STRADLEY RONON

Fund Alert

A Publication of the Stradley Ronon Investment Management Group

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NOVEMBER 2015

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What You Need to Know About Money Market Fund Reform — Ratings

SEC Adopts Amendments Removing Credit Ratings From Rule 2a-7 and Tightening Issuer Diversification Requirements

By Joan Ohlbaum Swirsky and Jamie M. Gershkow

The fifth time was a charm for the U.S. Securities and Exchange Commission (SEC), as on September 16, 2015, the SEC adopted amendments (Credit Rating Amendments) to remove the requirement that a money market fund (a fund) limit its investments to those rated within the top two categories by rating agencies (or to unrated securities of comparable quality).[1] The SEC initially had discussed the removal of ratings from the money market fund rule in a 2003 concept release and had proposed the changes in 2008, 2009, 2011[2] and, most recently, July 2014 (the Re-Proposal).[3] In place of the ratings requirement, a fund's board of directors or its delegate (such as the investment adviser) must determine whether each security presents minimal credit risk. The minimal credit risk test has been imposed since 1983, when Rule 2a-7, the money market fund rule, was adopted, but the Credit Rating Amendments flesh out that requirement by specifying factors that must be included in the minimal credit risk analysis, to the extent appropriate.

Specifically, in making the minimal credit risk determination, the board of directors or its delegate must analyze the capacity of the security's issuer to meet its financial obligations, which analysis must include, to the extent appropriate, consideration of the following factors:

1. the issuer's or guarantor's financial condition;
2. the issuer's or guarantor's sources of liquidity;
3. the issuer's or guarantor's ability to react to future marketwide and issuer- or guarantor-specific events, including the ability to repay debt in a highly adverse situation; and
4. the strength of the issuer's or guarantor's industry within the economy and relative to economic trends, and the issuer's or guarantor's competitive position within its industry.

Click here for further detail regarding the analysis of these factors.

While the minimal credit risk determination is currently required by Rule 2a-7 (the Current Rule) under the Investment Company Act of 1940, as amended, the only basis for that determination is "factors pertaining to credit quality."

Rule 2a-7, as amended by the Credit Rating Amendments (the Amended Rule), also eliminates the current distinction between first-tier and second-tier securities, which results in elimination of the current limits on securities rated in the second-tier short-term rating category. Under the Current Rule, these limits are no more than 3 percent of total assets in second-tier securities in the aggregate, and no more than 1/2 percent in any one second-tier issuer.

The SEC also adopted rules, as proposed in the Re-Proposal, to tighten issuer diversification requirements.[4]

The Amended Rule is part of the SEC's process to implement Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which became law in July 2010. Section 939A directs the SEC, "to the extent applicable, [to] review any regulation that requires an assessment of credit-worthiness," to "modify any such regulations identified by the review" to remove references to or requirements for reliance on ratings, and to substitute a standard of creditworthiness as the SEC determines to be appropriate. This directive addresses the concern that investors and regulators may have relied too heavily on rating agency ratings rather than on independent credit analysis — particularly in light of perceived errors by rating agencies during the financial crisis of 2008, when those agencies rapidly downgraded highly rated structured investment vehicle securities.

Over the years since the Dodd-Frank Act was adopted, many industry participants had opposed the removal of ratings from the Current Rule, because the ratings requirement has been accompanied by a "minimal credit risk" requirement. Accordingly, the rating is a quality floor rather than a safe harbor, and removing the floor "runs counter to the entire philosophy of Rule 2a-7," in the words of SEC Commissioner Luis A. Aguilar in 2011. Commissioner Aguilar, and many commenters, also stated that a subjective standard to replace ratings would be difficult to oversee.

Although the Dodd-Frank Act mandated the removal of ratings from the Current Rule, it seems clear that, in several respects, the SEC does not expect amendments to change current practices. The SEC said, "[w]e believe that most money market funds are not likely to change their current investment policies in response to the adopted amendments." Several specific points where the SEC-flagged practices may not change are highlighted below. It appears that the amendments satisfy the Dodd-Frank Act but facilitate continued use of ratings where appropriate.

