INVESTMENT COMPANY INSTITUTE

History of Rule 2a-7—The Evolution of Money Market Fund Regulation

As of March 1, 2012

I. Introduction

Some have suggested that the regulation of money market funds is the single greatest success story in the history of financial services regulation.[1] Money market funds serve as an important source of direct financing for governments, businesses and financial institutions, and of indirect financing for households. Without these funds, financing for all these institutions and individuals would be more expensive and less efficient. Yet this product would never have achieved its full potential without the flexible and resilient regulatory structure created by the Investment Company Act of 1940 (Investment Company Act).

Many fundamental features of today's investment companies—including some of the features essential to the success of money market funds—are prohibited by the Investment Company Act and owe their existence to the exercise of exemptive authority by the Securities and Exchange Commission (SEC or Commission). For example, the Investment Company Act and applicable rules generally require mutual funds to calculate current net asset value (NAV) per share by valuing their portfolio securities for which market quotations are readily available at market value and other securities and assets at fair value as determined in good faith by the board of directors.[2] Rule 2a-7 under the Investment Company Act exempts money market funds from these provisions and permits the valuation of their shares at par. As detailed below, the history of Rule 2a-7 could be characterized as a periodic rebalancing of the demand for a liquid, low-fee, stable-value investment against the credit and market risks that could result in a fund breaking a dollar. The trend has been a continual reduction in the risks permitted in the face of an increasing demand for the funds.

The first money market fund was offered to investors in 1971. By the end of 1974, "[t]otal assets under management [in money market funds] … amounted to $2[.]434 billion constituting approximately 7.2 percent of the assets managed by the industry generally (compared to 0.2 percent as of December 31, 1973)."[3] Figure 1 illustrates the principal reason for the early popularity of money market funds. From the introduction of money market funds through the mid-1980s, the Federal Reserve's Regulation Q limited the maximum rate that could be paid on passbook savings accounts and prohibited the payment of interest on demand accounts.[4] In contrast, the yield on short-term

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[1] *See e.g.*, Rulemaking Petition from Fund Democracy, Consumer Federation of America, Consumer Action, AFL-CIO, Financial Planning Association, and National Association of Personal Financial Advisers to Nancy M. Morris, Secretary, Securities and Exchange Commission (January 16, 2008).

[2] *See* Section 2(a)(41) of the Investment Company Act and Rules 2a-4 and 22c-1 under that Act.

[3] *Proposal Concerning Valuation of Short Term Debt Instruments Owned by Registered Investment Companies Including Money Market Funds,* SEC Release No. IC-8757 (April 15, 1975), 40 FR 18467 (April 28, 1975) at n.1.

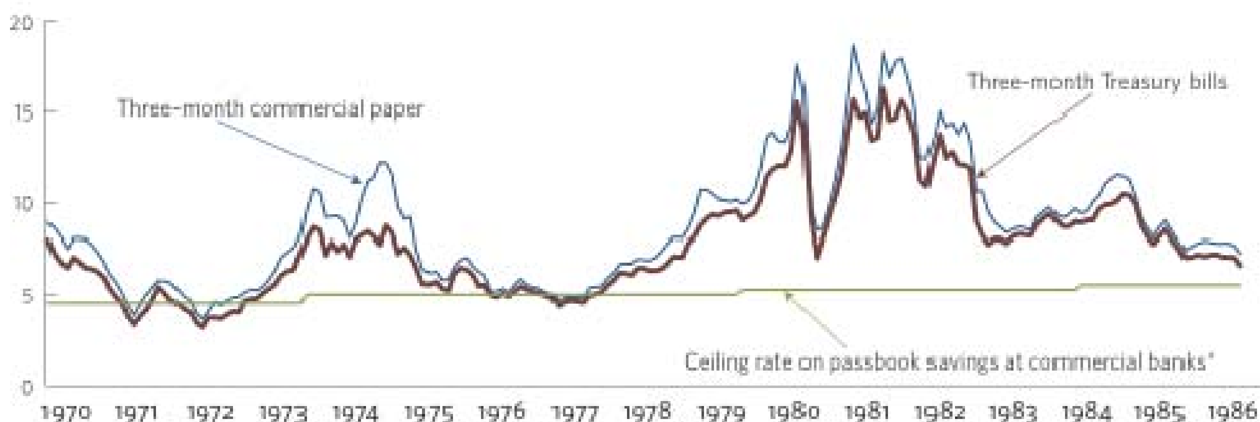
[4] As shown in Figure 1, the maximum permitted rate on thrift passbook accounts increased slowly during the period, from 5 percent to 5.25 percent and eventually 5.5 percent. The maximum rate for bank passbook accounts was 0.25 percent lower.

U.S. Treasury securities during most of this period was well above the maximum passbook rate. As shown in Figure 1, the yield on Treasury Bills (T-Bills) exceeded the maximum passbook rate throughout 1973 and 1974. Moreover, from late 1979 through 1982, T-Bills had double-digit yields, often more than twice the maximum passbook rate.

FIGURE E.1

Annual Yields on Commercial Paper, Treasury Bills, and Passbook Savings

Percent, monthly



*Ceiling rates were phased out by March 1986.

Sources: Federal Reserve Bank of St. Louis and Federal Reserve Board

Other low-risk short-term instruments, such as commercial paper and jumbo certificates of deposit, offered even higher yields. All of these instruments, however, had minimum denominations beyond the reach of the average investor (*e.g.*, $10,000 for T-Bills or $25,000 for commercial paper). Their short terms also required frequent reinvestment. Money market funds provided a conduit through which smaller investors could gain access to these higher-yielding investments. For institutional investors, money market funds provided better liquidity and greater diversification than direct investments in these instruments, creating a more efficient means of cash management. In addition, money market funds served an important role for the economy that other financial products did not fulfill. By investing across a spectrum of money market instruments, money market funds provided a vast pool of liquidity to the U.S. money market.

Thus, the first decade following the introduction of money market funds provided almost ideal conditions for their growth. Although banks and thrifts eventually developed higher-yielding products to compete with money market funds, none of their offerings could match the combination of yield, stability and daily liquidity that these funds offered.

II. Methods of Maintaining a Stable Net Asset Value

The first money market fund initially offered its shares for a price of $1.00 and then calculated its NAV each day, rounding the price to the nearest cent. This is known as the “penny-rounding” method of maintaining a stable NAV

per share. The penny-rounding method helps maintain a stable NAV by making the share price less sensitive to changes in the market value of the fund's portfolio.[5]

A second type of registered money market fund, which used the amortized cost value of its portfolio securities to calculate its NAV, was introduced in 1974.[6] Money market funds use "amortized cost" to account for the difference between the cost of a security (*i.e.*, its purchase price) and the amount payable at maturity. Under the amortized cost method, an investment is valued initially at its cost. The fund then adjusts the amount of interest income accrued each day over the term of the investment to account for any difference between the initial cost of the investment and the amount payable at its maturity. If the amount payable at maturity exceeds the initial cost (a discount), then the daily accrual is increased; if the initial cost exceeds the amount payable at maturity (a premium), then the daily accrual is decreased.[7] The fund adds the amount of the increase to (in the case of a discount), or subtracts the amount of the decrease from (in the case of a premium), the investment's cost each day, so that, when the instrument matures, its adjusted cost will equal the amount payable at maturity. The fund uses this adjusted cost to value the investment each day.

Although rarely noted, another important practice of both penny rounding and amortized cost money market funds is the daily declaration of dividends equal to the funds' net accrued income. Accrual of income increases the assets of any investment company; without an offsetting increase in liabilities, this necessarily results in an increase in the company's net assets and an increase in NAV. Dividends, once declared, however, represent liabilities that the company owes to its shareholders. Thus, by declaring dividends to offset each day's accrued income, a money market fund prevents a buildup in undistributed income that could eventually affect its stable NAV.[8]

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[5] Traditionally, mutual funds offered their shares at an initial price of $10.00 and calculated their daily NAV to the nearest cent per share. Under these circumstances, a change of 0.05 percent or more in the value of the portfolio will result in a change in the NAV. If the initial share price is $1.00, however, the value of the portfolio must change by at least 0.50 percent to change a NAV calculated to the nearest cent. In other words, a fund with a $1.00 NAV using the penny-rounding method is one-tenth as sensitive to changes in the value of its portfolio as a fund with a standard $10.00 NAV. There was precedent for using an initial offering price of less than $10.00 a share prior to the introduction of money market funds, with some funds starting as low as $2.00 per share.

[6] This type of money market fund relied on a determination by the fund's board of directors that amortized cost represented the "fair value" of its portfolio securities. Section 2(a)(41) of the Investment Company Act requires that the board determine in good faith the "fair value" of a fund's securities and assets unless "market quotations are readily available… ." As the Commission has noted, "[m]arket quotations are not readily available for many money market instruments … because they are generally held to maturity, thereby eliminating a meaningful secondary market." Release No. 8757, *supra* note 3, at text preceding n.4. Given the short maturity and high quality of these instruments, many boards concluded in good faith that amortized cost provided the best measure of their fair value.

[7] These adjustments to accrued income also prevent money market funds from over- or under-distributing their income. By amortizing premiums to reduce income, the fund retains sufficient cash to compensate for the shortfall between the premium paid for the instrument and the amount received at maturity. By accreting discounts to increase income, the fund distributes sufficient cash to avoid realizing an apparent gain when the discount is paid at maturity.

[8] Daily dividends also play an important role in preventing dilution to money market fund shareholders through systematic arbitrage. If a money market fund allowed undistributed income to accrue while maintaining a stable NAV, shareholders who bought shares of the fund just before a dividend was declared would receive a share of the income previously earned without paying for it, at the expense of shareholders who had held shares throughout the entire period.

III. Regulation of Money Market Funds before Adoption of Rule 2a-7

When money market funds were first introduced, their regulation was limited to the SEC registration process. Technically, a fund could employ the penny-rounding method simply by offering its shares at an initial price of $1.00 rather than the traditional $10.00. A fund using the amortized cost method also might disclose that its board of directors could employ this method to determine the fair value of the fund's securities. In addition, both types of funds generally made reference to the conservation of principal or the maintenance of a stable value in their investment objectives, and disclosed investment strategies and limitations consistent with this objective. In fact, until the SEC announced in 1977 a new interpretation of the valuation requirements of the Investment Company Act, none of the money market funds sought exemptions as a condition of offering their shares to the public.

A. Accounting Series Release No. 219 and the Early Exemptive Orders

The SEC first raised questions regarding the use of the amortized cost method in a 1975 proposal to issue an interpretive release. Citing various deficiencies of amortized cost valuation, including the SEC's belief that it is "undesirable to determine value by a mechanical or automatic formula with no reference to market value and no judgmental input on the part of the directors," the SEC asked for comments on an interpretation of the Investment Company Act that would discontinue the use of amortized cost as a method of fair valuing securities.[9] At the time, "[t]hirty-six money market funds had effective registration statements … with 12 more in the process of registration."[10]

After reviewing the comments, the SEC issued an interpretive release regarding money market funds in May 1977.[11] The release interpreted the Investment Company Act's definition of "value" and Rule 2a-4 so as to effectively preclude money market funds from using the amortized cost or the penny-rounding method of calculating their NAVs. Three statements were particularly detrimental to money market funds:

1. "The Commission … concluded that it shall prospectively consider it inconsistent with the provisions of Rule 2a-4 for a money market fund to determine the fair value of debt securities which mature at a date more than 60 days subsequent to the valuation date on an amortized cost basis."

2. "The Commission believes that money market funds … should value debt securities with greater than 60 days remaining to maturity based upon current market quotations if readily available or, if such quotations are not readily available, in such a manner as to take into account any unrealized appreciation or depreciation due to changes in interest rates and other factors which would influence the current fair values of such securities."

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9 Release No. 8757, *supra* note 3, at text preceding n.6.

10 *Id.* at n.1.

11 *Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies,* SEC Release No. IC-9786, Accounting Series Release No. 219 (May 31, 1977) (ASR 219).

