

**SECURITIES AND EXCHANGE  
COMMISSION****17 CFR Parts 270 and 274**

[Release No. IC-31828; File No. S7-07-11]

RIN 3235-AL02

**Removal of Certain References to  
Credit Ratings and Amendment to the  
Issuer Diversification Requirement in  
the Money Market Fund Rule****AGENCY:** Securities and Exchange  
Commission.**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is adopting certain amendments, initially proposed in March 2011 and re-proposed in July 2014, related to the removal of credit rating references in rule 2a-7, the principal rule that governs money market funds, and Form N-MFP, the form that money market funds use to report information to the Commission each month about their portfolio holdings, under the Investment Company Act of 1940 (“Investment Company Act” or “Act”). The amendments will implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). In addition, the Commission is adopting amendments to rule 2a-7’s issuer diversification provisions to eliminate an exclusion from these provisions that is currently available for securities subject to a guarantee issued by a non-controlled person.

**DATES:** Effective Date: October 26, 2015;  
Compliance Date: October 14, 2016.

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**I. Background***A. Credit Rating References*

Section 939A of the Dodd-Frank Act requires each federal agency, including the Commission, to “review any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings.”<sup>1</sup> That section further provides that each such agency shall “modify any such regulations identified by the review . . . 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 as appropriate for such regulations.”<sup>2</sup>

As a step toward implementing these mandates, and as a complement to similar initiatives by other federal agencies,<sup>3</sup> in March 2011 the Commission proposed to replace references to credit ratings issued by nationally recognized statistical rating organizations (“NRSROs”) in two rules and four forms under the Securities Act of 1933 (“Securities Act”) and the Investment Company Act, including rule 2a-7 and Form N-MFP under the Investment Company Act.<sup>4</sup> We subsequently adopted certain of the rule provisions proposed in 2011: Namely, amendments to rule 5b-3 under the Investment Company Act, new rule 6a-5 under the Investment Company Act, and amendments to Forms N-1A, N-2, and N-3 under the Securities Act and

<sup>1</sup> Public Law 111-203, Sec. 939A(a)(1)–(2). Section 939A of the Dodd-Frank Act applies to all federal agencies.

<sup>2</sup> Public Law 111-203, Sec. 939A(b). Section 939A of the Dodd-Frank Act provides that agencies shall seek to establish, to the extent feasible, uniform standards of creditworthiness, taking into account the entities the agencies regulate and the purposes for which those entities would rely on such standards.

<sup>3</sup> A number of other federal agencies have also taken action to implement Section 939A of the Dodd-Frank Act, as discussed in Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, Investment Company Act Release No. 31184 (Jul. 23, 2014) [79 FR 47986 (Aug. 14, 2014)] (“2014 Proposing Release” or “Proposing Release”).

<sup>4</sup> See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29592 (Mar. 3, 2011) [76 FR 12896 (Mar. 9, 2011)] (“2011 Proposing Release”).

the Investment Company Act.<sup>5</sup> But in light of comments received on the 2011 proposed amendments to rule 2a-7 and Form N-MFP, and in conjunction with the wider money market fund reforms that the Commission adopted in July 2014 (the “2014 money market fund reforms”),<sup>6</sup> we decided to re-propose the amendments to rule 2a-7 and Form N-MFP instead of adopting them directly following the 2011 proposal.<sup>7</sup> Specifically, the 2014 re-proposed amendments to rule 2a-7 and Form N-MFP (the “2014 Proposing Release,” “Proposing Release,” or “proposal”)<sup>8</sup> responded to concerns that commenters raised with respect to the 2011 proposal.

We received 16 comment letters on the 2014 proposal.<sup>9</sup> The majority of commenters generally supported the proposed amendments to varying degrees.<sup>10</sup> However, many commenters expressed concern about the proposed “exceptionally strong” standard to replace credit ratings references in the requirements of rule 2a-7 for those securities eligible to be purchased by money market funds.<sup>11</sup> These

<sup>5</sup> In December 2013, we adopted amendments removing references to credit ratings in rule 5b-3 and eliminating the required use of credit ratings in Forms N-1A, N-2, and N-3. See Removal of Certain References to Credit Ratings under the Investment Company Act, Investment Company Act Release No. 30847 (Dec. 27, 2013) [79 FR 1316 (Jan. 8, 2014)] (“2013 Ratings Removal Adopting Release”). We adopted new rule 6a-5 on November 19, 2012. See Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)].

<sup>6</sup> See Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (Jul. 23, 2014) [79 FR 47736 (Aug. 14, 2014)] (“2014 Money Market Fund Adopting Release”).

<sup>7</sup> See 2014 Proposing Release, *supra* note 3.

<sup>8</sup> For clarity and because the re-proposal issued in July 2014 functions as the proposal for this adopting release, we refer to the re-proposal simply as the proposal throughout.

<sup>9</sup> The comment letters on the Proposing Release (File No. S7-07-11) are available at <http://www.sec.gov/comments/s7-07-11/s70711.shtml>. The Commission received 18 comment letters on the Proposing Release, but 2 of these letters did not discuss amendments to remove NRSRO credit ratings references from rule 2a-7 and Form N-MFP.

<sup>10</sup> Comment Letter of Chris Barnard (Aug. 23, 2014) (“Barnard Comment Letter”); Comment Letter of Michael Mark-Berger (Jul. 28, 2014) (“Berger Comment Letter”); Comment Letter of BlackRock, Inc. (Oct. 14, 2014) (“BlackRock Comment Letter”); Comment Letter of CFA Institute (Oct. 14, 2014) (“CFA Institute Comment Letter”); Comment Letter of the Investment Company Institute (Oct. 14, 2014) (“ICI Comment Letter”); Comment Letter of the Independent Directors Council (Oct. 7, 2014) (“IDC Comment Letter”); Comment Letter of Invesco Ltd. (Oct. 14, 2014) (“Invesco Comment Letter”); Comment Letter of Mutual Fund Directors Forum (Sep. 14, 2014) (“MDF Comment Letter”); Comment Letter of Charles Schwab Investment Management, Inc. (Oct. 14, 2014) (“Schwab Comment Letter”).

<sup>11</sup> We proposed to replace the reference to NRSRO credit ratings in rule 2a-7’s definition of “eligible

commenters suggested that the proposed “exceptionally strong” standard could lead to interpretive confusion in light of the similar existing “minimal credit risk” requirement, and might potentially change the kinds of securities that funds could purchase, contrary to the intent of the proposal to retain a similar degree of credit quality standards as under current rule 2a–7.<sup>12</sup>

In adopting final amendments to rule 2a–7 and Form N–MFP to implement Section 939A of the Dodd-Frank Act, we have carefully considered the comments received, and the final amendments include certain modifications intended to respond to commenters’ concerns. As proposed, we are adopting amendments to rule 2a–7 that would remove references to ratings and adopt a uniform standard to define an eligible security to be a security that has been determined to present minimal credit risks. However, we have eliminated the proposed “exceptionally strong capacity” standard from this determination, and as a substitute for this finding, the final rule amendments require that a minimal credit risk determination include, to the extent appropriate, an analysis of the guidance factors discussed in the preamble of the Proposing Release.<sup>13</sup> We believe that this approach will better fulfill the original goals of the rulemaking by replacing credit ratings references with a new standard that includes objective factors, which is designed to retain a similar degree of credit quality in money market fund portfolios as under the current rule.

For these reasons, we are also adopting a similar approach for funds to determine whether a long-term security subject to a conditional demand feature is an eligible security.<sup>14</sup> Finally, we are

security” with a required finding that each security’s issuer “has an exceptionally strong capacity to meet its short-term financial obligations.” See 2014 Proposing Release, *supra* note 3, at section II.A.1. Many commenters expressed concern about this proposed standard. See Comment Letter of Better Markets, Inc. (Oct. 14, 2014) (“Better Markets Comment Letter”); Comment Letter of the Consumer Federation of America (Oct. 14, 2014) (“CFA Comment Letter”); Comment Letter of the Dreyfus Corporation (Oct. 14, 2014) (“Dreyfus Comment Letter”); Comment Letter of Fidelity Investments (Oct. 14, 2014) (“Fidelity Comment Letter”); ICI Comment Letter; Comment Letter of the Committee on Investment Management Regulation of the New York City Bar (Oct. 14, 2014) (“NYC Bar Comment Letter”); Schwab Comment Letter; Comment Letter of the Securities Industry and Financial Markets Association (Oct. 14, 2014) (“SIFMA Comment Letter”); Comment Letter of Vanguard (Oct. 14, 2014) (“Vanguard Comment Letter”); see also *infra* section II.A.

<sup>12</sup> See, e.g., Dreyfus Comment Letter; Fidelity Comment Letter.

<sup>13</sup> See rule 2a–7(a)(11); see also *infra* section II.A.

<sup>14</sup> See rule 2a–7(d)(2)(iii); see also *infra* section II.B.

also adopting other amendments to rule 2a–7 and Form N–MFP, including the requirement that funds engage in ongoing monitoring of their portfolio securities and perform stress testing for a credit deterioration rather than specifically for a ratings downgrade, substantially as they were proposed, with certain changes as discussed below.

### B. Exclusion From the Issuer Diversification Requirement

Rule 2a–7’s risk limiting conditions require a money market fund’s portfolio to be diversified, both as to the issuers of the securities it acquires and providers of guarantees and demand features related to those securities.<sup>15</sup> When we proposed the amendments to rule 2a–7 that were adopted as part of the 2014 money market fund reforms, we discussed and sought comment on alternatives to the rule’s diversification provisions that we had considered to appropriately limit money market funds’ risk exposure.<sup>16</sup> Some of the comments we received in response prompted us to re-evaluate the current exclusion to the issuer diversification requirement for securities subject to a guarantee issued by a non-controlled person.<sup>17</sup> In consideration of these comments, and consistent with our reform goal of limiting concentrated exposure of money market funds to particular economic enterprises, as part of the 2014 proposal we proposed an amendment that would eliminate this exclusion from rule 2a–7’s issuer diversification requirement.<sup>18</sup>

We received 8 comment letters discussing the proposed issuer diversification amendment,<sup>19</sup> with most

<sup>15</sup> See rule 2a–7(d)(3).

<sup>16</sup> See Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (Jun. 5, 2013) [78 FR 36834 (Jun. 19, 2013)] (“2013 Money Market Fund Proposing Release”).

<sup>17</sup> See, e.g., 2014 Money Market Fund Adopting Release, *supra* note 6, at n.1612 and accompanying text. Current rule 2a–7’s risk limiting conditions generally require that money market funds limit their investments in the securities of any one issuer of a first tier security (other than government securities) to no more than 5 percent of total assets. Money market funds must also generally limit their investments in securities subject to a demand feature or a guarantee to no more than 10 percent of total assets from any one provider. Notwithstanding these conditions, a money market fund is not required to be diversified with respect to issuers of securities that are subject to a guarantee issued by a non-controlled person. See current rule 2a–7(d)(3); see also *infra* section II.F (detailed discussion of current issuer diversification requirements).

<sup>18</sup> See Proposing Release, *supra* note 3, at section II.C.

<sup>19</sup> See Better Markets Comment Letter; BlackRock Comment Letter; Dreyfus Comment Letter; ICI Comment Letter; Schwab Comment Letter; Comment Letter of the Structured Finance Industry

of these commenters opposing the proposed amendment.<sup>20</sup> After carefully considering the comments we received, as well as the staff’s updated analysis of relevant data, the Commission is adopting the proposed diversification amendments as proposed.<sup>21</sup> We believe that, on balance, adopting the proposed issuer diversification amendment will help increase the resiliency of money market funds, and thereby better protect their investors, by limiting their ability to have concentrated exposure to any particular issuer. We are also adopting several technical amendments to Form N–MFP and the portfolio diversification provisions of rule 2a–7.<sup>22</sup>

## II. Discussion

### A. Eligible Securities

Under current rule 2a–7, money market funds must limit their portfolio investments to securities that are both “eligible securities” and have been determined by fund boards to pose minimal credit risks to the fund.<sup>23</sup> Currently, rule 2a–7 defines “eligible securities” largely by reference to NRSRO ratings, and generally requires that 97% of a fund’s portfolio securities be rated in the top short-term credit quality category by an NRSRO<sup>24</sup> (known as “first tier” securities).<sup>25</sup>

The proposal would have eliminated the rule’s reference to NRSRO ratings in the eligible security definition, and consolidated the minimal credit risk standard into a single new standard under rule 2a–7’s definition of eligible security.<sup>26</sup> As a substitute for NRSRO ratings in the eligible security definition, the proposed new standard would have required an eligible security to be a security with a remaining

Group (Oct. 14, 2014) (“SFIG Comment Letter”); SIFMA Comment Letter; Vanguard Comment Letter.

<sup>20</sup> See BlackRock Comment Letter; Dreyfus Comment Letter; ICI Comment Letter; SFIG Comment Letter; SIFMA Comment Letter; Vanguard Comment Letter.

<sup>21</sup> See rule 2a–7(d)(3).

<sup>22</sup> See *infra* sections II.E. and II.F.

<sup>23</sup> Current rule 2a–7(d)(2)(i).

<sup>24</sup> Rule 2a–7 limits a money market fund’s portfolio investments to “eligible securities,” or securities that have received credit ratings from the “requisite NRSROs” in one of the two highest short-term rating categories or comparable unrated securities. A requisite NRSRO is an NRSRO that a money market fund’s board of directors has designated for use (a “designated NRSRO”) and that issues credit ratings that the board determines, at least annually, are sufficiently reliable for the fund to use in determining the eligibility of portfolio securities. See current rule 2a–7(a)(11), (a)(24).

<sup>25</sup> Current rule 2a–7(a)(12). The rule currently also permits up to 3% of a fund’s portfolio to be invested in so called “second tier” securities, or securities which are rated in the second highest short-term credit quality category by an NRSRO. Current rule 2a–7(d)(2)(ii).

<sup>26</sup> See proposed rule 2a–7(a)(11).

maturity of 397 calendar days or less that the fund's board of directors (or its delegate<sup>27</sup>) determined presents minimal credit risks, which determination would have included a finding that the security's issuer has an exceptionally strong capacity to meet its short-term financial obligations. Thus, under our proposal, a money market fund would have been limited to investing in securities that the fund's board (or its delegate) had determined present minimal credit risks, notwithstanding any rating the security may have received. To assist funds in their minimal credit risk determination under the revised standard, the proposal also included as guidance a number of factors that funds should consider, to the extent appropriate, as part of that process.<sup>28</sup> These credit analysis factors were presented in both a primary list of factors generally applicable to all securities, and a secondary list of factors applicable to specific asset classes. In addition, under the proposal, fund boards would no longer have been required to designate NRSROs or to use their ratings to determine first or second tier status.<sup>29</sup> Accordingly, the proposal would have eliminated the distinction between first and second tier securities, and would have removed the prohibition on funds investing more than 3 percent of their portfolios in second tier securities.<sup>30</sup> The intent of

these proposed amendments was to remove references to NRSRO ratings from rule 2a-7 while retaining a degree of credit risk similar to that permitted under the current rule.

Most of the commenters who discussed the proposed definition of "eligible security" generally supported it,<sup>31</sup> although, as described below, many of these commenters expressed certain reservations about details of the Commission's approach and various aspects of the proposed definition. Two commenters supported the elimination of the first and second tier distinction.<sup>32</sup> However, two other commenters expressed concern that removal of the distinction and the limit on second tier securities could lead to funds purchasing more risky securities.<sup>33</sup> Some of the commenters who supported the amendment stated that the Commission's proposed definition of eligible security would provide an appropriate substitute standard of creditworthiness in rule 2a-7.<sup>34</sup> Other commenters who opposed the definition,<sup>35</sup> and even some that generally supported the Commission's approach,<sup>36</sup> cautioned that the lack of objective criteria in the proposed definition could make it more likely that money market funds would increase their exposure to riskier securities. Specifically, some commenters argued that the proposed definition would produce an incentive for money market funds to reach for yield.<sup>37</sup> A number of commenters also contended that the proposed definition might decrease uniformity among funds in evaluating credit risk, which could cause certain funds to present significantly greater risks to investors than others.<sup>38</sup>

Some commenters who acknowledged that the removal of credit ratings from rule 2a-7 could create incentives for funds to invest in riskier securities also suggested that certain countervailing factors would alleviate this concern. These commenters stated that revising the definition of eligible security should mitigate concerns about increased credit

risk and decreased uniformity by creating a single standard for identifying eligible securities, particularly when viewed in conjunction with the proposed Form N-MFP disclosure requirements and new disclosure requirements that were adopted as part of the 2014 money market fund reforms (which we expect would help to expose the increased volatility and other risks that could accompany greater investment in riskier portfolio holdings).<sup>39</sup>

While generally supporting the overall approach of incorporating the eligible security definition into the general minimal credit risk determination, multiple commenters expressed concerns about the proposed secondary "exceptionally strong capacity" standard incorporated in the proposed definition of eligible security. They suggested that the Commission should reconsider or clarify this standard for a number of reasons. Several commenters argued that the word "exceptional" implies something unusual or extraordinary, which could be read as not including a large number of money market securities of very high credit quality that comprise a portion of money market fund portfolios today.<sup>40</sup> Commenters also argued that the word "exceptional" is not commonly used with gradations, yet rule 2a-7 was designed to allow different gradations of high quality securities.<sup>41</sup> Accordingly, these commenters argued that the proposed standard might have the effect of restricting the universe of securities which money market funds could purchase, contrary to the stated goal of the proposal of seeking to retain a similar degree of credit quality in fund portfolios as under the current rule.<sup>42</sup>

Some commenters also contended that the "exceptionally strong capacity" language adds an unnecessary standard to a money market fund's minimal credit risk analysis and imposes burdens on advisers without any corresponding benefit to investors.<sup>43</sup> Specifically, these commenters argued that money market funds' minimal credit risk determinations already provide the framework for making a

<sup>27</sup> See current rule 2a-7(j) (permitting a money market fund's board to delegate to the fund's investment adviser or officers a number of the determinations required to be made by the fund's board under the rule, including minimal credit risk determinations).