Credit Risk Factors, Monitoring Minimal Credit Risks, Board Notification, Stress Testing, Form N-MFP, Conditional Demand Features

Credit risk factors — intent to retain similar degree of risk. By codifying the general credit analysis factors, the SEC believed that the use of such factors should "assist fund boards by serving as objective and verifiable tools to rely on in the absence of [nationally recognized statistical rating organization (NRSRO)] ratings."[5] In addition to the codification in the Amended Rule of the general factors that a fund may consider (to the extent appropriate) in its minimal credit risk determinations, the release adopting the Amended Rule (Adopting Release) includes commentary relating to additional factors that an adviser "may wish to consider," "to the extent applicable," for specific types of instruments. Noncodified commentary typically carries weight, because it represents the imprimatur of the SEC. This commentary may be accorded even more weight than usual, because the Amended Rule itself includes a note referring to the commentary. The note states that "[f]or a discussion of additional factors that may be relevant in evaluating certain specific asset types see [the Adopting Release]." The types of instruments for which additional factors are provided include:

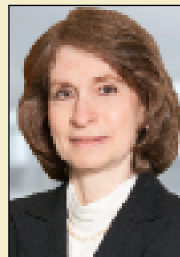
- municipal securities
- conduit securities
- asset-backed securities
- other structured securities
- repurchase agreements

Click here for a list of these factors relating to these types of instruments in the commentary in the Adopting Release.

The Adopting Release made clear that the list of factors in the Amended Rule and the commentary in the Adopting Release are not meant to be exhaustive.

The SEC said one of its goals was to "preserve a similar degree of credit quality to that currently present in fund portfolios."

Interestingly, the SEC also pointed out that credit risk must be evaluated not only on a security-by-security basis, but in light of the fund as a whole: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> In determining whether a security presents minimal credit risks, therefore, a board (or its delegate) should consider not just the individual risks of the security, but also the overall impact of adding that security to the fund in light of the fund's other holdings. Such consideration might include an examination of correlation of risk among the securities held or purchased, the credit risks associated with market-wide stresses, or specific security credit or liquidity disruptions. [footnotes omitted]

Monitoring of ongoing minimal credit risks — practices not expected to change. The Amended Rule also requires a fund's board to adopt written procedures requiring the fund's adviser to provide an ongoing review of the credit quality of each portfolio security to determine that the security continues to present a minimal credit risk. This replaces the provision in the Current Rule requiring the fund's board or its delegate to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks. Although the Amended Rule does not specify the frequency with which monitoring must occur, the SEC states in the Adopting Release that such ongoing monitoring should occur on a regular and frequent basis.

Both money market fund shares and U.S. government securities are defined as eligible securities under the Amended Rule, but, in commentary, the SEC points out that government securities, but not money market fund shares, are carved out of the ongoing minimal credit risk monitoring. The SEC further explains:

> [W]e believe there are significant differences between the risk profile of government securities and shares of money market funds … that make ongoing monitoring prudent for shares of money market funds. Nonetheless, the difference in risk profiles between shares of money market funds and other portfolio securities may influence the specific written ongoing monitoring procedures adopted by the board pursuant to this final rule. [footnote:] For example, a fund may decide to use different outside sources to assist it in evaluating the ongoing credit quality of portfolio securities it determines present a heightened credit risk profile (as compared with other portfolio securities held by the fund).

In certain ways, the SEC does not expect that this ongoing monitoring will change current practices. First, the SEC noted that funds could continue to consider external factors, including credit ratings, as part of the ongoing monitoring process. Further, the SEC said that it, and commenters, believed that "most fund advisers currently engage in similar types of ongoing monitoring and that an explicit monitoring requirement would not significantly change current fund practices."

Board notification eliminated — but procedures may not change. Because ratings provisions are eliminated, the Amended Rule eliminates the requirement that a board be notified about a security that receives a rating below second tier that the fund disposes of without a credit reassessment. However, the Adopting Release confirms that the SEC expects that a fund board generally will establish procedures for the adviser to notify the board when a security no longer meets the minimal credit risk standard.

The SEC also adopted a related revision to the record-keeping requirements of the Current Rule to require record keeping of the minimal credit risk determination when the security is first acquired or during periodic or event-driven reassessments, as determined by the board or its delegate.