3. "The Commission believes that any money market fund which reflects capital changes in its net asset value per share should calculate, and utilize for purposes of sales and redemptions, a current net asset value per share with an accuracy of one-tenth of one percent (equivalent to the nearest one cent on a net asset value of $10.00)."[12]

The first two conclusions effectively prevented a money market fund from continuing to use the amortized cost method to value its entire portfolio. The third conclusion prevented a money market fund from continuing to use the penny-rounding method to calculate its NAV.

Many money market funds responded to ASR 219 by filing applications for exemptive orders that would permit the funds to continue utilizing either the penny rounding or amortized cost method.[13] In November 1977, the SEC issued a temporary order granting exemptions while it determined whether to hold hearings on the applications.[14] In April 1978, the SEC issued an order for a consolidated hearing on the money market fund applications.[15] Prior to commencement of the evidentiary portion of the hearings, however, the funds seeking to use the penny-rounding method reached an agreement with the Division of Investment Management (Division). After these funds amended their applications to address the SEC's concerns regarding the manner of valuing assets and pricing shares, the SEC granted orders permitting these funds to continue to maintain a stable NAV using the penny-rounding method.[16]

The basic conditions to the penny-rounding exemptive orders made a money market fund's board of directors (Board) responsible for ensuring that the fund's price per share, as rounded, would be $1.00, and provided the first risk-limiting restrictions on the management of a money market fund's portfolio:

1. The Board undertook—as a particular responsibility within the overall duty of care owed to its shareholders—to assure to the extent reasonably practicable, taking into account current market conditions, that the fund's price per share as computed for the purpose of distribution, redemption and repurchase, rounded to the nearest one cent, would not deviate from $1.00;

2. The fund would maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable price per share, and would not (a) purchase an instrument with a remaining matur-

[12] Notwithstanding ASR 219, the SEC has continued to permit mutual funds with fluctuating NAVs to offer shares at NAVs substantially below $10.00, while still calculating their NAV to the nearest cent per share.

[13] Some money market funds, notably those managed by Merrill Lynch Asset Management, used a hybrid approach to operate in compliance with ASR 219 without obtaining an exemptive order. These funds would use the amortized cost method to value securities maturing in 60 days or less, which would compose the bulk of their portfolio. Longer-term securities were valued at their estimated market value and the NAV was rounded to the nearest tenth of a cent. To assure that a fund maintained a rounded $1.00 NAV, the fund would adjust its daily dividend to compensate for changes in the portfolio's value. For example, if a fund had accrued income of 2 basis points, and its NAV fell to $0.9994, the fund would declare a dividend of 1 basis point and retain 1 basis point of accrued income. This would increase the NAV to $0.9995, which would round to $1.00. If the fund did not have sufficient income to compensate for a change in its NAV, it would split or reverse split its shares to maintain a $1.00 NAV.

[14] SEC Release No. IC-10027 (November 28, 1977).

[15] SEC Release No. IC-10201 (April 12, 1978), 43 FR 16830 (April 20, 1978).

[16] SEC Release No. IC-10451 (October 26, 1978), 43 FR 51485 (November 3, 1978).

ity of greater than one year, or (b) maintain a dollar-weighted average portfolio maturity in excess of 120 days; and

3. The fund would limit its investments to U.S. Government issues, U.S. Government agency issues, and bank and corporate issues subject to rating and/or size of issuer requirements.

The SEC conducted hearings on the amortized cost applications from November 1978 through March 1979. After the hearings were completed, but before a decision was announced, the funds submitted offers of settlement to amend their applications to provide for the use of the amortized cost method of valuation subject to certain conditions, which the SEC agreed to grant.[17] The conditions to the amortized cost exemptive orders were somewhat lengthier than the original penny-rounding orders.

1. The Board undertook—as a particular responsibility within the overall duty of care owed to its shareholders—to establish procedures reasonably designed, taking into account current market conditions, to stabilize the fund's NAV per share, as computed for the purpose of distribution, redemption, and repurchase, at $1.00 per share.

2. The procedures adopted by the Board would include:

    (a) Review by the Board, at such intervals as are reasonable in light of current market conditions, to determine the extent of deviation, if any, of the NAV per share as determined by using available market quotations from the $1.00 amortized cost price per share.

    (b) In the event such deviation from the $1.00 amortized cost price per share exceeded one-half of 1 percent, the Board would promptly consider what action, if any, should be initiated.

    (c) Where the Board believed the extent of any deviation from the $1.00 amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, the Board would take such action as it deems appropriate to eliminate or to reduce to the extent reasonably practicable such dilution or unfair results.

3. The fund would maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable NAV per share; provided, however, that the fund would not (a) purchase any instrument with a remaining maturity of greater than one year, or (b) maintain a dollar-weighted average portfolio maturity in excess of 120 days.

4. The fund would limit its portfolio investments, including repurchase agreements, to those instruments which the Board determined presented minimal credit risks, and which would be of high quality as

[17] SEC Release No. IC-10824 (August 8, 1979).

determined by any major rating service or, in the case of any instrument that is not so rated, of comparable quality as determined by the Board.

5. The fund would record, maintain and preserve permanently in an easily accessible place a written copy of the procedures (and any modifications thereto) described in condition 1, and the fund would record, maintain and preserve for a period of not less than six years (the first two years in an easily accessible place) a written record of the Board's considerations and actions taken in connection with the discharge of its responsibilities, to be included in the Board's minutes. The documents preserved pursuant to this condition would be subject to inspection by the Commission.

6. The fund would include as an attachment to Form N-1Q (a quarterly report filed with the SEC and made public) a statement as to whether any action pursuant to condition 2(c) was taken during the preceding fiscal quarter, and, if any action was taken, would describe the nature and circumstances of such action.

This release provided the template for nearly 100 subsequent exemptive orders, mostly permitting use of the amortized cost method to calculate a money market fund's NAV.[18]

B. Trust Banking Circular No. 4 and Reserve Requirements

The market conditions that fostered the development of money market funds also created difficulties for many banks and thrifts. As noted above, Regulation Q limited the interest that could be paid on savings accounts and prohibited interest on demand deposits. The higher rates available from money market funds attracted money that would normally have been deposited with a bank or thrift.

For example, trust accounts provided a regular source of deposits for many banks. Due to the conservative interpretation of the "prudent man rule" during the period, many trustees maintained large cash deposits for their clients or invested in short-term Treasury securities and certificates of deposits. Starting in 1974, however, more and more trustees started to invest cash balances in money market funds in order to achieve a higher return than available from banks. This led the Comptroller of the Currency to publish Trust Banking Circular No. 4 (Circular No. 4), reminding national banks that:

> It has been and remains the position of this Office that the investment of trust assets in shares of mutual funds constitutes an improper delegation of the trustee's investment authority under the common law. This delegation may be authorized and the practice therefore appropriate only if there exists: (A) specific authority in state statutes or decisions, (B) specific authority in the

[18] After the first amortized cost exemptive order, "more than 90 money market funds … requested, and the Division … granted, exemptive relief to permit the use of amortized cost valuation, subject to substantially the same conditions as those contained in the original order settling the hearing. Certain minor changes were made in subsequent orders to reflect technical corrections. In addition, subsequent orders permitting amortized cost valuation as well as penny rounding were issued based upon applications that reflected a broader range of permissible portfolio investments." *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, SEC Release No. IC-12206 (February 1, 1982), 47 FR 5428 (February 5, 1982) at text preceding n.4.

> appropriate governing instrument for a given account; or (C) binding consents from all beneficiaries. In addition, such investments must be appropriate for the accounts being so invested.
>
> Various "money market funds" are currently being offered for the short term investment of small amounts of trust cash. These funds are mutual funds and as such are subject to the above stated rules.[19]

The mutual fund industry responded to Circular No. 4 in two ways. First, industry representatives met with the Comptroller and argued that Circular No. 4 was an incorrect interpretation of the "prudent man rule." Ultimately, the Comptroller agreed with this view and amended Circular No. 4 to state:

> the conclusion of this Office is that the little available precedent in this area is insufficient to permit continued adherence to this statement as a correct version of the state of the "common law" of trusts throughout the country. Rather, the courts of many states having either no statute stating fiduciary responsibilities or a statute merely restating the general "prudent man" standard could conclude that the applicable standard in that state would not preclude a trustee from making a responsible, prudent investment in mutual fund shares. Trust Banking Circular Number 4, accordingly, has been revised to permit national bank trust officers to obtain the advice of local counsel as to the state of the law on this question in their state.[20]

Additionally, the industry sought unambiguous authorization under state laws permitting trustees to invest in mutual funds, including money market funds. In some cases, funds obtained opinions from the state attorney general finding that money market funds were permitted investments under existing state trust laws. In many other cases, state laws were amended to specifically authorize investment in money market funds. A list of current state laws authorizing investments in money market funds is attached as Appendix D.

Another threat to money market funds developed in 1980, when the Federal Reserve Board imposed reserve requirements on the funds. On March 14, 1980, President Jimmy Carter signed an executive order "designed to moderate and reduce inflationary forces in the United States economy."[21] As part of its implementation of the executive order, the Federal Reserve imposed a special deposit requirement on mutual funds investing in obligations with maturities of 13 months or less. Such funds were required to deposit with a Federal Reserve Bank 15 percent of the amount by which their "covered credit" exceeded the amount of covered credit held as of March 14, 1980 (base amount).[22] Covered credit was defined as "any extension of credit originated through the acquisition of a security,

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[19] Circular No. 4, 73-78 CCH FBLR Transfer Binder ¶96,786 (December 23, 1975).

[20] Circular No. 4 (Rev.), ¶35-562B (September 29, 1976).

[21] *See* Circular No. 139, 79-80 CCH FBLR Transfer Binder ¶98,194 (March 14, 1980). Given the context of the Presidential order, it was clear that these reserve requirements were intended to curtail the amount of financing that money market funds could engage in, and not to protect their shareholders. The reserve requirement directly limited the amount of new cash flow that could be used for financing to 85 percent, and indirectly limited new cash flow by lowering the income available for dividends to investors. The reserve was funded, however, by new investments and represented part of the $1.00 NAV payable upon redemption. Thus, the reserve did nothing to protect shareholders if a default or other event caused a money market fund's market-based NAV to deviate from $1.00.

[22] *Effect of Credit Controls on the Operations of Certain Registered Investment Companies Including Money Market Funds,* SEC Release No. IC-11088 (March 14, 1980), 45 FR 17954 (March 20, 1980).

deposit or other instrument, including but not limited to domestic and Eurodollar certificates of deposit, U.S. Treasury bills, repurchase agreements, commercial paper, bankers acceptances, and state and local obligations … ."[23]

Contemporaneously with the Federal Reserve's action, the SEC issued a release identifying various legal issues raised by the special deposit requirement. Chief among these issues was the concern that continued sales of money market fund shares would dilute a fund's yield to the detriment of the fund's existing shareholders, as any growth beyond the March 14 base amount would require substantial non-income-producing deposits with the Federal Reserve Banks. The SEC therefore urged:

> the investment adviser … and directors, particularly the directors who are not interested persons of the company, of each "money market" fund, consistent with their fiduciary duties under the [Investment Company] Act, [to] consider immediately: (1) the appropriateness of new sales of fund shares which would increase covered credit above the base, and (2) the appropriateness of implementing various arrangements designed to protect the interests of shareholders.[24]

The industry responded to this new reserve requirement by creating new funds or new classes of shares for investments made after March 14. In April, the SEC adopted temporary regulations designed to facilitate the creation of such new funds and classes without obtaining an exemptive order or amending an existing order.[25] The Federal Reserve reduced the deposit requirement from 15 percent to 7.5 percent in June, and eliminated the requirement entirely on July 3, 1980.[26]

IV. Adoption of and Amendments to Rule 2a-7

A. Codification of the Exemptive Orders in Rule 2a-7

The growing popularity of money market funds led to an onslaught of exemptive orders seeking to create more funds. The SEC responded in 1982 by proposing an exemptive rule permitting money market funds to use either the amortized cost or penny-rounding method to maintain a stable $1.00 NAV.[27] In proposing the rule, the SEC noted its belief that such a rule would benefit shareholders by facilitating the ability of certain investment companies to fulfill their shareholders' investment objectives.[28] The SEC adopted the exemptive rule, designated as Rule 2a-7, on July 11, 1983.[29] The original rule was just over 1,800 words. In explaining the conditions of the new rule, the release identified:

[23] *Id.* at n.1.

