

July 27, 2009

Memorandum to Our Mutual Fund Clients and Friends

SEC Proposes Reforms to Money Market Fund Regulations

Introduction

On June 24, 2009, the Securities and Exchange Commission (“SEC”) approved proposed amendments and new rules (the “Proposals”) under the Investment Company Act of 1940 (the “1940 Act”) to regulations governing money market funds (“MMFs”) and requested comments on significant issues relating to MMFs.¹ According to the SEC, the Proposals are designed to enable MMFs to be more resilient when encountering higher market risk and to provide greater protections for investors in an MMF that is unable to maintain a stable net asset value (“NAV”) of \$1.00 per share (commonly referred to as “breaking the buck”).²

This Memorandum begins with a brief overview of the proposed amendments and new rules followed by a more in-depth analysis of the Proposals. The Proposing Release includes numerous requests for comments and questions (approximately 300 requests and questions). In this Memorandum, we highlight some of the SEC’s concerns and requests for comments.

OVERVIEW

Proposed Amendments

Rule 2a-7: The Proposals would, among other things, amend Rule 2a-7 to:

- modify the definition of “eligible securities” to require MMF investments to be in the highest, rather than one of the two highest, nationally recognized statistical rating organizations (“NRSROs”) ratings category;
- eliminate MMF investments in second-tier securities;
- reduce an MMF’s weighted average maturity limits;
- eliminate an MMF’s abilities to acquire illiquid securities and set minimum daily and weekly liquidity requirements with different standards for “retail” and “institutional” MMFs;
- direct Boards to conduct periodic stress-testing of MMFs’ portfolios;
- require more frequent disclosures of portfolio holdings on an MMF’s website; and
- require an annual good-faith evaluation of an MMF’s ability to sell and redeem its shares.

Rule 17a-9: The Proposals would amend Rule 17a-9 to allow affiliated persons to purchase eligible securities from MMFs. (Such purchases are currently limited to securities that are no longer eligible securities.)

¹ *Money Market Fund Reform*, Investment Company Act Release No. 28807 (June 30, 2009) (the “Proposing Release”).

² A special committee of the Investment Company Institute issued a report on MMFs in March, 2009 (the “ICI Report”) recommending new standards for MMFs. With some modifications, many of these recommendations are included in the Proposals.

Proposed New Rules

Rule 22e-3: Proposed as a replacement to the current Rule 22e-3T, a new Rule 22e-3 would permit an MMF that has broken the buck to suspend its redemptions in order to liquidate in an orderly manner. Before an MMF could take advantage of this rule, its Board, including the majority of its independent directors, would have to approve the MMF's liquidation.

Rule 30b1-6: New Rule 30b1-6 would require MMFs to submit monthly electronic filings to the SEC with more detailed portfolio information.

Form N-MFP: This new Form would provide a format for filings under new Rule 30b1-6.

ANALYSIS

The Proposals

Portfolio Quality

The Proposals would limit MMF investments to first-tier securities, which would be redefined as "eligible securities". Eligible securities would include securities receiving the highest (rather than one of the highest two) ratings from the "requisite NRSROs". Eligible securities would no longer be divided into first and second tier securities.

- **Second Tier Securities:** The SEC determined to disallow MMF investments in second-tier securities because of the securities' weaker credit quality and potentially greater risks.
- **Long-term Securities Required to be Rated:** The Proposals would allow an MMF to invest in long-term securities with a remaining maturity of 397 days or less only if they have received long-term ratings in the one of highest two ratings categories.
- **Credit Reassessments:** An MMF's Board would only be required to perform a reassessment of an unrated security if, after its acquisition, the adviser becomes aware that an unrated security has received a rating from an NRSRO below its highest short-term rating category.