<sup>28</sup> Proposing Release, *supra* note 3, at 47991-47993. The proposal also requested comment on these factors and whether codifying these factors would further ensure that funds use objective factors and market data in making credit quality determinations and thereby promote uniformity in making minimal credit risk determinations and/or assist money market fund managers in understanding their obligations pertaining to portfolio quality under rule 2a-7.

<sup>29</sup> See proposed rule 2a-7(a)(11); 2a-7(d)(2); current rule 2a-7(d)(2)(ii). In conforming changes, the proposal would have moved the requirement currently in the definition of eligible security that the issuer of a demand feature or guarantee promptly notify the holder of the security in the event the demand feature or guarantee is substituted with another demand feature or guarantee (if such substitution is permissible) to the paragraphs of the rule that address securities subject to guarantees and conditional demand features. Compare current rule 2a-7(a)(12)(iii)(B) with proposed rule 2a-7(d)(2)(ii) and 2a-7(d)(2)(iii)(D). We are adopting these amendments as proposed.

<sup>30</sup> Money market funds also are currently limited from investing more than 0.5% of their assets in second tier securities of a single issuer and 2.5% of their portfolios in second tier securities issued, guaranteed or subject to a demand feature issued by the same entity. See current rule 2a-7(d)(3)(i)(C) and 2a-7(d)(3)(iii)(C). These limits also would be eliminated under the final rule.

<sup>31</sup> See, e.g., CFA Institute Comment Letter; MFDF Comment Letter; Schwab Comment Letter.

<sup>32</sup> See Fidelity Comment Letter; MFDF Comment Letter.

<sup>33</sup> See Better Markets Comment Letter; CFA Comment Letter.

<sup>34</sup> CFA Institute Comment Letter; Invesco Comment Letter; MFDF Comment Letter.

<sup>35</sup> CFA Comment Letter; Vanguard Comment Letter.

<sup>36</sup> BlackRock Comment Letter; CFA Institute Comment Letter.

<sup>37</sup> See *id.*

<sup>38</sup> BlackRock Comment Letter; CFA Comment Letter; CFA Institute Comment Letter; NYC Bar Comment Letter; Schwab Comment Letter; Vanguard Comment Letter.

<sup>39</sup> See CFA Institute Comment Letter; Invesco Comment Letter; Schwab Comment Letter; SIFMA Comment Letter.

<sup>40</sup> Fidelity Comment Letter; Dreyfus Comment Letter; ICI Comment Letter; NYC Bar Comment Letter; Schwab Comment Letter; SIFMA Comment Letter.

<sup>41</sup> Dreyfus Comment Letter; ICI Comment Letter; NYC Bar Comment Letter; SIFMA Comment Letter.

<sup>42</sup> See, e.g., Dreyfus Comment Letter; ICI Comment Letter; NYC Bar Comment Letter; SIFMA Comment Letter.

<sup>43</sup> Dreyfus Comment Letter; Fidelity Comment Letter; SIFMA Comment Letter.

definitive finding of creditworthiness, and previously provided staff guidance regarding minimal credit risk factors has enhanced clarity and consistency in the application of this standard across the industry.<sup>44</sup> Commenters argued that the “exceptionally strong capacity” standard would result in confusion for the industry<sup>45</sup> and operational and procedural burdens<sup>46</sup> that money market funds’ current minimal credit risk analysis does not entail. Commenters raising these concerns advocated for a modified approach that restricts money market fund investments to those that the fund’s board (or the board’s delegate) determines present minimal credit risks, but this determination would not involve an additional finding that the security’s issuer has an exceptionally strong capacity to meet its short-term financial obligations (or any similar finding).<sup>47</sup> In addition, some commenters argued that the difference between the “exceptionally strong” and “very strong” (the proposed new standard relating to conditional demand features discussed below) standards is not readily apparent, and argued that a consistent credit risk standard should apply equally to eligible securities and securities subject to a conditional demand feature, as discussed below.<sup>48</sup>

Numerous commenters expressed support for the guidance factors included in the Proposing Release.<sup>49</sup> One commenter, however, objected to the inclusion of the asset-specific factors, suggesting that they could become stale and outdated.<sup>50</sup> Commenters who supported the use of these factors stated that the factors were consistent with best practices and appropriately tailored.<sup>51</sup> Some

commenters presented technical recommendations about specific guidance factors.<sup>52</sup> One commenter suggested including additional guidance factors regarding counterparty relationships and the effects of rising interest rates on credit risk.<sup>53</sup>

Commenters’ opinions varied on whether the guidance factors should be codified. Multiple commenters expressed support for preserving the factors as guidance, rather than codifying them, in order to provide funds with flexibility and the ability to respond to changing market conditions, financing terms, laws, and regulations.<sup>54</sup> Conversely, some commenters urged the Commission to codify the guidance factors as part of rule 2a–7.<sup>55</sup> One commenter argued that codification of the factors would enhance investor protections.<sup>56</sup> Another commenter stated that the inclusion of the factors in rule 2a–7 would promote uniform credit quality standards in the absence of specific NRSRO ratings requirements, and would facilitate inspections by Commission staff to aid in maintaining those standards.<sup>57</sup> The commenters who specifically mentioned the secondary list of asset-specific factors mostly supported them.<sup>58</sup> Two of these commenters believed that the asset-specific factors should be incorporated into the rule,<sup>59</sup> but others opposed codification of any of the factors, including the asset-specific ones.<sup>60</sup> One

commenter opposed the inclusion of the asset-specific factors even as guidance, stating that the dynamic nature of the marketplace could cause such specific guidance to become stale and outdated.<sup>61</sup>

#### 1. Revised “Eligible Security” Definition

After review of comments received, we are today adopting a revised standard for eligible securities under rule 2a–7 that does not require an “exceptionally strong capacity” fund board finding, but instead requires a single uniform minimal credit risk finding, based on the capacity of the issuer or guarantor of a security to meet its financial obligations.<sup>62</sup> As a complement to this uniform minimal credit risk standard, we are also today codifying the general credit analysis factors into rule 2a–7, the use of which should assist fund boards by serving as objective and verifiable tools to rely on in the absence of NRSRO ratings and which should help to achieve our goal of maintaining a similar degree of credit risk as in current money market fund portfolios.<sup>63</sup>

We have been persuaded by the commenters that suggested that the “exceptionally strong capacity” determination could create an unclear standard for determining eligible securities that might change the current credit quality profile of money market funds. Variations in how this language may be understood could lead to some funds only purchasing the lowest risk securities possible, creating a risk profile even more stringent than the

the primary factors with two suggested additions, though it did not discuss possible codification).

<sup>61</sup> ICI Comment Letter.

<sup>62</sup> Rule 2a–7(a)(11). We are also adopting as proposed the elimination of the following defined terms from the rule: “designated NRSRO,” “first tier security,” “rated security,” “requisite NRSROs,” “second tier security,” and “unrated security.” We are also making final several proposed revisions of provisions in the rule that currently reference these terms. See current rule 2a–7(a)(12) (eligible security); rule 2a–7(d)(2) (portfolio quality); rule 2a–7(d)(3)(i)(A)(1) and (C) (portfolio diversification); rule 2a–7(d)(3)(iii)(C) (portfolio diversification); rule 2a–7(f)(1) (downgrades); rule 2a–7(h)(3) (record keeping and reporting); rule 2a–7(j) (delegation). In addition, fund boards will no longer have to designate NRSROs, disclose them in the statement of additional information or use their ratings to determine first or second tier status. Finally, we are also adopting as proposed a conforming change to the recordkeeping requirements under the rule to reflect that funds must retain a written record of the determination that a portfolio security is an eligible security, including the determination that it presents minimal credit risks.

<sup>63</sup> The codified factors only include the general factors that were discussed in the Proposing Release. Proposing Release, *supra* note 3, at 47991–47992. The asset-specific factors are not codified, but revised as discussed in section II.A.2 below, and continue to be included as guidance.

<sup>44</sup> Dreyfus Comment Letter; Fidelity Comment Letter; SIFMA Comment Letter. In addition to presenting updated guidance on credit analysis factors, *see supra* note 28, the Proposing Release noted that the Commission staff has previously provided guidance on specific factors that a board could consider in making minimal credit risk determinations under rule 2a–7. See Letter to Registrants from Kathryn McGrath, Director, Division of Investment Management, SEC (May 8, 1990) (“1990 Staff Letter”); *see also* Letter to Matthew Fink, President, Investment Company Institute from Kathryn McGrath, Director, Division of Investment Management, SEC (Dec. 6, 1989) (“1989 Staff Letter”).

<sup>45</sup> Dreyfus Comment Letter; Fidelity Comment Letter.

<sup>46</sup> Fidelity Comment Letter.

<sup>47</sup> Dreyfus Comment Letter; Fidelity Comment Letter; SIFMA Comment Letter.

<sup>48</sup> IDC Comment Letter; Schwab Comment Letter; *see infra* section II.B.

<sup>49</sup> *See, e.g.*, Better Markets Comment Letter; BlackRock Comment Letter; CFA Comment Letter; ICI Comment Letter; IDC Comment Letter; NYC Bar Comment Letter; Schwab Comment Letter.

<sup>50</sup> ICI Comment Letter.

<sup>51</sup> IDC Comment Letter; MFDF Comment Letter.

<sup>52</sup> Fidelity Comment Letter; ICI Comment Letter. The first commenter provided suggestions regarding guidance on two of the asset-specific credit factors, asset-backed securities and repurchase agreements. These suggestions have been adopted in this release, as discussed below. The second commenter suggested that the phrase “worst case scenario” should be removed from the list of general factors. Because the phrase limited the situations that might be analyzed under this factor, we are not including this phrase in the final rule. See rule 2a–7(a)(11)(i)(C).

<sup>53</sup> CFA Institute Comment Letter.

<sup>54</sup> ICI Comment Letter; IDC Comment Letter; Schwab Comment Letter. Similarly, some commenters suggested that the Commission reiterate that the list of factors is not meant to be exhaustive. See IDC Comment Letter; MFDF Comment Letter; SIFMA Comment Letter.

<sup>55</sup> Better Markets Comment Letter; CFA Comment Letter; NYC Bar Comment Letter.

<sup>56</sup> Better Markets Comment Letter.

<sup>57</sup> NYC Bar Comment Letter. Two of the commenters supporting codification also recommended that the Commission require a fund’s analysis of the factors to be appropriately documented. See Better Markets Comment Letter; CFA Comment Letter.

<sup>58</sup> Better Markets Comment Letter; BlackRock Comment Letter; MFDF Comment Letter; NYC Bar Comment Letter; Schwab Comment Letter.

<sup>59</sup> Better Markets Comment Letter; NYC Bar Comment Letter.

<sup>60</sup> *See, e.g.*, BlackRock Comment Letter; Schwab Comment Letter; ICI Comment Letter. See also CFA Institute Comment Letter (providing a list of factors that it considered appropriate, comprised of only

current standard. Others might interpret the standard differently and not limit their securities purchases in the same way, which might thereby create significant disparities between money market funds. Such different interpretations might also lead to difficulties in our inspection staff's review of compliance with the proposed standard. We also appreciate commenters' concerns that it may be difficult to determine the difference between "exceptionally strong" and other similar standards such as "very strong" credit quality. Accordingly, the Commission has decided that adopting a uniform standard based on the well-developed existing requirement that a security present minimal credit risks, in conjunction with codifying the general factors to be considered, as discussed below, will more effectively achieve the goals of the proposal.

The requirement that a security present minimal credit risks to a money market fund has been part of rule 2a-7 since it was adopted in 1983.<sup>64</sup> The minimal credit risk determination was meant to provide an independent assurance of safety above and beyond the existence of a "high quality" rating by an NRSRO, as explained in the original adopting release:

[T]he 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 (emphasis added).<sup>65</sup>

Under this existing standard, a board (or its delegate) should determine that a security presents minimal credit risks not just in isolation, but also in the context of the fund as a whole. The 2014 Proposing Release made clear that the removal of NRSRO ratings is not intended to change the current risk profile of money market funds, or their evaluation of minimal credit risks.<sup>66</sup> In determining whether a security presents minimal credit risks, therefore, a board (or its delegate) should consider not just the individual risks of the security, but also the overall impact of adding that security to the fund in light of the fund's other holdings.<sup>67</sup> Such consideration

<sup>64</sup> Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies, Investment Company Act Release No. 13380 (Jul. 11, 1983) [48 FR 32555 (Jul. 18, 1983).]

<sup>65</sup> *Id.* at 32560.

<sup>66</sup> See, e.g., Proposing Release, *supra* note 3, at 47989.

<sup>67</sup> In order to clarify that the requirements of the minimal credit risks analysis have not changed

might include an examination of correlation of risk among the securities held or purchased, the credit risks associated with market-wide stresses, or specific security credit or liquidity disruptions. Based on comments received, we are persuaded that this existing requirement to evaluate the minimal credit risk of portfolio securities on the fund as a whole (not just on a security-by-security basis) will help mitigate potential risks that money market funds might change their current credit risk profile after our removal of NRSRO ratings references from the rule as part of the final amendments.

## 2. Codified Factors

Although we believe that the minimal credit risk standard should serve as an effective limitation on credit risk in money market fund portfolios even without the proposed secondary "exceptionally strong" finding, we appreciate commenters' concerns that eliminating the "floor" provided by NRSRO ratings in the rule without a replacement might lead to fund managers taking on additional credit risk if the rule does not provide objective and verifiable standards. As discussed above, several commenters suggested that codifying the general factors would enhance investor protections and promote uniform credit quality standards in the absence of specific NRSRO ratings requirements. We agree.

Accordingly, the final rule amendments now include, as part of the analysis of minimal credit risks, a requirement to consider, to the extent appropriate, the general credit analysis factors from the Proposing Release.<sup>68</sup> As noted in the Proposing Release, our staff has had opportunities to observe how money market fund advisers evaluate minimal credit risk, and although staff has noted a range in the quality and breadth of credit risk analyses among the money market funds examined, staff has also observed that most of the advisers to these funds evaluate some common factors that bear on the ability of an issuer or guarantor to meet its short-term financial obligations. Based

from the original requirements as described in the 1983 release, the phrase "to the fund" has been added to the final rule definition of eligible security. Rule 2a-7(a)(11). This phrase is intended to indicate that, unlike a security's NRSRO rating that measures only the security's risks in isolation, the minimal credit risk determination must consider any credit risk introduced by the security to the entire fund.

<sup>68</sup> Rule 2a-7(a)(11)(i). The Proposing Release included a second list of asset-specific factors that staff had observed funds making use of for credit analysis of specific types of securities which will be retained as guidance as discussed further below. Proposing Release, *supra* note 3, at 47992-47993.

on staff observations in examinations and prior staff guidance, we understand that most money market fund managers already generally take these factors into account, as appropriate, when they determine whether a portfolio security presents minimal credit risks. We believe that codifying the general factors will help provide a uniform and objective check on credit risk that can be verified by our examiners. We also believe that incorporating these factors into the rule text will further promote effective and uniform application of the risk standard. Although multiple commenters expressed support for preserving the factors as guidance, rather than codifying them,<sup>69</sup> the Commission believes that codification of these factors is justified by the need for verifiable credit quality determinations in the absence of required references to NRSRO ratings. In addition, the Commission believes that the changes to the proposed standard made in this final rule should reduce the likelihood of increased credit risk because funds will have to perform a rigorous analysis using the codified factors and consider how each security affects the aggregate risk of the portfolio.

As discussed above, commenters disagreed over the proposed elimination of the first and second tier distinction,<sup>70</sup> with two commenters expressing concern that removing the distinction and the limit on second tier securities could lead to funds purchasing more risky securities.<sup>71</sup> However, we believe that the codification of the credit analysis factors in the final rule, combined with the increased transparency gained through our amendments to Form N-MFP disclosures (both adopted today, as well as the amendments adopted as part of the 2014 money market fund reforms<sup>72</sup>), should mitigate this concern. The codified credit factors should establish a minimum baseline that should help guard against the risk that funds'

<sup>69</sup> ICI Comment Letter; IDC Comment Letter; Schwab Comment Letter. Similarly, some commenters suggested that the Commission reiterate that the list of factors is not meant to be exhaustive. See IDC Comment Letter; MFDF Comment Letter; SIFMA Comment Letter. As noted below, we state that the list of factors in the rule and the additional factors discussed in this release as guidance are not meant to be exhaustive, and there may be additional factors that could be relevant depending on the type of security analyzed.

<sup>70</sup> See Fidelity Comment Letter; MFDF Comment Letter; Better Markets Comment Letter; CFA Comment Letter.

<sup>71</sup> See Better Markets Comment Letter; CFA Comment Letter.

<sup>72</sup> For example, the 2014 money market fund reforms eliminated the 60-day delay in making public the information filed on Form N-MFP.

approach to credit analysis will become less uniform, or that some funds would substantially increase the riskiness of their portfolios by increasing their investments in second tier securities. Such changes would not likely be consistent with a minimal credit risk analysis using the factors we are codifying today.

