

## REGULATORY ADMINISTRATION DIGEST

A summary of mutual fund regulatory updates for the first quarter of 2011

## SEC Proposal Changes Standards for Money Market Fund Assessment of Portfolio Security Creditworthiness

In the near future, money market funds may rely less on credit ratings when making security quality determinations if rule amendments proposed by the Securities and Exchange Commission (SEC) are ultimately adopted. The proposed rule amendments, published by the SEC on March 2, 2011, removes references to credit ratings in certain rules under the Investment Company Act of 1940 (1940 Act) and replaces the ratings with alternative standards of creditworthiness. Among the rules the SEC proposes amending is Rule 2a-7 under the 1940 Act, which establishes quality, liquidity, maturity and diversification standards for money market fund portfolio investments.

The rule amendments are the latest in the SEC's efforts to give effect to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Among other things, Dodd-Frank directs the SEC to review regulations that require the use of credit ratings as an assessment of the creditworthiness of a security. SEC Chairman Mary L. Schapiro has described her agency's undertaking as an effort to "eliminate over-reliance on credit ratings . . . and encourage an independent assessment of creditworthiness."

**Rule 2a-7.** Under current Rule 2a-7, money market funds may invest in a limited universe of high-quality, short-term securities. Funds currently engage in a two-step analysis to determine which securities qualify for investment. First, the fund must determine if a security is an "eligible security", which generally is a security with a remaining maturity of 397 calendar days or less that has received a rating from a nationally recognized statistical rating organization ("NRSRO") in one of the two highest short-term rating categories -- "first tier" or "second tier." Second, the fund must evaluate the security to determine whether it presents minimal credit risks. Only securities that satisfy both criteria qualify as "eligible securities."

**Amendments to Rule 2a-7.** The rule amendments retain the two-step analysis currently used by funds to determine which securities may be included in portfolios, but significantly modifies step one of the analysis. Gone is the objective standard provided by NRSRO ratings, replaced with a subjective standard based on newly proposed criteria for determining if a security is a first tier security.

Specifically, the requirement that a security be rated by a NRSRO would be removed from the definitions of both eligible security and first tier security. In place of the ratings requirement, the rule amendments provide that the definition of a "first tier security" includes a security which the fund determines "has the highest capacity to meet its short-term financial obligations." The definition of second tier security – a security the fund has determined presents minimal credit risk, but does not qualify as a first tier security – would be unchanged.

In the near future, money market funds may rely less on credit ratings when making security quality determinations if rule amendments proposed by the Securities and Exchange Commission (SEC) are ultimately adopted.

*This Regulatory Administration Digest Newsletter is provided for informational and educational purposes only and is not accounting, legal or tax advice, opinion or a substitute for the advice of your legal counsel or other professional advisors..*



References to credit ratings would also be removed from Rule 2a-7's down-grade and default provisions. The rule amendments would require the fund to reassess a portfolio security if the fund's adviser (or other board delegate) becomes aware of credible information about the security or the issuer of the security suggesting that the security no longer meets the criteria of a first tier or second tier security.

While the rule amendments preclude reliance on NRSRO ratings solely, eligible securities must meet many of the quality criteria applied by NRSROs. In discussing application of the new standards, the SEC observed that "first tier securities would have to satisfy a standard similar to the credit quality standards that have been articulated by the credit rating agencies." In addition, the SEC anticipates that funds will continue to consider ratings by NRSROs and other outside sources the fund concludes are credible and reliable. When such sources are used, the SEC makes clear that it expects funds to:

- understand the source's method for determining the rating;
- make an independent judgment of credit risks, and
- consider the outside source's record with respect to evaluating the types of securities in which the fund invests.

**Other Amendments.** If adopted, the rule amendments will remove references to credit ratings from rules governing both securities collateralizing repurchase agreements and business and industrial development companies. In addition, the rule amendments are expected to remove references to NRSROs from Forms N-1A, N-2 and N-3 under the 1940 Act and the Securities Act of 1933 (1933 Act), and Form N-MFP under the 1940 Act. Funds that elect to disclose credit quality in their shareholder reports will not be required to provide credit ratings.

**Fund Policies and Procedures.** Funds may want to begin the process of reviewing their policies and procedures with respect to credit quality evaluation and monitoring in anticipation of the final rule adopting the rule amendments. Those funds that have robust policies and procedures will likely be able to rely on their current policies and procedures with limited, if any, modifications.

Public comments on the proposed rule amendments are due to the SEC on or before April 25, 2011.

## Deadline Passes for XBRL Implementation

As of January 1, 2011, all mutual funds are now required to use eXtensible Business Reporting Language (XBRL) in regulatory filings. Under rules adopted by the SEC in 2009, mutual funds must provide the risk/return summary section of their prospectuses in interactive data format using XBRL. Mutual funds must file the XBRL-tagged risk/return summaries with the SEC for all new funds and post-effective amendments filed on or after January 1, 2011, in addition to posting the data on the fund's website, if it has one. The XBRL-tagged data must be filed and posted on the fund's website subsequent to the filing of the related registration statement, but no later than fifteen days after its effective date.

