

# FUND ALERT

## REGULATORY ANALYSIS

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Stradley Ronon Stevens & Young, LLP  
2005 Market Street  
Suite 2600  
Philadelphia, PA 19103-7098  
215.564.8000 Telephone  
215.564.8120 Facsimile  
www.stradley.com

1250 Connecticut Avenue, N.W.  
Suite 500  
Washington, DC 20036  
202.822.9611 Telephone  
202.822.0140 Facsimile

With other offices in:  
Harrisburg, Pa.  
Malvern, Pa.  
Wilmington, Del.  
Cherry Hill, N.J.



www.meritas.org

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## Money Market Fund Reform: SEC Proposes Rule Amendments and Seeks Comment on Fundamental Issues

By Joan Ohlbaum Swirsky

On June 30, 2009, the SEC proposed amendments to Rule 2a-7 (the Rule), the money market fund rule under the Investment Company Act of 1940. The amendments were designed to increase the resilience of money market funds to economic stresses, reduce the risks of runs on the funds, facilitate the orderly liquidation of a money market fund that breaks the dollar and liquidates, and improve the SEC's oversight of money market funds. Among other things, the proposed amendments would:

- tighten quality, maturity and liquidity requirements (including imposing new requirements for repurchase agreements)
- require monthly Web site disclosure of portfolio holdings and additional monthly reporting to the SEC
- require each money market fund Board to determine that the money market fund has the capacity to process share transactions at other than \$1.00 (that is, after the fund has broken the dollar)
- expand permission for affiliates to “bail out” troubled money market funds
- allow each money market fund Board to suspend redemptions when the money market fund liquidates

The SEC's release (the release) also requests public comment on possible fundamental reform of money market funds; more specifically, whether the stable \$1.00 share price should be abandoned in favor of a floating net asset value (NAV) per share and whether money market funds should be required to satisfy redemption requests in excess of a certain size through in-kind redemptions.

Each proposal is set forth in one of three ways:

- recommendations for specific revisions to language in the Rule (specific proposals)
- requests for comment on possible revisions with no specific Rule language suggested (inquiry proposals)
- in the case of the fundamental reforms only, questions as to whether the SEC should continue to explore the reform

The abundance of inquiry proposals in the release creates a sense that the reforms are still, in large measure, a work in progress on which the SEC hopes to draw substantial public comment.

*(Continued on page 2)*

The specific proposals generally track the recommendations of the Investment Company Institute (ICI) in its Report of the Money Market Working Group (the ICI Report) released March 17, 2009. The SEC apparently thoroughly considered those industry recommendations in crafting the proposals, as the release cites the ICI Report about 60 times. The specific proposals do, however, include certain recommendations that were not addressed by the ICI, such as distinguishing between retail and institutional funds with regard to liquidity requirements (which the ICI specifically opposed and which is likely to be a flashpoint for comment), tightening the requirements for repurchase agreement collateral, forbidding a fund from holding any illiquid security, creating a new form to be filed with the SEC to provide monthly disclosure of holdings and instituting a requirement that a fund be capable of processing share transactions at other than \$1.00 (after the fund breaks the dollar). Further, most of the inquiry proposals, and also the fundamental reforms, go beyond the ICI Report recommendations. But the fact that these topics are posed as concepts for comment rather than as specific proposals may indicate that the SEC is treading cautiously before advocating these changes that have not been vetted with the industry and that, in some cases, have been opposed by the industry (more specifically, a suggestion to remove ratings requirements from the Rule and both fundamental reforms). The release alludes to a possible reason for caution: changes to money market funds could have far-reaching ripple effects throughout the economy generally as a result of the central role that money market funds play as a source of short-term funding to businesses and municipalities and as a vehicle for cash management.

On the other hand, an SEC staff member stated at the open meeting at which the SEC considered the proposals (the open meeting) that the SEC could, in fact, adopt the inquiry proposals even though specific language was not provided. With regard to the fundamental reforms, however, the SEC has sidestepped for now the concept of abandoning the stable \$1.00 share value and requiring redemptions in kind. The release states that the SEC will review the comments on those changes “before deciding whether to propose these changes.” Thus, the industry will have an additional opportunity to comment on these more fundamental reforms before they are imposed.

Besides tracking the ICI Report, the specific proposals also echo the Obama administration’s money market fund proposals set forth in the Report on Financial Regulatory Reform released June 17, 2009 (Administration Report). The Administration Report states that the President’s Working Group (PWG) on Financial Markets should complete a report by Sept. 15, 2009, addressing the more fundamental aspects of money market fund reform, which “could include” abandoning the stable NAV or requiring access to private emergency liquidity facilities. The SEC is a member of the PWG, and SEC Chairman Mary Schapiro said that the SEC will share with the PWG the comments submitted to the SEC on the proposed amendments. Comments are due on or before Sept. 8, 2009.

### A WORK IN PROGRESS

The release poses multiple questions on every aspect of the proposals—literally hundreds of specific questions on which the SEC hopes to receive guidance. (This plethora of questions is significantly more extensive in proportion to the length of the release than the number of questions posed by the SEC in 1990 and 1993, when the SEC last proposed major revisions to the Rule). The nature of the questions evidences that the SEC is treading a fine line between enhancing safety of money market funds and allowing them to continue as a competitive product that provides an important source of short-term funding. For example, the SEC solicits views not only on whether various proposals would effectively mitigate risk but also on whether the proposals would impact yield or cause investors to shift to alternative products.

The industry is likely to submit substantial comments on the fundamental reforms and certain of the other proposals, particularly those that create interpretive “gray” areas. For example, the requirement to distinguish between retail and institutional funds and the requirements to implement stress testing may raise interpretive questions. Even the more “straightforward” proposals that raise fewer interpretive questions, could elicit substantial comment. For example, the single proposal to require calculation of weighted average life occupies five pages of the release and includes 15 separate questions on which the SEC solicits comment.

## IMPLEMENTATION

The ICI has recommended that money market funds seek to implement the ICI Report's recommendations by Sept. 18, 2009 (when the authorization for the Treasury Temporary Guarantee Program for money market funds expires), in order to provide additional assurance to investors and help facilitate an orderly transition out of the Guarantee Program. When the ICI introduced the ICI Report, it urged the SEC to require funds to disclose that the fund did not implement the proposals pending enactment of a final rule. The SEC did not include that requirement in the proposed amendments. Each fund is free to analyze whether advance compliance for any particular proposal (and disclosure of compliance) is in the fund's interest, in light of the fact that the proposals are a "moving target" and that industry practices may evolve. Certain funds have announced publicly that they are in compliance with at least certain parts of the proposals. Further, Robert Plaze, the associate director of the SEC Division of Investment Management, when asked at the open meeting about the transition to compliance, said that he has the sense that "funds are already there."

