Fund redemptions despite a material break in the stable NAV including those that facilitate reliance on Rule 17a-9 under the 1940 Act (see next page).

⁵ In the proposing release, the SEC suggests that a Fund adopt procedures to facilitate compliance with this requirement pursuant to obligations under Rule 38a-1 of the 1940 Act (e.g. requirement to approve and implement a Compliance Program).

Other Fund regulatory initiatives referenced in the release include:

- Proposed Rule 30b1-6 under the 1940 Act which requires a Fund to file separate monthly portfolio holdings reports with the Commission on new Form N-MFP;⁶
- Amendments to Rule 17a-9 under the 1940 Act which provide relief from Section 17(a) of the Act and permit any portfolio security to be purchased by Fund affiliate, promoter or principal underwriter of the Fund, and their respective affiliates, if the purchase satisfied current requirements of the rule (e.g. the purchase is paid on cash and is equal to the greater of the amortized cost of the security or its market value (inclusive in each case of accrued interest) and the purchaser remits any profit subsequently made on the sale of the security to the Fund.⁷
- Proposed Rule 22e-3 which provides relief from Section 22(e) of the act and permits the suspension of redemptions and the postponement of the payment of related proceeds to help ensure an orderly liquidation of a Fund. Rule 22e-1 as proposed, would be available to a Fund: (i) whose current NAV calculated based on the current market value of portfolio securities is less than that of its stable NAV; (ii) whose Board, including a majority of the independent Directors, have approved the liquidation of the Fund; and (iii) that notifies the Commission prior to suspending redemptions consistent with the rule.

REQUEST FOR COMMENT:

In addition to requesting comments on the aforementioned rule initiatives, the proposal also solicits response on several other matters relating to Fund regulation including but not limited to: (i) the future role of NRSRO ratings in determining investment eligibility under Rule 2a-7; (ii) the implementation of a floating NAV requirement for Funds; and (iii) the imposition of in-kind redemption requirements to satisfy large liquidation requests.

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⁶ While the requirement to file monthly portfolio information pursuant to Form N-MFP eliminates a Fund obligation to file a Schedule of Investments in response to Item 1 of Form N-Q, a Fund must still provide the requisite information regarding disclosure controls and certifications mandated by Form N-Q when filing the form with the SEC. Corresponding amendments to Rule 2a-7 also requires that a Fund post its Schedule of Investments to its website monthly. Each Schedule of Investments must be prepared consistent with applicable requirements of Regulation S-X, must be posted within the first two business days of the month, and must be as of the last business day of the prior month. Each Schedule of Investments must be maintained on the website site for at least 12 months.

⁷ Proposed corresponding amendments to Rule 2a-7 require that the Fund notify the Commission of any such sales and the reasons therefor.