Therefore, the final rule requires a money market fund's board (or its delegate) to consider, in making its minimal credit risk determinations, the capacity of each security's issuer, guarantor, or provider of a demand feature, to meet its financial obligations, and in doing so, consider, to the extent appropriate, the following factors: (1) Financial condition; (2) sources of liquidity; (3) ability to react to future market-wide and issuer- or guarantor-specific events, including ability to repay debt in a highly adverse situation; and (4) 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.<sup>73</sup> In incorporating the credit analysis factors into the rule, we have revised them to make them as generally applicable as possible to all money market funds. As we discussed in the Proposing Release, and as reflected in a number of comments received, we understand that the majority of the industry already typically considers these factors when making minimal credit risk determinations.<sup>74</sup> One commenter's recommendation suggested that we include as a codified factor an analysis of the existence, nature, and magnitude of any counterparty relationships.<sup>75</sup> However, in its observations of how money market funds evaluate minimal credit risk, our staff has not identified this factor as one of the common factors that bear on the ability of an issuer or guarantor to meet its short-term financial obligations and we are not aware of other information that suggests that many money market funds are currently performing (or have the information readily available to perform) this type of analysis. Accordingly, we are not including as a codified factor an analysis of counterparty relationships, although we

believe that, to the extent that funds have such information available, analyzing counterparty relationships should assist funds in making minimal credit risk determinations.

As discussed in the Proposing Release, the financial condition factor generally should include examination of recent financial statements, including consideration of trends relating to cash flow, revenue, expenses, profitability, short-term and total debt service coverage, and leverage (including financial and operating leverage). The second factor, sources of liquidity, generally should include consideration of bank lines of credit and alternative sources of liquidity. The third factor, involving market-wide events, generally should include analysis of risk from various scenarios, including changes to the yield curve or spreads, especially in a changing interest rate environment. The fourth factor, the competitive position of the firm and its industry, generally should include consideration of diversification of sources of revenue, if applicable.<sup>76</sup> As explained in the proposal, in addition to the codified factors used to evaluate the issuer or guarantor of a security, a minimal credit risk evaluation may also include consideration of whether the price and/or yield of the security itself is similar to that of other securities in the fund's portfolio.<sup>77</sup>

The Commission is not codifying the asset-specific factors into the final rule text. As one commenter pointed out,<sup>78</sup> overly specific and numerous factors could over time become dated. Consistent with the concern raised by this commenter, the Commission is mindful of the pitfalls that may result from codifying too many factors, and/or factors that are not sufficiently broad and yet relevant enough to withstand changing markets over time. The Commission believes that keeping these asset-specific factors as guidance may help avoid any unintended burden while providing funds with additional and potentially relevant considerations that may be useful when making minimal credit risk determinations in the absence of required references to NRSRO ratings. Accordingly, we are

limiting the factors we are codifying into the rule itself to the list of general factors that we believe are sufficiently universal and tested enough to avoid this problem, but that will form the basis of a rigorous analysis. Nonetheless, where relevant, funds may wish to consider whether the asset-specific factors should also be evaluated in making minimal credit risk determinations, especially if they make significant investment in such asset classes. In addition, we have included a cross reference in the rule text to the guidance regarding the asset specific factors, to better inform readers of the applicability of the asset specific factor guidance discussed here.<sup>79</sup>

Accordingly, to the extent applicable, fund advisers may wish to consider the following asset-specific factors:

- For municipal securities: (i) Sources of repayment; (ii) issuer demographics (favorable or unfavorable);<sup>80</sup> (iii) the issuer's autonomy in raising taxes and revenue; (iv) the issuer's reliance on outside revenue sources, such as revenue from a state or federal government entity; and (v) the strength and stability of the supporting economy.<sup>81</sup>
- For conduit securities under rule 2a-7:<sup>82</sup> Analysis of the underlying

<sup>79</sup> We have also incorporated technical recommendations from two commenters on the assets specific factor guidance. ICI Comment Letter; Fidelity Comment Letter. We have (1) combined the two bullets on repurchase agreements into one; (2) altered language in the guidance on repurchase agreements, reflecting increased standardization of the market; and (3) removed the reference to analyzing underlying assets in the asset-backed securities bullet.

<sup>80</sup> Demographics could include considerations such as the type, size, diversity and growth or decline of the local government's tax base, including income levels of residents, and magnitude of economic activity.

<sup>81</sup> See 1989 Staff Letter, *supra* note 44 (additional factors such as sources of repayment, autonomy in raising taxes and revenue, reliance on outside revenue sources and strength and stability of the supporting economy should be considered with respect to tax-exempt securities); see also Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment, Office of the Comptroller of the Currency, Docket ID OCC-2012-0006 [77 FR 35259 (Jun. 13, 2012)] ("OCC Guidance") (matrix of examples of factors for national banks and federal savings associations to consider as part of a robust credit risk assessment framework ("OCC credit risk factors") for certain investment securities includes capacity to pay and assess operating and financial performance levels and trends).

<sup>82</sup> Under rule 2a-7, a "conduit security" means a security issued by a municipal issuer involving an arrangement or agreement entered into, directly or indirectly, with a person other than a municipal issuer, which arrangement or agreement provides for or secures repayment of the security. Rule 2a-7(a)(7). A "municipal issuer" is defined under the rule to mean a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentality of a state or

<sup>73</sup> As explained in the Proposing Release, many of these considerations have been included in staff guidance as well as in best practices for determining minimal credit risk set forth in Appendix I of the Report of the Money Market Working Group submitted to the Board of Governors of the Investment Company Institute in 2009. See also 1990 Staff Letter and 1989 Staff Letter, *supra* note 44.

<sup>74</sup> See Proposing Release, *supra* note 3, section II.A.1, at nn. 53-57 and accompanying text.

<sup>75</sup> CFA Institute Comment Letter.

<sup>76</sup> See Proposing Release, *supra* note 3, section II.A.1, at 47991-47992.

<sup>77</sup> See 2014 Proposing Release, *supra* note 3. This consideration is not being incorporated into the rule text because it does not relate to the overall strength of a security's issuer or guarantor, as do the codified factors. We therefore believe that it would be more useful for a fund's manager to evaluate a security's price and/or yield (as compared with other similar portfolio securities) as a way to quickly assess the appropriateness of a given security, and hence is provided only as guidance.

<sup>78</sup> ICI Comment Letter.

obligor for all securities except asset-backed securities (including asset-backed commercial paper).<sup>83</sup>

- For asset-backed securities, such as asset-backed commercial paper: (i) Analysis of the terms of any liquidity or other support provided; and (ii) legal and structural analyses to determine that the particular asset-backed security involves no more than minimal credit risks for the money market fund.<sup>84</sup>

- For other structured securities, such as variable rate demand notes,<sup>85</sup> tender option bonds,<sup>86</sup> extendible bonds<sup>87</sup> or

territory of the United States. *Id.* A conduit security does not include a security that is: (i) Fully and unconditionally guaranteed by a municipal issuer; (ii) payable from the general revenues of the municipal issuer or other municipal issuers (other than those revenues derived from an agreement or arrangement with a person who is not a municipal issuer that provides for or secures repayment of the security issued by the municipal issuer); (iii) related to a project owned and operated by a municipal issuer; or (iv) related to a facility leased to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a municipal issuer. *Id.*

<sup>83</sup> See OCC Guidance, *supra* note 81 (OCC credit risk factors for revenue bonds include consideration of the obligor's financial condition and reserve levels).

<sup>84</sup> See Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010) [75 FR 10060 (Mar. 4, 2010)] (“2010 Money Market Fund Adopting Release”) at section II.A.3 (citing Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] (“1996 Money Market Fund Adopting Release”) at section II.E.4).

<sup>85</sup> A variable rate demand obligation (“VRDO”) (which includes variable rate demand notes) is a security for which the interest rate resets on a periodic basis and holders are able to liquidate their security through a “put” or “tender” feature, at par. To ensure that the securities are able to be “put” or “tendered” by a holder in the event that a remarketing agent is unable to remarket the security, a VRDO typically operates with a liquidity facility—a Letter of Credit or Standby Bond Purchase Agreement—that ensures that an investor is able to liquidate its position. See Electronic Municipal Market Access, Understanding Variable Rate Demand Obligations, available at <http://emma.msrb.org/EducationCenter/UnderstandingVRDOs.aspx>.

<sup>86</sup> A tender option bond is an obligation that grants the bondholder the right to require the issuer or specified third party acting as agent for the issuer (e.g., a tender agent) to purchase the bonds, usually at par, at a certain time or times prior to maturity or upon the occurrence of specified events or conditions. See Municipal Securities Rulemaking Board, Glossary of Municipal Securities Terms, Tender Option Bond, available at <http://www.msrb.org/glossary/definition/tender-option-bond.aspx>. Tender option bonds are synthetically created by a bond dealer or other owner of a long-term municipal obligation purchased in either the primary or secondary markets, or already in a portfolio.

<sup>87</sup> An extendible bond is a long-term debt security with an embedded option for either the investor or the issuer to extend its maturity date. To qualify as an eligible security under rule 2a-7, the issuer must not have the right to extend the maturity of the bond so that it is more than 397 days to maturity at any time. Typically, if an extendible bond is of

“step up” securities,<sup>88</sup> or other structures: In addition to analysis of the issuer or obligor's financial condition, analysis of the protections for the money market fund provided by the legal structure of the security.<sup>89</sup>

- For repurchase agreements under rule 2a-7: A financial analysis and assessment of the minimal credit risk of the counterparty, an assessment as to whether the haircut level is appropriate for the particular type of collateral based upon price volatility in the market for such collateral type, and a legal analysis of the protections for the money market fund provided by the terms of the repurchase agreements.

The list of factors in the rule and the additional factors discussed in this release as guidance are not meant to be exhaustive, and there may be additional factors that could be relevant depending on the type of security analyzed. We recognize that the range and type of specific factors appropriate for consideration could vary depending on the category of issuer and particular security or credit enhancement under consideration, and that the board (or its delegate) therefore may determine to include other factors in its credit assessment.<sup>90</sup> We also recognize that specific purchases may require more or less analysis depending on the security's risk characteristics. As discussed in greater detail below, amended rule 2a-7 will also require that the written record of the minimal credit risk determination address any factors considered and the analysis of those factors.<sup>91</sup>

### B. Conditional Demand Features

Rule 2a-7 limits money market funds to investing in securities with remaining maturities of no more than 397 days.<sup>92</sup> A long-term security subject to a

the type that qualifies as an eligible security under rule 2a-7, a money market fund will have the option to either extend the maturity of the bond to no more than 397 days in the future, or elect not to extend, in which case the bond's maturity must be no longer than 397 days at that time.

<sup>88</sup> A “step up” security pays an initial interest rate for the first period, and then a higher rate for the following periods.

<sup>89</sup> See OCC Guidance, *supra* note 81 (OCC credit risk factors for structured securities include evaluation and understanding of specific aspects of the legal structure including loss allocation rules, potential impact of performance and market value triggers, support provided by credit and liquidity enhancements, and adequacy of structural subordination).

<sup>90</sup> As discussed in the 2014 Proposing Release, *supra* note 3, money market fund boards of directors typically delegate minimal credit risk determinations to the fund's adviser, as provided for in rule 2a-7(j).

<sup>91</sup> See *infra* section II.C.; rule 2a-7(h)(3).

<sup>92</sup> See current rule 2a-7(a)(12).

conditional demand feature<sup>93</sup> (“underlying security”), however, may be determined under the current rule to be an eligible security (or a first tier security) if among other conditions: (i) The conditional demand feature is an eligible security or a first tier security; and (ii) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security.<sup>94</sup> The rule currently requires this analysis of both the short-term and long-term credit aspects of the demand instrument because a security subject to a conditional demand feature combines both short-term and long-term credit risks.<sup>95</sup>

The Commission's proposal would have required a similar analysis, but consistent with Section 939A of the Dodd-Frank Act, it would have removed the requirement in the rule that the fund board (or its delegate) consider credit ratings of underlying securities.<sup>96</sup> Under

<sup>93</sup> A conditional demand feature is a demand feature that a fund may be precluded from exercising because of the occurrence of a condition. See rule 2a-7(a)(6) (defining “conditional demand feature” as a demand feature that is not an unconditional demand feature); rule 2a-7(a)(30) and proposed rule 2a-7(a)(25) (defining “unconditional demand feature” as a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security). For purposes of rule 2a-7, a demand feature allows the security holder to receive, upon exercise, the approximate amortized cost of the security, plus accrued interest, if any, at the later of the time of exercise or the settlement of the transaction, paid within 397 calendar days of exercise. Current rule 2a-7(a)(9).

<sup>94</sup> Current rule 2a-7(d)(2)(iv). Although underlying securities are generally long-term securities when issued originally, they become short-term securities when the remaining time to maturity is 397 days or less.

<sup>95</sup> The quality of a conditional demand instrument depends both on the ability of the issuer of the underlying security to meet scheduled payments of principal and interest and upon the availability of sufficient liquidity to allow a holder of the instrument to recover the principal amount and accrued interest upon exercise of the demand feature. See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14607 (Jul. 1, 1985) [50 FR 27982 (Jul. 9, 1985)], at n.33. The current rule permits the determination of whether a security subject to an unconditional demand feature is an eligible or first tier security to be based solely on whether the unconditional demand feature is an eligible or first tier security because credit and liquidity support will be provided even in the event of default of the underlying security. See current rule 2a-7(d)(2)(iii).

<sup>96</sup> In a conforming change, the Commission proposed to remove two provisions in current rule 2a-7 that reference credit ratings in connection with securities subject to a demand feature or guarantee of the same issuer that are second tier securities: Rule 2a-7(d)(3)(i)(C) (limiting a fund's investments in securities subject to a demand feature or guarantee of the same issuer that are

the proposal, a fund would have had to determine, as with any short-term security, that the conditional demand feature is an eligible security.<sup>97</sup> In addition, a fund's board of directors (or its delegate) would have had to evaluate the long-term risk of the underlying security and determine that it (or its guarantor) "has a very strong capacity for payment of its financial commitments."<sup>98</sup> We proposed this standard because it was similar to those articulated by credit rating agencies for long-term securities assigned the second highest rating.<sup>99</sup> Because the conditional demand feature could be terminated by a ratings downgrade, we believed that the underlying security should present only limited credit risk.<sup>100</sup>

The commenters who addressed this section generally opposed the proposed approach of requiring a different "very strong" standard for conditional demand features as compared to the proposed "exceptionally strong" standard for all other eligible securities. Instead, most commenters that addressed this issue suggested that the Commission adopt a single uniform standard for both eligible securities and conditional demand features as such a uniform standard would eliminate any

second tier securities to 2.5% of the fund's total assets); rule 2a-7(f)(1)(iii) (providing that if, as a result of a downgrade, more than 2.5% of a fund's total assets are invested in securities issued by or subject to demand features from a single institution that are second tier securities, a fund must reduce its investments in these securities to no more than 2.5% of total assets by exercising the demand feature at the next succeeding exercise date(s)). In other conforming changes, the Commission proposed to amend two rules under the Act that reference the definition of "demand feature" and "guarantee" under rule 2a-7, which references would have changed under the proposed amendments. Specifically, the Commission proposed to amend: (i) Rule 12d3-1(d)(7)(v), to replace the references to "rule 2a-7(a)(8)" and "rule 2a-7(a)(15)" with "\$ 270.2a-7(a)(9)" and "\$ 270.2a-7(a)(16)"; and (ii) rule 31a-1(b)(1), to replace the phrase "(as defined in § 270.2a-7(a)(8) or § 270.2a-7(a)(15) respectively)" with "(as defined in § 270.2a-7(a)(9) or § 270.2a-7(a)(16) respectively.)" We are adopting these changes as proposed.

<sup>97</sup> See proposed rule 2a-7(d)(2)(iii)(A). The Proposing Release also reiterated the existing monitoring and substitutability requirements for conditional demand features in rule 2a-7, and noted that the Commission believed it would be prudent for a money market fund to avoid investing in securities whose eligibility as portfolio securities depended on a conditional demand feature that may be terminated if the underlying portfolio security is downgraded a single ratings category. See Proposing Release, *supra* note 3, at n.90 and accompanying and preceding text.

<sup>98</sup> Proposed rule 2a-7(d)(2)(iii)(C). An underlying security that is a short-term security (because its remaining maturity is less than 397 days, although its original maturity may have been longer) also would have had to meet the proposed standard.

<sup>99</sup> See Proposing Release, *supra* note 3, at n.83 and accompanying text.

<sup>100</sup> *Id.*, at n.89 and accompanying text.

potential inconsistencies and confusion. We agree, and therefore the final amendments do not include the proposed "very strong" standard for conditional demand features, but instead apply the single uniform minimal credit risk standard (including an analysis of relevant factors) for all eligible security determinations, including conditional demand features.

