Amendments to Money Market Fund Regulations Mark Initial Steps in Fundamental Industry Changes

By Shanna Palmersheim, Esq. and Gwen C. Cooney

The dust is still settling from the 2007-2008 financial crisis, which profoundly impacted all aspects of the mutual fund industry. Nowhere, perhaps, was this impact more keenly felt than by money market funds, which experienced substantial losses as a result of their exposure to debt securities, the default of those securities and subsequent redemptions by shareholders.

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In an attempt to insulate money market funds from future turbulence, the **Securities and Exchange Commission (SEC)**, in consultation with the President's Working Group and industry leaders, reviewed existing regulations and proposed a series of amendments in June 2009. On Feb. 23, 2010, the SEC adopted several amendments to Rule 2a-7 under the Investment Company Act of 1940, and others (the Amendments) implementing permanent changes to the operation and regulation of money market funds. As a result of these changes, more resources will need to be devoted to credit research, risk management and administration, thereby increasing fund expenses in the short-term and further compressing portfolio yields.

The Amendments are designed to make money market funds more resilient and protect investors if a fund is unable to maintain a stable net asset value (NAV). Under Rule 2a-7, the Amendments will limit the risks funds may assume by, among other things, requiring them to increase the credit quality and reduce the maximum weighted average maturity (WAM) of their portfolios, and maintain liquidity buffers to help them withstand sudden redemption demands.

First, the Amendments (i) change the limit for money market funds' investments in "second tier securities" (generally defined as securities eligible to be purchased by a fund that, if rated, have received the second-highest rating from a nationally recognized securities rating organization (NRSRO)) from five to three percent; and (ii) lower the permitted concentration of total assets in second tier securities of a single issuer from the greater of one percent or $1 million to one-half of one percent. In addition, funds will not be permitted to acquire any second tier security with a remaining maturity in excess of 45 days, rather than the current 397 days.

Second, the Amendments reduce the maximum portfolio WAM permitted by Rule 2a-7 from 90 to 60 days. The Amendments also introduce a 120-day weighted average life (WAL) requirement, which takes into account the final maturity date of adjustable-rate securities, reflecting how a portfolio would react to deteriorating credit or tightening liquidity conditions.

Third, the Amendments limit the purchase of illiquid securities (those that cannot be sold or disposed of at carrying value within seven days) to no more than five percent of a fund's portfolio, reduced from 10 percent. The Amendments also require all taxable money market funds to hold at least 10 percent of their total assets in cash, U.S. Treasury securities or assets that convert to cash within one day. All money market funds are required to have a minimum of 30 percent of assets in cash, U.S. Treasury securities and certain other securities that convert to cash within one week. Further, the Amendments contain a general liquidity standard that requires a fund to hold sufficient liquid securities to meet foreseeable redemptions. In order to meet this requirement, funds must adopt policies and procedures designed to identify and monitor the risk characteristics of shareholders. Additionally, the Amendments require fund managers to stress test their portfolios against potential economic shocks such as sudden increases in interest rates, heavy redemptions and potential defaults.

Furthermore, the Amendments attempt to hold managers more accountable for the risks they take by providing that money market funds disclose timelier, more relevant information about their portfolios. Funds will be required to report the mark-to-market value of each fund's net assets to the SEC on a monthly basis with a 60-day delay. Funds must also post portfolio holdings on their websites monthly.

Finally, the Amendments provide a means to wind down the operations of a fund that breaks the buck or suffers a run in a way that is fair to the fund's investors and reduces the risk of market losses. Accordingly, the Amendments permit a fund to suspend redemptions without an SEC order if the fund is about to break the buck, in order to allow for an orderly liquidation.

Except as specifically indicated in the SEC's release, funds must begin to comply with the Amendments beginning May 28, 2010. Funds must meet the new maximum WAM and WAL limits by June 30, 2010, public website disclosure requirements by Oct. 7, 2010, and filing of mark-to-market information by Dec. 7, 2010.

The SEC has indicated that these reforms constitute only the first round of changes and that it will be adopting additional reforms later this year. Possible items for further reform include: floating NAV; mandatory in-kind redemptions for large investors; real-time disclosure of a fund's shadow price; participation in liquidity facilities; and a two-tier regulatory structure for stable NAV and floating NAV funds.

Although the outcome of future reforms is uncertain, it is clear that the regulatory landscape for money market funds will continue to evolve over the next year as funds and their service providers implement changes to their policies and procedures in order to comply with new regulations. MFSG

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