

March 9, 2010

Memorandum to Our Clients and Friends

SEC Adopts Reforms to Money Market Fund Regulations

Introduction:

On January 27, 2010, the Securities and Exchange Commission (“SEC”) adopted amendments to Rule 2a-7, new rules and forms and other rule amendments (“new rules”) applicable to money market funds (“MMFs”) under the Investment Company Act of 1940 (“1940 Act”).¹ According to the SEC, the new rules are designed to enable MMF’s to be more resilient when encountering higher short-term 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”).

The new rules were adopted substantially as proposed, with a few modifications as discussed below.² The SEC noted in the Adopting Release, and echoed at the open meeting, that it is continuing to evaluate the MMF rules, particularly with respect to whether MMF’s should not be allowed to use the amortized cost method of valuation that enables them to maintain a stable “NAV” and instead move to a “floating NAV”. The SEC expects to issue a release proposing further reforms.

Effective Date: The effective date for the new rules is May 5, 2010.

Compliance Dates: The general compliance date for the new rules is May 5, 2010. There are varying compliance dates for specific aspects of the new rules. Attached as an Appendix is a table setting forth these compliance dates.

Discussion

1. Portfolio Quality

The new rules will continue to limit MMF investments to “eligible securities”, which are securities that have been rated in either of the highest two short-term debt rating categories from the relevant NRSROs or are of comparable quality. Eligible securities will continue to be divided into first and second tier securities.³

- **Second Tier Securities:** Rather than eliminating MMF investments in second tier securities, as proposed, the SEC determined to continue to allow MMF’s to invest in these securities, citing certain benefits of such investments, although at the following reduced levels to take account of the securities’ weaker credit quality and potentially greater risks.

¹ *Money Market Fund Reform*, Investment Company Act Release No. 29132 (Feb. 23, 2010) (the “Adopting Release”). The SEC proposed the amendments and new rules on June 24, 2009. *Money Market Fund Reform*, Investment Company Act Release No. 28807 (June 30, 2009).

² We have not included citations to amended Rule 2a-7 in this Memorandum because of the complexity of citations in that rule. A version of Rule 2a-7 marked to show the amendments is available at the SEC’s web site at www.sec.gov/rules/final.shtml.

³ The SEC determined not to adopt, as proposed, the requirement that long-term securities with remaining maturities of less than 397 days have received long-term ratings in the one of highest two ratings categories and retained the current requirement that they be rated in the highest three categories.

- The amount of permissible MMF investments in second tier securities is reduced from five to three percent of total assets. This requirement applies to all MMF's, including tax-exempt MMF's.
- The amount of second tier securities that can be invested in any one issuer is reduced from one percent of total assets or \$1 million, whichever is greater, to one-half of one percent of total assets.⁴
- An MMF's acquisition of second tier securities is limited to those securities with remaining maturities of 45 days or less.
- **Designated NRSROs:** The new rules require that the board of directors of an MMF (the "board") designate four or more NRSROs whose short-term ratings will be used by the MMF in determining if a security is an eligible security. The Board must determine at least once each calendar year that the designated NRSROs issue credit ratings that continue to be reliable. The designated NRSROs must be disclosed in an MMF's statement of additional information ("SAI").

NRSRO ratings continue to be a controversial issue and have been eliminated from certain other SEC rules. The SEC had proposed several alternatives relating to NRSROs, including the new rule, but also including elimination of the NRSRO standard. Most commenters were opposed to such an approach. At least one SEC Commissioner continues to believe that NRSRO ratings should be eliminated from Rule 2a-7. The SEC cited the utility of the use of NRSRO ratings as a threshold investment criterion. The SEC also believed that the designated NRSRO rule would foster competition among NRSROs to produce reliable ratings. It could be argued that the new rule will be anti-competitive because all MMFs will tend to choose the largest, most well-known NRSROs as their designated NRSROs, but it remains to be seen how the new rule will work in practice.⁵