Funds that wish to take action on any of the proposals before the amendments are enacted may choose an approach along a continuum of possible early responses: begin considering how the proposed amendments would affect their portfolios; discuss with their Boards the anticipated effect of the proposed amendments; or begin complying on an internal, informal basis with the proposals that do not require substantial modification of the portfolio. Funds are unlikely to self-impose formal procedural amendments at this point, given that the landscape may shift.

It appears that there should not be a rush to modify portfolios either before or after the amendments are finalized. Mr. Plaze said during the open meeting that he anticipated that when and if the proposals are adopted, the effective date would allow time for noncompliant holdings to mature, so a fund would not need to sell holdings to achieve compliance.



For more information about this article, please contact Joan Ohlbaum Swirsky at 215.564.8015, or by e-mail at [jswirsky@stradley.com](mailto:jswirsky@stradley.com).

## NEW BOARD REVIEWS; NEW PROCEDURES

Money market fund Boards are already responsible for overseeing the stability of share value and liquidity, but some of the proposed amendments would require the Boards to review additional reports and make additional determinations in carrying out those oversight responsibilities. The proposals that relate specifically to new Board reviews are highlighted below with a bolded, capitalized reference to **"BOARD"** for ease of reference. (The SEC did not follow the ICI's recommendation to modernize the Rule by eliminating Board duties that, in practice, are almost always delegated to the investment adviser).

In some cases, the proposed amendments would require money market funds to adopt new procedures (not only revisions to tighten existing amortized cost procedures). The proposals that relate to new procedures are highlighted below with a bolded, capitalized reference to **"PROCEDURES"** for ease of reference. <sup>n</sup>

Please see the attached documents for a list of the proposals and also for a summary of each proposal:

### List of Rule 2a-7 Proposals

### Summary of Rule 2a-7 Proposals

Given the vast range of possibilities covered by the SEC's request for comment, the summary does not include every possible alternative version of each proposal suggested by the SEC, but only the more significant ones.

## Stradley Ronon's Investment Management Group

### ATTORNEYS

Bruce G. Leto, Chair .....bleto@stradley.com.....215.564.8115  
 John N. Ake .....jake@stradley.com .....215.564.8003  
 John M. Baker .....jbaker@stradley.com.....202.419.8413  
 Fabio Battaglia III .....fbattaglia@stradley.com .....215.564.8077  
 E. Carolan Berkley .....ecberkley@stradley.com .....215.564.8018  
 Emily Taylor Brody .....ebrody@stradley.com .....215.564.8071  
 Jana L. Cresswell .....jcresswell@stradley.com.....215.564.8048  
 Matthew R. DiClemente .....mdiclemente@stradley.com .....215.564.8173  
 Lisa A. Duda .....lduda@stradley.com .....215.564.8143  
 J. Stephen Feinour .....jfeinourjr@stradley.com .....215.564.8521  
 Amy C. Fitzsimmons .....afitzsimmons@stradley.com.....215.564.8711  
 Alison M. Fuller .....afuller@stradley.com .....202.419.8412  
 Robert K. Fulton .....rfulton@stradley.com .....215.564.8042  
 Alan R. Gedrich .....agedrich@stradley.com .....215.564.8050  
 Samuel K. Goldstein .....sgoldstein@stradley.com .....215.564.8128  
 Kenneth L. Greenberg .....kgreenberg@stradley.com.....215.564.8149  
 Cory Owen Hippler .....chippler@stradley.com .....215.564.8089  
 Peter M. Hong .....phong@stradley.com.....202.419.8429  
 Kristin H. Ives .....kives@stradley.com .....215.564.8037  
 Lisa M. King .....lking@stradley.com .....215.564.8733  
 Jonathan M. Kopcsik .....jkopcsik@stradley.com .....215.564.8099  
 Nicolas Lombo .....nlombo@stradley.com .....215.564.8553  
 Cillian M. Lynch .....clynch@stradley.com .....202.419.8416  
 Michael D. Mabry .....mmabry@stradley.com .....215.564.8011  
 Gino E. Malaspina .....gmalaspina@stradley.com .....215.565.8080  
 Katherine R. Mason .....kmason@stradley.com .....215.564.8006  
 Prufesh R. Modhera .....pmodhera@stradley.com.....202.419.8417  
 Barbara A. Nugent .....bnugent@stradley.com .....215.564.8092  
 Aidan H. O'Connor .....aoconnor@stradley.com .....202.419.8406  
 James J. O'Connor .....joconnor@stradley.com .....215.564.8139  
 Michael P. O'Hare .....mohare@stradley.com.....215.564.8198  
 William H. Rheiner .....wrheiner@stradley.com .....215.564.8082  
 Mena M. Ryley .....mryley@stradley.com .....215.564.8014  
 Mark A. Sheehan .....msheehan@stradley.com.....215.564.8027  
 Alexander F. Smith .....lexsmith@stradley.com .....215.564.8554  
 Amy G. Smith .....asmith@stradley.com .....215.564.8104  
 Lawrence P. Stadulis .....lstadulis@stradley.com .....202.419.8407  
 Merrill R. Steiner .....msteiner@stradley.com .....215.564.8039  
 Joan Ohlbaum Swirsky .....jswirsky@stradley.com .....215.564.8015  
 Angela R. Thompson .....athompson@stradley.com.....202.419.8409  
 Christopher J. Zimmerman .....czimmerman@stradley.com .....202.419.8402

### IMG PRACTICE GROUP ADMINISTRATOR

Sinclair A. Ziesing .....sziesing@stradley.com .....215.564.8055

### LEGAL ASSISTANTS

Robert Davis .....rdavis@stradley.com.....215.564.8768  
 Dawn E. Mac Donald .....dmacdonald@stradley.com...408.241.1770  
 Staci J. Pesin .....spesin@stradley.com .....215.564.8710  
 Kristopher R. Pietrzykowski .....kpietrzykowski@stradley.com...215.564.8114  
 Bonnie M. Scott .....bscott@stradley.com .....215.564.8727  
 Theresa West .....twest@stradley.com .....202.419.8411

## FUND TAXATION

### ATTORNEYS

Zachary P. Alexander .....zalexander@stradley.com .....215.564.8043  
 David J. Karasko .....dkarasko@stradley.com .....215.564.8542  
 Kristin M. McKenna .....kmckenna@stradley.com .....215.564.8176  
 William S. Pilling III .....wpilling@stradley.com .....215.564.8079  
 Christopher C. Scarpa .....cscarpa@stradley.com.....215.564.8106

## FUND ENFORCEMENT AND LITIGATION

### ATTORNEYS

Sean R. Adam .....sadam@stradley.com .....215.564.8094  
 Steven B. Davis .....sdavis@stradley.com.....215.564.8714  
 Gregory D. DiMeglio .....gdimeglio@stradley.com .....202.419.8401  
 Keith R. Dutill .....kdutill@stradley.com .....610.640.5809  
 Thomas W. Dymek .....tdymek@stradley.com.....215.564.8053  
 Zachary T. Knepper .....zknepper@stradley.com .....202.419.8414  
 David C. Franceski Jr. ....dfranceski@stradley.com .....215.564.8062  
 Margaret Manolakis .....mmanolakis@stradley.com .....610.640.5801  
 Rachel Tausend .....rtausend@stradley.com .....202.419.8405