Most commenters' discussion of the credit analysis of securities subject to conditional demand features focused on aligning the credit quality standard for these securities with the standard used to identify eligible securities generally.<sup>101</sup> One commenter stated that employing the same standard would minimize confusion among investors.<sup>102</sup> Another commenter argued that the termination of a conditional demand feature has much the same effect as a default on other securities, and thus the degree of risk permitted with respect to the termination of a conditional demand feature should be equivalent to the risk of default with respect to other eligible securities.<sup>103</sup> Commenters were split in their opinions about what uniform standard to use, if the same credit quality standard were to be employed for eligible securities and securities subject to a conditional demand feature. Some argued that the "very strong" capacity standard should be used in both contexts.<sup>104</sup> Commenters who advised that the minimal credit risk standard should stand alone, without an additional "exceptionally strong capacity" finding (or similar finding), maintained that this stand-alone minimal credit risk standard should apply equally to eligible securities and securities subject to a conditional demand feature.<sup>105</sup>

We agree with these commenters' concerns and are adopting the rule amendments without the proposed "very strong capacity" standard.<sup>106</sup> Instead, the final amendments require application of a single uniform "minimal credit risk" standard that will apply to all securities purchased by money market funds, pursuant to the revised eligible security definition as discussed above.<sup>107</sup> We agree with commenters' reasoning that a uniform credit quality standard would be appropriate given the similar degree of risk presented by the termination of a

conditional demand feature and the default of a portfolio security. We also agree with commenters that the difference between the terms "very strong" and "exceptionally strong" is not readily apparent and that a uniform minimal credit risk standard will thus reduce confusion, and still preserve a similar degree of credit quality to that currently present in fund portfolios. Therefore, under the uniform standard that we are adopting today for conditional demand features, a fund's board (or its delegate) must determine that both the conditional demand feature and the underlying security (or guarantee) are eligible securities.<sup>108</sup>

As noted in the Proposing Release and reiterated here, we do not believe that securities that are rated by NRSROs in the third-highest category for long-term ratings (or comparable unrated securities) would satisfy the standard that underlying securities present minimal credit risks to the fund. We also note that funds currently can invest exclusively in underlying securities rated in the second-highest category if the instrument meets the other conditions for eligibility.<sup>109</sup> We estimate that most underlying securities held by money market funds (77 percent) are rated in the second-highest long-term category, and a smaller portion (23 percent) are rated in the highest long-term category.<sup>110</sup> For these reasons, we do not currently anticipate that funds are likely to increase the portion of their underlying securities that are rated in the second-highest long-term category as a result of the adopted amendments (since these funds do not currently invest in these securities to the extent permitted under existing rules).

### C. Monitoring Minimal Credit Risks

Currently, rule 2a-7 requires a money market fund board (or its delegate) to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and to take such action as it determines is in the best interests of the

<sup>108</sup> The credit risk standard that is being adopted for conditional demand features aligns the credit quality standard for these securities with the standard used to identify eligible securities by requiring the fund's board (or its delegate) to determine that these securities are eligible securities. We note that such a determination, by expressly incorporating the definition of eligible securities, will also incorporate the requirement of a fund to consider, to the extent appropriate, the general credit analysis factors discussed above. Rule 2a-7(a)(11); see *supra* section II.A.2 ("Codified Factors").

<sup>109</sup> Current rule 2a-7(d)(2)(iv).

<sup>110</sup> See *infra* note 258 and accompanying text.

<sup>101</sup> Dreyfus Comment Letter; ICI Comment Letter; IDC Comment Letter; Schwab Comment Letter.

<sup>102</sup> IDC Comment Letter.

<sup>103</sup> ICI Comment Letter. See also *supra* note 93.

<sup>104</sup> ICI Comment Letter; Schwab Comment Letter.

<sup>105</sup> Dreyfus Comment Letter; Fidelity Comment Letter.

<sup>106</sup> Rule 2a-7(d)(2)(iii).

<sup>107</sup> Rule 2a-7(a)(11).

fund and its shareholders.<sup>111</sup> In the Proposing Release, the Commission proposed to eliminate this requirement and instead require each money market fund to adopt written procedures that would require the fund adviser to provide an ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.<sup>112</sup>

As discussed in the Proposing Release, such ongoing monitoring of minimal credit risks would include the determination of whether the issuer of the portfolio security, and the guarantor or provider of a demand feature, to the extent relied upon by the fund to determine portfolio quality, maturity or liquidity, continues to have the capacity to repay its financial obligations such that the security presents minimal credit risks. The review would typically update the information that was used to make the initial minimal credit risk determination and would have to be based on, among other things, financial data of the issuer or provider of the guarantee or demand feature.<sup>113</sup> The Commission noted that funds could continue to consider external factors, including credit ratings, as part of the ongoing monitoring process.<sup>114</sup>

All of the commenters who addressed the ongoing monitoring provision supported the proposed requirement.<sup>115</sup> Commenters agreed with the Commission's belief that most fund advisers currently engage in similar types of ongoing monitoring and that an explicit monitoring requirement would not significantly change current fund

practices,<sup>116</sup> nor would it impose significant extra costs.<sup>117</sup> Commenters also stated that the ongoing monitoring requirement would assist funds to better position themselves to quickly identify potential risks of credit events that could impact portfolio security prices.<sup>118</sup> Accordingly, as discussed in more detail below, we are now adopting these amendments as proposed.<sup>119</sup>

#### 1. Frequency of Monitoring

Three commenters requested more specificity regarding the frequency of the monitoring requirement.<sup>120</sup> One of these commenters requested that the Commission adopt a specific periodic basis for the ongoing review, so that the process would occur with a minimum frequency.<sup>121</sup> The other two commenters requested that the Commission make clear that "ongoing" monitoring does not necessarily mean a constant or daily evaluation.

We are not specifying a periodic basis for the ongoing monitoring requirement adopted today. As a preliminary matter, doing so would conflict with the intent of an explicit ongoing monitoring requirement. Specifying a periodic frequency for monitoring might suggest that regular awareness of the credit profile of portfolio securities is not required, and might also interfere with the discretion of fund managers to react to changing market conditions. In addition, as discussed above, specifying the frequency of monitoring would be inconsistent with our understanding of how a majority of the industry currently evaluates minimal credit risk.<sup>122</sup>

Although we are not codifying a specific frequency upon which

monitoring must occur, we expect that for purposes of the rule, ongoing monitoring would mean that monitoring efforts should occur on a regular and frequent basis. We understand that many funds today engage in daily monitoring of changes in the markets or conditions relating to issuers that may affect their credit evaluation of portfolio holdings, and do so even on an hourly basis if there are rapidly changing events. We believe that this type of monitoring is consistent with the ongoing monitoring requirement adopted today.

One commenter who requested a specific periodic basis for minimal credit risk evaluations also suggested that the Commission require that the fund's board be notified when a portfolio security no longer meets the minimal credit risk standard (and thus, the definition of an eligible security).<sup>123</sup> As a general matter, the Commission expects, as explained in the Proposing Release, that a fund board generally will establish procedures for the adviser to notify the board when a security no longer meets the minimal credit risk standard, and thus expect that a board would be notified as the commenter suggested. We also note that under current rule 2a-7 and the final rule, a fund must dispose of a security that is no longer an eligible security, unless the board makes a finding that it would not be in the interests of the fund to do so.<sup>124</sup> Therefore, if a fund chooses not to dispose of a security that is no longer an "eligible security," the fund's board will already have had the notice sought by this commenter, and thus we do not believe that further specific notification requirements are necessary.

#### 2. Recordkeeping

Today, funds are required to retain a written record of the determination that a portfolio security is an eligible security, including the determination that it presents minimal credit risks. If the proposed requirement to conduct an ongoing review of the credit quality of a fund's portfolio securities were adopted, rule 2a-7's current recordkeeping requirement could have been understood to require the fund to provide for an ongoing documentation of the adviser's ongoing review, which could prove burdensome. Accordingly, we had proposed to make conforming amendments to the recordkeeping provision, requiring the fund to maintain and preserve a written record of the determination that a portfolio security presents minimal credit risks at

<sup>111</sup> Rule 2a-7(f)(1)(i)(A). This current reassessment is not required, however, if the downgraded security is disposed of or matures within five business days of the specified event and in the case of certain events (specified in rule 2a-7(f)(1)(i)(B)), the board is subsequently notified of the adviser's actions. Rule 2a-7(f)(1)(ii). In addition, rule 2a-7 requires ongoing review of the minimal credit risks associated with securities for which maturity is determined by reference to a demand feature. Rule 2a-7(g)(3).

<sup>112</sup> Proposing Release, *supra* note 3, at 47994-47996; proposed rule 2a-7(g)(3). The Commission proposed to remove current rule 2a-7(f)(1)(i) (downgrades) and 2a-7(g)(3) (securities for which maturity is determined by reference to demand features). Proposed rule 2a-7 included a new paragraph (g)(3), which would contain the required procedures for the ongoing review of credit risks.

<sup>113</sup> See proposed rule 2a-7(g)(3)(ii).

<sup>114</sup> We note that a fund adviser's obligation to monitor risks to which the fund is exposed will, as a practical matter, require the adviser to monitor for downgrades by relevant credit rating agencies because such a downgrade would likely affect the security's market value.

<sup>115</sup> See Barnard Comment Letter; BlackRock Comment Letter; CFA Institute Comment Letter; Dreyfus Comment Letter; Fidelity Comment Letter; ICI Comment Letter; IDC Comment Letter; Invesco Comment Letter; Schwab Comment Letter; Vanguard Comment Letter.

<sup>116</sup> All commenters that specifically addressed this issue agreed with the Commission's understanding of current practices. See BlackRock Comment Letter; Fidelity Comment Letter; Barnard Comment Letter; Schwab Comment Letter. Although the NYC Bar Comment Letter did not specifically answer this question, it suggested that the Proposing Release had not presented a sufficiently detailed description of those current practices. This comment is discussed further below.

<sup>117</sup> The only commenter to address the question about costs stated that it did not believe that most funds would experience additional costs beyond the initial adoption and implementation. See Schwab Comment Letter.

<sup>118</sup> Fidelity Comment Letter; Schwab Comment Letter; Barnard Comment Letter.

<sup>119</sup> Rule 2a-7(g)(3).

<sup>120</sup> Better Markets Comment Letter; NYC Bar Comment Letter; SIFMA Comment Letter.

<sup>121</sup> Better Markets Comment Letter.

<sup>122</sup> Similarly, in response to the Commission's query as to whether the rule should include specific objective events that would require a reevaluation of minimal credit risks, the only commenter to address the question stated that such a change might cause fund managers to limit their reviews to those triggering events, rather than truly evaluating risk on an ongoing basis. Schwab Comment Letter. We agree, and are not requiring specific events that would trigger a reevaluation.

<sup>123</sup> Better Markets Comment Letter.

<sup>124</sup> Current rule 2a-7(f)(2)(ii).

the time the fund acquires the security, or at such later times (or upon such events) that the board of directors determines that the investment adviser must reassess whether the security presents minimal credit risks.<sup>125</sup>

One commenter objected to the way the recordkeeping provision was phrased, stating that the rule was not clear as to the extent of the monitoring and whether and when recordkeeping was required.<sup>126</sup> However, another commenter expressed support for how the Commission proposed the new recordkeeping requirement.<sup>127</sup> We are adopting the amendments as proposed and reiterate that the recordkeeping amendments require recordkeeping of the minimal credit risk determination only when the security is first acquired or during periodic or event-driven reassessments, as determined by the board (or its delegate).

### 3. Other Issues

Three commenters objected to the nature of the standard to be applied in determining minimal credit risks through ongoing monitoring.<sup>128</sup> Two of these commenters objected to the need to determine on an ongoing basis that the capacity to repay short-term financial obligations is “exceptionally strong.” The other commenter requested that the standard be made clearer and stronger by inclusion of the specific factors to be considered in determining whether a security presents minimal credit risks. We note that the final amended definition of “eligible security” addresses these comments by eliminating the “exceptionally strong” standard and also codifying general credit analysis factors.<sup>129</sup>

The proposed amendments specified that government securities would not be subject to the initial minimal credit risk determination or the ongoing monitoring requirement. One commenter suggested that money market funds held in the fund’s portfolio, which also would not be subject to the initial minimal credit risk determination, should be treated the same and carved out of the ongoing monitoring requirement as well.<sup>130</sup> We

are not making such a change to the rule because we believe there are significant differences between the risk profile of government securities and shares of money market funds, as was evident in the recent financial crisis, that make ongoing monitoring prudent for shares of money market funds.<sup>131</sup> Nonetheless, the difference in risk profiles between shares of money market funds and other portfolio securities may influence the specific written ongoing monitoring procedures adopted by the board pursuant to this final rule.<sup>132</sup>

We believe that explicitly requiring that funds perform ongoing monitoring of credit risks will help to ensure that funds are better positioned to quickly identify potential risks of credit events that could impact portfolio security prices and ultimately, for certain funds, the ability of the fund to maintain its stable net asset value.<sup>133</sup> Accordingly, we are adopting these amendments largely as proposed.

#### D. Stress Testing

Money market funds currently must adopt written procedures for stress testing their portfolios and perform stress tests according to these procedures on a periodic basis.<sup>134</sup> These required tests include consideration of certain hypothetical events, including the downgrade of particular portfolio security positions.<sup>135</sup> In the Proposing

provider of a guarantee or demand feature in addition to the financial data of an issuer of a security. Also, an erroneous citation in 2a-7(g)(3)(ii) has been corrected.

<sup>131</sup> For example, in the 2014 Money Market Fund Adopting Release, we discussed how investor money flowed out of institutional prime money market funds and into government money market funds (and government securities) during the financial crisis following the Reserve Primary Fund’s “breaking the buck.” See 2014 Money Market Fund Adopting Release, *supra* note 6, at sections II.B and D.

<sup>132</sup> For example, a fund may decide to use different outside sources to assist it in evaluating the ongoing credit quality of portfolio securities it determines present a heightened credit risk profile (as compared with other portfolio securities held by the fund).

<sup>133</sup> As under the current rule and discussed in the proposal, the process undertaken by the fund’s board (or adviser) for establishing credit quality and the records documenting that process would be subject to review in regulatory examinations by Commission staff. See 2014 Proposing Release, *supra* note 3. In the context of such an examination, a fund should be able to support each minimal credit risk determination it makes with appropriate documentation to reflect that process and determination. A fund that acquires portfolio securities without having adopted, maintained, or implemented written policies and procedures reasonably designed to assess minimal credit risk, as required under rules 2a-7 and 38a-1, could be subject to disciplinary action for failure to comply with those rules. See *id.* See also Ambassador Capital Management LLC, *et al.*, Investment Company Act Release No. 30809 (Nov. 26, 2013).

<sup>134</sup> See current rule 2a-7(g)(8).

<sup>135</sup> See current rule 2a-7(g)(8)(i).

Release, the Commission proposed to replace this reference to ratings downgrades in the stress testing requirement with a hypothetical event that is designed to have a similar impact on a money market fund’s portfolio, namely an “event indicating or evidencing credit deterioration” of particular portfolio security positions.<sup>136</sup> Thus, under the proposed amendments, funds could continue to test their portfolios against a potential downgrade or default in addition to any other indication or evidence of credit deterioration they determine appropriate.

All commenters addressing the stress testing amendment supported it.<sup>137</sup> One commenter suggested that allowing a choice of hypothetical events to be used would improve disclosure by increasing variation in the testing.<sup>138</sup> Another commenter stated that it would prefer retaining the original reference to a downgrade, but that the proposed change was appropriate.<sup>139</sup> We continue to believe that amending the stress testing provision as proposed will continue to promote effective stress testing while implementing Section 939A of the Dodd-Frank Act. Accordingly, we are adopting the amendment as proposed.

#### E. Form N-MFP

As part of the money market fund reforms adopted in 2010, money market funds must provide to the Commission a monthly electronic filing of portfolio holdings information on Form N-MFP.<sup>140</sup> The information that money market funds must disclose with respect to each portfolio security (and any guarantee, demand feature, or other enhancement associated with the portfolio security) includes the name of each designated NRSRO for the portfolio security and the rating assigned to the security.<sup>141</sup> Our staff, however, issued a

<sup>136</sup> Proposing Release, *supra* note 3, at 47996–47997; proposed rule 2a-7(g)(8)(i)(B) (the proposal would require stress testing for an event indicating or evidencing the credit deterioration, such as a downgrade or default, of a portfolio security position representing various portions of the fund’s portfolio (with varying assumptions about the resulting loss in the value of the security), in combination with various levels of an increase in shareholder redemptions).

<sup>137</sup> ICI Comment Letter; Barnard Comment Letter; BlackRock Comment Letter; CFA Institute Comment Letter; MFD Comment Letter; Vanguard Comment Letter.

<sup>138</sup> CFA Institute Comment Letter.

<sup>139</sup> MFD Comment Letter.

<sup>140</sup> See rule 30b1-7; see also 2010 Money Market Fund Adopting Release, *supra* note 84, at 10082–10086.

<sup>141</sup> See current Form N-MFP Items 34 (requiring disclosure of each designated NRSRO for a portfolio security and the credit rating given by the

Continued

<sup>125</sup> See proposed rule 2a-7(h)(3).

<sup>126</sup> NYC Bar Comment Letter.

<sup>127</sup> ICI Comment Letter.

<sup>128</sup> Dreyfus Comment Letter; BlackRock Comment Letter; Better Markets Comment Letter.

<sup>129</sup> Rule 2a-7(a)(11). See *supra* section II.A.

<sup>130</sup> ICI Comment Letter. (The Vanguard Comment Letter expressed support for the ICI comments.) The ICI Comment Letter also suggested two technical corrections to the ongoing monitoring provision, which the Commission is adopting. First, the language of clause (i) of 2a-7(g)(3) has been made consistent with the language of clause (ii) and now includes reference to the financial data of a

no-action letter in response to the passage of Section 939A of the Dodd-Frank Act indicating that, among other things, they would not object if a fund did not “designate NRSROs and [did] not make related disclosures in its statement of additional information before the Commission has completed the review of rule 2a–7 required by the [Dodd-Frank Act] and has made any modifications to the rule.”<sup>142</sup> Notwithstanding the staff’s position, many funds are already reporting this information on Form N–MFP.