Some of the Questions and Concerns Raised by the SEC:

- Are there diversification or other concerns tied to eliminating second-tier securities from MMF portfolios?
- Acknowledging that the SEC had previously proposed eliminating NRSRO ratings from Rule 2a-7 and that most commenters had opposed this proposal, the SEC again requested comment on whether NRSRO references should be retained. The SEC posed many questions concerning NRSRO ratings. It stated that it was considering an approach under which an MMF's Board would designate (and review annually) three (or more) NRSROs that an MMF should look to for all purposes under Rule 2a-7 in determining whether a security is an eligible security. NRSRO ratings were the subject of much discussion at the SEC's open meeting considering the Proposals, with one SEC Commissioner apparently evidencing opposition to their continued presence in the Rule and another SEC Commissioner strongly supporting the continued use of NRSRO ratings.
- The SEC expressed concerns about MMF investments in asset-backed securities ("ABS"). The SEC noted that Rule 2a-7 does not specifically address how a Board should determine that an investment in ABS presents minimal credit risks. Its concerns were primarily based on MMF investments in structured investment vehicles ("SIVs"), which are a type of leveraged special purpose entity ("SPE") funded by the issuance of,

among other securities, commercial paper.³ MMFs with investments in SIVs faced issues with respect to the decreased market value of these securities and many required support from an affiliate to maintain a stable NAV and avoid breaking a buck.

Despite the disruptions for MMF investments being primarily related to SIV investments, which are now largely an historical anomaly, the SEC requested comment on whether parts of Rule 2a-7 should be revised to require Boards to assess specific risks posed by investing in ABS. For example, the SEC mentioned a limitation on MMFs investing in ABS whose payment is dependent on the ability of an SPE to roll over debt rather than being based on cash flows from underlying assets. Another alternative posed by the SEC was to require ABS to be subject to unconditional demand features in order to be eligible securities. The possibility that actions regarding ABS by the SEC could affect, and possibly limit, MMF investments in ABS could have significant implications for the commercial paper market generally because ABS represent a large portion of that market.

Portfolio Maturity

The Proposals would revise Rule 2a-7's maturity limits to reduce the exposure of MMF investors to, among other things, interest rate risk.

- **Weighted Average Maturity:** The Proposals would lower the maximum average maturity of an MMF from 90 to 60 days.⁴ The SEC is concerned that the current weighted average maturity limit of 90 days does not provide enough protection from market fluctuations, especially in the face of heavy redemptions. The SEC believes that portfolios with shorter maturities would be better able to withstand credit and interest rate spreads.
- **Weighted Average Life:** The Proposals would add a new maturity test to Rule 2a-7 that would ignore a security's interest rate reset dates and limit the weighted average life of an MMF's portfolio to 120 days or less. According to the SEC, this new maturity test would limit the extent to which an MMF could invest in longer-term securities, which may have more interest rate and credit spread risk.

Some of the Questions and Concerns Raised by the SEC:

- Would the decrease in weighted average maturity produce the desired decrease in portfolio volatility and an increase in an MMF's liquidity?
- What would be the effect of such changes on yields?
- Are there better ways to manage interest rate and credit spread risks?
- Should different maturity periods be considered, such as 45 or 90 days for average weighted maturity or 90 days or 150 days for the weighted average life?
- The SEC requested comment on whether the maximum maturity of individual non-Government securities should be reduced from 397 days to, for example, 270 days.

³ In the face of, among other things, liquidity issues due to disruptions in the commercial paper market, SIVs have wound down their operations and are currently considered a defunct model for ABS issuance.

⁴ The ICI Report recommended a maximum average weighted maturity of 75 days. The SEC determined that a shorter period was appropriate because, among other things, MMFs frequently extended maturities to capture higher yields thereby assuming greater risks and many MMFs maintain an average weighted maturity of 60 days or less.

Portfolio Liquidity

In light of the liquidity problems faced by MMFs beginning in September 2008, the SEC determined to revise Rule 2a-7 to incorporate daily, weekly, and general liquidity standards and eliminate investments by MMFs in illiquid securities. These requirements are intended to address liquidity risks and to improve MMFs' ability to meet significant redemption requests.