[24] *Id.* at text preceding n.11 and n.12.

[25] *Temporary Rule Providing Exemptions to Certain Money Market Funds and Other Persons and Companies*, SEC Release No. IC-11137 (April 22, 1980), 45 FR 28307 (April 29, 1980).

[26] Federal Reserve Board Release, 79-80 CCH FBLR ¶98,346 (July 25, 1980).

[27] Release No. 12206, *supra* note 18.

[28] *Id.*

[29] *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, SEC Release No. IC-13380 (July 11, 1983), 48 FR 32555 (July 18, 1983).

> basically two types of risk which cause fluctuations in the value of money market fund portfolio instruments: the market risk, which primarily results from fluctuations in the prevailing interest rate, and the credit risk. In general, instruments with shorter periods remaining until maturity and which are of higher quality have reduced market and credit risks and thus tend to fluctuate less in value over time than instruments with longer remaining maturities or of lesser quality.[30]

Therefore, Rule 2a-7, like the exemptive orders that preceded it, focused largely on limiting the maturity and examining the credit quality of the portfolio securities held by money market funds.

In fact, Rule 2a-7 largely codified the conditions of the previous exemptive orders with few substantive changes. For example, a money market fund was required to "maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share," which could not exceed 120 days. The maximum maturity of individual portfolio securities was one year. All portfolio securities were required to be U.S. dollar–denominated and determined by the Board to present minimal credit risks. In addition, unless a major rating service determined that a portfolio security was "high quality," the Board was required to determine that the security was of "comparable quality."

In explaining the need for *both* a high quality rating and a minimal credit risk determination, the Commission observed the following:

> The requirement that a security have a high quality rating provides protection by ensuring input into the quality determination by an outside source. However, the mere fact that an instrument has or would receive a high quality rating may not be sufficient to ensure stability. The Commission believes that the instrument must be evaluated for the credit risk that it presents to the particular fund at that time in light of the risks attendant to the use of amortized cost valuation or penny-rounding. Moreover, the board may look at some aspects when evaluating the risk of an investment that would not be considered by the rating services.[31]

Rule 2a-7 also required Boards of money market funds to establish procedures for maintaining a stable NAV using either the penny-rounding or amortized cost method. The Board of a fund using the amortized cost method was required to monitor the deviation between the fund's NAV "calculated using available market quotations (or an appropriate substitute which reflects current market conditions)" and its amortized cost value per share, a process commonly referred to as "shadow pricing." The Board was required to determine whether to take action if the deviation exceeded one-half cent per share or to prevent dilution or other unfair results. Amortized cost funds were required to maintain records of the Board's determinations and report any actions taken by the Board. This reporting requirement was eventually moved to Form N-SAR.

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[30] *Id.* at n.7.

[31] *See* Release 13380, *supra* note 29, at text preceding n.32.

The new rule and adopting release also provided additional guidance. For example, the rule included a lengthy definition of how to calculate a security's maturity. Generally, the maturity was "the date noted on the face of the instrument as the date on which the principal amount owed must be paid."[32] There were exceptions, however, for variable and floating rate securities that the Board determined would approximate their amortized cost values whenever the interest rate was adjusted (adjustable-rate securities). Adjustable-Rate Government Securities could be treated as maturing on the date of the next interest rate adjustment, regardless of their final maturity.[33] Other adjustable-rate securities were required to either (a) mature in one year or less, or (b) have "Demand Features" that entitled the holder to receive the principal amount of the security on not more than seven days' notice. Such adjustable-rate securities were deemed to mature on the later of the next interest rate adjustment or the date on which principal would be received following exercise of the Demand Feature.[34] Boards were required to determine at least quarterly that securities with Demand Features remained of high quality.

Repurchase agreements and securities lending agreements were treated as maturing on the date that securities were scheduled to be repurchased or returned.[35] Interestingly, the rule originally defined "one year" as 365 days, "except, in the case of an instrument that was originally issued as a one year instrument, but had up to 375 days until maturity, one year shall mean 375 days." The SEC explained that, "[t]his part of the definition has been extended beyond the usual definition of one year (365 days) to encompass securities, particularly government securities such as project notes, which are denominated as and intended to be "one year" notes, but which occasionally are issued with maturities slightly longer than 365 days."[36]

In the adopting release, the SEC provided the following explanation of "high quality":

> Moody's defines "high quality" for bonds to be those instruments which receive an Aaa or Aa rating. Similarly, the Commission would consider bonds rated AAA or AA by Standard & Poor's or by Fitch to be high quality. Therefore, a money market fund seeking to rely on this rule could invest only in bonds which were rated AA (Aa) or better. Commercial paper receiving one of the two top ratings (Prime-1 or 2, A-1 or 2, or Fitch-1 or 2) also would be considered high quality. The rule requires only that an instrument receive a "high quality" rating from one major financial rating service. In a case where an instrument received different ratings from different services, the instrument would be an acceptable investment so long as at least one rating was a high quality rating and provided that the Board found that the instrument presented minimal credit risks.[37]

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[32] Rule 2a-7(b)(5) (1983). The adopting release also explained that "[t]he date of purchase is regarded as the date on which the fund's interest in the instrument is subject to market action. Thus, for securities purchased under normal settlement procedures, the length of maturity would be calculated starting on the trade date." Release 13380, *supra* note 29, at n.11.

[33] Rule 2a-7(b)(5)(i)(A) (1983).

[34] Rule 2a-7(b)(5)(i)(B)-(C) and (ii) (1983).

[35] Rule 2a-7(b)(5)(iii)-(iv) (1983).

[36] Release No. 13380, *supra* note 29, at n.13.

[37] *Id.* at n.34.

The release went on to state that "[i]f the instrument were ever deemed to be of less than high quality, the fund either would have to sell the instrument or exercise the Demand Feature, whichever were more beneficial to the fund."[38]

With respect to shadow pricing procedures, the SEC made it clear that amortized costs funds were required to obtain market quotations (or an appropriate substitute that reflects current market conditions) for *all* of their portfolio securities, regardless of whether they had maturities of 60 days or less.[39] The SEC permitted funds, however, to round their amortized cost NAVs to the nearest cent in the same manner as penny-rounding funds. As the adopting release explained:

> Funds using the amortized cost valuation method may need to use penny-rounding in computing their price per share when a gain or a loss in the value of their portfolio, which was not offset against earnings, is recognized. Where the gain or loss has been recognized, there is no longer merely a potential for a deviation between the value assigned by the fund for the securities sold and that actually realized by the fund. The Commission does not wish to define the permissible amount of deviation. However, to the extent a fund has realized gains or losses that cause the fund's price per share to deviate from the amortized cost net asset value per share, the Board must be particularly careful to ensure that the fund can maintain a stable price per share.[40]

Although nothing in the exemptive orders or Rule 2a-7 dealt directly with liquidity, the SEC took the opportunity to remind funds that purchases of Illiquid Securities should not exceed 10 percent of a fund's net assets. The SEC observed that money market funds may "experience a greater and perhaps less predictable volume of redemption transactions than do other investment companies," because they were commonly used for short-term investments and provided same day redemptions. This raised concerns that:

> By purchasing or otherwise acquiring illiquid instruments, a money market fund exposes itself to a risk that it will be unable to satisfy redemption requests promptly.… In addition, … management of the investment company's portfolio could also be affected by the purchase of illiquid instruments.… Finally, the purchase of illiquid instruments can seriously complicate the valuation of a money market fund's shares and can result in the dilution of shareholder's interests.

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[38] *Id.* at n.22.

[39] *Id.* at n.44 ("Thus, while it may be appropriate for the board to value certain portfolio securities at amortized cost without adherence to the conditions contained in the rule, [ASR 219] does not affect the monitoring procedures under this rule. Where the fund is using amortized cost valuation to such an extent that exemptive relief is necessary, *i.e.,* its portfolio contains any security with a maturity in excess of 60 days, the monitoring procedures contained in the rule are designed to place a limitation on the total deviation between the fund's amortized cost value and its market-based value. In order to calculate precisely that total deviation, all instruments must be valued at market value.")

[40] *Id.* at text preceding n.6.

"Therefore," the SEC concluded, "when a fund purchases illiquid instruments, the board of directors has a fiduciary duty to ascertain that the fund is operated in such a manner that the purchase of such instruments does not materially affect the valuation of the fund's shares."[41]

The final noteworthy feature of the original rule was its permissive nature. A mutual fund could use the penny-rounding or amortized cost method to maintain a stable NAV by complying with Rule 2a-7. Money market funds that already had exemptive orders, however, could continue to rely upon their orders, rather than complying with Rule 2a-7. Moreover, money market funds that operated without using the amortized cost or penny-rounding method (see, *supra*, note 13) also could disregard the rule's conditions.

B. The 1986 Amendments to Rule 2a-7

The reference to a "Demand Feature" in the original version of Rule 2a-7 referred to an obligation of the *issuer* of the security to pay principal within seven days of a demand by the holder. The adopting release specifically noted "that the rule does not speak to the acquisition or valuation of [third-party] puts or stand-by commitments by a money market fund. … Accordingly, a fund requiring exemptive relief in order to acquire [third-party] puts or standby commitments must still seek an individual exemptive order."[42] Tax-exempt money market funds relied on puts and standby commitments to provide liquidity for long-term variable rate bonds, which comprised the bulk of their portfolios.[43]

In 1985, in response to a number of market changes since Rule 2a-7 was adopted, the SEC issued a release proposing to amend Rule 2a-7 and Rule 12d3-1 to permit money market funds to acquire new types of Demand Features, such as third-party puts and standby commitments. [44] These new Demand Features were developed to avoid "reissuance" problems under the Internal Revenue Code that otherwise may have forced municipal issuers to requalify their securi-

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41 *Id.* at text preceding n.40.

42 *Id.* at text preceding n.10.

43 The requirements for federal tax-exemption make the frequent reissuance of securities prohibitively expensive for states and municipalities. Generally, the principal short-term financing used by state and municipal issuers are tax and revenue anticipation notes, which are issued near the beginning and mature at the end of each fiscal year. The fact that these securities are typically issued around the same period (from July through September) with one year maturities made it practically impossible for a tax-exempt money market fund to maintain a weighted-average maturity of less than 120 (now 60) days without also making substantial investments in long-term variable rate demand obligations (VRDOs).

44 *Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies,* SEC No. IC-14607 (July 1, 1985), 50 FR 27982 (July 9, 1985). Relief from Section 12(d)(3) of the Investment Company Act was required because most puts and standby commitments were provided by banks, brokers and other companies engaged in securities related activities. The current version of Rule 2a-7 no longer differentiates between standby commitments and other forms of Demand Features, so this discussion does not cover provisions relating solely to standby commitments.

ties as tax-exempt prior to remarketing.[45] The SEC adopted the amendments in March 1986.[46] Although the amended rule moved the provisions governing the calculation of a security's maturity to a separate paragraph, the wording of the paragraph was close to that of the original rule. The substantive change was the introduction of a new definition of a "Demand Feature" as:

> a put that entitles the holder to receive the principal amount of the underlying security or securities and which may be exercised either (A) at any time on no more than 30 days' notice; or (B) at specified intervals not exceeding one year and upon no more than 30 days' notice.[47]

"Put" was defined as "a right to sell a specified underlying security or securities within a specified period of time and at a specified exercise price, that may be sold, transferred or assigned only with the underlying security or securities."[48] A Put or Demand Feature would be "unconditional" only if it "would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities."[49]

Under the amended rule, adjustable-rate securities continued to be treated as maturing on the later of the date of the next adjustment to the interest rate or the date on which principal would be paid following exercise of the Demand Feature. The amended rule imposed additional requirements on the quality and diversification of Demand Features. First, the rule required Demand Features to receive both short- and long-term "high quality" ratings, or be determined to be comparable to securities having such ratings. An exception was made for Unconditional Demand Features, which could qualify as high quality based solely on short-term ratings (or their comparability to securities receiving short-term ratings).[50]

Second, a money market fund could not invest more than 5 percent of the market value of its assets in securities underlying Puts from the same institution. This new diversification requirement applied, however, to only 75 percent of the market-based value of the fund's assets. In addition, an Unconditional Demand Feature was not treated as a Put from an institution unless securities issued or guaranteed by the institution comprised more than 10 percent of the market value of the fund's assets. An Unconditional Demand Feature was treated as a Guarantee for purposes of

[45] The SEC noted that avoiding the appearance of a reissuance has always been a factor in the structuring of municipal debt issues subject to Demand Features. In a tax context, the ability of the issuer to set a new interest rate, coupled with a Demand Feature that requires the security to be put back to the issuer or to a direct agent of the issuer, could create the appearance that the remarketed security is a fundamentally different instrument from the original security. Under such circumstances, the remarketing of the security could be deemed a reissuance under the tax law. To "avoid the possibility of a reissuance, issuers of municipal securities ha[d] begun to structure Demand Features that do not run directly to the issuer or its agent, but run, in the first instance, to a separate entity that is provided with sufficient third-party credit support to honor the demands. The securities that are put to the separate entity are then remarketed without ever having entered into the possession of the issuer or a direct agent of the issuer. The issuer is then able to make a more convincing argument that the remarketing of the securities is nothing more than a secondary market transaction and not a reissuance of the securities." Release No. 14607, *supra* note 44, at Section A.