## ERISA

### ATTORNEYS

John J. Hunter .....jhunter@stradley.com .....215.564.8072  
 James F. Podheiser .....jpodheiser@stradley.com .....215.564.8111

## FUND BANKING ISSUES

### ATTORNEY

David F. Scranton .....dscranton@stradley.com.....610.640.5806

## ISDA/STRUCTURED FINANCE MATTERS

### ATTORNEYS

E. Carolan Berkley .....ecberkley@stradley.com .....215.564.8018  
 Deborah Hong .....dhong@stradley.com.....610.640.5818  
 Kevin P. Kundra .....kkundra@stradley.com .....215.564.8183  
 Kevin M. Masucci .....kmasucci@stradley.com .....215.564.8013

## LIST OF RULE 2A-7 PROPOSALS

### **A. QUALITY – SPECIFIC PROPOSALS**

1. No Second Tier Securities
2. Corresponding Elimination of Required Reassessments Applicable to Second Tier Securities
3. Tightening of Long-Term Rating Requirement for Stub Period Securities to Second Tier
4. Prohibition on Securities Subject to Conditional Demand Feature unless underlying Security is First Tier
5. Repurchase Agreements – Tighten Requirements for Collateral
6. Repurchase Agreements – Evaluate Creditworthiness of Counterparty [**BOARD**] [**PROCEDURES**]

### **B. QUALITY – INQUIRY PROPOSALS**

1. Asset Backed Securities (ABS) – Rating Requirement Eliminated
2. ABS - Minimal Credit Risks
3. Eliminate References to Rating Agencies
4. Board Selection of Rating Agencies [**BOARD**] [**PROCEDURES**]

### **C. MATURITY – SPECIFIC PROPOSALS**

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2. Weighted Average Life Portfolio Maturity – 120 Days
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### **D. MATURITY – INQUIRY PROPOSALS**

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### **G. DISCLOSURE AND SEC REPORTING – SPECIFIC PROPOSALS**

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2. Reporting about Holdings to the SEC
3. Reporting to the SEC under Rule 17a-9

### **H. DISCLOSURE AND SEC REPORTING – INQUIRY PROPOSALS**

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2. Disclosure of Market Value of Holdings

- I. EXIGENT CIRCUMSTANCES – SPECIFIC PROPOSALS**
  - 1. Capacity to Process at other than \$1.00 [BOARD] [PROCEDURES]
  - 2. Bail-outs by Affiliates
  - 3. Board Suspend Redemptions upon Liquidation [BOARD]
  
- J. EXIGENT CIRCUMSTANCES – INQUIRY PROPOSALS**
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## SUMMARY OF RULE 2A-7 PROPOSALS

### A. QUALITY – SPECIFIC PROPOSALS

1. **No Second Tier Securities.** The proposals would forbid money market funds from purchasing second tier securities (in summary, securities rated in the second highest short-term rating category by rating agencies). Money market funds would be limited to purchasing first tier securities. Currently, in general, money market funds are permitted to invest up to five percent of their assets in second tier securities. (Tax exempt funds are subject to the second tier security limit only with respect to conduit securities, which, in summary, are municipal securities where the ultimate obligor is a non-municipal entity). A fund would not need to dispose of a security immediately upon a downgrade, but, consistent with current requirements in the Rule, would have to dispose of the security “as soon as practical consistent with achieving an orderly disposition of the security” unless the fund’s Board finds that such disposal would not be in the best interest of the fund. In favor of the proposal, the SEC notes that the market for second tier securities is relatively small, second tier securities present potentially more risk than first tier securities and that funds have reduced their second tier holdings to almost zero, so the change would not be materially disruptive to funds. The SEC asks whether the change would negatively impact yield or diversification benefits available through second tier investments, and also asks whether there are alternatives to eliminating entirely the ability of a money market fund to invest in second tier securities. For example, should specific minimal credit risk analysis or other procedures be applied to second tier securities, rather than a prohibition on the securities. At the open meeting, certain SEC commissioners voiced reservations about the need to forbid Second Tier Securities.
2. **Corresponding Elimination of Required Reassessments Applicable to Second Tier Securities.** The Rule currently requires a money market fund to promptly reassess whether a portfolio security continues to present minimal credit risk if, subsequent to its acquisition by the fund: (1) the security has ceased to be a first tier security; or (2) the fund’s adviser becomes aware that an unrated or second tier security has received a rating from any rating agency below the second highest short-term category. In light of the proposed elimination of second tier securities from the definition of eligible security, the event in clause (i) (security ceases to be first tier) would be covered by the existing separate provision that requires reassessment when a security is no longer eligible. Clause (ii) (unrated security or second tier security receives rating below second tier) would be covered by a requirement that the adviser reassess the minimal credit risk status of a security if, subsequent to its acquisition, the fund’s adviser becomes aware that an unrated security has received a rating from any rating agency below the highest short-term rating category. (As under the current Rule, the proposed Rule would not require the adviser to subscribe to every rating service publication to comply with this requirement. Rather, the SEC would expect the adviser to become aware of a subsequent rating if it is reported in the national financial press or in publications to which the adviser subscribes).
3. **Tightening of Long-Term Rating Requirement for Stub Period Securities to Second Tier.** In general under Rule 2a-7, a money market fund may not invest in a long-term security with a remaining maturity of 397 calendar days or less (a stub security) that has no short-term rating if the security has received a long-term rating from any rating agency that is not with the rating agency’s three highest long-term rating categories. In light of the proposed prohibition on securities rated second tier, the SEC is proposing a corresponding tightening of

the rating standard for stub period securities. The SEC proposes to permit money market funds to acquire such securities only if they have no long-term ratings within the top two, rather than three, rating categories.