Instead of disclosure of designated NRSRO ratings, the Commission’s Proposing Release would have required that each money market fund disclose, for each portfolio security, (i) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO’s services, as well as the name of the agency providing the rating, and (ii) any other NRSRO rating that the fund’s board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.<sup>143</sup>

Most commenters addressing the proposed provision supported the Commission’s proposal to require disclosure of NRSRO ratings, though many commenters suggested changes, in particular related to the subscription requirements, as discussed below.<sup>144</sup> As suggested by commenters, we are not adopting the proposed requirement that a fund disclose the ratings of the NRSROs to which it subscribes. We are, however, adopting as proposed, a requirement that funds disclose those NRSRO ratings that the fund’s board of directors (or its delegate) considered, if any, in making its minimal credit risk

designated NRSRO for each portfolio security); 37b–c (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security demand feature); 38b–c (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security guarantee); and 39c–d (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security enhancement).

<sup>142</sup> Letter to Karrie McMillan, General Counsel, Investment Company Institute from Robert E. Plaze, Associate Director, Division of Investment Management, SEC (Aug. 19, 2010). Because the requirements of this rule supersede the staff letter, the letter is withdrawn as of the compliance date of this rule.

<sup>143</sup> See proposed Form N–MFP Item C.10. In a conforming change, the proposal would have also amended Form N–MFP Item C.9 to require disclosure of whether the portfolio security is an eligible security. We did not receive any comments on this provision. This conforming change is now adopted in the final rule.

<sup>144</sup> See Consumer Federation of America Comment Letter; Better Markets Comment Letter; MFDF Comment Letter; BlackRock Comment Letter; Schwab Comment Letter.

determination for a given security, along with the name of the agency that provided the rating.

#### 1. Use of Subscriptions

Many commenters stated that requiring funds to disclose each rating assigned by any NRSRO that a fund or its adviser subscribes to would create unnecessary cost burdens for money market funds, as well as cause other problems.<sup>145</sup> These commenters explained that funds do not consider every rating of every NRSRO they subscribe to when determining the credit profile of a given security. They stated that subscriptions are often used for many other reasons, such as evaluating pricing levels, monitoring market activity and context, and assessing other securities. These commenters also suggested that such disclosures would be unhelpful or even misleading to investors, since the ratings disclosed would often be unrelated to the determinations of minimal credit risks. One commenter stated that the required disclosure of every rating of a portfolio security for which the fund has a subscription would discourage subscriptions, and potentially interfere with the NRSRO market.<sup>146</sup> Another commenter suggested that any usefulness of receiving this information on Form N–MFP for purposes of Commission monitoring was minimal because the information is readily available elsewhere.<sup>147</sup> In addition, one commenter suggested that NRSROs may decide that inclusion of ratings information on Form N–MFP constitutes publication of the ratings and therefore assess extra fees associated with publication.<sup>148</sup> In regard to the general requirement of disclosing any NRSRO ratings on Form N–MFP, one commenter objected that the proposed provision conflicts with Section 939A of the Dodd-Frank Act.<sup>149</sup>

After considering the comments received, we are persuaded by those commenters who argued, as discussed above, that requiring disclosure of each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO’s services, as well as the name of the agency providing the rating, is unnecessary and potentially misleading. Except as discussed elsewhere in the section, these commenters did not

<sup>145</sup> MFDF Comment Letter; BlackRock Comment Letter; ICI Comment Letter; Vanguard Comment Letter; SIFMA Comment Letter; Fidelity Comment Letter.

<sup>146</sup> ICI Comment Letter.

<sup>147</sup> SIFMA Comment Letter.

<sup>148</sup> Schwab Comment Letter.

<sup>149</sup> SIFMA Comment Letter.

oppose general disclosure of ratings information on Form N–MFP, provided the requirement is not based on subscribing to an NRSRO’s service.<sup>150</sup> Consequently, the final rule requires that funds disclose on Form N–MFP any NRSRO rating that the fund’s board of directors (or its delegate) considered in making its minimal credit risk determination for that particular security, as well as the name of the agency providing the rating. This requirement will provide meaningful and concise information to investors and the SEC regarding the process by which a fund evaluates its securities. If a fund’s adviser has considered more than one NRSRO rating in making a minimal credit risk determination for a particular portfolio security, the Form N–MFP disclosure will need to reflect each rating considered. We believe this information on ratings will be useful both to the Commission and to investors to monitor credit ratings that funds use in evaluating the credit quality of portfolio securities and to evaluate risks that fund managers take. Moreover, we believe this requirement is consistent with many funds’ current Form N–MFP disclosure practices.<sup>151</sup> Disclosures of individual portfolio securities ratings will provide investors, Commission staff, and others with a snapshot of potential trends in a fund’s overall risk profile, which can in turn impose discipline on the industry to continually research and evaluate whether that profile is changing.

In regard to the comment that requiring disclosure might trigger the charging of publication fees by the NRSROs, numerous money market funds currently voluntarily report ratings on Form N–MFP, and we are not aware of the imposition of such fees on funds. In regard to the comment suggesting that requiring disclosure of ratings on Form N–MFP conflicts with Section 939A of the Dodd-Frank Act, we believe that requiring disclosure of the NRSRO ratings *considered* satisfies the requirements of Section 939A. We do not believe that requiring disclosure of credit ratings considered by funds as part of their minimal credit risk determinations conflicts with Section 939A, which requires federal agencies to “remove any reference to or requirement of *reliance* on credit ratings. . . .”

<sup>150</sup> Commenters did not specifically object to our proposed disclosure requirement based on a fund board’s (or its delegate’s) “consideration” of such ratings in making minimal credit risk determinations.

<sup>151</sup> See Proposing Release, *supra* note 3, at section II.B.

## 2. Other Issues

Some commenters suggested that fund Web site disclosure of NRSRO ratings would be more useful and effective than disclosure on Form N-MFP.<sup>152</sup> These commenters stated that such Web site disclosure could be made clearer and more understandable for investors than the proposed disclosure. Although we appreciate the benefits associated with Web site disclosure, we expect that the ready public availability of the information on Form N-MFP should achieve many of the same benefits. We also note that the 2014 money market reforms eliminated the 60-day delay on public availability of the information filed on Form N-MFP (making such information public immediately upon filing). Accordingly, we are not adopting a fund Web site disclosure requirement for NRSRO ratings at this time. We note, however, that nothing in our final rule prohibits money market funds from making such disclosure on fund Web sites.

One commenter suggested another approach that we did not propose, namely that the Commission require disclosure on Form N-MFP of the factors that a fund considers when determining whether a security presents minimal credit risks and the details of that determination.<sup>153</sup> The commenter stated that this expanded disclosure would enhance investors' and regulators' understanding of risks in money market fund portfolios. We believe that expanding disclosures in this way is unlikely to provide additional useful information because all funds will be required to use the codified general factors that we had initially proposed as guidance. All funds will now have to apply the specific factors the Commission is requiring in the rule and retain records of the specifics of the determination made for possible review by the Commission. Although public disclosure of the details of the reasoning behind the funds evaluation of each factor and overall minimal credit risk determination would provide additional information to investors, we currently do not believe that many investors would be likely to benefit from this potentially voluminous disclosure for each security held. Such a disclosure requirement would also effectively require funds to publicly disclose their entire credit risk evaluation process, which may include proprietary data. On balance, it is not clear that the potential benefits of this particular disclosure

<sup>152</sup> Schwab Comment Letter; ICI Comment Letter; Fidelity Comment Letter.

<sup>153</sup> Better Markets Comment Letter.

would justify the potentially significant costs. Therefore, we are not adopting such a disclosure requirement at this time.

Finally, one commenter stated that government money market funds should not have to disclose ratings information.<sup>154</sup> We note that no money market funds, including government money market funds, are required by the final rule to disclose ratings information if that information is not considered in evaluating a particular security. Accordingly, to the extent that government money market funds do not consider ratings in selecting portfolio securities, any burden should be minimal.

## 3. Technical Amendments

In addition to the substantive amendments to Form N-MFP, the Commission is also making a technical change to one of the definitions of "money market fund" on Form N-MFP.<sup>155</sup> We are also making a technical change to the definition of "collateralized fully" in rule 2a-7.<sup>156</sup>

### *F. Exclusion From the Issuer Diversification Requirement*

We are amending the rule 2a-7 diversification provision as proposed.<sup>157</sup> Under the current rule, in addition to the provisions regarding credit quality discussed above, rule 2a-7's risk limiting conditions require a money market fund's portfolio to be diversified, both as to the issuers of the securities it acquires and providers of guarantees (and demand features)<sup>158</sup> related to

<sup>154</sup> ICI Comment Letter.

<sup>155</sup> The definition in the heading of the Instructions did not match the version in the Definitions section. For consistency and clarity, we are now adopting the heading definition in both places, as well as on Form N-1A.

<sup>156</sup> See rule 2a-7(a)(5). We are eliminating from the definition of "collateralized fully" in rule 2a-7(a)(5) an erroneous cross reference to rule 5b-3(c)(1)(iv)(D) (which has since been removed). See 2013 Ratings Removal Adopting Release, *supra* note 5.

<sup>157</sup> We are also adopting several technical amendments to the portfolio diversification provisions of rule 2a-7, as described below in this section.

<sup>158</sup> A "demand feature" means a feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the later of the time of exercise or the settlement of the transaction, paid within 397 calendar days of exercise. Rule 2a-7(a)(9) (definition of demand feature). A "guarantee" as defined in rule 2a-7 includes an unconditional demand feature. See rule 2a-7(a)(18) (definition of guarantee). An "unconditional demand feature" means a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security or securities. Rule 2a-7(a)(30) (definition of unconditional demand feature).

those securities.<sup>159</sup> These diversification provisions were designed to diversify the risks to which money market funds may be exposed and thereby reduce the impact of any single issuer's or guarantor's (or demand feature provider's) financial distress on a fund.<sup>160</sup> Generally, money market funds must today limit their investments in the securities of any one issuer of a first tier security to no more than 5 percent of total assets, other than with respect to government securities and securities subject to a guarantee by a non-controlled person.<sup>161</sup> A single state money market fund, however, may also currently invest up to 25 percent of its total assets in the securities of any single issuer.<sup>162</sup> In addition to the issuer diversification provisions, money market funds must generally limit their investments in securities subject to a guarantee (or demand feature) to no more than 10 percent of total assets from any one provider.<sup>163</sup> A money market

<sup>159</sup> See current rule 2a-7(d)(3). The diversification requirements of rule 2a-7 differ in significant respects from the requirements for diversified management investment companies under section 5(b)(1) of the Investment Company Act. A money market fund that satisfies the applicable diversification requirements of paragraphs (d)(3) and (e) of rule 2a-7 is deemed to have satisfied the requirements of section 5(b)(1). Rule 2a-7(d)(3)(v). Subchapter M of the Internal Revenue Code contains other diversification requirements for a money market fund to be a "regulated investment company" for federal income tax purposes. 26 U.S.C. 851 *et seq.*

<sup>160</sup> See Money Market Fund Reform, Investment Company Act Release No 28807 (Jun. 30, 2009) [74 FR 32688 (Jul. 8, 2009)] ("2009 Money Market Fund Proposing Release") at n.220 and accompanying text; Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 17589 (Jul. 17, 1990) [55 FR 30239 (Jul. 25, 1990)], at text accompanying n.23 ("Diversification limits investment risk to a fund by spreading the risk of loss among a number of securities.").

<sup>161</sup> Current rule 2a-7(d)(3)(i)(A) and (B). A fund also may invest no more than 0.5 percent of fund assets in any one issuer of a second tier security. Current rule 2a-7(d)(3)(i)(C). The rule provides a safe harbor under which a taxable or national tax-exempt fund may invest up to 25 percent of its total assets in the first tier securities of a single issuer for a period of up to three business days after acquisition (but a fund may use this exception for only one issuer at a time). Current rule 2a-7(d)(3)(i)(A). Because the amendments we are adopting today eliminate the distinction between first and second tier securities, the issuer diversification requirements and the safe harbor, as amended, will not refer to or rely on a portfolio security's rating.

<sup>162</sup> Current rule 2a-7(d)(3)(i)(B).

<sup>163</sup> Rule 2a-7 also provides a "fifteen percent basket" for tax-exempt (including single state) money market funds, under which as much as 15 percent of the value of securities held in a tax-exempt fund's portfolio may be subject to guarantees or demand features from a single institution. See rule 2a-7(d)(3)(iii)(B). The tax-exempt fund, however, may only use the 15 percent basket to invest in demand features or guarantees issued by non-controlled persons that are first tier securities. See rule 2a-7(d)(3)(iii). Under the

fund is permitted to take on greater indirect exposure to a guarantor because rather than looking solely to the issuer, the money market fund would have two potential sources of repayment—the issuer whose securities are subject to the guarantees and the providers of those guarantees if the issuer defaults. Most recently, the Commission adopted amendments to certain provisions of these diversification requirements as part of the 2014 money market fund reforms.<sup>164</sup>

Notwithstanding the 5 percent issuer diversification provision, rule 2a–7 currently does not require a money market fund to be diversified with respect to issuers of securities that are subject to a guarantee by a non-controlled person.<sup>165</sup> This exclusion could allow, for example, a fund to invest a significant portion or all of the value of its portfolio in securities issued by the same entity if the securities were guaranteed by different non-controlled person guarantors and none of the guaranteed securities had a value exceeding 10 percent of the fund's total assets. We continue to be concerned that a fund that relies on this issuer diversification exclusion could have a highly concentrated portfolio and would be subject to substantial risk if the single issuer in whose securities it had such a significant investment were to come under stress or default.

The diversification amendments that we adopt today will remove the current exclusion to the issuer diversification requirement for securities subject to a guarantee issued by a non-controlled person. That is, under this amendment, each money market fund that invests in

amendments we are adopting today, the 15 percent basket will be available with respect to any demand feature or guarantee issued by a non-controlled person without regard to the rating of the security, guarantee or demand feature.

<sup>164</sup> See 2014 Money Market Fund Adopting Release, *supra* note 6. Among other things, the 2014 money market fund amendments require that money market funds treat certain entities that are affiliated with each other as single issuers when applying the 5 percent issuer diversification provision of rule 2a–7 and treat the sponsors of asset-backed securities as guarantors subject to the 10 percent diversification provision of rule 2a–7 applicable to guarantees and demand features, unless the fund's board makes certain findings. These amendments were intended to increase the resiliency of and reduce risk in money market funds by limiting their ability to concentrate investments in a single economic enterprise.

<sup>165</sup> See current rule 2a–7(d)(3). A guarantee issued by a non-controlled person means a guarantee issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the guarantee (*control* means “control” as defined in section 2(a)(9) of the Act) (15 U.S.C. 80a–2(a)(9)), or a sponsor of a special purpose entity (“SPE”) with respect to an asset-backed security. Rule 2a–7(a)(17).

securities subject to a guarantee (whether or not the guarantor is a non-controlled person) will have to comply with both the 10 percent diversification requirement for the guarantor as well as the 5 percent diversification requirement for the issuer.<sup>166</sup>

One commenter supported the proposed issuer diversification amendment.<sup>167</sup> Another commenter did not specifically oppose the proposal but questioned the additive value of the proposed amendment.<sup>168</sup> The majority of commenters, however, that discussed the diversification proposal opposed it, for a variety of reasons as further discussed below.<sup>169</sup>

#### 1. Credit Quality of the Guarantor and Two Sources of Repayment

In cases where a money market fund invests in a security subject to a guarantee, the guarantor assumes the credit risks presented by a particular issuer by agreeing to provide principal and interest payments in the event the issuer of the underlying security is unable to do so. Accordingly, rule 2a–7 allows a money market fund to look to the credit quality of the guarantor as opposed to the issuer to meet rule 2a–7's portfolio quality provisions.<sup>170</sup> Several commenters emphasized a money market fund's ability to rely on the credit quality of the guarantor in this case, arguing that it is appropriate to direct the minimal credit risk determination to the guarantor as opposed to refocusing the analysis on issuer concentration risk.<sup>171</sup> One of these commenters also suggested that securities subject to a guarantee in many cases trade on the basis of the credit quality of the provider of that guarantee, and thus exposure to the underlying security issuer may not be relevant to a money market fund's ability to maintain

<sup>166</sup> *But see* rule 2a–7(e). If the fund's board of directors has determined that the fund is not relying on a guarantee to determine the quality, maturity or liquidity of a portfolio security and maintains a record of this determination, then the fund need not comply with the 10 percent guarantor diversification requirement with respect to such guarantee.

<sup>167</sup> See Better Markets Comment Letter. This commenter also opined that there was no rationale for setting a more generous limit for guarantors of the securities than for issuers and that accordingly, the Commission should strengthen the diversification requirements by preventing any one guarantor from guaranteeing more than 5 percent of a fund's assets as opposed to 10 percent.

<sup>168</sup> See Schwab Comment Letter.

<sup>169</sup> See BlackRock Comment Letter; Dreyfus Comment Letter; ICI Comment Letter; SFIG Comment Letter; SIFMA Comment Letter; Vanguard Comment Letter.

<sup>170</sup> See rule 2a–7(d)(2)(iii).

<sup>171</sup> See Dreyfus Comment Letter; Schwab Comment Letter; SIFMA Comment Letter.

a stable net asset value in these cases.<sup>172</sup> Another commenter suggested that complying with the proposed requirement for guaranteed securities could be construed to require the manager to also conduct a credit review and on-going monitoring of the issuer.<sup>173</sup> We are not amending the provision in rule 2a–7 that permits money market funds to look to the credit quality of the guarantor as opposed to the issuer to meet rule 2a–7's portfolio quality provisions.