[46] *Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies*, SEC Release No. IC-14983 (March 12, 1986), 51 FR 9773 (March 21, 1986).

[47] Rule 2a-7(c)(5) (1986).

[48] Rule 2a-7(c)(3) (1986).

[49] Rule 2a-7(c)(6) (1986).

[50] Rule 2a-7(a)(2)(iv) and (a)(3)(iii) (1986).

this limit. In other words, apart from a 25 percent "basket" for undiversified Puts, a money market fund could not invest more than 5 percent of its assets in securities underlying Conditional Demand Features from the same institution, or more than 10 percent of its assets in securities issued or underlying Unconditional Demand Features (or other Guarantees) from the same institution.[51]

This second change is noteworthy because it represents the first diversification requirement imposed on money market funds. Neither the original rule nor the earlier exemptive orders required money market funds to adopt fundamental diversification policies under Section 5(b) of the Investment Company Act. In fact, many single state tax-exempt funds were non-diversified, due to the limited number of state tax-exempt issuers.

The 1986 amendments also introduced the concept of a "nationally recognized statistical rating organization" (later defined as an NRSRO) to Rule 2a-7. The amended rule required a Board to determine whether a security was comparable to other high quality securities, unless it was rated "by any nationally recognized statistical rating organization that is not an affiliated person … of the issuer of, or any insurer, guarantor or provider of credit support for the instrument."[52] This provision applied to the high quality determination for any investment, not just investments subject to Demand Features.

The revised maturity provisions eliminated the requirement that the Board make quarterly determinations as to the high quality of securities subject to Demand Features. In addition, the new definition of "Demand Feature" increased the permitted notice period for exercising a Demand Feature from seven to 30 days. Finally, renewed concern regarding the liquidity of money market funds prompted the SEC to add a note to the end of the amended rule, reiterating the language from the 1983 release discussed above.

C. The 1991 Revision of Rule 2a-7

The SEC proposed the next amendments to Rule 2a-7 in response to adverse credit conditions that developed during the savings and loan crisis and worsened during the 1990 recession. At the time of the proposal, there were "649 money market funds with over $450 billion in assets in approximately 21.3 million shareholder accounts," representing more than one-third of all mutual fund assets and accounts.[53]

The proposing release noted two particular developments that had the potential to disrupt money market funds. First were recent commercial paper defaults.

> [T]he commercial paper had a 'high quality' rating from a NRSRO until shortly before the default and was held by several money market funds at the time of the default. The shareholders of these money market funds were not adversely affected, however, because each fund's invest-

[51] Rule 2a-7(a)(2)(v) and (a)(3)(iv) (1986). "[T]hese requirements track the diversification requirements of section 5(b)(1) of the [Investment Company] Act and rule 5b-2 thereunder." Release No. 14983, *supra* note 46, at text preceding n.13 [citations omitted].

[52] Rule 2a-7(a)(2)(iv) and (a)(3)(iii) (1986) [citation omitted].

[53] *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-17589 (July 17, 1990), 55 FR 30239 (July 25, 1990).

> ment adviser purchased the defaulted commercial paper from the funds at its amortized cost or principal amount.[54]

Second, the SEC noted that "[t]he credit ratings of some large money center banks also have declined recently," which threaten to curtail the supply of high-quality securities available to money market funds.[55]

These developments led the SEC to propose further restrictions on money market fund operations and investments. After receiving substantial comments, the SEC adopted the amended rule on February 20, 1991.[56] The amendments completely reorganized and substantially rewrote Rule 2a-7, expanding the text to nearly 4,400 words. Every aspect of the rule was changed in some respect, but the principal changes related to the risk-limiting provisions (quality, diversification, and maturity of portfolio securities) and required that all mutual funds that hold themselves out as money market funds meet those conditions.

1. Changes to the Portfolio Quality Requirements

The amendments changed the credit quality requirements of Rule 2a-7 by limiting money market fund portfolios to Eligible Securities. To qualify as an "Eligible Security," a portfolio security had to satisfy the following requirements:

- It must have a remaining maturity of 397 days or less.
- If the security had received short-term credit ratings from an NRSRO, or if its issuer had received short-term credit ratings for securities of comparable priority and security, then the Requisite NRSROs must have provided ratings in the two highest short-term categories.
- Securities not meeting the previous requirement were defined as "Unrated Securities" and were required to be of comparable quality to securities meeting the requirement. An Unrated Security, however, could not be considered of comparable quality if it had been originally issued with a maturity in excess of 366 days and received a rating from any NRSRO below the second highest long-term rating category.[57]

The provisions essentially codified the SEC's previous guidance that "high quality" referred to securities rated in the two highest long-term or short-term rating categories. It clarified further that short-term securities could qualify as Eligible Securities even if the issuer had received long-term ratings below the second-highest category. The SEC explained that the "correct yardstick" of quality is the rating given to the issuer's short-term securities, since at the time a money market fund invests in a long-term security, its remaining maturity will be less than 13 months.[58] This was an important point, as most issuers who received the second-highest short-term rating category also received ratings in the third-highest, and sometimes the upper range of the fourth-highest, long-term categories.

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[54] *Id.* at text preceding n.18.

[55] *Id.* at text preceding n.19 and n.20.

[56] *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-18005 (February 20, 1991), 56 FR 8113 (February 27, 1991). The SEC received 289 comment letters on the proposed amendments.

[57] Rule 2a-7(a)(5) (1991).

[58] *See* Release No. 18005, *supra* note 56, at text preceding n.65.

The 1991 amendments also introduced the concept of "Requisite NRSROs," defined as "(a) any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer, or (b) if only one NRSRO has issued a rating with respect to such security or issuer … that NRSRO."[59] The definition represented a compromise proposed by the Investment Company Institute, some of whose members objected to the "any NRSRO" standard of the 1986 amendments because it allowed funds to pick the highest rating regardless of what the other NRSROs did, while other members objected to a "majority of NRSROs rule" proposal because it raised the possibility that funds would have to disregard the ratings of the two most widely followed NRSROs, Moody's and Standard & Poor's. The definition of Requisite NRSRO allowed funds to rely on the highest ratings given by any two NRSROs, regardless of what ratings the other NRSROs provided.

The 1991 amendments also provided that a security could qualify as an Eligible Security based solely on whether its Unconditional Demand Feature was an Eligible Security.[60] Securities subject to other types of Demand Features, however, had to have long-term ratings in the two highest long-term rating categories from the Requisite NRSROs, or if they did not have such ratings, be determined to be comparable to securities having such long-term ratings.[61]

The 1991 amendments included the only substantive change ever made to the wording of the minimal credit risk requirement. The SEC added the parenthetical "(which determination must be based on factors pertaining to credit quality in addition to the rating assigned to such instruments by a NRSRO)" at the end of the requirement.[62] The SEC explained that this language was intended to underscore that:

> Possession of a certain rating by a NRSRO is not a 'safe harbor.' Where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security has minimal credit risks.[63]

Finally, the 1991 amendments clarified the consequences of changes in a portfolio security's credit quality. First, the amended rule provided that the Eligible Security requirement applied only "at the time of acquisition."[64] Second, the amended rule required a "money market fund [to] dispose of [a] security as soon as practicable consistent with achieving an orderly disposition of the security," after the security defaulted, ceased to be an Eligible Security, or was determined to no longer present minimal credit risks. The amended rule authorized the Board to override the disposition if it found "that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly

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[59] Rule 2a-7(a)(13) (1991).

[60] The ratings of the Unconditional Demand Feature also could be used to classify the security as a First or Second Tier Security. *See* subsection I.C.2 below.

[61] Rule 2a-7(c)(3)(i)-(ii) (1991).

[62] Rule 2a-7(c)(3) (1991).

[63] Release No. 18005, *supra* note 56, at text preceding n.18.

[64] Rule 2a-7(c)(3) (1991).

disposition of the security) … ."[65] Thus, an adverse change in a portfolio security's credit risk or status as an Eligible Security would not result in a violation of Rule 2a-7 so long as the fund either disposed of the security or obtained the necessary finding from its Board. The amended rule also added a requirement to report any default affecting more than 0.5 percent of a fund's Total Assets to the Division. [66]

2. Imposition of Diversification Requirements

As already noted, the 1986 version of Rule 2a-7 regulated the diversification of Demand Features only. The 1991 amendments expanded on the earlier amendments by requiring diversification with respect to the issuers of securities as well. The 1991 amendments also imposed stricter limits on securities of issuers who received (or were comparable to issuers receiving) ratings from the Requisite NRSROs in the second-highest short-term rating categories, defined as "Second Tier Securities," as compared to securities of issuers who received (or were comparable to issuers receiving) such ratings in the highest short-term rating categories, defined as "First Tier Securities."

The new requirements limited the amount that a money market fund could invest in First Tier Securities of the same issuer to 5 percent of its Total Assets, and the amount that it could invest in Second Tier Securities of the same issuer to 1 percent of its Total Assets (or $1 million, if greater). Total Assets were calculated based on amortized cost for amortized cost funds and on market value for penny-rounding funds. Unlike the diversification requirements of Section 5(b) of the Investment Company Act, which apply only to 75 percent of a "diversified" company's assets, these requirements applied to 100 percent of a money market fund's Total Assets. The amendments further restricted a fund's total investments in Second Tier Securities to 5 percent of Total Assets.[67]

Investments in Government Securities were not limited, so a fund could invest any amount of its assets in securities issued by the U.S. Treasury or a federal agency or instrumentality. In addition, the amended rule permitted money market funds to treat repurchase agreements as investments in the underlying securities for purposes of diversification, provided the repurchase agreement was "collateralized fully." A repurchase agreement was "collateralized fully" if it met the following four conditions:

- the value of the underlying securities is at all times at least equal to the resale price provided in the agreement;
- the money market fund or its custodian either has physical possession of the underlying securities or they are held in a securities account in the name of the money market fund or its custodian;
- the money market fund retains an unqualified right to possess and sell the underlying securities in the event of a default by the seller; and

[65] Rule 2a-7(c)(5)(ii) (1991).

[66] Rule 2a-7(c)(5)(iii) (1991).

[67] Rule 2a-7(c)(4)(i) (1991).

- the underlying securities consist entirely of Government securities or securities rated in the highest rating category by the Requisite NRSROs.[68]

This last condition codified for money market funds an interpretive position previously taken by the Division,[69] and extended it beyond Government Securities to the highest rated securities generally.

The amended rule also established a safe harbor permitting investment of up to 25 percent of a fund's Total Assets in a single First Tier issuer for not more than three days.[70] The SEC added the safe harbor:

> in response to commenters who asserted that the twenty-five percent basket often is useful in managing portfolio liquidity and large cash inflows; they urged that the ability to invest a large percentage of fund assets in a single high quality issuer on a temporary basis is an efficient way to assure liquidity in the event of unexpected redemptions by shareholders or to invest unanticipated cash inflows. The Commission believes that a three day limit will permit a fund to realize these efficiencies without being exposed to the risks associated with investing more than five percent of fund assets in a single issuer for an indefinite period of time.[71]

The new issuer diversification requirements were not applied to "Tax Exempt Funds,"[72] due to concerns that those "funds often would have difficulties meeting the tests due to the limited number of tax exempt issuers in certain markets."[73] On the other hand, the Demand Feature diversification requirements, which were clarified but not changed in any substantive manner, continued to apply to all types of money market funds. Thus, the 1991 amendments created two independent diversification requirements: one for issuers (applicable only to taxable funds) and another for Demand Feature providers (applicable to all funds).