Stress-testing amendment — but procedures may not change. The Amended Rule replaces the requirement to stress test against the downgrade or default of particular portfolio securities with a requirement to stress test against "an event indicating or evidencing credit deterioration" of a particular security "such as a downgrade or default." Given that the Amended Rule suggests downgrades and defaults as examples of such events, funds may continue to test their portfolios against a potential downgrade or default.

Form N-MFP — possible continued importance of ratings recognized. The Amended Rule also revises certain requirements to list ratings on portfolio securities on Form N-MFP, which funds file monthly with the SEC to report portfolio holdings and other information. Prior to the amendments, funds were required to include on Form N-MFP each "designated NRSRO"[6] rating for a holding. The Credit Rating Amendments require a fund to disclose NRSRO ratings that the fund's board (or its delegate) considered, if any, in making its minimal credit risk determination for a given security. Disclosure of ratings was not eliminated entirely, implicitly recognizing that ratings may continue to be a useful data point for credit risk analysis.

"Conditional demand features" — third tier underlying still not satisfactory. Current Rule 2a-7 imposes a rating requirement on a particular type of "put" right, known as a "conditional demand feature." Such securities must be rated in one of the top two ratings tiers, or be equivalent-quality unrated securities. The amendments eliminate the rating requirement and replace it with the minimal credit quality standard. Although the rating standard has been removed, the SEC stated in the Re-Proposal that it does not believe that securities rated in the third-highest category for long-term ratings (or comparable unrated securities) would satisfy the replacement standard. The SEC said in the Adopting Release that "we believe that our rule will result in only small changes to the practices of funds with respect to investments in securities with conditional demand features."

Exclusion From the Issuer Diversification Requirement

To understand the change to the credit support diversification requirement under the Credit Rating Amendments, it is necessary to understand the two separate diversification tests

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under Rule 2a-7. Rule 2a-7 imposes a diversification test that limits a fund's exposure to any one issuer of portfolio securities, and another diversification test that limits a fund's exposure to any one provider of credit support on portfolio securities (such as a guarantor). The issuer diversification test generally limits exposure to any one issuer to 5 percent of the portfolio and exposure to any one guarantor to 10 percent of the portfolio.

The Current Rule does not require the first diversification test — the issuer diversification test — to be applied to a security that has a guarantee by a noncontrolled person of the issuer. Such a security is tested only under the second test — the guarantee test. The reason for this exception from testing of the fund's exposure to the issuer is that, for a security with a guarantee, the fund may be relying only on the credit quality of the guarantor, rather than the credit quality of the issuer. If so, exposure to the issuer is less important to risk in the fund. However, the SEC is concerned that this exception may allow a fund to have a portfolio that is highly concentrated in one issuer.

The Amended Rule provides that each fund that invests in securities subject to a guarantee (whether or not the guarantor is a noncontrolled person) will have to comply with both the 10 percent diversification requirement for the guarantor as well as the 5 percent diversification requirement for the issuer. In addition, the Amended Rule contains technical amendments to certain diversification provisions intended to clarify the diversification amendments adopted as part of the July 2014 Money Market Fund Reform.[7]

The SEC received eight comment letters discussing the proposed issuer diversification amendment, mostly in opposition to such an amendment.

Actions to Comply

No new non-delegable board duties, though procedures and board reports may change. Fund boards typically delegate the day-to-day responsibility for credit quality determinations to the investment adviser. The Amended Rule does not impose any new duties on fund boards that may not be delegated to the investment adviser.

Actions necessary to comply with the Amended Rule:

- Advisers will need to consider whether they will excise ratings from their credit analysis or continue to consider ratings as an independent third-party viewpoint that may bring to bear expertise not otherwise readily available to each adviser.

- Funds may need to update their amortized cost and stress-testing procedures, compliance policies and systems, disclosure, and board reports. Among other things:

  - Funds must ensure they have written policies to keep written records of their minimal credit risk determination that includes the factors considered and an analysis of such factors.

  - Funds must ensure they have written procedures requiring the fund adviser to undertake ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

  - Funds may establish procedures for the adviser to notify the board when a security no longer meets the minimal credit risk standard.

  - Advisers may incorporate into their written procedures the factors contained in the Amended Rule that a fund must consider in its minimal credit risk determination to the extent appropriate.

