Blogs
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Asset Management ADVocate

It's a Miracle: Rule 2a-7 Gets Shorter

Yesterday, the SEC adopted what I hope will be the final amendments to Rule 2a-7 made during my career. For the first time in the history of Rule 2a-7, the SEC cut more than it added, reducing the length of the rule by over 12%. The amendments relate primarily to credit and diversification requirements, but also incorporate some of the staff's FAQs on the 2014 reforms. **Revised Credit Standards** The amendments were prompted by Section 939A of the Dodd-Frank Act, which required the SEC to "to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine." The SEC has complied by removing all references to NRSROs and "rated securities" from Rule 2a-7, which is why the amended rule is shorter. The amended rule retains the minimal credit risk standard that dates back to the original money market fund exemptive orders. Thus, an "eligible security" is now defined as a security that presents minimal credit risk. The amended rule also codifies the following general factors to be considered in assessing credit risk:

- Financial condition;
- Sources of liquidity;
- Ability to react to future market-wide and issuer- or guarantor-specific events, including ability to repay debt in a highly adverse situation; and
- Strength of the issuer or guarantor's industry within the economy and relative to economic trends, and issuer or guarantor's competitive position within its industry.

The SEC staff's original list of general factors was:

- a cash flow analysis;
- an assessment of the issuer's ability to react to future events, including a review of the issuer's competitive position, cost structure, and capital intensiveness;
- an assessment of the issuer's liquidity, including bank lines of credit and alternative sources of liquidity to support its commercial paper; and
- a "worst case scenario" evaluation of the issuer's ability to repay its short-term debt from cash sources or asset liquidations in the event that the issuer's backup credit facilities are unavailable.

So, apart from being in a different order, the codified factors are more general and refer to a "highly adverse situation" rather than a "worst case scenario." It will take time to digest the revised factors. **Diversification for All Issuers** Generally speaking, Rule 2a-7 has two diversification limits: a 5% limit for issuers and a 10% limit for guarantees and demand features. When the limits were added to the rule in 1991, securities subject to third-party guarantees needed to comply with only the 10% limit and did not count towards the 5% limit on the underlying issuer. The amendments remove this exclusion. For example, prior to the amendments, a money market fund could theoretically invest 10% of its total assets in securities issued by Company X and guaranteed by Bank A, and another 5% in securities issued by Company X without any guarantee. Now the fund could only invest 5% of its total assets in these securities, and would have to find another issuer's securities guaranteed by Bank A to take Bank A up to the 10% limit. Unlike earlier releases, the adopting release does not explicitly grandfather securities already held by money market funds in excess of the 5% limit. As the limit is tested at the time of acquisition, however, it seems unlikely that funds will need to sell such securities to comply with the reforms. The amendments also codify Questions 45 through 48 of the FAQs, which interpreted the revised diversification requirements of the 2014 amendments. **Rating Disclosure** The SEC concluded that Section 939A did not prohibit regulations requiring the disclosure of ratings information, and amended Form N-MFP to disclose "each rating assigned by any NRSRO that the fund's board of directors (or its delegate) considered in determining that the security presents minimal credit risks." This is probably the most burdensome change made by the amendments. **Compliance Date** The SEC coordinated the compliance date for these reforms with the existing compliance date for the floating NAV and fees and gates requirements: October 14, 2016. Funds could come into compliance at an earlier date, however, once the amendments take effect on October 26, 2015.

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