As stated in the SEC's final rule release, special liability rules will apply to XBRL filings until October 31, 2014. Under new Rule 406T of SEC Regulation S-T, XBRL filings generally are subject to the same liability provisions as the related registration statement filing, including the anti-fraud provisions of Section 17(a)(1) of the 1933 Act; Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 (1934 Act); and Section 206(1) of the Investment Advisers Act of 1940. However, XBRL filings are deemed "not filed" for purposes of Sections 11 and 12 of the 1933 Act; Section 18 of the 1934 Act; and Section 34(b) of the 1940 Act. And, although XBRL files are deemed to be

As of January 1, 2011, all mutual funds are now required to use eXtensible Business Reporting Language (XBRL) in regulatory filings.



“filed” for purposes of Rule 103 of Regulation S-T, funds have no liability for electronic transmission errors beyond their control if the error is corrected through an amended filing as soon as reasonably practicable following its discovery. Amended Rule 405 under SEC Regulation S-T provides a non-exclusive safe harbor under which a correction made by the later of 24 hours or 9:30 a.m. EST on the next business day after the filer becomes aware of the problem is deemed “promptly” made. Following the October 31, 2014 expiration date of the special liability rules, XBRL filings will be subject to the same liability provisions as other filings.

Funds that fail to file or post the XBRL-tagged data as required will be automatically suspended from making further filings under Section 485(b) of the 1940 Act until the XBRL data is filed and posted. Failure to file or post XBRL data for one fund of a multi-fund family will automatically suspend the right to file under 485(b) for all funds in the family. Funds may submit a hardship request to the SEC in order to receive an exemption from filing, but the request must be completed in writing at least ten days prior to the filing and/or website posting date.

Also adopted in 2009, a separate amendment now requires all public companies to provide financial statement information in XBRL. For these companies, XBRL financial reporting has been phased-in beginning in 2009. Approximately 500 companies who file using U.S. Generally Accepted Accounting Principles (GAAP) with a public float above \$5 billion were required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2009. Other remaining domestic and foreign large accelerated filers using U.S. GAAP were required to file in 2010. All other filers, including companies reporting in IFRS, will be required to file XBRL tagged financial statements beginning for fiscal periods ending on or after June 15, 2011. As with mutual funds, all XBRL tagged documents will be included as exhibits to EDGAR-based SEC filings.

The XBRL mandate was intended not only to make financial statement and risk/return summary information easier for investors to analyze, but also to assist in automating regulatory filings and business information processing. According to the SEC, the use of interactive data will increase the speed, accuracy, and usability of mutual fund disclosure, and ideally reduce costs. Using XBRL, companies or mutual funds label all of the facts in a financial statement or risk/return summary with unique computer-readable “tags.” These tags operate like bar codes, making financial information searchable on the Internet and readable by spreadsheets and other software. XBRL-tagged data can then be downloaded directly into spreadsheets and analyzed in a variety of ways using commercial off-the-shelf applications. Using XBRL-tagged data, investors are now able to locate specific information disclosed by companies and mutual funds, and compare that information with other companies and mutual funds to help them make investment decisions.

The XBRL mandate was intended not only to make financial statement and risk/return summary information easier for investors to analyze, but also to assist in automating regulatory filings and business information processing.



## Regulatory Administration Group

For further information, contact:

Jose J. Del Real, Esq.

[jjd4@ntrs.com](mailto:jjd4@ntrs.com)

312.557.1441

Marcia Lucas, Esq.

[ml141@ntrs.com](mailto:ml141@ntrs.com)

312.557.3361

Shanna Palmersheim, Esq.

[sp141@ntrs.com](mailto:sp141@ntrs.com)

312.557.8746

Matthew Hancock

[mh141@ntrs.com](mailto:mh141@ntrs.com)

312.557.2013

Maria Ortiz

[meo3@ntrs.com](mailto:meo3@ntrs.com)

312.444.7077

Patrick M. Donofrio, Esq.

[pmd5@ntrs.com](mailto:pmd5@ntrs.com)

312.444.3535

Owen Meacham, Esq.

[otm1@ntrs.com](mailto:otm1@ntrs.com)

312.557.3948

Lana Lewandowski

[lm3@ntrs.com](mailto:lm3@ntrs.com)

312.444.5529

Alina Kucherenko

[ak181@ntrs.com](mailto:ak181@ntrs.com)

312.557.6503

**Regulatory Administration Digest is compiled by our Regulatory Administration Group.**

**© Northern Trust Corporation. All rights reserved.**

*This Regulatory Administration Digest Newsletter is provided for informational and educational purposes only and is not accounting, legal or tax advice, opinion or a substitute for the advice of your legal counsel or other professional advisors.*

*IRS CIRCULAR 230 NOTICE: To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. For more information about this notice, see*

*<http://www.northerntrust.com/circular230>*