- 4. Prohibition on Securities Subject to Conditional Demand Feature unless Underlying Security is First Tier.** Under Rule 2a-7, a security that is subject to a conditional demand feature (cdf) must satisfy certain requirements. (A cdf is, generally, a right to demand payment that may become unavailable under certain conditions). One of the requirements is that the security which has the cdf must itself have either long-term or short-term rating quality in one of the top two rating categories, without giving effect to the quality of the cdf. It is important to money market funds that a long-term rating on a security underlying a cdf is acceptable for this purpose, because frequently the security underlying a cdf is a long-term security and does not have a short-term rating. (The security is permissible for a money market fund even though the underlying security is long-term if the security qualifies to use the “maturity shortening” provisions of the Rule described below under the caption “Maturity-Specific Proposals.” These provisions permit the fund to ignore the nominal long-term maturity, and instead to “deem” the maturity to be shortened until the date principal can be recovered on demand). The proposed amendments would require that the underlying security have a long- or short-term rating in the top rating category, rather than in the top two categories. This tightened quality requirement could be problematic for some money market funds, as the long-term rating of securities that have conditional demand features frequently is below first tier quality. The SEC does not explain the reason for this tightening in the release.
- 5. Repurchase Agreements – Tighten Requirements for Collateral.** The proposals would restrict the types of collateral permitted for repurchase agreements that qualify for special treatment under diversification testing. Currently, a money market fund can “look through” a repurchase agreement to the issuer of the underlying collateral for purposes of diversification testing, if, among other things, the collateral meets certain requirements that qualify the repo as “collateralized fully.” Funds generally enter into repurchase agreements with conforming collateral to benefit from this eased diversification test. Under the current Rule, conforming collateral includes cash items or U.S. Government securities or securities rated in the highest rating category (or deemed of comparable quality by the investment adviser). The proposals would eliminate first tier quality securities as permitted collateral for “look through” treatment. To benefit from the eased diversification testing, the repurchase agreements would need to be collateralized by cash items or U.S. Government securities. The SEC states that this limitation would make it less likely that, in the event of the default of a counterparty, a money market fund would suffer loss on the sale of the collateral.
- 6. Repurchase Agreements – Evaluate Creditworthiness of Counterparty.** The proposals would require the Board or the investment adviser to a money market fund to evaluate the creditworthiness of the counterparty to a repurchase agreement, even if the repurchase agreement is “collateralized fully.” Prior to 1991, the SEC had required an investment adviser to consider the creditworthiness of a repurchase agreement counterparty in all cases, because it was unclear under bankruptcy law that a fund would have access to the collateral upon a bankruptcy. This concern arose because an automatic bankruptcy stay of creditors’ rights might prevent the fund from obtaining the collateral. Hence, the creditworthiness of the counterparty was important, even for a “collateralized fully” repo. The SEC states that it had eliminated this requirement to consider the credit of the counterparty for repurchase agreements that qualified as “collateralized fully” in 1991, in light of bankruptcy law

amendments that protected funds from the automatic stay of creditors' rights under bankruptcy law. The change in law was thought to allow the repurchase agreement buyer (the fund) to obtain the repo collateral despite the bankruptcy stay, so that the creditworthiness of the counterparty was less critical to the fund. The SEC proposes to reinstate the requirement to consider the creditworthiness of the counterparty even when the repurchase agreement is collateralized fully, because the SEC is concerned that a fund may find it difficult to fully protect its interests in the collateral even if the stay is lifted.

The SEC reports that recent bankruptcy cases have highlighted the difficulty of realizing on repurchase agreement collateral, even when the stay is lifted. The proposal makes the Board responsible for evaluating the counterparty, although this determination, like most determinations under the Rule, can be delegated to the investment adviser. It is not clear why the SEC has made the Board responsible for this determination, when the determination in all likelihood will be delegated to the investment adviser. **[BOARD]** It is possible that funds will consider re-instating repurchase agreement procedures that were rescinded in 1991, although the release does not impose this requirement. **[PROCEDURES]**

## **B. QUALITY - INQUIRY PROPOSALS**

- 1. Asset Backed Securities (ABS) – Rating Requirement Eliminated.** Currently the Rule requires ABS to be rated. The SEC asks whether the requirement that ABS be rated should be eliminated, in light of the rating agencies' rapid downgrade of one type of ABS – structured investment vehicles (SIVs) – starting in 2007.
- 2. ABS – Minimal Credit Risks.** The SEC asks whether it should provide additional guidance to money market funds on the required minimal credit risk evaluation of ABS. The discussion in the release provides insight as to the issues that the SEC believes are relevant to the minimal credit risk analysis of ABS, regardless of whether the SEC implements these factors as formal proposals. Specifically, the SEC believes that the analysis should include an evaluation of the issuer's ability to maintain its promised cash flows, which would entail an analysis of the underlying assets, their behavior in various market conditions, and the terms of any liquidity or other support provided by the ABS sponsor. The release notes that the money market funds that encountered problems with SIVs placed less emphasis on the length of time that payment experience was available on assets in the collateral pool and were willing to accept sub-prime mortgage credits as a seasoned asset class. In addition, those funds may have been influenced by the greater amount of over-collateralization of the collateral pool and the high yields paid by notes supported by sub-prime credits.

The ICI Report did not include any corresponding recommendation regarding the quality of ABS. Rather, the ICI Report included general quality recommendations applicable to all types of portfolio securities in a money market fund. Specifically, the ICI Report recommended that: (1) money market fund advisers establish a "new products" or similar committee to review and approve new structures prior to investment by their funds; and (2) money market fund advisers consider and, when appropriate, follow best practices in connection with minimal credit risk determinations.

- 3. Eliminate References to Rating Agencies.** Currently under the Rule, each holding must have ratings of at least second tier quality. This requirement creates a quality "floor," separate from and in addition to the requirement that each security must present minimal credit risk based on factors other than ratings. The SEC noted that during 2008 and 2003 the SEC had

sought comment on the concept of eliminating ratings requirements from Rule 2a-7, to emphasize that investment advisers must perform an independent credit analysis of each security. The SEC recognized that most comments supported retaining the ratings floor. The SEC, for a third time, seeks comment on whether reference to rating agencies should be eliminated from Rule 2a-7. At the open meeting, Commissioner Kathleen Casey voiced a desire for a reduction of the reliance on credit agency ratings, while Commissioner Luis Aguilar stated his support for the continued use of credit rating agencies in money market fund regulations, noting in particular the public comments in favor of retaining the ratings floor in response to prior proposals.

4. **Board Selection of Rating Agencies.** The SEC says it is considering whether a money market fund's Board should be required to designate three (or more) rating agencies that the fund would look to for all purposes under Rule 2a-7. In addition, the Board would be required to determine at least annually that the designated rating agencies issue credit ratings that are sufficiently reliable for that use. The SEC asks whether, under this approach, rating agencies would compete through ratings to achieve designation by money market funds. The SEC states that under this approach, as under the current Rule, the only time a fund would be required to look at all rating agency ratings for a particular security would be to confirm that a stub period security (discussed above) is eligible. (A stub period security is not eligible if the issuer has received a long-term rating below third tier (or below second tier under the proposals), subject to certain exceptions). The SEC also asks several questions about this proposal. Should Boards be permitted under Rule 2a-7 to designate credit rating agencies or credit evaluation providers that are not registered with the SEC as rating agencies? Should a Board be solely responsible for designating and annually reviewing a designated rating agency or should the Board be permitted to delegate this responsibility? How many rating agencies would money market fund Boards be likely to evaluate before making their designations? After a fund Board had designated rating agencies, what incentives would the Board have to change the designated rating agencies? **[BOARD]** The SEC asks whether specific policies and procedures should be required for monitoring rating agencies. **[PROCEDURES]**