As we discussed in the Proposing Release, by permitting money market funds a higher 10 percent limit on their indirect exposures to a single provider of a guarantee than the 5 percent limit on direct investments in any one issuer, rule 2a–7 permits a money market fund to take on greater indirect exposures to providers of guarantees. As we previously discussed, and as acknowledged by commenters, a money market fund is permitted to take on greater indirect exposure because, rather than looking solely to the issuer, the money market fund would have two potential sources of repayment—the issuer whose securities are subject to the guarantees and the providers of those guarantees if the issuer defaults.<sup>174</sup> Both the issuer and the guarantor would have to default at the same time for the money market fund to suffer a loss. And if a guarantor were to come under stress, the issuer may be able to obtain a replacement.<sup>175</sup>

By diversifying solely against the guarantor, as is the case under the current issuer diversification exclusion, a fund could rely on the guarantors' credit quality or repayment ability, not the issuer's. Thus, in addition to looking to the credit quality of the guarantor as opposed to the issuer to meet rule 2a–7's portfolio quality provisions, the fund would also effectively substitute the credit of the guarantor for that of the issuer for diversification purposes, without imposing the tighter 5 percent requirement that rule 2a–7 generally applies for issuer diversification. This means that a fund could have a highly concentrated portfolio and could be subject to substantial risk if it has a significant investment in securities of a

<sup>172</sup> See SIFMA Comment Letter.

<sup>173</sup> See Schwab Comment Letter.

<sup>174</sup> See BlackRock Comment Letter; SFIG Comment Letter.

<sup>175</sup> See, e.g., Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at n.83 and accompanying text (observing that, if the guarantor of one of the money market fund's securities comes under stress, “issuers or investors generally can either put the instrument back on short notice or persuade the issuer to obtain a substitute for the downgraded institution”).

single issuer, and such issuer were to come under stress or default. As we stated in the Proposing Release, we are concerned that a money market fund relying on the exclusion from the issuer diversification provision need only comply with the 10 percent guarantor diversification requirement, notwithstanding the credit substitution discussed above. In consideration of our reform goal of limiting concentrated exposure of money market funds to particular economic enterprises, we continue to believe that ignoring a fund's exposure to the issuer in these circumstances is not appropriate.<sup>176</sup>

In the Proposing Release, we requested comment as to whether commenters agreed with our proposed approach to treat securities subject to a guarantee by a non-controlled person similar to other securities with a guarantee under rule 2a-7, or whether we should instead require that a guarantor be treated as the issuer and subject to a 5 percent diversification requirement when a money market fund is relying exclusively on the credit quality of the guarantor or when the security need not meet the issuer diversification requirements. We also asked in the 2013 Money Market Fund Proposing Release more generally whether we should continue to distinguish between a fund's exposure to guarantors and issuers by providing different diversification requirements for these exposures.<sup>177</sup> We explained that rule 2a-7 permits a money market fund, when determining if a security subject to a guarantee satisfies the credit quality standards, to rely exclusively on the credit quality of the guarantor.<sup>178</sup> As in the Proposing Release, we also specifically asked whether the guarantor should be treated as the issuer and subject to a 5 percent diversification

requirement whenever the money market fund is relying exclusively on the credit quality of the guarantor. Although most commenters did not specifically address this issue, one commenter argued that guarantors and demand feature providers should generally be subject to the same 5 percent issuer diversification requirements instead of a higher 10 percent limit.<sup>179</sup> We continue to believe, however, that the approach we are adopting today is preferable to making both the guarantor and issuer subject to a 5 percent diversification requirement because, among other things, the approach we are adopting today would treat securities subject to a guarantee by a non-controlled person similarly to other securities with a guarantee under rule 2a-7.

As discussed further in the economic analysis section below, we believe that the potential costs of requiring both the guarantor and issuer to be subject to a 5 percent diversification requirement would likely be more significant than the costs of the amendment we are adopting today. As of the end of April 2015, we estimate that approximately 110 (of 214) prime money market funds had total exposure to a single entity (including directly issued, asset-backed commercial paper sponsorship, and provision of guarantees and demand features) in excess of 5 percent. If we adopted an amendment that both the guarantor and issuer are subject to a 5 percent diversification requirement, any fund that had exposure to an entity greater than 5 percent when those assets matured would have to reinvest the proceeds of the securities creating that exposure in different securities or securities with a different guarantor. Those changes may or may not require those funds to invest in alternative securities, and those securities might present greater risk if they offered lower yields, lower liquidity, or lower credit quality. In addition, we believe the approach we take today is preferable to making both the guarantor and issuer subject to a 5 percent diversification requirement because unlike a security that is not subject to a guarantee, a security that is subject to a guarantee would continue to have two sources of repayment.

Another commenter stated that the Commission has provided for the higher 10 percent limit on indirect exposure of money market funds to guarantors in part because of the "double-barreled" protection, as discussed above, and suggested that the same logic should apply in imposing an issuer

diversification limit on guaranteed securities.<sup>180</sup> This commenter recommended that a 10 percent issuer diversification limit be applied under the rule for securities of an issuer that are guaranteed by a non-controlled person.<sup>181</sup> Rather than subject these issuers to a unique 10 percent requirement, however, we continue to believe that a better approach would be to restrict risk exposures to all issuers of securities subject to a guarantee or demand feature under rule 2a-7 in the same way. As noted above, a money market fund is permitted to take on greater exposure to guarantees because rather than solely looking to the issuer, the money market fund would have two sources of repayment. We believe that this rationale applies to all securities equally (whether the security is subject to a guarantee by a controlled person or a non-controlled person), and that if a money market fund is permitted to take on a greater exposure to a guarantor, then it must also comply with the underlying 5 percent issuer diversification provision. Therefore, under these amendments, each money market fund that invests in securities subject to a guarantee (whether or not the guarantor is a non-controlled person) will have to comply with both the 10 percent diversification requirement for the guarantor as well as the 5 percent diversification requirement for the issuer. As a result, except for the special provisions regarding single state money market funds, no money market fund non-government portfolio security would be excluded from rule 2a-7's limits on issuer concentration.<sup>182</sup>

## 2. Tax-Exempt Funds

Several commenters argued that the proposed issuer diversification amendment should not be applied to tax-exempt money market funds in particular.<sup>183</sup> A couple of these commenters stated that the Commission has previously recognized that tax-exempt money market funds should have unique treatment in certain instances due to the particular characteristics of tax-exempt money market funds, including the more constrained supply of investable securities as opposed to other types of money market funds.<sup>184</sup> Several

<sup>176</sup> See 2014 Money Market Fund Adopting Release, *supra* note 6, at text following n.1600 and accompanying n.1601. The exclusion from the 5 percent issuer diversification requirement for certain guaranteed securities was adopted in the 1996 money market fund amendments to provide flexibility in municipal investments, and was premised on the ability of a money market fund to rely on the guarantee if an issuer became distressed. See 1996 Money Market Fund Adopting Release, *supra* note 84.

<sup>177</sup> See 2013 Money Market Fund Proposing Release, *supra* note 16, at sections III.J.1-2.

<sup>178</sup> Rule 2a-7(d)(2)(iii). As noted above, a money market fund is permitted to take on greater indirect exposure because the fund has two potential sources of repayment. However, the fact that a money market fund has both the issuer and guarantor as sources of repayment may not fully reduce the risks of the investment in all cases because in the event that both the issuer and guarantor default at the same time the fund could suffer a loss. Additionally, the issuer of the guaranteed securities need not satisfy rule 2a-7's credit quality requirements.

<sup>179</sup> See Better Markets Comment Letter.

<sup>180</sup> See SFIG Comment Letter.

<sup>181</sup> See *id.*

<sup>182</sup> See rule 2a-7(d)(3)(i)(B) (issuer diversification requirements for single state money market funds).

<sup>183</sup> See Dreyfus Comment Letter; Fidelity Comment Letter; ICI Comment Letter.

<sup>184</sup> See ICI Comment Letter; Fidelity Comment Letter.

commenters argued that removing the issuer diversification exclusion would cause greater supply challenges, particularly in the tax-exempt market.<sup>185</sup> One of these commenters stated that the proposed amendment would be particularly difficult for single state money market funds due to the limited supply of eligible securities, but these commenters did not acknowledge that the 5 percent issuer diversification limit for single state funds applies to only 75 percent of a single state fund's total assets.<sup>186</sup> Another commenter stated that the proposal assumes a ready supply of securities supported by the same guarantor with different issuers so that a fund could comply with the issuer diversification requirement without reducing its holdings of the guarantor's securities, but that this is not the case, particularly in the tax-exempt market.<sup>187</sup>

One commenter suggested that tax-exempt money market funds regularly rely on the exclusion for securities guaranteed by non-controlled persons to exceed the 5 percent diversification limit.<sup>188</sup> In the Proposing Release, staff believed that based on an analysis of February 2014 Form N-MFP data, only 8 out of 559 money market funds, the majority of which were tax-exempt money market funds, held securities with a guarantee issued by a non-controlled person that exceeded the 5 percent diversification requirement for issuers. A couple commenters suggested that Commission staff review a broader sample of data from Form N-MFP to determine the magnitude of funds that rely on the issuer diversification exclusion.<sup>189</sup> One of these commenters also suggested that Commission staff confirm that for any given fund the staff are aggregating an issuer's securities subject to guarantees by non-controlled persons with the issuer's securities subject to guarantees by control persons and the issuer's securities that are not guaranteed, in order to determine whether a fund is potentially relying on the issuer diversification exclusion by exceeding the 5 percent issuer diversification limit.<sup>190</sup>

In order to obtain a greater sample, and in response to commenters, the staff supplemented its analysis using October 2014 and April 2015 Form N-MFP data to review the number of funds that

exceeded the 5 percent issuer diversification limit, which would indicate that such funds were potentially relying on the 5 percent issuer diversification exclusion.<sup>191</sup> As discussed further in the economic analysis section below, the staff's analysis shows that for October 2014, 60 money market funds out of 553 total money market funds, or approximately 10.8 percent of all money market funds, were potentially relying on the 5 percent issuer diversification exclusion. In addition, staff analysis shows that as of October 2014, only 0.0482 percent of total money market fund assets were above the 5 percent issuer diversification threshold.<sup>192</sup> For April 2015, staff analysis shows that 63 money market funds out of 542 total money market funds, or approximately 11.6 percent of all money market funds, were potentially relying on the 5 percent issuer diversification exclusion. In addition, staff analysis shows that as of April 2015, only 0.0624 percent of total money market fund assets were above the 5 percent issuer diversification threshold.<sup>193</sup>

Based on their updated analysis, Commission staff believes that only tax-exempt money market funds appeared to be relying on the 5 percent issuer diversification exclusion. For October 2014, staff analysis shows that 16 national tax-exempt money market funds out of 72 total national tax-exempt money market funds were potentially relying on the 5 percent issuer diversification exclusion. In addition, staff analysis shows that as of October 2014, only 0.1 percent of national tax-exempt money market fund assets were above the 5 percent issuer diversification threshold.<sup>194</sup> For April 2015, staff analysis shows that 25 national tax-exempt money market funds out of 71 total national tax-exempt money market funds were potentially relying on the 5 percent issuer diversification exclusion. In

<sup>191</sup> In calculating funds' issuer concentrations, staff made assumptions about the relationships among issuers. Such assumptions may have caused the number of funds that appear to be relying on the 5 percent issuer diversification exclusion to be overstated. To be conservative, staff assumed, for example, that a position in a tender option bond that is over 5 percent of the fund's assets is exposure to a single issuer, even though tender option bond trusts may have more than one issuer as the underlying obligor. We expect that funds' analysts, portfolio managers and counsel can make these determinations based on specific facts that were not available to the staff.

<sup>192</sup> This percentage amount corresponds to \$1,447,300,000 in assets.

<sup>193</sup> This percentage amount corresponds to \$1,833,000,000 in assets.

<sup>194</sup> This percentage amount corresponds to \$198,500,000 in assets.

addition, staff analysis shows that as of April 2015, only 0.5 percent of national tax-exempt money market fund assets were above the 5 percent issuer diversification threshold.<sup>195</sup>

One commenter argued that the proposed amendment would particularly affect single state money market funds.<sup>196</sup> In response to this commenter, and because a single state fund may currently invest up to 25 percent of its total assets in the first tier securities of any single issuer, Commission staff also separately identified the number of single state money market funds that appear to be relying on the issuer diversification exclusion. For October 2014, staff analysis shows that 44 single state money market funds out of 97 total single state money market funds were potentially relying on the 5 percent issuer diversification exclusion. In addition, staff analysis shows that as of October 2014, only 1.7 percent of single state money market fund assets were above the 5 percent issuer diversification threshold (while taking into account the 25 percent issuer diversification basket).<sup>197</sup> For April 2015, staff analysis shows that 38 single state money market funds out of 90 total single state money market funds were potentially relying on the 5 percent issuer diversification exclusion. In addition, staff analysis shows that as of April 2015, only 1.3 percent of single state money market fund assets were above the 5 percent issuer diversification threshold (while taking into account the 25 percent issuer diversification basket).<sup>198</sup>

These updated analyses confirm the Commission's initial assumption that overall, few money market funds would be affected by the issuer diversification amendment. As indicated by the staff's analysis above, and as discussed further in the economic analysis section below, we continue to believe a small number of all money market funds rely on the 5 percent issuer diversification exclusion and therefore believe the amendment's effect on funds, including the available supply of investable securities, would be minimal. We recognize that although overall few money market funds are relying on the 5 percent issuer exclusion, the amendment to remove such exclusion would disproportionately affect tax-exempt money market funds and single

<sup>195</sup> This percentage amount corresponds to \$893,400,000 in assets.

<sup>196</sup> See Dreyfus Comment Letter.

<sup>197</sup> This percentage amount corresponds to \$1,248,800,000 in assets.

<sup>198</sup> This percentage amount corresponds to \$939,600,000 in assets.

<sup>185</sup> See Dreyfus Comment Letter; Fidelity Comment Letter; ICI Comment Letter.

<sup>186</sup> See Dreyfus Comment Letter. See also rule 2a-7(d)(3)(i)(B).

<sup>187</sup> See ICI Comment Letter.

<sup>188</sup> See *id.*

<sup>189</sup> See Dreyfus Comment Letter; ICI Comment Letter.

<sup>190</sup> See ICI Comment Letter.

state money market funds. However, we believe that our staff's analysis of the percentage of assets in excess of the 5 percent issuer diversification threshold provides an accurate reflection of the potential impact that the elimination of the 5 percent issuer diversification exclusion would have on money market funds. We also believe that looking to the percentage of assets in addition to the number of funds (which shows only absolute numbers), comprehensively shows the corresponding level of assets that will need to be reinvested. The above data shows that for October 2014 and April 2015, approximately 99.95 percent and 99.94 percent, respectively, of total money market fund assets are not above the 5 percent issuer diversification threshold. Thus, because most money market funds are not using the exclusion and because a very high percentage of money market fund assets are not above the threshold, we continue to believe any negative effects for money market funds will generally be minimal.

We also note that money market funds will not be required to sell any of their portfolio securities as a result of our diversification amendment because rule 2a-7's diversification limits are measured at acquisition, and they may therefore retain these assets until they mature. Although we understand that national tax-exempt money market funds and single state money market funds may have made greater use of the 5 percent issuer exclusion in the past (and might do so in the future if we retained the 5 percent issuer diversification exclusion), we remain concerned that funds were previously exposed to concentrated risks inconsistent with the purposes of rule 2a-7's diversification requirements. As discussed above, we also continue to believe that restricting risk exposures to all issuers of securities subject to a guarantee or demand feature in the same way will appropriately limit the concentration of exposure that a money market fund could otherwise have to a particular issuer. Accordingly, we continue to believe that removing the exclusion to the 5 percent issuer diversification provision furthers our reform goal of limiting concentrated exposure of money market funds to particular economic enterprises.

### 3. Technical Amendments

The Commission is also making technical amendments to certain diversification provisions in rule

2a-7.<sup>199</sup> First, the Commission is amending rule 2a-7(d)(3)(i)(A)(2) to clarify that a tax-exempt fund (other than a single state fund) is required to comply with rule 2a-7(d)(3)(i)(A)(2) with respect to only 85 percent of its total assets.<sup>200</sup>

Second, the Commission is clarifying the use of the three-day safe harbor as it pertains to issuer diversification. The current three-day safe harbor provides that a money market fund may invest up to 25 percent of its total assets in first tier securities of a single issuer for a period of three business days after the acquisition thereof.<sup>201</sup> Specifically, rule 2a-7(d)(3)(i)(A)(1) generally prohibits a money market fund (other than a single state fund) from investing more than 5 percent of its total assets in an issuer's first tier securities, provided that such a fund may invest up to 25 percent of its total assets in the first tier securities of a single issuer for a period of up to three business days after the acquisition thereof. In addition, rule 2a-7(d)(3)(i)(A)(2) prohibits, at the time of any acquisition, investment of more than ten percent of a money market fund's total assets in securities issued by or subject to demand features or guarantees from the institution that issued the demand feature or guarantee, without making reference to the three-day safe harbor. Because the three-day safe harbor is referenced solely in subparagraph (1) of rule 2a-7(d)(3)(i)(A) and not in subparagraph (2) of rule 2a-7(d)(3)(i)(A), it may have been unclear as to whether a money market fund (other than a single state fund) could invest up to 25 percent of its total assets in a single issuer's securities for a period of up to three business days if some of the money market fund's securities were subject to guarantees or demand features provided by such issuer. In order to clarify that a money market fund (other than a single state

<sup>199</sup> See rule 2a-7(d)(3)(i) (issuer diversification) and rule 2a-7(d)(3)(iii) (diversification rules for demand features and guarantees).