- **Prohibition on Acquisition of Illiquid Securities:** The Proposals would prohibit MMFs from acquiring securities unless, at the time of acquisition, the securities are liquid, which would be defined as securities that can be sold or disposed of, in the ordinary course of business, within seven calendar days at their amortized cost. This standard would replace current SEC guidance that permitted MMFs to invest up to 10% of their assets in illiquid securities. The prohibition on acquiring illiquid securities will have the effect of precluding MMFs from acquiring certain securities issued by highly-rated institutions, such as loan participations, insurance company funding arrangements and structured securities, or bank-issued certificates of deposit, which are backed by Federal Deposit Insurance Corporation insurance in amounts up to \$250,000. These securities are typically short-term but are technically illiquid, and are otherwise generally considered safe and highly desirable investments for MMFs. It is questionable whether the prohibition is necessary in light of the proposed new liquidity standards discussed below.⁵
- **Minimum Daily Liquidity Requirements:** The Proposals would impose minimum daily liquidity requirements on taxable MMFs (tax-exempt MMFs would not be subject to these requirements). These proposed requirements reflect several concerns. One is that MMFs typically undertake to redeem their shares daily or by the day following a redemption request, so adequate liquidity is important. Another is that market events in 2008 indicated that liquidity based on a secondary or dealer market could be an undependable source of liquidity. Perhaps the most important concern expressed by the SEC was that institutional investors redeemed their MMF shares rapidly in September 2008 leading to significant outflows from MMFs while retail investors tended to make more modest redemptions.
 - MMFs would be required to maintain daily liquid assets with the intent that they would then be less dependent on their ability to find buyers of securities to meet redemptions. Daily liquid assets would be defined as cash, direct obligations of the U.S. Government or securities that will mature or are subject to a demand feature that is exercisable within one day.
 - Under the Proposals, the minimum daily liquidity requirement for a “retail” MMF would be 5% of total assets. The 5% threshold would apply at the time of acquisition of each security and an MMF would not have to maintain the level at all times as long as the test was satisfied at the time of acquisition of the security. A “retail” MMF would be one that is not an “institutional” MMF, as described below.
 - The minimum daily liquidity requirement for an “institutional” MMF would be 10% of total assets.⁶ The SEC’s determination to set a different requirement for “institutional” MMFs is based on its concern that MMFs with institutional investors may be subject to greater redemption pressures. An “institutional” MMF would be one that the Board determined, no less frequently than once each calendar year, was an “institutional” MMF for the purposes of meeting the daily

⁵ The ICI Report did not recommend prohibitions on the acquisition of illiquid securities.

⁶ The ICI Report did not recommend distinguishing between retail and institutional MMFs.

liquidity requirements. A Board's determination would be based on an overall evaluation of the characteristics of an MMF, such as whether the MMF is intended to be offered to institutional investors or has the characteristics of an MMF that is intended to be offered to institutional investors (e.g., type of current investors, minimum investment amounts, and historical cash flows).

- **Minimum Weekly Liquidity Requirements:** Under the Proposals, all MMFs (including tax-exempt MMFs) would be required to meet minimum weekly liquidity requirements. The Proposals would retain the distinction between retail and institutional funds, requiring retail MMFs to have a minimum of 15% of total assets invested in weekly liquid net assets at the time of acquisition of any security and institutional MMFs to have a minimum of 30% of total assets so invested. Weekly net assets would include the same securities as daily net assets except that the requirement for maturing securities or demand features would be five business days instead of one business day.⁷
- **General Liquidity Requirement:** In addition to the daily and weekly liquidity requirements, the Proposals would impose on MMFs a general liquidity requirement by mandating that they hold enough highly liquid securities to meet all foreseeable redemption needs. In connection with the general liquidity requirements, the SEC stated that its belief that an MMF should have policies and procedures that would enable it to identify the risk characteristics of its shareholders, in particular those arrangements that lack transparency (e.g., shareholders holding their investments through omnibus accounts). The SEC did not propose amendments to Rule 2a-7 to require specific procedures based on its belief that they would be required by Rule 38a-1 (the "compliance rule") under the 1940 Act.
- **Stress Testing:** The Proposals would amend Rule 2a-7 to require MMF Boards that use the amortized cost method of valuation to conduct periodic stress tests of their portfolios. While the SEC plans on leaving the specifics to the Boards, it would require the tests to be reflective of such hypothetical events as an increase in short-term interest rates, an increase in redemptions, and the widening and narrowing of spreads between yields.