## C. MATURITY – SPECIFIC PROPOSALS

1. **Average Portfolio Maturity Reduced to 60 Days.** The proposed amendments would shorten the maximum average portfolio maturity for money market funds from 90 days to 60 days. The SEC states that securities that have a shorter period remaining until maturity (and are of higher quality) generally exhibit a low level of volatility and thus provide greater assurance that the money market fund will be able to maintain a stable share price. Also, these securities pose a lower level of liquidity risk, because more securities mature on a daily or weekly basis. Further, shorter maturities dampen the effect of widening credit and interest rate spreads on a fund. (The interest rate spread is the excess of the rate that an issuer must pay on its securities over the rate on risk-free rate U.S. Treasury bills. As the appetite for risk in the markets declined during 2008, spreads between the rate on U.S. Treasury bills and other securities increased. Funds with shorter maturity holdings were better able to withstand rising interest rates). The SEC states that during the last 20 years, the average weighted maturity of taxable money market funds has not exceeded 58 days, and points out that money market funds that are highly rated by rating agencies are required to have shorter maturities than currently required under the Rule. Thus, the SEC does not anticipate that the proposed shortening would pose a hardship for portfolio management.

2. **Weighted Average Life Portfolio Maturity – 120 Days.** The proposed amendments would impose a new requirement that money market funds limit “weighted average life” portfolio maturity to no more than 120 days. A weighted average life portfolio maturity would be a new, more restrictive method of calculating average portfolio maturity, intended to assure that funds can maintain stability even during volatile markets. Currently under the Rule, a fund is permitted to “deem” the maturity of certain variable rate instruments to be “shortened” to less than their nominal maturity, based on, among other things, the next date the interest rate on the instruments is readjusted. In effect, for purposes of calculating maturity, the security is treated as if it were a series of short-term obligations that each matures on each next succeeding interest rate reset date. But, the SEC explains, a security with a “deemed” shorter maturity is more volatile than a security that actually matures on the interest reset date. This means that the “shortened” maturity is not an accurate measure of the volatility of the security. Further, while the interest rate adjustment may offer some protection against interest rate changes in the marketplace, permitting maturity shortening does not protect against liquidity risk to the portfolio.

The newly proposed weighted average life calculation would forbid a money market fund from using that type of “maturity shortening” approach when calculating weighted average portfolio maturity. As a result, the maturity of a portfolio calculated under the weighted average life method is longer than it would be using maturity shortening. Under the proposals, average weighted life would be limited to 120 days.

This amendment would not affect a money market fund’s existing ability under the Rule to “shorten” maturity based on the period until principal can be recovered by demand under a demand feature. A demand feature is a right to demand payment of amortized cost plus accrued interest during the life of the security.

3. **Funds that use Penny Rounding Rather than Amortized Cost.** The proposals would eliminate the existing permission for money market funds that use penny rounding (rather than amortized cost) to acquire Government securities with maturities up to 762 days.

#### D. MATURITY – INQUIRY PROPOSALS

1. **Shorten Maximum Maturity for an Individual Security.** The SEC asks whether it should reduce the maximum maturity for an individual security from 397 days to a shorter time period. The SEC notes that a shorter maturity entails less sensitivity to interest rate increases, but notes that this change may not be necessary to improve safety if the SEC adopts the proposed 60 day limit on weighted average portfolio maturity and the 120 day limit on weighted average life. Further, the stricter maturity limit could negatively impact issuers of short-term obligations such as issuers of tax-exempt municipal securities, which typically are in the longer end of the maximum range. The SEC asks the likely impact of this change on yields and on the supply of 2a-7-eligible securities.
2. **Maturity without Government Securities.** The SEC states that some funds calculate maturity not only by disregarding interest rate spreads, but also by excluding U.S. Government securities from the weighted average maturity calculation. This method is intended to focus solely on credit spread risk (which is assumed to relate only to non-Government securities). The SEC asked whether the Rule should be amended to impose this method of testing on money market funds.

3. **Maximum Maturity for Adjustable Rate Securities.** The SEC asks whether money market funds should be permitted to use the maturity-shortening provisions of the Rule only for adjustable rate securities that have a maximum actual final maturity of no more than a specified number of years (from two to four years).

## E. LIQUIDITY – SPECIFIC PROPOSALS

1. **No Illiquid Instruments.** The proposed amendments would forbid the purchase of illiquid securities, which are defined as securities that cannot be sold or disposed of in the ordinary course of business within seven days at approximately amortized cost. This definition may be more strict than the definition included in the SEC’s proposed amendments to the Rule issued in 2008. The definition proposed in 2008 identified a liquid security as one “that can 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.” The 2008 definition could be read to permit a fund to consider whether it can sell a security for its market value in determining whether the security is liquid, rather than whether the fund can sell the security for its amortized cost value. Market value is often lower than amortized cost value. The release does not discuss the reason for the differing wording.

The proposed amendments would have the effect of forbidding investment in securities with no secondary market that are currently sometimes purchased by money market funds, unless they are payable on demand or mature within seven days. The SEC notes that illiquid securities expose the fund to a risk that it may be unable to satisfy redemption requests promptly, without selling illiquid securities at a loss that could impair its ability to maintain a stable net asset value. Further, illiquid securities are subject to greater price volatility, exposing a fund to greater risk of breaking the dollar. The SEC asks whether the proposal would materially impact yield.

2. **Minimum Holdings of Cash and Securities Convertible to Cash – Institutional Fund Requirements More Strict than Retail Fund Requirements.** The proposed amendments would impose minimum percentage requirements for holdings of cash (which includes demand deposits, according to the release) and securities that mature or provide the legal right to receive cash (e.g., a demand feature) within one business day or five business days (daily liquid assets and weekly liquid assets). The minimums are higher for institutional funds than retail funds, the SEC states, because institutional funds typically have been subject to substantially greater redemption pressure than retail funds.

Institutional funds would be identified by the Board at least once annually, based on the nature of the record owners of the fund, minimum initial investment requirement to establish an account and historical or expected cash flows that would result from purchases or redemptions. It is possible a Board would need to change its categorization of funds from year to year, and might find this categorization to be a challenge, for the reasons set forth in the following paragraph. **[BOARD]**

The ICI Report had objected to the distinction between retail and institutional funds, on the basis that it would be difficult to draw a distinction between the two types of shareholders, and that funds might have a mix of the shareholder types. Further, the retail funds likely

would perform better, since they could hold less cash and highly liquid securities, and therefore might be more appealing to some shareholders. It could be a challenge to police adequately the assignment of shareholders to one or the other category. For example, institutional shareholders might split their investments among separate money market funds to qualify for investment in funds that permit a lower initial investment. This aspect of the proposed rule is likely to generate substantial comment, and, if it is adopted, the SEC and the industry likely will need to flesh out this standard for identifying retail and institutional funds.