<sup>200</sup> See rule 2a-7(d)(3)(i)(A)(2). Current rule 2a-7(d)(3)(i)(A)(2) could be read to suggest that a tax-exempt money market fund must not invest more than 10 percent of its total assets in securities issued by or subject to demand features or guarantees from the institution that issued the demand feature or guarantee. However, the 2014 money market fund reform amendments provided that as much as 15 percent of the value of securities held in a tax-exempt money market fund's portfolio may be subject to guarantees or demand features from a single institution. The technical amendment incorporates and reflects these 2014 money market fund reform amendments and clarifies that a tax-exempt fund need only comply with this provision with respect to 85 percent of its total assets, and not with respect to all of its total assets.

<sup>201</sup> See *supra* note 161. In the amendments we are adopting today, the three-day safe harbor will not refer to investments in first-tier securities.

fund) can invest up to 25 percent of its total assets in a single issuer's securities for a period of up to three business days if some of the money market fund's securities are subject to guarantees or demand features provided by such issuer, the Commission is amending rule 2a-7(d)(3)(i)(A) to clarify that the three-day safe harbor for issuer diversification should be read to apply to both subparagraphs (1) and (2).<sup>202</sup>

Last, the Commission is amending rule 2a-7(d)(3)(i)(B)(2) to clarify that a single state fund is required to comply with the diversification limitations of rule 2a-7(d)(3)(i)(B)(2) with respect to only 75 percent of its total assets, so long as not more than 15 percent of its total assets are invested in securities subject to guarantees or demand features provided by an institution as provided for in rule 2a-7(d)(iii)(B).<sup>203</sup> These amendments are intended only to clarify the diversification amendments that the Commission adopted as part of the 2014 money market reform.

### III. Compliance Period for the Final Rule and Form Amendments

In the Proposing Release, we proposed a compliance date for the final amendments to rule 2a-7 and Form N-MFP that would coordinate compliance with the rule 2a-7 amendments relating to diversification, stress testing, and Form N-MFP, adopted in the 2014 Money Market Fund Adopting Release. We solicited comments on this compliance period in the Proposing Release, and one commenter addressed the issue, suggesting that the date be pushed back so that funds will have at least one full year to comply.<sup>204</sup>

In response to this comment, we are now adopting October 14, 2016 as the compliance date for this final rule. This date will give funds more than a full year to comply, which we agree is appropriate, and will also coordinate with the floating net asset value, liquidity fee, and redemption gate

<sup>202</sup> See rule 2a-7(d)(3)(i)(A).

<sup>203</sup> See rule 2a-7(d)(3)(i)(B)(2). Current rule 2a-7(d)(3)(i)(B)(2) could be read to suggest that a single state fund must not invest more than 10 percent of its total assets in securities issued by or subject to demand features or guarantees from the institution that issued the demand feature or guarantee.

However, a single state fund may invest up to 25 percent of its total assets in securities of any single issuer. In addition, the 2014 money market fund reform amendments provided that as much as 15 percent of the value of securities held in a single state fund's portfolio may be subject to guarantees or demand features from a single institution. The technical amendment incorporates and reflects these provisions and clarifies that a single state fund need only comply with this provision with respect to 75 percent of its total assets, and not with respect to all of its total assets.

<sup>204</sup> Schwab Comment Letter.

provisions in the 2014 Money Market Fund Adopting Release. We believe that this compliance date will provide an adequate period of time for money market funds to review and revise their policies and procedures for complying with amended rule 2a-7.<sup>205</sup> Although this compliance date will not coincide with the compliance date for the rule 2a-7 amendments relating to diversification, stress testing, and Form N-MFP adopted in the 2014 Money Market Fund Adopting Release, we believe that coordinating the compliance date of these amendments with the compliance date of the floating net asset value amendments adopted in the 2014 Money Market Fund Adopting Release should reduce costs by consolidating changes to be made to a fund's policies and procedures at that time, while also providing more than a year for implementation of these amendments.

#### IV. Paperwork Reduction Act Analysis

Certain provisions of this final rule contain "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>206</sup> An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The titles and control numbers for the existing collections of information that are affected by the rule amendments are: (1) "Rule 2a-7 under the Investment Company Act of 1940, Money market funds" (OMB Control No. 3235-0268); (2) "Rule 30b1-7 under the Investment Company Act of 1940, Monthly report for money market funds" (OMB Control No. 3235-0657); and (3) "Form N-MFP under the Investment Company Act of 1940, Monthly schedule of portfolio holdings of money market funds" (OMB Control No. 3235-0657). This final rule contains no new collections of information not present in the proposed rule. The Commission published notice soliciting comments on the collection of information requirements in the Proposing Release and submitted the proposed collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. We did not receive any comments on the collection of information requirements.

##### A. Rule 2a-7

As discussed above, we are removing references to credit ratings in rule 2a-

7, which affect five elements of the rule: (i) Determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings downgrades and other credit events; and (v) stress testing. These amendments involve collections of information, and the respondents to the collections of information are money market funds. This collection of information will be mandatory for money market funds that rely on rule 2a-7, and to the extent that the Commission receives confidential information pursuant to the collection of information, such information will be kept confidential, subject to the provisions of applicable law.<sup>207</sup>

##### 1. Eligible Security Determinations for Money Market Fund Portfolio Securities, Including Securities That Are Subject to a Conditional Demand Feature

Rule 2a-7 limits a money market fund's portfolio investments to "eligible securities," which are currently defined as securities that have received credit ratings from a requisite NRSRO in one of the two highest short-term rating categories, or comparable unrated securities.<sup>208</sup> The rule also restricts money market fund investments to securities that the fund's board, or its delegate, determines present minimal credit risks, and requires a fund to adopt policies and procedures regarding minimal credit risk determinations.<sup>209</sup> As discussed above, we are adopting amendments to rule 2a-7 that will remove any reference to, or requirement of reliance on, credit ratings in rule 2a-7 and modify the credit quality standard to be used in determining the eligibility of a money market fund's portfolio securities, including securities that are subject to a conditional demand feature. Specifically, the amendments will eliminate the current requirement that an eligible security be rated in one of the two highest short-term rating categories by an NRSRO or be of comparable quality, and will combine

the current "first tier" and "second tier" credit risk categories into a single standard, which will be included as part of rule 2a-7's definition of eligible security. A security will be an eligible security only if the money market fund's board of directors (or its delegate) determines that it presents minimal credit risks, which determination will involve consideration of specified credit analysis factors that are listed in the rule.<sup>210</sup> The amendments also require that, with respect to a security (or its guarantee) subject to a conditional demand feature, the underlying security (or its guarantee) must meet the same minimal credit risks standard.<sup>211</sup>

Money market funds are required to have written policies and procedures regarding minimal credit risk determinations.<sup>212</sup> Thus, each money market fund complex will incur one-time costs to comply with these amendments. Specifically, each fund complex will incur costs to review the amended provisions of rule 2a-7 and, as it determines appropriate in light of the amendments, revise its policies and procedures to incorporate the amended credit quality standards to be used in determining the eligibility of a money market fund's portfolio securities. As discussed below, we anticipate that many funds are likely to retain their investment policies as currently required under rule 2a-7, which incorporate NRSRO ratings and which will be permitted under the rule amendments.<sup>213</sup> Some funds, on the other hand, may choose to revise their investment policies to remove references to NRSRO ratings and to incorporate the standards provided in the rule. Even if funds choose to eliminate references to ratings in their investment policies, funds' investment policies may not change substantially, as funds are already required to assess credit quality apart from ratings as part of their minimal credit risk determinations.<sup>214</sup> As we noted in the discussion above, based on staff observations in examinations and prior staff guidance, we believe that most

<sup>210</sup> Rule 2a-7(a)(11); see *supra* section II.A.

<sup>211</sup> Rule 2a-7(d)(2)(iii)(C); see *supra* section II.B. The proposal included a further finding that the issuer of the demand feature would have a very strong capacity for payment of its financial commitments. See proposed rule 2a-7(d)(2)(iii)(C). As discussed below, because the minimal credit risk standard, as proposed, remains in the amendments we are adopting today, and, because the strong capacity standard, as commenters noted, would be generally superfluous and subsumed by the overriding minimal credit risk determination, we are not revising our burden estimate from the proposal.

<sup>212</sup> See rule 2a-7(j)(1).

<sup>213</sup> See *infra* section V.A.

<sup>214</sup> See current rule 2a-7(d)(2)(i).

<sup>207</sup> See, e.g., 5 U.S.C. 552 (Exemption 4 of the Freedom of Information Act provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). Exemption 8 of the Freedom of Information Act provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8)).

<sup>208</sup> See current rule 2a-7(a)(12).

<sup>209</sup> See rules 2a-7(d)(2)(i); 2a-7(j)(1); 38a-1.

<sup>205</sup> See *infra* section V.A.2.v.

<sup>206</sup> 44 U.S.C. 3501-3520.

money market fund managers currently take the codified credit analysis factors into account, as appropriate, when they determine that a portfolio security presents minimal credit risks.

The Proposing Release provided the credit analysis factors as guidance, rather than in rule text, and required that the fund make a finding that the issuer of a security had an “exceptionally strong capacity” to meet its short-term financial obligations.<sup>215</sup> Because the final rule is merely codifying the analysis that staff believes money market fund managers currently take into account, we do not believe that the burden associated with the final rule will be different from that estimated for the proposed rule. The estimates associated with the analysis for the proposal assumed use of the credit analysis factors presented as guidance, thus providing the fund sufficient information to make the minimal credit risk and “exceptionally strong capacity” findings. Therefore, we believe that codifying the factors and eliminating the “exceptionally strong capacity” finding will have no effect on the burden estimates, because use of the factors was already assumed in those estimates and the “exceptionally strong capacity” finding was assumed to be built into that analysis, creating no additional burden. Similarly, the proposal included a further finding that the issuer of a conditional demand feature would have a “very strong capacity” for payment of its financial commitments.<sup>216</sup> As with the “exceptionally strong capacity” finding, this “very strong capacity” finding was assumed to be built into the credit analysis, and we do not believe that removal of this finding will change the estimated burden associated with this requirement.

While we cannot predict with precision the extent to which funds may revise their policies and procedures for determining minimal credit risk, we estimate that each money market fund complex on average will incur a one-time burden of 9 hours,<sup>217</sup> at a cost of

\$2,838,<sup>218</sup> to review and revise, as appropriate, its policies and procedures. Using an estimate of 103 money market fund complexes,<sup>219</sup> we estimate that money market funds would incur, in aggregate, a total one-time burden of 927 hours,<sup>220</sup> at a cost of \$292,314,<sup>221</sup> to comply with the amended provisions of rule 2a–7 modifying the credit quality standard to be used in determining the eligibility of a fund’s portfolio securities. Amortizing these hourly and cost burdens over three years results in an average annual increased burden for all money market fund complexes of 309 hours<sup>222</sup> at a cost of \$97,438.<sup>223</sup> We do not believe that funds would newly implement or change any annual review of policies and procedures that they currently perform as a result of the adopted amendments. There will be no external costs associated with this collection of information.

## 2. Monitoring Minimal Credit Risks

Rule 2a–7 currently requires a money market fund board (or its delegate) to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks.<sup>224</sup> As discussed above, we are adopting as proposed amendments to rule 2a–7 that will eliminate the current use of credit ratings in the rule’s downgrade and default provisions. Rule 2a–7 instead will require a money market fund to adopt written procedures requiring the fund adviser, or any person to whom the fund’s board of

9 hours (6 hours by a compliance manager, and 3 hours by an attorney).

<sup>218</sup> This estimate is based on the following calculation: (6 hours (mid-point of 4 hours and 8 hours incurred by a compliance manager) × \$283 (rate for a compliance manager) = \$1,698) + (3 hours (mid-point of 2 hours and 4 hours incurred by an attorney) × \$380 (rate for an attorney) = \$1,140) = \$2,838. All estimated wage figures discussed here and throughout this release are based on published rates that have been taken from SIFMA’s Management & Professional Earnings in the Securities Industry 2013, available at <http://www.sifma.org/research/item.aspx?id=8589940603>, modified by Commission staff to account for an 1800 hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

<sup>219</sup> Based on data from Form N–MFP and iMoneyNet as of April 30, 2015. The Proposing Release PRA statement was based on data as of February 28, 2014. We have updated the estimates used in this final PRA to reflect more current data as of April 30, 2015.

<sup>220</sup> This estimate is based on the following calculation: 9 hours × 103 money market fund complexes = 927 hours.

<sup>221</sup> This estimate is based on the following calculation: \$2,838 × 103 money market fund complexes = \$292,314.

<sup>222</sup> This estimate is based on the following calculation: 927 hours ÷ 3 years = 309 hours.

<sup>223</sup> This estimate is based on the following calculation: \$292,314 ÷ 3 years = \$97,438.

<sup>224</sup> See current rule 2a–7(f)(1)(i).

directors has delegated portfolio management responsibilities, to provide ongoing review of each portfolio security to determine that the issuer continues to present minimal credit risks.<sup>225</sup> To comply with these amendments, a fund complex will incur one-time costs to review the amended provisions of rule 2a–7 and adopt policies and procedures providing for ongoing review to determine whether a money market fund’s portfolio securities continue to present minimal credit risks. Money market funds are not currently required to maintain policies and procedures that specifically address ongoing minimal credit risk monitoring. Although we understand, based on staff experience, that most money market funds currently monitor portfolio securities for minimal credit risk on an ongoing basis,<sup>226</sup> we are assuming that all money market fund complexes would need to adopt new written policies and procedures to provide for this ongoing review in order to comply with the amended provisions of rule 2a–7.

We estimate that each money market fund complex on average would incur a one-time burden of 5 hours,<sup>227</sup> at a cost of \$3,619,<sup>228</sup> to adopt policies and

<sup>225</sup> Rule 2a–7(g)(3); see *supra* section II.C.

<sup>226</sup> See *supra* note 116 and accompanying text.

<sup>227</sup> These hour estimates assume that the process of adopting written policies and procedures will consist primarily of transcribing and reviewing any existing policies and procedures that funds currently use when monitoring minimal credit risk on an ongoing basis. Because we cannot predict the extent to which funds may need to develop these policies and procedures to comply with the amended provisions of rule 2a–7, or may need to transcribe and review any existing policies and procedures, we have taken, as an estimated average burden, the mid-point of a range of hour estimates discussed below in the following paragraph for purposes of our PRA analysis.

We estimate that the lower range of the one-time hour burden for a money market fund complex to adopt policies and procedures for ongoing review to determine whether a money market fund’s portfolio securities continue to present minimal credit risks would be 3.5 hours (2 hours by a compliance manager and 1 hour by an attorney to develop and review policies and procedures (or transcribe and review pre-existing policies and procedures) + 0.5 hours for the fund’s board to adopt the policies and procedures). We estimate that the upper range of the one-time hour burden for a money market fund complex to adopt such policies and procedures would be 6.5 hours (4 hours by a compliance manager and 2 hours by an attorney to develop and review policies and procedures (or transcribe and review pre-existing policies and procedures) + 0.5 hours for the fund’s board to adopt the policies and procedures). The mid-point of the lower range estimate and the upper range estimate is 5 hours.

<sup>228</sup> This estimate is based on the following calculation: (3 hours (mid-point of 2 hours and 4 hours incurred by a compliance manager) × \$283 (rate for a compliance manager) = \$849) + (1.5 hours (mid-point of 1 hour and 2 hours incurred by an attorney) × \$380 (rate for an attorney) = \$570) + (0.5

Continued

<sup>215</sup> See proposed rule 2a–7(a)(11).

<sup>216</sup> See proposed rule 2a–7(d)(2)(iii)(C).

<sup>217</sup> We estimate that the lower range of the one-time hour burden for a money market fund complex to review and revise, as appropriate, its policies and procedures for determining minimal credit risk would be 6 hours (4 hours by a compliance manager, and 2 hours by an attorney). We estimate that the upper range of the one-time hour burden for a money market fund complex to review and revise, as appropriate, its policies and procedures for determining minimal credit risk would be 12 hours (8 hours by a compliance manager, and 4 hours by an attorney). For purposes of our estimates for the PRA analysis, we have taken the mid-point of this range (mid-point of 6 hours and 12 hours =

procedures for ongoing review of minimal credit risks. Using an estimate of 103 money market fund complexes,<sup>229</sup> we estimate that money market funds will incur, in aggregate, a total one-time burden of 515 hours,<sup>230</sup> at a cost of \$372,757,<sup>231</sup> to comply with the amended provisions of rule 2a-7. Amortizing these hourly and cost burdens over three years results in an average annual increased burden for all money market fund complexes of 172 hours<sup>232</sup> at a cost of \$124,252.<sup>233</sup> There will be no external costs associated with this collection of information.

### 3. Stress Testing

Rule 2a-7 currently requires money market funds to adopt written stress testing procedures and to perform stress tests according to these procedures on a periodic basis.<sup>234</sup> We are adopting as proposed amendments to rule 2a-7 that would replace the reference to ratings downgrades in the rule's stress testing provisions with a hypothetical event that is designed to have a similar impact on a money market fund's portfolio.<sup>235</sup> The amendment is designed to retain a similar standard for stress testing as under current rule 2a-7. Specifically, while rule 2a-7 currently requires a fund to stress test its portfolio based on certain hypothetical events, including a downgrade of portfolio securities, the adopted amendment will require a fund to stress test for an event indicating or evidencing credit deterioration in a portfolio security, and will include a downgrade or default as examples of that type of event. As discussed below, we recognize that a money market fund could use its current policies and procedures to comply with the amendment, and could continue to use credit quality evaluations prepared by

hours  $\times$  \$4,400 per hour for a board of 8 directors = \$2,200) = \$3,619. The staff previously estimated in 2009 that the average cost of board of director time was \$4,000 per hour for the board as a whole, based on information received from funds and their counsel. Adjusting for inflation, the staff estimates that the current average cost of board of director time is approximately \$4,400 per hour.