- Funds will need to reconsider their reporting of ratings on portfolio securities on Form N-MFP.

- Advisers should review their compliance programs and portfolio management systems to ensure their programs and systems adequately reflect the new diversification requirements.

- Boards will need to adopt revised amortized cost procedures to reflect the new requirements.

To assist you in understanding the proposed changes, we have prepared a marked copy of Rule 2a-7 showing the changes contained in the Amended Rule. Click here to view this marked copy.

Board Designation of Rating Agencies Put to Rest

Amendments to the Current Rule that became effective during 2010 included a provision requiring fund boards to designate at least four rating agencies as having ratings that are sufficiently reliable as the basis for certain credit quality determinations under the Current Rule. Boards were to have made this designation and disclosed it in the fund's statement of additional information by December 31, 2010, but the SEC staff has permitted funds to delay implementing this requirement, pending the SEC's implementation of the Dodd-Frank Act's directive to eliminate reference to ratings from rules.[8] With the adoption of the Amended Rule, the requirement that boards designate rating agencies is eliminated from the Amended Rule and will not become effective.

Implementation Timeline

The compliance date for the Amended Rule will be October 14, 2016 — the same compliance date for the floating net asset value, liquidity fee and redemption gate provisions of the July 2014 money market fund reforms.

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[1] See Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, Investment Company Act Release No. 31828, 80 Fed. Reg. 58124 (adopted Sept. 16, 2015).

[2] See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act Release No. 9193, Investment Company Act Release No. 29592, 76 Fed. Reg. 12896 (proposed Mar. 3, 2011); Money Market Reform, Investment Company Act Release No. 28807, 74 Fed. Reg. 32688 (proposed June 30, 2009); References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327, Advisers Act Release No. 2751, 73 Fed. Reg. 40124 (proposed July 1, 2008); Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Investment Company Act Release No. 26066 (June 4, 2003) (concept release).

[3] See Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, Investment Company Act Release No. 31184, 79 Fed. Reg. 47986 (proposed July 23, 2014). This release is discussed in the Fund Alert titled "What You Need to Know About Money Market Fund Reform — Ratings," available at http://www.stradley.com/insights/publications/2014/09/fund-alert-sept-2014.

The SEC also adopted amendments to the Rule on July 23, 2014, as part of its broader money market fund reform ("July 2014 Money Market Fund Reform"). These amendments are discussed in the Fund Alert titled "What You Need to Know About Money Market Fund Reform," available at http://www.stradley.com/insights/publications/2014/07/fund-alert.

[4] The July 2014 Money Market Fund Reform included other changes relating to the Rule's diversification provisions. In the same release as the ratings Re-Proposal, the SEC proposed a further tightening of the Rule's diversification testing, beyond the new diversification strictures included in the July 2014 money market fund reforms.

[5] NRSROs are credit rating agencies registered with the SEC under section 15E of the Securities Exchange Act of 1934, as amended. An NRSRO can be registered in one or more of five classes of credit ratings: financial institutions, brokers or dealers; insurance companies; corporate issuers; issuers of asset-backed securities; and issuers of government securities, municipal securities or securities issued by a foreign government.

[6] A "designated NRSRO" is an NRSRO that a money market fund's board of directors has designated for use and that issues credit ratings that the board determines, at least annually, are sufficiently reliable for the fund to use in determining the eligibility of portfolio securities. The requirement to designate NRSROs had been suspended, and has been eliminated in the Credit Rating Amendments.

[7] The technical revisions include:

(1) clarifying that a tax-exempt fund (other than a single state fund) is required to comply with Rule 2a-7(d)(3)(i)(A)(2) with respect to only 85 percent of its total assets,

(2) clarifying that the three-day safe harbor for issuer diversification should be read to apply to both subsections (1) and (2) of Rule 2a-7(d)(3)(i)(A); and

(3) clarifying that a single state fund is required to comply with the diversification limitation of Rule 2a-7(d)(3)(i)(B)(2) with respect to only 75 percent of its total assets, so long as not more than 15 percent of its total assets are invested in securities subject to guarantees or demand features provided by an institution as provided for in Rule 2a-7(d)(iii)(B).

[8] See Karrie McMillan, General Counsel, Investment Company Institute, SEC No-Action Letter (Aug. 9, 2010).

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