3. Changes to the Maturity Requirements

The definition of Eligible Security extended the maximum maturity of individual portfolio securities from one year (defined as 375 days) to 397 days (which is the maximum number of days in any thirteen-month period that includes a leap day). The SEC provided the following explanation for the extension:

> This change has been made in order to accommodate funds purchasing annual tender bonds, and securities on a when-issued or delayed delivery basis. These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them. Since the purchaser must 'book' the security on the day it agrees to purchase it, the maturity period begins on that day.[74]

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[68] Rule 2a-7(a)(3) (1991).

[69] *See MoneyMart Assets Inc.*, SEC No-Action Letter (pub. avail. September 3, 1980).

[70] Rule 2a-7(c)(4)(i)(A) (1991).

[71] Release No. 18005, *supra* note 56, at text preceding n.25.

[72] Rule 2a-7(a)(17) (1991).

[73] Release No. 18005, *supra* note 56, at n.35.

[74] *Id.* at text preceding n.56.

The original proposal was to extend the maximum permitted maturity to two years. The SEC decided against this, except in the case of Government Securities held by penny-rounding funds, which were permitted to acquire Government Securities with maturities of up to 762 days.[75] The SEC decided that the greater potential market volatility of these securities created too much risk unless the fund was marking its portfolio to market on a daily basis.

The SEC was willing to extend the maturity limits on individual securities because the amendments reduced the maximum average weighted portfolio maturity from 120 to 90 days.[76] In explaining this change, the SEC noted that:

> As of February 5, 1991 the average portfolio maturity of taxable money market funds was 53 days and the average maturity of tax exempt funds was 50 days. [Citation omitted.] … In 1987, municipal money market instruments fluctuated by 240 basis points over a sixty day period, a fluctuation large enough to cause a fund with a ninety-day dollar weighted average maturity to break a dollar. … However, the Commission believes that a ninety day period should provide money market fund investors with additional safeguards without unduly limiting the flexibility of money market funds to adjust fund maturities to levels that are appropriate in view of market conditions.[77]

4. Changes to the Scope of Rule 2a-7: Holding Out

The 1991 amendments also changed Rule 2a-7 from a permissive to a mandatory rule for any registered investment company holding itself out as a money market fund. New paragraph (b) of Rule 2a-7 made it:

> an untrue statement of material fact within the meaning of section 34(b) of the [Investment Company] Act [citation omitted] for a registered investment company … to:
>
> (1) adopt the term 'money market' as part of its name or title … , or
>
> (2) hold itself out to investors as, or adopt a name which suggests that it is, a money market fund or the equivalent of a money market fund, unless such registered investment company meets the conditions of paragraphs (c)(2), (c)(3), and (c)(4) of this section. …

This provision extended the portfolio maturity, quality and diversification requirements of Rule 2a-7 to all money market funds, regardless of whether they had previously obtained an exemptive order or had operated in accordance with ASR 219.

The 1991 amendments also added new disclosure requirements for all money market funds. The amendments required every money market fund prospectus and Rule 482 advertisement to include the following disclaimer:

> (i) an investment in the fund is neither insured nor guaranteed by the U.S. Government and
> (ii) there can be no assurance that the fund will be able to maintain a stable net asset value of

[75] Rule 2a-7(c)(2)(ii) (1991).

[76] Rule 2a-7(c)(2)(iii) (1991).

[77] Release No. 18005, *supra* note 56, at n.50.

$1.00 per share ….

After the 1991 version of Rule 2a-7 superseded their original exemptive orders, many money market funds switched from the penny-rounding method to the amortized cost method. Under the 1991 version of Rule 2a‑7, the only advantage of using the penny-rounding method was the ability to acquire Government Securities with remaining maturities of up to 762 days, as compared to the normal 397-day limitation. The penny-rounding method is more expensive to implement, as it requires the daily calculation of the fund's NAV, which is then rounded to $1.00. In addition, if the fund's calculated NAV ever falls below $0.995, the penny-rounding method *requires* the fund to reduce its NAV below a dollar (*i.e.*, break a dollar). In contrast, funds using the amortized cost method are only required to call a board meeting to decide "what actions, *if any*" should be taken.

D. The 1996 Amendments and 1997 Technical Amendments

After adoption of the 1991 amendments, the Division continued to assess whether Tax Exempt Funds could operate in compliance with the new diversification requirements that had been established for taxable funds. The failure of Mutual Benefit Insurance, which provided Puts for several VRDOs held by Tax Exempt Funds, and the deterioration in the credit of many Japanese banks, which provided letters of credit supporting VRDOs, reinforced concerns regarding Tax Exempt Funds. These concerns led the SEC to propose further amendments to Rule 2a-7 at the end of 1993.[78]

The proposed amendments also addressed, for the first time, the application of Rule 2a-7 to "Asset Backed Securities," as discussed below. This was due, in part, to the use of "tender option bonds" by Tax Exempt Funds. Tender option bonds are long-term municipal bonds restructured through a trust to add a Demand Feature to effectively shorten the maturity of the bond and provide for a variable interest rate. The proposal also sought to address the widespread use of asset-backed commercial paper and structured products by taxable funds.

During the comment period, the Orange County bankruptcy and problems with derivative securities led to wide-spread sponsor support of money market funds. The SEC adopted sweeping amendments to Rule 2a-7 in March 1996.[79] Many in the industry, however, expressed concerns over whether they could operate funds under the more complicated amended rule. This led the SEC to postpone the effective date of the 1996 amendments and propose further technical amendments.[80] The SEC adopted these technical amendments at the end of 1997.[81]

These amendments added considerably to the length (nearly 8,400 words) and complexity of the rule. At the same time, money market funds had continued to grow in number and size. At the time of the 1996 amendments, "[m]ore

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[78] *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-19959 (December 17, 1993), 58 FR 68585 (December 28, 1993).

[79] *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-21837 (March 21, 1996), 61 FR 13955 (March 28, 1996).

[80] *Technical Revisions to the Rules and Forms Regulating Money Market Funds,* SEC Release No. IC-22383 (December 10, 1996), 61 FR 66621 (December 18, 1996).

[81] *Technical Revisions to the Rules and Forms Regulating Money Market Funds*, SEC Release No. IC-22921 (December 2, 1997), 62 FR 64968 (December 9, 1997).

than $775 billion in assets [was] invested in approximately 25 million money fund shareholder accounts."[82] Of this amount, approximately $127 billion was invested in Tax Exempt Funds.

Like the 1991 amendments, the 1996 and 1997 amendments touched all three of the risk-limiting provisions of Rule 2a-7: portfolio quality, diversification and maturity. The technical amendments also made an effort to eliminate redundant definitions and apply defined terms in a consistent manner. For example, references to Puts and standby commitments were eliminated in favor of a revised definition of "Demand Feature," and a new definition of "Guarantee" was added to cover forms of credit substitution (such as bond insurance, surety agreements or guarantees) in addition to Unconditional Demand Features.

1. Changes to Portfolio Quality Requirements

The 1997 version of Rule 2a-7 retained the basic elements of the definition of Eligible Security, including the definition of Requisite NRSROs. The SEC added explicit ratings requirements, however, to the definition of Eligible Security for specific types of securities. Thus, an Asset-Backed Security could not qualify as an Eligible Security unless it received an NRSRO rating.[83] The SEC imposed this requirement based on a belief that:

> in view of the role NRSROs have played in the development of the structured finance markets, a rating requirement should not be burdensome. Because both short- and long-term debt ratings from NRSROs reflect the NRSROs' legal, structural, and credit analyses, the rule requires that an [Asset Backed Security] be rated in order to be eligible for fund investment, but does not specify whether the rating received must be short- or long-term.[84]

A security whose eligibility is based on a third-party Guarantee was required to satisfy a similar rating requirement. In this case, either the Guarantee must have received a rating from an NRSRO or the provider of the Guarantee must have received ratings for obligations of comparable priority and security. The SEC explained that this requirement was intended to "provide additional protection by ensuring input into the minimal credit risk determination by an outside source."[85] Guarantees of affiliated persons, Guarantees that are Government Securities, and Guarantees of repurchase agreements that are Collateralized Fully were not subject to the requirement.

The amendments also added a requirement that, for a security subject to a Guarantee or a Demand Feature to be an Eligible Security, the issuer of the security must undertake to notify the holder in the event that there is a substitution of the Guarantee or Demand Feature. This requirement was added in response to "several instances in which a money fund had invested in a security backed by a [letter of credit] or other credit or liquidity enhancement that was replaced during the life of the underlying security without notice to the fund." The SEC observed that: "A fund must

[82] Release No. 21837, *supra* note 79, at text preceding n.2.

[83] Rule 2a-7(a)(10)(ii)(B) (1997).

[84] Release No. 21837, *supra* note 79, at Section II.E.4.

[85] *Id.* at text preceding n.89.

know the identity of the put provider for a number of reasons, which include a determination of whether the fund is in compliance with the rule's put diversification and credit quality provisions."[86]

The amendments also clarified the requirements for Conditional Demand Features (*i.e.*, Demand Features other than Unconditional Demand Features). In addition to satisfying the general requirements for an Eligible Security, a Conditional Demand Feature also needed to satisfy the following conditions:

- the Board must determine that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur;
- the conditions limiting exercise (a) either can be monitored readily by the fund, or relate to the tax-exempt status of the security or (b) the Conditional Demand Feature requires that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the Demand Feature; and
- the Underlying Security or any Guarantee of such security (or the debt securities of the issuer of the Underlying Security or Guarantee that are comparable in priority and security with the Underlying Security or Guarantee) must receive either a short-term rating or a long-term rating, as the case may be, from the Requisite NRSROs within the NRSROs' two highest short-term or long-term rating categories or, if unrated, is determined to be of comparable quality.[87]

2. Changes to the Diversification Requirements

The 1996 and 1997 amendments made two primary changes to the diversification requirements of Rule 2a-7. First, they established issuer diversification requirements for Tax Exempt Funds. Second, they clarified the application of the diversification requirements to Asset Backed Securities. The amendments continued to apply the Demand Feature diversification requirements to all money market funds, but extended these requirements to all types of Guarantees.

With regard to Tax Exempt Funds (*i.e.*, funds investing primarily in securities exempt from regular federal income tax), the amendments drew distinctions between "Conduit Securities" and other municipal obligations, and between national Tax Exempt Funds and Single State Funds (*i.e.*, Tax Exempt Funds that restrict their investments to securities exempt from a particular state's income taxes). A Conduit Security is a security in which the municipal issuer serves as a conduit for tax-exempt financing to a non-governmental entity. Under limited circumstances, municipalities can provide the benefits of tax-exempt financing to non-governmental entities by issuing bonds and lending proceeds to the entity. Recourse on these bonds is limited to the non-governmental entity's obligation to repay the municipality, and the municipality has no obligation to repay the bonds from other resources. Conduit Securities are very common because federal law only exempts interest paid by municipal issuers.

Given that Conduit Securities are obligations of entities that also may issue taxable securities, the amendments subject Conduit Securities held by Tax Exempt Funds to the same diversification limitations as taxable funds. Thus, a Tax Exempt Fund could not invest more than 5 percent of its Total Assets in First Tier Conduit Securities of the same

[86] Release No. 21837, *supra* note 79, at text preceding n.105.