- **Asset-Backed Securities ("ABS"):** The new rules eliminate the requirement that an ABS receive a rating from an NRSRO in order to be an eligible security. Thus, an unrated ABS may be an eligible security under the same standards applicable to the other unrated securities, *i.e.*, determined by the Board (or its delegate) to be of comparable quality. Under the circumstances affecting certain ABS in 2008-2009, the SEC noted that NRSRO ratings did not appear to serve a role as a threshold criterion that justified requiring all ABS to have an NRSRO rating.⁶

⁴ Similar to the maximum amount limitation, these second tier issuer diversification limitations also apply to tax-exempt MMFs, which are currently subject to this limit only for conduit securities, and to single state MMFs. In addition, the new rules reduce the issuer diversification limits for second tier issuers of "demand features" and "guarantees" from 5% to 2.5% of total assets. The limit for issuers of demand features and guarantees is higher than for a single issuer because, according to the SEC, an MMF has recourse to both the issuer of the security and the issuer of the demand feature or guarantee.

⁵ The use of designated NRSROs will affect issuers of securities as well as MMFs. Issuers will likely seek to have their securities rated by NRSROs that are most likely to be selected as designated NRSROs by a majority of MMFs in order not to exclude their securities from being eligible investment for MMFs. MMFs will likely use the most commonly used NRSROs to avoid reducing the availability of potential investments. For these and other reasons, the designated NRSRO provision would appear to have more anti-competitive results than competitive effects.

⁶ The SEC noted that a Board's minimal risk analysis for ABS investments should (i) analyze the underlying ABS assets to ensure they are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS under various market conditions; (ii) analyze the terms of any liquidity or other

2. Portfolio Maturity

The new rules, as proposed, revise Rule 2a-7's maturity limits to reduce the exposure of MMFs to, among other things, interest rate risk.

- **Weighted Average Maturity (“WAM limits”):** The new rules lower the maximum average maturity of an MMF from 90 to 60 days.
- **Weighted Average Life (“WAL limits”):** The new rules add a new maturity test to Rule 2a-7 that will limit the weighted average life of an MMF's portfolio to 120 days or less.

3. Portfolio Liquidity

The new rules, as proposed, incorporate general liquidity standards and minimum daily and weekly liquidity requirements.

- **General Liquidity Requirement:** The new rules impose a general liquidity standard on MMFs by requiring that they hold enough highly liquid securities to meet all foreseeable redemption needs. In connection with the general liquidity requirements, the SEC stated MMFs should adopt policies and procedures to address the risk characteristics of their investors and their likely redemptions. The SEC did not adopt 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.
- **Illiquid Securities:** The SEC did not adopt its proposal to prohibit MMFs from acquiring illiquid securities citing the objections of many commenters. Instead, the new rules limit the acquisition of illiquid securities to no more than 5% of total assets, replacing the current SEC guidance limiting such investments to 10%. Illiquid securities are defined as securities that can not be sold or disposed of, in the ordinary course of business, within seven calendar days at approximately the value ascribed to them by the MMF.⁷
- **Minimum Daily and Weekly Liquidity Requirements:** The new rules impose minimum daily and weekly liquidity requirements on MMFs. These requirements will apply at the time a security is purchased.⁸ The SEC determined not to adopt, as proposed, separate liquidity standards for “retail” and “institutional” MMFs, citing, among other things, the difficulties in identifying an effective way to distinguish between the types of MMFs.
 - **Minimum Daily Liquidity Requirement.** The new rules require all taxable MMFs to hold at least 10% of their total assets in daily liquid assets, determined at the time of acquisition of a security.⁹ Tax-exempt MMFs will not be subject to these requirements). Daily liquid assets are defined as cash, direct obligations of the U.S. Government (not limited to Treasury securities as proposed), or securities

support provided by the sponsor (presumably third party credit support); and (iii) otherwise perform the legal structural and credit analysis to determine that an ABS involves appropriate risks.