The minimum standard for holdings of cash and securities convertible to cash included in the proposals differs from the existing liquidity standard described under the prior caption. This cash standard refers to a *right* to receive cash within one day or one week, while the existing definition of liquidity turns on the ability to dispose of (e.g., sell) a security. The importance of the right to receive cash became clear during the fall of 2008, when frozen markets made it difficult to obtain amortized cost upon a sale of securities, even for securities that were “liquid” in normal markets.

The proposed amendments include the minimum percentages of total assets set forth below to satisfy the new definitions of daily liquid assets and weekly liquid assets. For comparison, the percentages recommended in the ICI Report are set forth below as well.

	<b>SEC Daily</b>	<b>SEC Weekly</b>	<b>ICI Daily</b>	<b>ICI Weekly</b>
Taxable Retail	5%	15%	5%	20%
Taxable Institutional	10%	30%	5%	20%
Tax-Exempt Retail	None	15%	None	20%
Tax-Exempt Institutional	None	30%	None	20%

These minimums would be imposed upon acquisition, and a fund would not be required to dispose of assets to satisfy the requirement upon a subsequent decrease in liquidity due to redemptions (or, presumably due to change in status from liquid to illiquid, although the release does not state this). However, a fund could not acquire securities other than daily liquid assets or weekly liquid assets if, immediately after the acquisition, the fund would have invested less than the required percentage of assets in daily liquid assets or weekly liquid assets. In the release, the SEC asks whether the Rule should impose a liquidity requirement that would apply at all times, rather than just on acquisition.

- 3. Subjective Minimum Requirement for Daily and Weekly Liquidity.** The proposed amendments would require a fund to hold daily liquid assets and weekly liquid assets sufficient to meet reasonably foreseeable redemptions in light of its obligations to redeem shares and any commitments made to shareholders, such as an undertaking to pay redemptions more quickly than within seven days. Money market funds may find it to be a challenge to predict “reasonably foreseeable” redemptions, and funds will need to consider how often to re-evaluate what level of redemptions is “reasonably foreseeable.”

This approach of imposing a subjective standard in addition to an objective percentage requirement is consistent with other aspects of the Rule. Specifically, the Rule requires both an objective maturity standard (maximum portfolio maturity of 90 days), and a requirement

that maturity be appropriate to maintaining a stable NAV. Also, the Rule imposes both an objective quality test for each security (each security must be at least second tier quality) and a subjective requirement that each security pose minimal credit risk (although, as noted above, the SEC is considering abandoning the objective test of quality by eliminating the references to rating agencies in the Rule).

The SEC states that the obligation to evaluate liquidity needs would be ongoing, and that a fund should adopt policies and procedures to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders, particularly those that hold their securities through omnibus accounts, or who access the fund through “portals” or through other arrangements that provide the fund with little or no transparency with respect to the beneficial shareholder. The SEC said it is not proposing to amend the Rule to require that funds adopt specific procedures because the SEC believes those procedures would be required by Rule 38a-1, the “compliance rule” under the Investment Company Act. The SEC asks, if it adopts the proposed general liquidity requirement, whether the SEC should provide guidance to funds to assist them in determining the adequacy of their policies and procedures or should specify any particular aspects of the policies and procedures. The SEC says that fund directors, in their consideration of these procedures and in their oversight of implementation, should understand that fund managers’ interest in increasing fund assets, and thus their advisory fees, may lead them to accept investors who present greater risks to the fund than they might otherwise have accepted. The SEC urges directors to consider the need for establishing guidelines for advisers to money market funds that address this potential conflict. **[BOARD] [PROCEDURES]**

- 4. Stress Testing.** The proposed amendments would require the Board of each money market fund to adopt procedures for periodic stress testing of the portfolio, to assess the fund’s ability to maintain a stable net asset value based upon certain hypothetical events, including an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on a portfolio security and 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 proposed amendment also would require the procedures to include an assessment by the adviser of the fund’s ability to withstand the events (and concurrent occurrences of those events) that are “reasonably likely” to occur within the following year. The release states that the Board would determine the particular stress testing that should be done and the intervals at which it should be done. But, the release goes on to provide guidance to the Board on one point: “Boards should...consider procedures that require the fund to test for concurrence of multiple hypothetical events, e.g., where there is a simultaneous increase in interest rates and substantial redemptions.” **[BOARD] [PROCEDURES]**

The Board would be required to receive a report of the results of stress testing at its next regularly scheduled meeting, which report must include: (i) the date(s) on which the portfolio was tested; and (ii) the magnitude of each hypothetical event that would cause the money market fund to break the dollar. This assessment is intended to provide the Board with a context within which to evaluate the magnitude of the events that would cause the fund to break the dollar.

The SEC asks for comment on many aspects of the stress testing including whether specific stress events should be required (for example, an assumed 50 basis point increase in LIBOR

and a redemption of 15 percent of fund shares). The SEC asks whether the Board should receive a report only when tests indicate a particular level of risk. The SEC asks whether the Rule should require a particular frequency of stress testing, and if so, what frequency and whether the frequency should vary by type of fund. The SEC asks whether some funds (such as Treasury funds) should be exempt from certain types of stress testing. The SEC further asks whether different liquidity requirements should be imposed depending on the results of stress test.

The SEC mentions certain organizations that currently impose stress testing on money market funds: rating agencies and the Institutional Money Market Funds Association (a trade association representation European triple-A rated money market funds). It is not clear whether the SEC intends that the practices of these organizations will provide guidance on the nature of stress testing.

Funds would be required to maintain records of the stress tests for six years, the first two in an easily accessible place.

#### **F. DIVERSIFICATION; INDUSTRY CONCENTRATION – INQUIRY PROPOSAL**

The SEC asks whether diversification requirements under the Rule should be tightened. The current limits are, in summary, no more than five percent of assets in one issuer and no more than 10 percent of assets in one credit support provider, with lower limits for exposure to issuers and providers that are second tier quality. Also, tax-exempt funds are subject to the limit on second tier issuers only with respect to “conduit securities,” which, in summary, are municipal securities where the source of payment is a non-municipal entity.

The SEC asks whether industry concentration limitations should be added to the Rule. The current limit of no more than 25 percent in any one industry is imposed on all funds, with no other requirements applicable specifically to money market funds. The SEC notes that defining an “industry” has become increasingly difficult as the boundaries between industries have eroded and the trend towards corporate conglomeration has continued.