[87] Rule 2a-7(c)(3)(iv)(B)-(C) (1997).

issuer, or more than 1 percent (or $1 million if greater) in Second Tier Conduit Securities of the same issuer. Tax Exempt Funds also were limited to investing not more than 5 percent of their Total Assets in Second Tier Conduit Securities.[88] The amendments also limited investments in non-Conduit Securities of a single issuer to not more than 5 percent of a Tax Exempt Fund's Total Assets. This limit applied regardless of whether the non-Conduit Securities were First or Second Tier Securities.[89]

As with the taxable diversification requirements, these requirements applied to 100 percent of a Tax Exempt Fund's Total Assets, except for the three-day safe harbor for investments in a single issuer. The requirements were relaxed, however, for Single State Funds, which needed to satisfy the diversification requirement for First Tier Securities with respect to only 75 percent of their Total Assets. The 25 percent "basket" for First Tier Securities was a recognition by the SEC of the supply constraints faced by Single State Funds, which might be forced to invest in lower-quality investments if they were subject to a strict 5 percent limit. Given this general 25 percent basket, there was no need to extend the three-day safe harbor to Single State Funds.

With regard to Asset Backed Securities, the amended rule basically required money market funds to treat the Special Purpose Entity issuing the securities as the issuer for diversification purposes. The definition of Asset Backed Security turns on the security being payable primarily from cash flows from Qualifying Assets held by a Special Purpose Entity. Qualifying Assets are defined as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders."[90]

The SEC had originally proposed to base diversification on the originator of the Qualifying Assets or sponsor of the Special Purpose Entity. This ignored, however, one of the principal objectives of structured finance, which was to insulate the Asset Backed Securities from the financial condition of other companies that have dealt with the Qualifying Assets. The SEC ultimately agreed to treat the Special Purpose Entity as the issuer, but remained concerned that companies that issued obligations directly to the money market funds also could issue some of the Qualifying Assets. The amended rule therefore treated any issuer of 10 percent or more of the Qualifying Assets (a Ten Percent Obligor) as the issuer of a proportionate share of the Asset Backed Security. Moreover, if some of the Qualifying Assets are Asset Backed Securities, money market funds were required to "look through" to any Ten Percent Obligors of the secondary Asset Backed Securities. The amended rule also provided an exception to the Ten Percent Obligor "look through" requirements for certain restricted Special Purpose Entities that were formed to issue Asset Backed Securities to only one other Special Purpose Entity.[91]

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[88] Rule 2a-7(c)(4)(i) (1997).

[89] *Id.*

[90] Rule 2a-7(a)(3) (1997).

[91] Rule 2a-7(c)(4)(ii)(D) (1997).

As previously noted, the rule continued to impose uniform Demand Feature diversification requirements on all types of money market funds. The requirements were made more uniform by applying the same limitations on Demand Features regardless of whether they were Conditional or Unconditional. The limitations also were extended to all forms of Guarantees, not just Unconditional Demand Features. Only First Tier Demand Features and Guarantees, however, were permitted to exceed 5 percent of Total Assets, or qualify for the "25 percent basket."[92]

In addition, the amendments provided an exception from the issuer diversification requirements for securities subject to third-party Guarantees, in recognition of the fund's complete reliance on the credit of the provider of the Guarantee rather than on the issuer of the security. The amendments also clarified the treatment of fractional Guarantees (which were treated as Guarantees of only a portion of the security) and layered Guarantees (each of which was treated as a Guarantee of the entire security).[93] Finally, the amended rule acknowledged that a fund could elect not to rely on a Demand Feature or Guarantee if a security independently qualified as an Eligible Security.[94]

The amendments added a requirement to the definition of Collateralized Fully, namely that "Upon an Event of Insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller." The SEC added this provision to ensure that a bankruptcy or receivership proceeding would not prevent a fund from selling the underlying securities immediately following a default. The amendments also permitted funds to treat "Refunded Securities" as investments in the underlying Government Securities. Refunded Securities are bonds that have been defeased by a deposit of Government Securities (most typically U.S. Treasury obligations) that, upon maturity, will provide sufficient funds to pay all principal and interest on the bond when due. This codified an earlier no-action position taken by the Division.[95]

3. Changes to the Maturity Requirements

The 1996 and 1997 amendments left intact the 397 day and 90 day maturity limits. In response to problems presented by certain interest rate derivatives, however, the rule was amended to clarify that a determination that an adjustable-rate security would approximate its amortized cost value must be made for all interest rate adjustments until the final maturity, not just the next scheduled adjustment.[96] This was intended to prevent funds from assuming that they could dispose of an adjustable-rate security before foreseeable market conditions might cause the security to deviate significantly from its amortized cost value. The amended rule also imposed new procedural and recordkeeping requirements intended to help the SEC review these determinations during examinations.[97]

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[92] Rule 2a-7(a)(4)(iii) (1997).

[93] Rule 2a-7(a)(4)(iv) (1997).

[94] Rule 2a-7(a)(5) (1997).

[95] *See T. Rowe Price Tax Free Funds*, SEC No-Action Letter (pub. avail. June 24, 1993). The provisions governing repurchase agreements that are Collateralized Fully and Refunded Securities have been moved to Rule 5b-3.

[96] Rule 2a-7(a)(13) and (a)(29) (1997).

[97] Rule 2a-7(c)(9)(iii) and (c)(10)(iv) (1997).

In addition, the amendments made a small change to the deemed maturity of adjustable rate securities subject to Demand Features. Although adjustable-rate securities with final maturities of more than 397 days continue to be treated as maturing on the *later* of the next interest rate adjustment or the date on which principal must be paid following exercise of the Demand Feature, adjustable-rate securities with final maturities of less than 397 days are now treated as maturing on the *earlier* of those two dates.[98] This was the SEC's limited concession to an industry request to adopt an "earlier of" rule for all adjustable-rate securities subject to Demand Features.

E. The 2010 Amendments

The financial crisis that followed in the wake of the bankruptcy of Lehman Brothers Holdings, Inc. (Lehman) prompted the most recent amendments to Rule 2a-7. The impact of the crisis on money market funds was largely confined to the week of Lehman's bankruptcy. The sequence of events[99] was as follows:

- 9/15/2008—Lehman filed for bankruptcy
- 9/16/2008—Reserve Primary Fund (which held $785 million of Lehman commercial paper) announced that it had broken a dollar and reduced its share value to 97 cents.
- 9/15 to 9/19/2008—Shareholders redeemed approximately $300 billion (14% of total assets) from prime (taxable) money market funds. The funds reduce their investments in commercial paper, certificates of deposit and other instruments. During the last two weeks of September, money market fund holdings of commercial paper dropped by over $200 billion.
- 9/19/2008—The Treasury Department announced a Temporary Guarantee Program for Money Market Funds, which guaranteed shares held on that date up to an aggregate amount of $50 billion. The Federal Reserve Board contemporaneously announced the establishment of an Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, through which it extended credit to U.S. banks to finance their purchases of high-quality asset-backed commercial paper from money market funds, and a Commercial Paper Funding Facility, which provided support to issuers of commercial paper.

The actions taken by the Treasury Department and the Federal Reserve Board quickly shored up the prime money market funds. Assets in the funds bottomed out at just over $1.7 trillion at the end of the first week in October, and rose to nearly $1.9 trillion by the end of 2008.

In response to these unprecedented events, the Investment Company Institute organized a working group to study and propose regulatory reforms for money market funds. In March 2009, the Institute released the Working Group's

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[98] Compare Rule 2a-7(d)(2) to (d)(3) and (d)(4) to (d)(5) (1997).

[99] This chronology is based on Section I.D of *Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009).

recommendations.[100] Just three months later, the SEC proposed reforms based, in part, on the recommendations made in the Working Group Report.[101] The release also posed several fundamental questions, including whether the SEC should require money market funds to offer and redeem their shares at a fluctuating NAV. The SEC approved the amendments in January 2010.[102] At that time, "Money market funds [had] over $3.3 trillion dollars in assets under management, and comprise[d] over 30 percent of the assets of registered investment companies."[103]

Fortunately, the SEC chose to amend, rather than repeal, the rule. Although the policy debate over whether to require money market funds to "float" their NAV continues, the 2010 amendments left the principles of Rule 2a-7 intact—strict limits on credit and interest rate risks coupled with a high degree of diversification. More significantly, the SEC added provisions to Rule 2a-7 addressing the liquidity risks faced by money market funds, requiring periodic stress testing and posting of monthly portfolio information. Other reforms addressed what to do with a money market fund after it broke a dollar. For the first time, the amendments did not add materially to the length of the rule, as the new requirements were largely offset by the elimination of certain exceptions and rating requirements.

1. Imposition of Liquidity Requirements

As previously noted, the SEC emphasized the importance of liquidity (a money market fund's ability to redeem shares without jeopardizing its stable NAV) when it first adopted Rule 2a-7. Fund managers also recognized the importance of liquidity and developed various systems and techniques to assure adequate liquidity for their funds. Notwithstanding its importance, prior to the 2010 amendments, Rule 2a-7 did not include any liquidity requirements, as the limitation on Illiquid Securities was an interpretative position of the SEC that applied to all mutual funds.[104]

The 2010 amendments added three liquidity requirements to Rule 2a-7. The first was a general requirement that money market funds maintain sufficient liquidity "to meet reasonably foreseeable shareholder redemptions."[105] The genesis of this requirement was a recommendation in the Working Group Report to "Require advisers to adopt robust 'know your client' procedures."[106] Although Rule 2a-7 does not refer to know your client procedures, the SEC clearly intended to require them—

> Thus, to comply with rule 2a–7, …, money market funds should adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders. … [F]und boards should make sure that the adviser is monitoring and planning for ''hot money.'' … [F]und boards should appreciate that, in some cases, fund managers' interests in attracting additional fund assets may be in conflict with their overall duty to manage the fund in a manner consistent with maintaining a stable net asset value. We urge directors to consider

[100] Report of the Money Market Working Group, Investment Company Institute (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf [hereinafter Working Group Report].

[101] Release No. IC-28807, *supra* note 99.

[102] *Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010).

[103] *Id.* at text preceding n. 3.

[104] *See* releases cited in Release No. 29132, *supra* note 102, at n. 202.

[105] Rule 2a-7(c)(5)(i) (2010).

[106] Working Group Report, *supra* note 100, at 70.

the need for establishing guidelines that address this conflict.[107]

The second liquidity requirement codified the limit on Illiquid Securities and reduced it from 10 percent to 5 percent. The SEC initially proposed to prohibit money market funds from acquiring any Illiquid Securities. When several commenters noted that Illiquid Securities may be investments of the highest quality and are essential to new product development, the SEC decided to only reduce the limit on Illiquid Securities from 10 percent to 5 percent. The SEC also changed the requirement from a continual limitation to one a fund must satisfy each time it acquires an Illiquid Security. Although the SEC proposed changing its long standing definition of Illiquid Security, the definition in the 2010 amendments codified the SEC's prior guidance. Hence, "[u]nder the amended rule, a money market fund using the amortized cost method will be able to treat as liquid a security that the fund can sell at a price that deviates from the security's amortized cost value, as long as the price approximates the market-based value that the fund has ascribed to the security for purposes of determining its shadow price."[108]

The third liquidity requirement reflects another Working Group recommendation that was intended to make money market funds less dependent on secondary markets for liquidity. Specifically, the Working Group Report proposed requiring that a percentage of a fund's portfolio consist of securities scheduled to mature on the next day or within one week, or subject to Demand Features exercisable within such periods. These securities could provide funds with substantial amounts of cash even when the secondary market for short-term obligations effectively shuts down. The Working Group Report also recommended that Treasury securities count towards the daily liquidity requirement and other Government Securities count towards the weekly liquidity requirements, in light of the proven resiliency of these secondary markets during times of financial crisis.[109]

The SEC included this recommendation in the proposed amendments, but with two important changes. First, the SEC proposed to impose different daily and weekly liquidity standards for retail and institutional money market funds, while charging boards with responsibility for deciding whether their funds were retail or institutional. Retail funds would have to maintain daily liquidity of 5 percent and weekly liquidity of 15 percent, while institutional funds would have to maintain double these percentages. In contrast, the Working Group Report had recommended a single standard of 5 percent daily liquidity and 20 percent weekly liquidity. Second, the SEC proposal would not have counted Government Securities towards the weekly liquidity requirement.

Although some commenters supported the retail/institutional distinction, many commenters were skeptical about whether money market funds could be bifurcated in this manner. In response to the largely negative comments, the 2010 amendments imposed the proposed institutional requirements on all money market funds. The SEC relied on a statistical analysis of industry flows during the week following the Reserve Primary Fund breaking a dollar to justify these requirements, concluding that between 20 percent and 30 percent of funds experienced outflows during the

[107] Release No. 29132, *supra* note 102, at text preceding n. 199.