⁷ The SEC had proposed to define an illiquid security with respect to the security's amortized cost. As adopted, the definition provides an MMF with more flexibility because it can use the shadow price (market-based value) of a security, which may or may not be its amortized cost, to determine whether the security is illiquid.

⁸ An MMF that does not meet the minimum daily or weekly liquidity standards will not be in violation of Rule 2a-7, but would not be permitted to acquire any securities other than daily or weekly liquid assets until the minimum requirements are reestablished.

⁹ The SEC adopted a definition of “total assets” in the new rules, which are, for MMFs using the amortized cost method, the total amortized cost of its assets.

that will mature or are subject to a demand feature that is exercisable within one day.

- Minimum Weekly Liquidity Requirement. The new rules require all MMFs (including tax-exempt MMFs) to hold at least 30% their total assets in weekly liquid assets, determined at the time of acquisition of a security. Weekly liquid assets are defined in the same manner as daily liquid assets are defined except that they must mature, or be subject to a demand feature that is exercisable, within five days.
- **Stress Testing:** The new rules require an MMF's Board that uses the amortized cost method of valuation to adopt procedures providing for periodic stress testing of its portfolio based on certain hypothetical events. The new rules specify that these events include, but are not limited to, a change in short-term interest rates, an increase in shareholder redemptions, and the widening and narrowing of spreads between yields on an appropriate benchmark that the MMF has selected for overnight interest rates and commercial paper and other securities held by the MMF. The new rules require a report to the Board on the results of such tests at its next regularly scheduled meeting or, if appropriate, sooner.

4. Repurchase Agreements

The new rules, as proposed, 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 U.S. Government securities or cash items, eliminating as a category of permissible collateral securities with the highest rating or unrated securities of comparable quality. The new rules will also require that an MMF’s Board evaluate the creditworthiness of each repurchase agreement counterparty for the purposes of the look-through. An MMF would continue to be able to enter into repurchase agreements collateralized by other types of assets, but will not be able to look through to the underlying collateral for diversification purposes.

5. Disclosure of Portfolio Information

- **Public Website Posting:** The new rules require MMFs to post schedules of their investments on their websites.
 - Information Required. Rather than referring to the portfolio holdings schedule in Regulation S-X, as proposed, the new rules specify the type of information required. The schedule will have to include the name of the issuer; the category of investment; the CUSIP number, if any; the principal amount; the maturity date and the final maturity date, if different; coupon or yield; and current amortized cost. The schedule also requires disclosure of the MMF’s weighted average maturity and weighted average life.
 - Timing of Posting. The new rules require the schedule to be posted, current as of the last business day of each month, no later than the fifth (rather than the second, as proposed) business day after the month end.
 - Maintenance of Information. The schedule must be maintained on the website for no less than six months (rather than twelve months, as proposed) after posting.
- **Reporting to the SEC:** New Rule 30b1-6 requires 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 will enable it to create a central database of MMF information and enhance its oversight capabilities.¹⁰

- Information Required. The new rules require much more extensive information than the public website posting, including shadow pricing information.¹¹
- Timing and Public Availability. Form N-MFP will be required to be submitted no later than the second business day of each month. This information will be made publically available 60 days after the end of the reporting period (rather than two weeks, as proposed, to address concerns, in particular, about disclosure of shadow pricing information). The SEC stated in the Adopting Release that it may revisit the delayed public availability provision because investors and analysts may become accustomed to the information. Presumably, this means that they will better understand the information provided in the Form so that, if it becomes available on a more timely basis, MMF concerns over, among other things, overreaction to the small deviations in shadow pricing, would be reduced.
- Filing Procedure. Form N-MFP will be required to be filed electronically on EDGAR in an eXtensible Markup Language.

6. Processing of Transactions

The new rules, as proposed, require an MMF (or its transfer agent) 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.