Some of the Questions and Concerns Raised by the SEC:

- The SEC requested comment on the effect of the proposed requirements on yield. Among the many issues posed by SEC's proposed approach to liquidity, imposing higher liquidity requirements on "institutional" MMFs would most likely reduce the yield of institutional MMFs. Institutions may tend to be unlikely to accept reduced MMF yields as they typically have ready access to other forms of liquid investments. This could lead to a substantial decrease in MMF investments and have a dramatic effect on MMFs because, as the SEC noted, institutions now comprise approximately 67% of MMF investors. In turn, these liquidity requirements could have an effect on retail MMFs by reducing economies of scale, resulting in higher expenses, and on the commercial paper market by reducing MMF investments. These proposals can be expected to elicit significant comments.
- Should different threshold percentages be considered or should retail and institutional MMFs be subject to the same threshold, such as the 20% weekly liquidity standard recommended in the ICI Report?
- The SEC also requested comment on its definition of "institutional" MMFs, which requires a Board determination. The SEC stated that differences in the liquidity

⁷ The ICI Report recommended a minimum weekly liquidity standard of 20% held in securities accessible in seven days. Similar to the daily liquidity standard, the ICI Report did not distinguish between retail and institutional MMFs.

management of “institutional” and “retail” MMFs suggested that MMF managers, and “perhaps” the Boards, currently understand the distinction, which the SEC implies led to its proposal. It would appear that, if the SEC deems it important that the distinction should be in Rule 2a-7, then the SEC should set specific standards for determining what an “institutional” MMF is, rather than imposing this difficult determination on an MMF’s Board. On the other hand, having the Board make this determination may allow more flexibility than would be provided by a SEC rule.

- What would be the impact on MMFs of not being able to buy illiquid securities?
- Should the SEC impose more specific standards with regard to general liquidity requirements?
- Will the stress test requirement, as proposed, allow managers to better understand and manage risks?

Repurchase Agreements

The Proposals would limit the “look-through” to collateral for repurchase agreements that are “collateralized fully” for the purposes of meeting Rule 2a-7’s diversification tests to repurchase agreements that are collateralized by Government securities or cash items, eliminating securities with the highest rating or unrated securities of comparable quality.⁸ This change is intended to make it less likely that an MMF would hold illiquid securities in the case of a counterparty default. The Proposals would also require that an MMF’s Board evaluate the creditworthiness of each repurchase agreement counterparty regardless of whether the repurchase agreement is collateralized fully.

Some of the Questions and Concerns Raised by the SEC:

- Would the proposed amendments reduce the potential losses if a counterparty defaults?
- Would these amendments have a negative impact on MMFs or yields?

Disclosure of Portfolio Information

The Proposals would require MMFs to disclose information about their investments each month on their websites. Additionally, under proposed new Rule 30b1-6, each MMF would be required to submit to the SEC electronically a more detailed monthly report on its portfolio holdings.

- **Public Website Posting:** The Proposals would add to Rule 2a-7 a requirement that all MMFs post schedules of their investments on their websites. Among other things, a posted schedule would have to include the name of the issuer of each security, the title of the issue, current amortized cost and the principal amount of the security. The schedule would have to be posted no later than the second business day of each month.
- **Reporting to the SEC:** Proposed new Rule 30b1-6 would require MMFs to file with the SEC monthly holdings reports on proposed new Form N-MFP. According to the SEC, the information elicited by Form N-MFP would enable it to create a central database of MMF information and enhance its oversight capabilities. The Form would be filed electronically on EDGAR in an eXtensible Markup Language. The report would be submitted no later than the second business day of each month. This information would be made publically available two weeks after its filing.

⁸ In a footnote in the Proposing Release, the SEC stated that, consistent with its prior interpretations, MMFs could enter into repurchase agreements that are not collateralized fully and that these agreements would be deemed an unsecured loan. According to the SEC, the loan would have to meet the Rule 2a-7 quality tests as well as the five percent diversification test.

- **Amendment to Rule 30b1-5:** In light of the proposed monthly reporting requirements under Rules 2a-7 and 30b1-6, the Proposals would eliminate the reporting requirements under Form N-Q (but not the reporting requirements of Form N-CSR, used to file shareholder reports and provide other information to the SEC). The controls, procedures, and certification requirements of Form N-Q would still apply.