[108] Release No. 29132, *supra* note 102, at n.210.

[109] Working Group Report, *supra* note 100, at Sections 7.1.1 to 7.1.2.

week in excess of the Working Group Report's proposed requirements. Thus, the SEC has established liquidity requirements that would have allowed more than 80 percent of funds to satisfy redemption requests during the worst market conditions yet experienced without selling a single non-Government Security.

Funds must satisfy Daily and/or Weekly Liquid Asset standards whenever they acquire a security. Daily Liquid Assets include cash (including deposit accounts), direct obligations of the U.S. Government, securities that will mature[110] in one business day, and securities subject to Demand Features exercisable and payable in one business day. A money market fund may always acquire a Daily Liquid Security; however, a fund (other than a Tax Exempt Fund) may not acquire any other security unless, immediately after the acquisition, the fund has invested at least 10 percent of its total assets in Daily Liquid Assets.[111] The exception of Tax Exempt Funds from this requirement, also recommended in the Working Group Report, reflects the paucity of one-day tax exempt instruments available to Tax Exempt Funds.[112]

The Weekly Liquid Asset requirement applies to all money market funds, including Tax Exempt Funds. In addition to Daily Liquid Assets, Weekly Liquid Assets include securities that will mature within five business days or which are subject to Demand Features exercisable and payable within that period. Weekly Liquid Assets also include non-interest bearing[113] Government Securities issued (but not guaranteed) by a federal instrumentality with a remaining maturity of 60 days or less. A fund that complies with the Daily Liquid Asset requirement (or a Tax Exempt Fund) may always acquire a Weekly Liquid Asset; however, a fund may not acquire any other security unless, immediately after the acquisition, the fund has invested at least 30 percent of its total assets in Weekly Liquid Assets.

2. Mandatory Stress Testing

Another recommendation in the Working Group Report was to "Mandate regular stress testing to assess a portfolio's ability to meet hypothesized levels of credit risk, shareholder redemptions, and interest rate changes." The report noted that certain European regulators required monthly stress testing by money market funds and that the Institutional Money Market Funds Association had issued "guidance on generic stress testing."[114] The SEC included periodic stress testing in the proposed amendments, but proposed to give the board responsibility for establishing testing procedures and to require four mandatory stress tests.

[110] "The maturity shortening provisions of paragraphs (d)(1) through (d)(8) are not always consistent with [the Daily and Weekly Liquid Asset] requirement and therefore should not be relied upon in interpreting those definitions. The term 'mature' in these definitions should be understood to mean only the date on which the principal amount must unconditionally be paid, or… the date on which the redemption payment must be made." Staff Responses to Questions about Money Market Fund Reform (May 25, 2010), available at http://www.sec.gov/divisions/investment/guidance/mmfreform-imqa.htm [hereinafter 2010 2a-7 Q&A], at Question II.1.

[111] "A money market fund may choose any reasonable time for determining its Total Assets, Daily Liquid Assets, and Weekly Liquid Assets…, provided that: (a) the determinations are made at least once every Business Day; and (b) the fund consistently makes the determinations at the same time or times." 2010 2a-7 Q&A, *supra* note 110, at Question II.3.

[112] Release No. 29132, *supra* note 102, at text preceding n. 241.

[113] "Whether an agency note may qualify as a Weekly Liquid Asset depends on whether the note is issued without an obligation to pay additional interest on the principal amount, so that income earned, if any, is solely the difference between the amount paid at issuance and the principal amount payable upon maturity." 2010 2a-7 Q&A, *supra* note 110, at Question II.2. It does not matter if the note was actually issued at a discount to its face value.

[114] Working Group Report, *supra* note 100, at n. at 138 and n. at 139.

The amended rule included the stress testing requirements as proposed. Although the SEC "agree[d] with the many commenters that asserted that the board may not have sufficient expertise to construct appropriate stress tests for a fund,"[115] Rule 2a-7 prohibits the board from delegating its responsibility for adopting stress testing procedures. "The rule does not, however, specifically require the board to design the portfolio stress testing" and "each board may, of course, consider the extent to which it wishes to become involved in design of the stress tests."[116]

Although the SEC stated that "[b]ecause different tests may be appropriate for different market conditions and different money market funds, we believe that the funds are better positioned to design and modify their stress testing systems,"[117] the 2010 amendments nevertheless mandated that every fund conduct four particular stress tests. First, a fund must test its "ability to maintain a stable net asset value per share based upon … a change in short-term interest rates." Second, a fund must test its "ability to maintain a stable net asset value per share based upon … an increase in shareholder redemptions." The interest rate stress test assumes a uniform instantaneous change in the market rates for all securities (known as a "parallel shift" in the yield curve); the redemption stress test assumes net redemptions of a specified percentage of the fund's outstanding shares.

The third mandatory test involves the "ability to maintain a stable net asset value per share based upon … a downgrade of or default on portfolio securities."[118] The staff provided the following guidance regarding this third test:

> This test should … be designed to assist the board of directors in assessing the effect of isolated stresses on a fund's shadow [NAV]. If a downgrade or default of a portfolio holding is likely to have a significant effect on the fund's shadow NAV, so that the shadow NAV would deviate by more than one-half cent per share, the test should indicate the full extent of the loss a fund might be expected to incur as a result.[119]

The final mandatory test is the most difficult to interpret. This test must be based on "the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund." This could be interpreted as requiring funds to repeat the test of changes in short-term interest rates, except the overnight rate would remain constant. Interest rate changes have little effect on overnight investments, however, so the result would not differ noticeably from the first stress test. Alternatively, the reference to a "widening or narrowing of spreads" could be interpreted to require a test of uniform changes in the credit or other spreads for securities. This will produce exactly the same results as the first test, except the change in interest rates would be due to a hypothetical repricing of credit risks rather than general

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[115] Release No. 29132, *supra* note 102, at text preceding n. 265.

[116] Release No. 29132, *supra* note 102, at text relating to n. 264.

[117] Release No. 29132, *supra* note 102, at text preceding n. 261.

[118] A Treasury fund (*i.e.*, a fund that invests solely in direct obligations of the U.S. government) may be able to forgo this test. 2010 2a-7 Q&A, *supra* note 110, at Question III.A.1.

[119] 2010 2a-7 Q&A, *supra* note 110, at Question II.A.3.

changes in interest rates. This approach would give the board the same test results twice, while receiving different explanations of why the results might occur.

Another approach is to focus on a "widening or narrowing of spreads" in the context of "commercial paper and other types of securities *held by the fund*." From this perspective "widening or narrowing of spreads" could relate to spreads for different types of securities held by the fund, assuming that interest rates for other types of securities remain constant. This test would produce different results from the first test because it assumes that subsets of the portfolio will be subject to different, rather than uniform, interest rate changes. The overnight benchmark would define what it means for a spread to widen or narrow. This would be an intermediate test between the most general stresses (changes in market rates and redemptions) and the most specific stress (the downgrade or default of a particular issuer). Following this approach, a fund might test the effects of (a) steeper and flatter yield curves (*i.e.*, assuming that the spread between overnight rates and longer term securities increase or decrease and the magnitude of the change increases with the security's maturity), (b) increases in spreads affecting a specific sector (such as financial companies or asset-backed securities) and (c) increases in the spreads for Variable and Floating Rate Securities.

The 2010 amendments gave the board authority to determine the frequency of stress testing as "appropriate and reasonable in light of current market conditions." Boards are expected to take the same approach to stress testing as they do to shadow pricing, by increasing the frequency as market conditions warrant. In particular, the SEC "would expect that if a fund's shadow [NAV] decreased to less than $0.9975, the fund would conduct stress tests at least every week …."[120]

The board must receive the results of the stress testing at each regular board meeting "or sooner, if appropriate in light of the results." The SEC added the interim reporting requirement because it "believe[s] that the board should be apprised of test results when they indicate that the magnitude of hypothetical events required to cause the fund to break a buck … is slight when compared with actual conditions."[121]

The report must contain all of the stress testing results since the last report.[122] Each report provided to the board must show the magnitude of each hypothetical event that would cause the fund's shadow NAV to fall to more than 50 basis points under a dollar.[123] This "test to failure" has implications for the design of the stress tests, as each test must be capable of being pushed to this limit, no matter how unrealistic the stress may be. The report to the board also must include the investment adviser's "assessment … of the fund's ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year." This "is

[120] Release No. 29132, *supra* note 102, at n. 262.

[121] Release No. 29132, *supra* note 102, at text following n. 266.

[122] 2010 2a-7 Q&A, *supra* note 110, at Question II.A.4.

[123] Funds are not required to test for events that will cause the shadow NAV to exceed one dollar. 2010 2a-7 Q&A, *supra* note 110, at Question II.A.2.

designed to provide to the board some context within which to evaluate the assessment on the magnitude of each hypothetical event that would cause the fund to break the buck."[124]

3. Changes to Existing Risks Limitations

The Working Group Report also recommended tightening the traditional limits on maturity, credit quality and diversification in several respects: first, to reduce the maximum dollar-weighted average portfolio maturity from 90 days to 75 days; second, to impose a new 120-day limit on the dollar-weighted average portfolio maturity calculated without regard to interest rate adjustments ("Modified WAM"); and finally, to prohibit money market funds from acquiring Second Tier Securities.[125]

The SEC went further than the Working Group Report*'s* recommendation by proposing to reduce the maximum average weighted portfolio maturity from 90 to 60 days. Comments on the proposal split three ways: some commenters supporting a 60-day limit, others supporting the Working Group Report*'s* 75 day recommendation, and others advocating no change in the 90-day limit. The SEC adopted the proposed 60-day limit, noting that rated funds and Europeans Funds have operated for many years with a 60 day average weighted portfolio maturity limitation and that the average weighted portfolio maturities for most U.S. money market funds rarely exceed 60 days.[126]

The SEC also adopted the Working Group Report's proposed 120-day limit on Modified WAM. The need for an alternative limit on a fund's average weighted portfolio maturity can be illustrated by the following example. Suppose a fund invests in a one-year note with an interest rate that adjusts at the end of each month to equal the current effective Federal Funds Rate plus 1.0 percent. For purposes of calculating the normal average weighted portfolio maturity, Rule 2a-7 would treat this note as maturing at the end of each month, so long as the effective Federal Funds Rate is expected to reflect changes in short-term interest rates.[127] If the Federal Reserve unexpectedly increased the Federal Funds Rate by 0.5 percent, the interest rate on the note would also increase by 0.5 percent at the end of the month, which should cause the note's market value to return to approximately its amortized cost.

What would happen if the Federal Funds Rate stayed constant, but the market became more concerned that the issuer might default on its note? In that event, potential buyers of the note might require a yield of 1.5 percent over the Federal Funds Rate. The month-end adjustment to the interest rate would not reflect this increase on the "spread" over the effective Federal Funds Rate (from 1.0 percent to 1.5 percent) because the effective Federal Funds Rate did not change, so the note would continue to bear interest at the same rate it did during the previous month. Hence, the only way to increase the note's spread would be to reduce its price. Once the price no longer approximated the note's amortized cost, however, Rule 2a-7 would treat the note as maturing on its due date (*i.e.*, one-year from issuance) and the fund's average weighted portfolio maturity would increase accordingly.

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[124] Release No. 29132, *supra* note 102, at n. 268.

[125] Working Group Report, *supra* note 100, at Sections 7.2 and 7.10.1.

[126] Release No. 29132, *supra* note 102, at n. at 151 and n. at 152.

[127] Rule 2a-7(d)(2)(2010).

The 120-day limit on Modified WAM limits the risk that adjustable rate securities may cause a money market fund's average weighted portfolio maturity to extend, and its portfolio to become more volatile, if changes in market "spreads" cause the securities to no longer approximate their amortized costs whenever their interest rates are adjusted.[128] The new limit does this by calculating the Modified WAM as though the words "shall be deemed to have a maturity equal to the period remaining until the next readjustment of the interest rate," with respect to Variable Rate Securities, and "shall be deemed to have a remaining maturity of one day," with respect to Floating Rate Securities, did not appear in paragraph (d) of Rule 2a-7. Instead, these securities either are deemed to mature on their legal maturity date or, if they are subject to a Demand Feature, when "the principal amount can be recovered through demand."