#### **G. DISCLOSURE AND SEC REPORTING – SPECIFIC PROPOSALS**

- 1. Public Web site Disclosure of Holdings.** The proposed amendments would require monthly Web site disclosure of holdings. The fund would be required to post the information no later than the second business day of the month, current as of the last business day of the prior month. Currently, money market funds must report their holdings to the SEC four times a year on Form N-Q and Form N-CSR, no earlier than 60 days after the close of the quarter. The SEC proposes to exempt money market funds from the quarterly reporting obligation (but not the controls and procedures and certification requirements) of Form N-Q.
- 2. Reporting about Holdings to the SEC.** The proposed amendments would require a money market fund to provide the SEC a monthly electronic file of more detailed portfolio holdings information on new Form N-MFP. The report would be due two business days following the end of each month, with respect to the preceding month. Currently money market funds provide quarterly reports to the SEC, in a format that does not allow the SEC to search expeditiously across portfolios or within portfolios to identify securities that may cause concerns. By reviewing the new report, the SEC would be able to identify quickly those funds that hold certain securities and that have unusual portfolios that may involve greater than

normal risks (for example funds with higher gross yields). The SEC expects to make the filed information available to the public two weeks after filing, in anticipation that academic researchers, financial analysts and economic research firms would use the information to study money market fund holdings and evaluate their risk, which, in turn would assist investors and regulators to understand the risks of money market funds.

The information on the Form N-MFP would include not only identifying information for each security, but also the ratings of the issuer and any credit enhancer, the final nominal maturity date and the maturity date calculated under the Rule, whether the maturity is extendable, whether the valuation inputs used in valuing the security are Level 1, 2 or 3 under FAS 157, the percentage of the fund's assets invested in the security, the fund's dollar weighted average maturity and its 7-day gross yield. The SEC states that funds would need to tag data in eXtensible Markup Language (XML) for filing with the SEC. Funds may face substantial operational challenges in arranging to make the required information available, and in gathering the information each month within a two day period.

- 3. Reporting to the SEC under Rule 17a-9.** A money market fund whose securities have been purchased by an affiliated person in reliance on Rule 17a-9 (see below) would be required to give the SEC prompt notice of the transaction via electronic mail.

## **H. DISCLOSURE AND SEC REPORTING – INQUIRY PROPOSALS**

- 1. Public Posting of Market-Based NAV.** The SEC asks whether money market funds should be required to post publicly their market-based NAV per share. The SEC states that this revision would enable investors to better understand the risk that the fund will not be able to maintain a stable NAV. The SEC acknowledges that disclosure of shadow pricing could have the unintended effect of causing greater instability, by causing investors to redeem their holdings once the shadow price drops below a certain threshold. The SEC asks 10 separate questions about this proposal, perhaps indicating an understanding that this could be a change with significant consequences.
- 2. Disclosure of Market Value of Holdings.** The SEC asks whether the new monthly form on which money market funds would provide holdings information to the SEC should include disclosure of the market value of holdings. This information is proposed to be made publicly available with a two-week delay.

The SEC also asks whether the form should be required to disclose any additional information, such as the fund's shareholder concentration levels, the percentage of each issue held by the fund, or last trade price and trade volume for each security.

## **I. EXIGENT CIRCUMSTANCES – SPECIFIC PROPOSALS**

- 1. Capacity to Process at other than \$1.00.** The proposed amendments would require each money market fund Board to determine in good faith at least once each calendar year that the fund or its transfer agent has the capacity to honor share transactions at prices other than \$1.00. (Once a fund has broken the dollar, the fund could no longer use the amortized cost method of valuation and therefore would be required to compute share price based on market value to at least 1/10th of a cent). Thus, the fund would have the operational capacity to break the dollar and to continue to process investor transactions in an orderly manner. This

proposal is intended to prevent funds from facing the operational limitations that contributed to delays in redeeming shareholders of the Reserve Primary Fund after it broke the dollar in September 2008. **[BOARD]** The SEC asks whether the Board involvement is appropriate. The SEC suggests possible alternatives to requiring the Board to make a determination of the capacity to process transactions: the Board could determine that the fund has procedures (or approve procedures) adequate to enable share transactions at a market-based price.

**[PROCEDURES]**

2. **Bail-outs by Affiliates.** The proposed amendments would ease requirements for affiliated transactions to bail out a money market fund. The Investment Company Act forbids certain transactions between a fund and its affiliates, due to the potential for self-dealing and conflicts of interest. But, a transaction whereby an affiliated person purchases a troubled security from its affiliated money market fund does not ordinarily raise these issues, and is permitted by an exemptive rule: Rule 17a-9. Rule 17a-9 currently is quite narrow, as it is available only where a security has lost its status as an “Eligible Security” under the Rule (a circumstance which generally relates to a reduction in the securities’ ratings). The proposed amendments would expand the exemptive rule and permit an affiliate to purchase a security that is still an Eligible Security. (The affiliate may wish to purchase the security, for example, if the affiliate anticipates that the security will suffer a ratings downgrade, or to generate cash to honor redemptions). If the security is not in default, the affiliate would be required to remit to the fund any profit it realizes from the later sale of the security. The SEC states that because there may not be an objective indication that the security is distressed (and thus that the transaction is clearly in the interest of the fund), the proposed “claw back” provision would eliminate incentives for fund advisers and other affiliated persons to buy securities for reasons other than protecting fund shareholders from potential future losses. The SEC asks whether the amendments should instead expand the exemption to include only those portfolio securities that fall within enumerated categories (e.g., securities have defaulted, have become illiquid, have been determined by the Board of Directors to no longer present minimal credit risk).
3. **Board Suspend Redemptions upon Liquidation.** The proposed amendments would create a new rule that would permit a money market fund Board, including a majority of independent directors, to suspend redemptions if the Board, including a majority of directors who are not interested persons, approves liquidation of the fund; the price per share is less than the fund’s stable NAV per share; and the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions, by electronic mail. This would allow for the orderly liquidation of the portfolio. This new rule would replace rule 22e-3T, which is a similar temporary exemption applicable only to money market funds participating in the Treasury Department’s Guarantee Program. **[BOARD]**

The proposed amendments also would provide a limited exemption from a fund’s obligation to redeem shares for certain conduit funds that invest all of their assets in a money market fund that suspends redemption in reliance on the foregoing new rule. Without this exemption, these conduit funds may be in the position of having to honor redemptions while being unable to liquidate shares of money market funds held as portfolio securities. The SEC anticipates that this provision would be used primarily by insurance company separate accounts issuing variable insurance contracts and by funds participating in master-feeder arrangements.

The proposed amendments would permit the SEC to rescind or modify the relief provided by the rule (and thus require the fund to resume honoring redemptions) “after appropriate notice

and opportunity for hearing.” The SEC might modify relief, for example, if the liquidating fund has not devised, or is not properly executing, a plan of liquidation that protects fund shareholders.