Some of the Questions and Concerns Raised by the SEC:

- The SEC requested comment on the monthly portfolio disclosure requirement and asked whether MMFs should also be required to post on their websites their market-based NAV per share (referred to as “shadow pricing”). The SEC stated that shadow pricing disclosure would help investors understand an MMF’s exposure to distressed securities and the risk that an MMF may be unable to maintain a \$1.00 per share NAV. The SEC’s concerns related to, once again, institutional investors who may be able to discern market values from information posted on MMF websites. Making shadow pricing information available would, according to the SEC, “level the playing field”. Shadow pricing may vary, within narrow limits, for many reasons, such as changes in interest rates or market developments. These small changes are unlikely to be significant for the most part and, if they do represent potentially significant issues, MMFs typically adjust their portfolios to address the deviation. Yet investors, who may be unable to assess the information, could seek to redeem shares based solely on this information and cause a run on an MMF. The SEC requests comment on this possibility. This proposal is controversial and, at the SEC meeting, one Commissioner expressed significant reservations about whether disclosure of this information would benefit investors or MMFs.
- The SEC also requested comment on whether shadow pricing information should be provided in reports to the SEC on a public or non-public basis.
- Should MMFs be required to provide more frequent disclosure, either on their websites or to the SEC?
- Should any of the proposed disclosure requirements be omitted?

Processing of Transactions

The Proposals would amend Rule 2a-7 to require an MMF to determine, at least annually and in good faith, whether it has the procedures necessary to sell and redeem its securities at the price reflected in the MMF’s market NAV per share and not just at its stable \$1.00 NAV per share. This amendment is intended to require MMFs to have the operational ability to break the buck and continue to process transactions in an orderly manner.

Some of the Questions and Concerns Raised by the SEC:

- Should the Board be the one conducting the good-faith determination of the MMF’s ability to sell and redeem its securities or should Rule 2a-7 simply require that an MMF have this capability?
- Should the determination be more frequent or less frequent?

Exemption for Affiliate Purchases

The Proposals would expand Rule 17a-9 to allow MMFs to sell eligible portfolio securities to affiliated persons in addition to, as currently permitted, securities that are no longer eligible securities.

- **Expanded Exemptive Relief:** Under the proposed amendments to Rule 17a-9, MMFs would be permitted to sell to affiliated persons distressed or other eligible portfolio securities, provided the transaction requirements of the current Rule 17a-9 are met. If an affiliated person buys portfolio securities that have not defaulted, Rule 17a-9 would

require that the affiliated person remit to the MMF any profits they might make upon the resale of the security (a “claw-back”).

- **New Reporting Requirement:** Under the proposed amendments to Rule 2a-7, MMFs that sold securities to affiliated persons would have to notify the SEC of, and provide reasons for, the transaction.

Some of the Questions and Concerns Raised by the SEC:

- Should there be any additional conditions for protections against conflicts of interest?
- Is the claw-back provision necessary or fair?
- Should there be a defined time limit after which the claw-back should no longer apply?

MMF Liquidation

The Proposals include a new rule, replacing temporary Rule 22e-T, that would permit an MMF that has broken the buck to suspend its redemptions in order to liquidate in an orderly manner. Before an MMF can take advantage of this rule, its Board would have to approve the MMF’s liquidation.

- **Proposed Rule 22e-3:** New Rule 22e-3 would provide an exemption from Section 22(e) of the 1940 Act and permit an MMF to suspend redemptions if:
 - the MMF’s market NAV per share falls below its stable NAV per share,
 - the MMF notifies the SEC of its intention to suspend redemptions prior to the suspension, and
 - the Board, including the majority of independent directors, approves the liquidation of the MMF.
- **SEC Preservation:** New Rule 22e-3 would permit the SEC to rescind or modify the exemptive relief provided by the Rule (and require an MMF to resume honoring redemptions) if the plan of liquidation is not properly devised or executed.
- **Conduit Funds:** New Rule 22e-3 would provide certain conduit funds (*e.g.*, insurance company separate accounts) an exemption due to liquidation of an underlying MMF.

Some of the Questions and Concerns Raised by the SEC:

- Is it appropriate to allow MMFs that break the buck to suspend redemptions?
- Should new Rule 23e-3 include additional conditions, for example, should there be a specified limit on the suspension period?
- Should the Board be allowed to suspend redemptions temporarily under circumstances other than liquidation?⁹
- Would permitting temporary redemptions drive potential investors away or accelerate redemptions?