Finally, the SEC followed the Working Group Report's recommendation by proposing to prohibit money market funds from acquiring Second Tier Securities. The comment letters revealed a rift in the industry over this issue, however. Many issuers of Second Tier Securities and others joined several fund managers in urging that funds should continue to participate in the market for Second Tier Securities. The final amendments imposed a compromise by allowing money market funds to continue to acquire Second Tier Securities but halving their diversification limits. Hence, Rule 2a-7 permits a money market fund to acquire a Second Tier Security only if the issuer would exceed 0.5 percent, or if the provider of any Demand Feature or Guarantee for the security would exceed 2.5 percent, of the fund's total assets. In addition, the overall limit on the acquisition of Second Tier Securities was reduced from 5 percent to 3 percent of total assets, and the maximum permitted maturity of Second Tier Securities was reduced from 397 to 45 days.

The 2010 amendments also eliminated the different treatment of Second Tier Conduit and non-Conduit Securities held by Tax Exempt Funds. Under the 1997 amendments, Second Tier non-Conduit Securities were subject to the same general diversification limits as First Tier Securities, and only Second Tier Conduit Securities were subject to the limits imposed on Second Tier Securities held by taxable funds. After the 2010 amendments, all Second Tier Securities were subject to the same limits, regardless of the type of security or fund. This includes the new 45 day maturity limit.

A change to Amended Rule 2a-7 not recommended by the Working Group Report was to restrict the treatment of repurchase agreements as investments in the underlying securities for purposes of diversification. The change effectively reinstated the requirements of the SEC's 1983 interpretive release on repurchase agreements.[129] Specifically, money market funds may treat a repurchase agreement as "Collateralized Fully" only if (a) the underlying securities are Government Securities and (b) the board determines that the seller is creditworthy. Other types of investment companies may still treat a repurchase agreement for securities rated by an NRSRO in the highest rating category as Collateralized Fully, and are not required to make a creditworthiness determination. Money market funds

[128] Release No. 29132, *supra* note 102, at n. 156.

[129] *Securities Trading Practices of Registered Investment Companies*, SEC Release No. IC-13005 (February 2, 1983), 48 FR 5894 (February 9, 1983).

may continue to engage in repurchase agreements for other types of securities, but must treat them as obligations of the seller for purposes of diversification.[130]

4. New Disclosure Requirements

The 2010 amendments introduced two new disclosure requirements for money market funds: (1) monthly website disclosure, focused primarily on the fund's portfolio and (2) more extensive information provided to the SEC each month (and made publicly available 60 days later) on new Form N-MFP. Monthly portfolio disclosure was another recommendation of the Working Group.[131] The SEC added a new paragraph ((c)(12)) to Rule 2a-7 requiring funds to disclose their average weighted portfolio maturities and Modified WAMs on their websites as of the end of each month, as well as information required about each portfolio holding. The new provision required such information as the holding's description and CUSIP number, its amortized cost, maturity (used to calculate the fund's average weighted portfolio maturity) and final maturity (used to calculate the fund's Modified WAM).[132] Each holding must be assigned to one of sixteen prescribed categories of investments (*e.g.*, Treasury debt, financial company commercial paper, certificate of deposit).[133]

In contrast to website disclosure, Form N-MFP was a novel reform proposed by the SEC. The Working Group Report had proposed "a nonpublic reporting regime for all institutional investors in the money market, including money market funds" and a formal "SEC program to monitor money market funds … ."[134] Although Form N-MFP allows the SEC to monitor money market funds, it is a public reporting regime that does not include any other type of institutional investor.

New Rule 30b1-7 required every registered investment company "regulated as a money market fund under [Rule 2a-7]" to file Form N-MFP with the SEC within five business days after the last business day of each month. Rule 2a-7(b) requires any fund that "holds itself out to investors as a money market fund or the equivalent of a money market fund" to comply with the risk limiting requirements of Rule 2a-7. Thus, even funds that do not use the Amortized Cost or Penny Rounding Method may be "regulated … under Rule 2a-7" and required to file Form N-MFP.[135]

[130] Release No. 29132, *supra* note 102, at n. 273.

[131] Working Group Report, *supra* note 100, at Section 7.6.2. Although the report recommended updating the portfolio disclosure within two days after the end of each month, industry members' comment letters expressed second thoughts regarding their ability to assure the quality and accuracy of portfolio information within such a limited period. The amendments therefore allowed five business days in which to post the required information following the end of each month.

[132] 2010 2a-7 Q&A, *supra* note 110, at Question V.H.1.

[133] Staff Responses to Questions about Rule 30b1-7 and Form N-MFP (June 25, 2010), available at http://www.sec.gov/divisions/investment/guidance/formn-mfpqa.htm [hereinafter Form N-MFP Q&A], at Question II.C.1. ("Q: Form N-MFP (like the monthly website posting provision under rule 2a-7) requires funds to indicate the specific category most closely identified with each portfolio security. Must funds use the categories specified in Form N-MFP or can they use other categories? A: Funds must use the categories specified in Form N-MFP.")

[134] Working Group Report at 71.

[135] Form N-MFP Q&A, *supra* note 133, at Question I.1.

Form N-MFP is divided into two parts: (1) information regarding the fund as a whole and (2) information about each portfolio investment. The first ten questions of Part I relate to the category of fund and its primary service providers. The fund and class level information in the remainder of Part I requires disclosure of the shadow NAVs for each class[136] and gross (at the fund level) and net (at the class level) seven-day yields. Total assets, liabilities and net assets are reported at the fund level; gross sales and redemptions of shares and net shareholder activity are reported at the class level.

The second part of Form N-MFP has twenty items for every portfolio holding, but it actually requires even more information. For example, there are six sub-items for each repurchase agreement,[137] and NRSROs and their ratings[138] must be provided for each Rated Security, Demand Feature and Guarantee. Form N-MFP must also include the value of each security, determined in the same manner as the value used to calculate the shadow NAV. Each security must be valued as of the last business day of the month covered by the form.[139] Alternative market values are required if a security is subject to a credit support arrangement.[140]

The SEC releases the information on Form N-MFP to the public sixty days after the end of each month. A fund's website must maintain copies of the last six months of portfolio disclosures, and also a link to the last twelve Form N-MFPs available on EDGAR. The links must take the viewer directly to the reports; it cannot lead to a webpage where the viewer can search for the filings.[141]

5. Designating NRSROs

The 2010 amendments included provisions requiring the Board to designate the NRSROs upon whose ratings their money market funds would rely and to monitor the effectiveness of the credit ratings. The Dodd-Frank Wall Street Reform and Consumer Protection Act, however, included a provision requiring all Federal agencies to identify and eliminate references to NRSRO credit ratings from their regulations. The Division therefore suspended these provisions,[142] and has proposed amendments that would remove from Rule 2a-7 any reference to an NRSRO.[143] It appears that, eventually, the SEC will eliminate all references to Requisite NRSROs in Rule 2a-7.

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[136] Funds that distribute all of their daily net income for every class of shares may use the fund level shadow price without a separate calculation. Form N-MFP Q&A, *supra* note 133, at Question II.B.1.

[137] A fund must provide this information even if it does not look through to the underlying securities for purposes of diversification. Form N-MFP Q&A, *supra* note 133, at Question II.E Item 32.

[138] If a fund determines whether a security is an Eligible Security based on the ratings of other obligations of the issuer that are of comparable priority and security, these ratings should be provided. Form N-MFP Q&A, *supra* note 133, at Question II.E Items 34, 37 and 38.

[139] Form N-MFP Q&A, *supra* note 133,. at Question II.A.1.

[140] Questions II.D.1 and II.D.2 of the Form N-MFP Q&A provide additional guidance on how to calculate the value of credit support arrangements.

[141] 2010 2a-7 Q&A, *supra* note 110, at Question V.C.1.

[142] Investment Company Institute, SEC Staff No-Action Letter (pub. avail. August 19, 2010).

[143] *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, SEC Release No. IC-29592 (March 3, 2011), 76 FR 12896 (March 9, 2011).

6. Dealing with Failed Funds

The process of the Reserve Primary Fund "breaking a dollar" revealed several problems that can arise when a money market fund shifts from a stable to a fluctuating NAV. [144] For example, errors in shadow pricing created uncertainty as to when the fund actually "broke a dollar." In addition, some of the systems used to process the fund's share transactions could only use a $1.00 NAV and had to be adjusted before the fund could make liquidating distributions.[145] The SEC also had to rush to issue an order under Section 22(e) of the Investment Company Act allowing the fund to suspend redemptions and delay redemption payments indefinitely while the fund was liquidated.

The 2010 amendments dealt with two of these problems. First, new paragraph (c)(13) of Rule 2a-7 required all money market funds to have the ability to calculate a fluctuating NAV for their shares. This presumably entails calculating the fund's NAV in compliance with ASR 219 (*i.e.*, rounding to the nearest tenth of a cent and using amortized cost only for securities maturing in 60 days or less). The amendments did not require funds to determine whether the intermediaries selling their shares also have this capacity.[146]

Second, the SEC adopted a new rule permitting the board to suspend redemptions while liquidating a money market fund. Although a mutual fund may delay payment of redemption proceeds for up to seven days, Section 22(e) does not permit a fund to suspend redemptions themselves except "for such … periods as the [SEC] may by order permit for the protection of security holders of the company." Section 22(e) also permits suspension of redemptions when "an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets," but requires the SEC to adopt regulations defining when an emergency exists. The SEC first exercised this authority in connection with the Treasury Department's Temporary Guarantee Program for Money Market Funds. Liquidation of the fund was a condition to payments under the Guarantee, and the SEC adopted a temporary regulation, Rule 22e-3T, to permit funds to suspend redemptions while liquidating. In the end, the Temporary Guarantee Program expired after one year, without receiving a single claim and thus Rule 22e-3T was never utilized.

The Working Group Report recommended allowing a board to temporarily suspend redemptions for up to five business days "if a fund has either broken or reasonably believes it may be about to break a dollar," as well as while a fund was liquidating.[147] In light of the significance to shareholders of their right to redeem, the SEC decided "only to facilitate the *permanent* termination of a fund in an orderly manner."[148] New Rule 22e-3 therefore required the board to "irrevocably approv[e] the liquidation of the fund" prior to suspending redemptions. The board must also have found "that the extent of the deviation between the fund's [one-dollar NAV] and its [shadow NAV] may result in

[144] *See In re the Reserve Fund Securities and Derivative Litigation*, 673 F.Supp.2d 182 (S.D.N.Y. 2009), for an explanation of some of these problems.

[145] Reserve Primary Fund Disbursement Update (October 15, 2008), available at http://www.reservefunds.com/pdfs/Press%20Release%20Reserve_Primary_Fund_2008_1015.pdf.

[146] Release No. 29132, *supra* note 102, at text preceding n. 363.

[147] Working Group Report, *supra* note 100, at 70.

[148] Release No. 29132, *supra* note 102, at text preceding n. 380 (added emphasis).

material dilution or other unfair results to investors or existing shareholders," and must notify the SEC before suspending redemptions. A board may want to consult the *Checklist for Suspending Redemptions and Liquidating a Money Market Fund* for other steps to consider under these dire circumstances.[149] A fund "may also need to update its prospectus to disclose the circumstances under which it may suspend redemptions."[150]

V. Conclusion

It has been over forty years since money market funds were first offered to investors, and next year will mark the thirtieth anniversary of Rule 2a-7. Money market funds have shown remarkable resiliency during this period, fairing better than any other form of financial institution throughout every form of financial crisis. This resiliency is due, in part, to the SEC's flexible approach to regulating money market funds, which has sought to balance investor needs for a diversified cash management with investor concerns for the safety of their cash. With luck, money market funds will continue to find ways to navigate challenges that will be posed by the market during the next forty years at least.

[149] This checklist is available on ICI's website at http://www.ici.org/pdf/susp_redemp_checklist.pdf.

[150] Release No. 29132, *supra* note 102, at n. 378.