## J. EXIGENT CIRCUMSTANCES – INQUIRY PROPOSALS

1. **Additional Board Ability to Suspend Redemptions.** The SEC asks whether money market fund Boards should be empowered to suspend redemptions during exigent circumstances other than liquidation of the fund. The ICI Report went further than the SEC’s specific proposal for suspension upon liquidation, and would also give the Board the authority to suspend redemptions for up to five days if a fund’s net asset value is or is reasonably believed to be about to become “materially impaired.” This authority could be exercised only once every five years. At the open meeting, the SEC staff indicated that the staff had considered this alternative and had rejected including it as a specific proposal, on the grounds that it would be difficult to create a standard for when the Board could determine that a fund is about to break the dollar. [BOARD]

However, the SEC asks numerous questions about this alternative. If the Board was permitted to direct the fund to suspend redemptions other than upon liquidation, how could the SEC ensure that directors would use this authority only in exigent circumstances? When is a money market fund’s net asset value “materially impaired?” Would this term include circumstances in which the fund has overvalued securities, which, if sold to satisfy redemptions, would have to be marked down? What factors should the Board of Directors take into consideration when deciding whether to suspend redemptions temporarily? How would directors weigh the various and possibly competing interests of shareholders? Would suspension of redemptions provide time for directors to find a solution? Or might it accelerate redemptions from shareholders once the suspension period ends, regardless of any action taken by the Board of Directors?

The SEC also asks questions about how the temporary suspension would operate, including: What disclosures should a money market fund be required to make, and when and where should the fund make them? Should a fund be required to calculate its net asset value during the suspension period, and, if so, should the net asset value be publicly disclosed? Should the suspension period be longer or shorter than five days?

2. **Shareholder Ability to Choose Liquidity or Capital Preservation.** The SEC solicits comment on an alternative that could provide the Board with an additional course of action during exigent circumstances. The SEC asks whether a fund Board should be permitted or required to recognize that investors will have different preferences for liquidity and capital preservation, by having shareholders choose how they will be treated upon liquidation. For example, a fund that decides to liquidate and suspend redemptions could be allowed to offer shareholders the choice of redeeming their shares immediately at a reduced net asset value per share that reflects the fair market value of fund assets, i.e., at a price below the fund’s stable net asset value, or receiving their redemption proceeds at the end of the liquidation process, when they would have the economic benefit of an orderly disposal of assets. The SEC asks numerous questions. Should investors be required to choose their preferences at the time they purchase fund shares? Should investors be able to change their preferences? If so, how and when? Should they be able to choose their preferences when a fund announces its intention to liquidate and suspend redemptions under the Rule? If so, should the SEC (or the fund Board) establish a default assumption for investors that fail to respond to the inquiry?

Would such an approach be fair to all fund shareholders? What conditions would be necessary and appropriate to ensure that shareholders are treated fairly? Specifically, how would such a mechanism operate? Should funds be able to deduct an additional discount or “haircut” from earlier redeeming shareholders to provide additional protection for later redeeming shareholders? Should the SEC permit Boards to decide the amount of the haircut? If so, what factors should Boards use to decide such haircuts? What disclosures and information would be necessary to permit shareholders to make an informed decision between the options? Should the SEC impose other requirements in connection with liquidations, such as a limit on allowable reserves? **[BOARD]**

## **K. FUNDAMENTAL REFORMS**

The SEC states that it is exploring other ways to improve the ability of money market funds to weather liquidity crises and other shocks to the short-term financial markets, and the SEC invites interested persons to submit comments on the advisability of pursuing the following possible reforms.

- 1. Floating NAV.** The SEC asks whether money market funds should be required to sell and redeem shares at a floating share price rather than a stable share price? The ICI has strongly opposed this concept on various grounds, including the tax, accounting and operational complications of a floating share value for a product that is used for daily liquidity. Further, some have suggested, a money market fund with a floating NAV may, in fact, be a short-term bond fund, rather than a money market fund. Short-term bond funds already exist and do not have the appeal as a cash management tool of a stable NAV fund. The SEC asks how money market funds whose share prices are market-based would differ from current short-term bond funds. The SEC asks whether a switch to a floating NAV may make funds more susceptible to runs because investors might respond quickly to small changes in NAV. The SEC states that it is “mindful that if we were to require a floating net asset value, a substantial number of investors might move their investments from money market funds to other investment vehicles.”

The SEC includes a detailed analysis of the dangers of the stable NAV. In summary, the use of amortized cost value makes the NAV insensitive to market fluctuations. Shareholders, particularly sophisticated institutions, realize that a money market fund share is not worth exactly \$1.00 in market value, but rather some value within a range of \$.995 to \$1.005. Further, these sophisticated shareholders may be able to determine approximately where within that range the market value falls. The shareholder can use this knowledge to redeem shares for \$1.00 when value is less than a \$1.00 and to purchase shares for \$1.00 when their value is more than \$1.00. Retail shareholders are less likely to be aware of this arbitrage opportunity. This arbitrage is accomplished at the expense of the retail shareholders, whose share value is diluted by purchases by institutions of shares for \$1.00 at times when market value is somewhat higher than \$1.00 and redemptions for \$1.00 when share value is somewhat lower than \$1.00.

- 2. In-Kind Redemptions.** The SEC asks whether funds should be required to satisfy redemption requests in excess of a certain size through in-kind redemptions. This requirement would protect funds from the need to sell assets into a down market to generate cash to honor redemptions. The SEC notes that money market funds are permitted to, and many money market funds disclose in their prospectus that they may, satisfy redemption requests through in-kind redemptions. But only one money market fund announced that it would do so during

recent market turmoil. The SEC said that if this requirement is imposed, the SEC expects that there would be a threshold sufficiently high that the SEC could reasonably assume that the investor would be in a position to assume ownership of the securities it receives in kind. The SEC asks whether there should be a different threshold for third-party shareholders versus affiliated shareholders (for example, prioritizing non-affiliate redemptions over affiliate redemptions requests that are submitted on the same day). The SEC also asks how a fund should value the securities that are distributed. The ICI has noted that redemptions in kind are unpopular with investors.

The SEC states that, alternatively, a Board could cause a money market fund to impose a redemption fee to shift some of the fund's costs from shareholders' liquidity needs on the redeeming shareholders.

**General Request for Comment.** The SEC invites interested persons to submit comments on the advisability of pursuing any or all of the proposed reforms, as well as to provide other approaches that the SEC might consider to achieve its goals.

**How Many More Funds Will Break the Dollar?** Under the "Paperwork Reduction Act," the SEC includes at the end of each rule release an estimate of the cost to industry participants of implementing each SEC proposal. The Paperwork Reduction analysis for the proposed amendments includes an estimate of the cost to the fund industry of sending to the SEC electronic mail notice that a fund has broken the dollar. For purposes of this calculation, the SEC estimates that, on average, one money market fund would break the dollar and liquidate every six years. Only two money market funds have broken the dollar since 1983.

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For a discussion of how the proposed amendments compare to the proposals in the ICI Report and the Administration Report and for a list of proposals that have been floated with respect to money market funds, but which are not included in the release, see our Fund Alert, Regulatory Update, June 2009 which is available at <http://www.stradley.com/newsletters.php?action=view&id=468>.