Other Requests for Comment About Significant Issues

Diversification

The SEC is seeking comments on whether it should impose stricter issuer and guarantor diversification limits under Rule 2a-7. The SEC stated that the current issuer diversification limits (5% in any one issuer) were not directly implicated in the crisis of 2008, but that guarantor

⁹ The ICI Report recommended that an MMF’s Board be allowed to suspend redemptions temporarily for up to five days if an MMF’s NAV was “materially impaired”.

diversification limits (10% in any one provider) were. For example, the SEC requested comment on whether the current issuer diversification test should be lowered from five percent to three percent.

The SEC also noted that MMFs were significantly exposed to investments in the financial sector in the fall of 2008 and that MMFs are not subject to any industry concentration limits under Rule 2a-7. Acknowledging the difficulties of industry definition, the SEC requested comment on whether MMFs should be subject to industry concentration limits.

Some of the Questions and Concerns Raised by the SEC:

- Would the quality of portfolio securities suffer if MMFs were required to meet lower diversification tests?
- Are distinctions among industry sectors clear enough to make concentration limits meaningful?

Floating Net Asset Value

In the Proposing Release, the SEC discusses issues concerning the use of the amortized cost method of valuation, which permits MMFs to maintain a stable NAV of \$1.00 per share. The SEC noted that the stable NAV was one of the “trademark” features of an MMF. Yet the SEC expressed concerns about the risks created by the stable \$1.00 NAV. For example, investors may have an incentive to redeem their shares when an MMF’s market value NAV is lower than \$1.00 per share, with unrealized losses attributable to redeeming shareholders being borne by the remaining MMF shareholders. The SEC discussed a list of additional negative consequences for such redemptions, including liquidity pressures and runs on MMFs resulting in fire sales of securities. Returning to its recurring theme, the SEC noted that institutional investors were more likely to be able to recognize and quickly take advantage of these pricing issues. The SEC also discussed that institutional investors could take advantage of instances where an MMF’s market NAV per share was greater than the stable \$1.00 per share. As a solution to these problems, the SEC requested comment on whether it should eliminate the use of the amortized cost method of valuation.

Some of the Questions and Concerns Raised by the SEC:

- Would this change produce a more stable investment vehicle in the money markets?
- Would it make the risks inherent in MMFs more transparent?
- Would the shift towards a floating net asset value encourage investors to move their assets from MMFs to bank accounts, unregulated offshore funds or other investments?
- What impact might such a change have on the short-term credit markets and issuers of short-term securities?

In-Kind Redemptions

Returning once again to its concern about the ability of large institutional investors to make rapid redemptions, posing a threat to a stable NAV and disadvantaging remaining shareholders, the SEC requested comment on requiring redemptions in excess of a certain size to be made in-kind. According to the SEC, such an approach would reduce the effect of large redemptions on other shareholders in an MMF and transfer the liquidity risk of selling securities to the redeeming shareholder.

Some of the Questions and Concerns Raised by the SEC:

- What would be the advantages and disadvantages of such an approach?
- What is the appropriate threshold redemption request for redemptions to be made in-kind?

- Should there be different thresholds for affiliated shareholders of an MMF or other restrictions on affiliate redemptions?
- How should an MMF determine the value of securities that are to be distributed in-kind?

CONCLUSION

The SEC's Proposals and requests for comments about significant MMF issues could result in significant changes to the MMF regulatory landscape and have consequences for the financial industry generally. If adopted, the Proposals are likely to result in increased MMF expenses and reduced yields. The proposed changes would affect institutional and retail investors and impose additional responsibilities on an MMF's Board. We expect that the SEC will receive many comments on the Proposals.¹⁰

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If you have any questions or need more information, please contact Bob Walder at (212) 574-1451 or Kathleen Clarke or Paul Miller at (202) 737-8833.

¹⁰ All comments should be submitted to the SEC on or before September 8, 2009. All submissions should refer to File Number S7-11-09. Comments may be submitted electronically at: <http://www.sec.gov/rules/proposed.shtml>; rule-comments@sec.gov; or <http://www.regulations.gov>. Alternatively, paper comments may be submitted in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.