7. Exemption for Affiliate Purchases

The new rules, as proposed, expand Rule 17a-9 under the 1940 Act to allow MMFs to sell eligible portfolio securities to affiliated persons in addition to, as currently permitted, securities that are no longer eligible securities. If an affiliated person buys portfolio securities that have not defaulted, Rule 17a-9 will require that the affiliated person remit to the MMF any profits the person might make upon the resale of the security (a "claw-back"). In addition, MMFs that sell securities to affiliated persons would have to notify the SEC of, and provide reasons for, the transaction.

8. MMF Liquidation

The new rules 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

¹⁰ In connection with the adoption of the new SEC reporting requirement, the SEC adopted as final Rule 30b-1-6T, which was a temporary rule requiring the filing of portfolio information by MMFs under certain circumstances. As adopted, the rule will expire on December 1, 2010, which is the first reporting date for the new SEC reporting requirements.

¹¹ This information includes: (i) the name of the issuer; (ii) the title of the issue, including the coupon or yield; (iii) the CUSIP number; (iv) the category of the investment; (v) the NRSROs designated by the MMF, the credit ratings given by each NRSRO, and whether each security is first tier, second tier, unrated or no longer eligible; (vi) the maturity date as determined under Rule 2a-7; (vii) the final legal maturity date; (viii) whether the instrument has certain enhancement features; (ix) the principal amount; (x) the current amortized value; (xi) the percentage of the MMF's assets invested in each security; (xii) whether the security is illiquid; and (xiii) explanatory notes. MMFs will also have to report information about risk characteristics, such as WAM and seven-day gross yield. Finally, MMFs will have to report the market-based values of each security, or shadow pricing, and the market-based NAV.

Board (including a majority of independent directors) will have to irrevocably approve the MMF's liquidation.

- **New Rule 22e-3:** The new rule will provide an exemption from Section 22(c) of the 1940 Act and permit an MMF to suspend redemptions if:
 - the Board determines that the extent of the deviation between the MMF's amortized cost per share and its shadow price may result in material dilution or other unfair results to investors and shareholders (as proposed, the standard was breaking the buck), and
 - the MMF notifies the SEC of its intention to suspend redemptions prior to the actual effective date of the suspension.
- **SEC Preservation:** The new rule 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:** The new rule will provide certain conduit funds (*e.g.*, insurance company separate accounts) an exemption form Section 22(e) due to an underlying MMF suspending redemptions.

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If you have any questions or need more information about the new rules, please contact:

Kathleen Clarke	clarke@sewkis.com	(202) 737-8833
Paul Miller	millerp@sewkis.com	(202) 737-8833
Bibb Strench	strench@sewkis.com	(202) 737-8833
Bob Walder	walder@sewkis.com	(212) 574-1451

Compliance Date Appendix

<u>New Rule Amendments, Reporting Requirements, and Other Rules</u>	<u>Compliance Date</u>
1. Portfolio Quality	
- Second Tier Securities	May 28, 2010
- Designated NRSROs	December 31, 2010 (Disclosure in SAI is required by this date.)
- ABS	May 28, 2010
2. Portfolio Maturity	
- WAM limits	June 30, 2010
- WAL limits	June 30, 2010
3. Portfolio Liquidity	
- General Liquidity Requirements	May 28, 2010
- Illiquid Securities	May 28, 2010
- Minimum Daily and Weekly Liquidity Requirements	May 28, 2010
- Stress Testing	May 28, 2010
4. Repurchase Agreement Requirements	May 28, 2010
5. Disclosure of Public Information	
- Public Website Disclosure	October 7, 2010
- Reporting to the SEC	December 7, 2010 (An MMF may report earlier on a voluntary, non-public basis beginning October 7, 2010.)
6. Processing of Transactions	October 31, 2011
7. Exemption for Affiliate Purchases	May 5, 2010
8. MMF Liquidations	May 5, 2010