<sup>229</sup> Based on data from Form N-MFP and iMoneyNet as of April 30, 2015. The Proposing Release PRA statement was based on data as of February 28, 2014. We have updated the estimates used in this final PRA to reflect more current data as of April 30, 2015.

<sup>230</sup> This estimate is based on the following calculation: 5 hours  $\times$  103 money market fund complexes = 515 hours.

<sup>231</sup> This estimate is based on the following calculation: \$3,619  $\times$  103 money market fund complexes = \$372,757.

<sup>232</sup> This estimate is based on the following calculation: 515 hours  $\div$  3 years = 172 hours.

<sup>233</sup> This estimate is based on the following calculation: \$372,757  $\div$  3 years = \$124,252.

<sup>234</sup> See current rule 2a-7(g)(8).

<sup>235</sup> Rule 2a-7(g)(8)(i)(B); see *supra* section II.D.

outside sources, including NRSRO downgrades, in stress tests.<sup>236</sup> Because the rule currently requires testing for a downgrade as a hypothetical event, we do not believe that funds will take any additional time to review and revise their policies and procedures with respect to the continued use of downgrades in stress testing. Accordingly, we do not expect the amendments will significantly change current collection of information burden estimates for rule 2a-7.<sup>237</sup>

*Total Burden for Rule 2a-7.* The current approved collection of information for rule 2a-7 is 632,244 annual aggregate hours. The aggregate additional burden hours associated with the adopted amendments to rule 2a-7 increase the burden estimate to 632,725 hours annually for all funds.<sup>238</sup>

#### B. Rule 30b1-7 and Form N-MFP

Rule 30b1-7 requires money market funds to file a monthly report electronically on Form N-MFP within five business days after the end of each month. The information required by the form must be data-tagged in XML format and filed through EDGAR. Preparing Form N-MFP is a collection of information under the PRA.<sup>239</sup> The respondents to this collection of information are money market funds. A fund must comply with the requirement to prepare Form N-MFP in order to hold itself out to investors as a money market fund or the equivalent of a money market fund in reliance on rule 2a-7. This collection of information is mandatory for money market funds that rely on rule 2a-7, and responses to the disclosure requirements of Form N-MFP are not kept confidential.

Money market funds are currently required to disclose on Form N-MFP, with respect to each portfolio security, whether the security is a first or second tier security or is unrated, as well as the "designated NRSROs" for each security (and for each demand feature, guarantee, or credit enhancement).<sup>240</sup> As discussed above, the adopted amendments will require that each money market fund disclose on Form

<sup>236</sup> See *infra* text surrounding note 288.

<sup>237</sup> See *id.*

<sup>238</sup> This estimate is based on the following calculation: 632,244 hours (current approved burden) + 309 hours (eligible security determinations for money market fund portfolio securities, including securities that are subject to a conditional demand feature) + 172 hours (monitoring minimal credit risks) = 632,725 hours.

<sup>239</sup> For purposes of the PRA analysis, the current burden associated with the requirements of rule 30b1-7 is included in the collection of information requirements of Form N-MFP.

<sup>240</sup> See Form N-MFP Items C.9, C.10, C.14.b-c, C.15.b-c, C.16.c-d.

N-MFP, for each portfolio security, any rating assigned by an NRSRO that the fund's board of directors (or its delegate) considered in determining that the security presents minimal credit risks (together with the name of the assigning NRSRO).<sup>241</sup> Because we believe that the majority of funds will continue to refer to credit ratings in making minimal credit risk determinations, we do not believe the amendments to Form N-MFP will result in material changes to the ongoing burden for most funds.<sup>242</sup> However, we believe that funds will incur one-time costs to re-program their filing software to reflect the new requirements of Form N-MFP.

We estimate that each fund will incur a one-time burden of 3 hours,<sup>243</sup> at a cost of \$943 per fund,<sup>244</sup> to comply with the amended disclosure requirements of Form N-MFP. Using an estimate of 537 money market funds that are required to file reports on Form N-MFP,<sup>245</sup> we estimate that money market funds will incur, in the aggregate, a total one-time burden of 1,611 hours,<sup>246</sup> at a cost of \$506,391,<sup>247</sup> to comply with the amended disclosure requirements of Form N-MFP. Amortizing these hourly and cost burdens over three years results in an average annual increased burden for all money market funds of 537 hours<sup>248</sup> at a cost of \$168,797.<sup>249</sup>

<sup>241</sup> See Form N-MFP Items C.9, C.10, C.14.e, C.15.c, C.16.d; *supra* section II.E. The proposal also would have required disclosure of any rating assigned by an NRSRO to whose services the fund or its adviser subscribes (together with the name of the assigning NRSRO). Because the estimated burden assigned to the form amendments is only the one-time re-programming cost, which will not be affected by the change from the proposal to the adopting release, the burden estimate above has not been reduced to reflect the removal of this requirement.

<sup>242</sup> See *supra* note 114.

<sup>243</sup> We estimate that the one-time hour burden for a money market fund to re-program its Form N-MFP filing software to reflect the new requirements of Form N-MFP would be 3 hours (1 hour by a senior systems analyst, 1 hour by a senior programmer, and 1 hour by an attorney).

<sup>244</sup> This estimate is based on the following calculation: (1 hour  $\times$  \$260 (rate for a senior systems analyst) + (1 hour  $\times$  \$303 (rate for a senior programmer) = \$303) + (1 hour  $\times$  \$380 (rate for an attorney) = \$380) = \$943.

<sup>245</sup> This estimate is based on a review of reports on Form N-MFP filed with the Commission for the month ended April 30, 2015. The Proposing Release PRA statement was based on data as of February 28, 2014. We have updated the estimates used in this final PRA to reflect more current data as of April 30, 2015.

<sup>246</sup> This estimate is based on the following calculation: 3 hours  $\times$  537 money market funds = 1,611 hours.

<sup>247</sup> This estimate is based on the following calculation: \$943  $\times$  537 money market funds = \$506,391.

<sup>248</sup> This estimate is based on the following calculation: 1,611 hours  $\div$  3 years = 537 hours.

<sup>249</sup> This estimate is based on the following calculation: \$506,391  $\div$  3 years = \$168,797.

There will be no external costs associated with complying with the amended disclosure requirements of Form N–MFP.<sup>250</sup>

The current approved collection of information for Form N–MFP is 83,412 annual aggregate hours and \$4,780,736 in external costs. The aggregate additional hours associated with the amendments to Form N–MFP increase the burden estimate to 83,949 hours annually for all funds.<sup>251</sup> Because we estimate no external costs associated with complying with the amended Form N–MFP disclosure requirements, the annual external costs associated with the Form N–MFP collection of information would remain \$4,780,736.

## V. Economic Analysis

As discussed above, we are adopting amendments to rule 2a–7 and Form N–MFP under the Investment Company Act to implement Section 939A of the Dodd-Frank Act, which requires the Commission, to “review any regulation issued by [the Commission] that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and any references to or requirements in such regulations regarding credit ratings.”<sup>252</sup> That section further provides that the Commission shall “modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as [the Commission] shall determine as appropriate for such regulations.”<sup>253</sup>

<sup>250</sup> We understand that a certain percentage of money market funds that report information on Form N–MFP license a software solution from a third party that is used to assist the funds to prepare and file the required information, and that a certain percentage of money market funds retain the services of a third party to provide data aggregation and validation services as part of the preparation and filing of reports on Form N–MFP. See 2014 Money Market Fund Adopting Release, *supra* note 6, at text accompanying nn.2334–2336.

We recognize that, in general, software service providers that modify their software may incur additional external costs, which they may pass on to money market funds in the form of higher annual licensing fees. See *id.* at text accompanying n. 2340. However, on account of the relatively low per-fund one-time hour burden that we estimate in connection with the amended disclosure requirements of Form N–MFP, we expect that any increase in licensing fees will be insignificant, and thus we estimate that there are no external costs associated with the amended Form N–MFP disclosure requirements.

<sup>251</sup> This estimate is based on the following calculation: 83,412 hours (current approved burden) + 537 hours = 83,949 hours.

<sup>252</sup> Public Law 111–203, Sec. 939A(a)(1)–(2). Section 939A of the Dodd-Frank Act applies to all federal agencies.

<sup>253</sup> Public Law 111–203, Sec. 939A(b). Section 939A of the Dodd-Frank Act provides that agencies shall seek to establish, to the extent feasible,

We are also amending rule 2a–7 to eliminate the exclusion to the issuer diversification requirement for securities subject to a guarantee issued by a non-controlled person. As a result, most non-government securities subject to a guarantee (including an asset-backed security with a presumed sponsor guarantee) will have to comply with both the 5 percent diversification requirement for issuers (including SPE issuers) and the 10 percent diversification requirement for guarantors and providers of demand features.<sup>254</sup>

The economic baseline for our economic analysis is the regulatory framework as it exists immediately before the adoption of these amendments, that is, the regulatory framework after the amendments to rule 2a–7 were adopted in the 2014 Money Market Fund Adopting Release. As discussed in more detail below, that release makes material changes to rule 2a–7 that we believe may result in material changes to the money market fund industry. Because there is an extended compliance period for those amendments, and we are not aware of any funds that are already complying with all of the amendments, we do not know how market participants, including money market fund managers selecting portfolio securities, may react as a result. Thus, we are not able to provide quantitative estimates for the incremental effects of this rule’s amendments. For example, under the baseline, institutional prime money market funds have floating NAVs and maintain the distinction between first and second tier securities. We are unable to estimate how institutional prime funds will choose to allocate their portfolios among first and second tier securities under our amendments when they have floating NAVs and no commenters provided any estimates. We discuss potential economic effects of complying with the amendments to the rule, but without knowing how fund portfolio allocations may change we cannot quantify these potential effects. For the remainder of our economic analysis, we discuss separately the rule

uniform standards of creditworthiness, taking into account the entities the agencies regulate and the purposes for which those entities would rely on such standards.

<sup>254</sup> As discussed above, the asset-backed security presumed guarantee is counted toward the 10% limitation on guarantees and demand features provided by the same institution. Up to 15% of the value of securities held in a tax-exempt money market fund’s portfolio may be subject to guarantees or demand features from a single institution, and up to 25% of the value of securities held in a single state money market fund portfolio may be issued by any single issuer. See *supra* section II.F.

2a–7 amendments to remove and replace ratings references, Form N–MFP amendments, and the amendments to rule 2a–7’s issuer diversification provision.

### A. Rule 2a–7: Ratings Removal and Related Amendments

The amendments to rule 2a–7 will affect five elements of the current rule. These are: (i) Determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings downgrades and other credit events; and (v) stress testing.<sup>255</sup> The amendments are designed to remove any requirement of reliance on credit ratings and to substitute standards of creditworthiness that we believe are appropriate.

#### 1. Economic Baseline

As discussed above, the current credit risk limitations in rule 2a–7 require that money market funds undertake a two-step analysis before acquiring a portfolio security.<sup>256</sup> First, funds must determine whether a security has received credit ratings from the “requisite NRSROs” in one of the two highest short-term rating categories or, if the security is unrated, determine that it is of comparable quality. A money market fund must currently invest at least 97 percent of its portfolio in first tier securities, which are eligible securities that have received a rating from the requisite NRSROs in the highest short-term rating category for debt obligations, or unrated securities of comparable quality. Second, the fund’s board of directors (or its delegate) must determine that the security presents minimal credit risks, based on factors pertaining to credit quality in addition to any rating assigned to such securities by a designated NRSRO. In addition, under current rule 2a–7, a security subject to a conditional demand feature may be determined to be an eligible security or a first tier security if, among other conditions: (i) The conditional demand feature is an eligible security or a first tier security, and (ii) the underlying security (or its guarantee) has received either a short-term rating or a long-term

<sup>255</sup> The final rule will also make conforming amendments to rule 2a–7’s recordkeeping and reporting requirements. See rule 2a–7(h)(3).

<sup>256</sup> See *supra* note 25 and accompanying and preceding text. The credit risk limitations of current rule 2a–7, as well as the other specific provisions of current rule 2a–7 that reference credit ratings, were not changed by the adoption of the amendments discussed in the 2014 Money Market Fund Adopting Release.

rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security.

Based on Form N-MFP filings from April 30, 2015, the Commission estimates that 98.26 percent of aggregate money market fund assets are in first tier securities, 0.14 percent of aggregate money market fund assets are in second tier securities, and 1.6 percent of aggregate money market fund assets are in unrated securities. Among the 537 funds that filed Form N-MFP that month, 412 funds reported that they held only first tier securities, 477 funds reported that they held no second tier securities, and 447 funds reported that they held no unrated securities. In addition, less than 4 percent of all money market funds held the maximum amount of second tier securities permitted under current rule 2a-7. Using additional data from the Federal Reserve Board, we estimate that money market fund holdings of second tier commercial paper represent 0.9 percent of the outstanding issues of second tier commercial paper.<sup>257</sup>

Securities subject to a conditional demand feature are typically variable rate demand notes issued by municipalities that have a conditional demand feature issued by a bank. Based on Form N-MFP filings as of April 30, 2015, the Commission estimates that 9.3 percent of money market fund assets are invested in securities with a demand feature. We estimate further that securities with conditional demand features represent 3.9 percent of securities with demand features and 0.4 percent of all securities held by money market funds. We further estimate that 77 percent of those underlying securities (or their issuers or guarantors) have received an NRSRO rating in the second-highest long-term rating category, while 23 percent have received an NRSRO rating in the highest long-term category.<sup>258</sup>

Rule 2a-7 currently requires a money market fund board (or its delegate) to promptly reassess whether a security

that has been downgraded by an NRSRO continues to present minimal credit risks.<sup>259</sup> We understand that downgrades are rare among money market fund portfolio securities.<sup>260</sup> As discussed above, we believe, based on staff experience, that most, if not all, money market funds currently monitor portfolio securities for minimal credit risk on an ongoing basis.<sup>261</sup> We assume for purposes of this analysis, however, that these funds do not have written policies and procedures that specifically address ongoing minimal credit risk monitoring.

Finally, rule 2a-7 currently requires money market funds to stress test their portfolios.<sup>262</sup> Under the rule, a money market fund's board of directors must adopt written procedures to test the ability of a fund to maintain at least 10 percent of its total assets in weekly liquid assets and minimize principal volatility (and, in the case of a money market fund using the amortized cost method of valuation or penny rounding method of pricing, the fund's ability to maintain a stable price per share) based on certain hypothetical events, including a downgrade or default of particular portfolio security positions, each representing various portions of the fund's portfolio. We believe that funds stress test at least monthly.<sup>263</sup>

## 2. Economic Analysis

The amendments to rule 2a-7 will assist in further implementing Section 939A of the Dodd-Frank Act. They are designed to establish credit quality standards similar to those currently in the rule. By replacing references to credit ratings, the amendments will, particularly when considered together with other amendments the Commission has adopted that remove credit ratings references in other rules and forms under the federal securities laws, contribute to the Dodd-Frank Act goals of reducing perceived government endorsement of NRSROs and over-

reliance on credit ratings by market participants.<sup>264</sup>

### i. Eligible Securities

Under the final rule, a money market fund board (or its delegate) will be required to determine minimal credit risk by applying certain credit quality factors. Because the application of these factors may differ among fund boards and their advisers, the possible range of securities available for investment may differ from that under the current rule. However, inclusion of the credit analysis factors in the rule, as opposed to the more subjective standard in the proposed rule, should limit this range by helping to make compliance more uniform across money market funds. The final rule also clarifies that, when making minimal credit risk determinations, the fund's board (or its delegate) should consider the contribution of the security to aggregate credit risks and not just evaluate the security in isolation. In particular, a potential addition to the portfolio that has low risk by itself might increase portfolio risk to unacceptable levels if it is sufficiently correlated with the overall portfolio. For example, a security that has a very low probability of default might be inappropriate for the fund if that security is likely to default at the same time as other securities in the fund's portfolio.

In addition, we believe that fund managers are generally unlikely to increase exposure of their funds to riskier second tier securities in light of both current market practices and amendments to rule 2a-7 adopted in the 2014 Money Market Fund Adopting Release.<sup>265</sup> First, we anticipate that many money market funds, particularly those that are themselves rated, are likely to retain their current investment policies, which incorporate NRSRO ratings and would be permitted under the rule amendments. Indeed, we understand that many funds today have investment policies that are more restrictive than rule 2a-7 requires, including policies that, for example, limit investments to first tier securities.<sup>266</sup> As a result, we do not

<sup>259</sup> See *supra* note 111 and accompanying text.

<sup>257</sup> This data is based on the Federal Reserve Board's statistics on outstanding volume of commercial paper as of April 30, 2015. See Commercial Paper Outstanding by special categories, available at <http://www.federalreserve.gov/releases/cp/outstanding.htm>. The Proposing Release used earlier data from this Web site. We have updated the figures used in this final rule analysis to reflect more current data as of April 30, 2015.

<sup>258</sup> An underlying long-term security would become a short-term security when its remaining time to maturity is less than 397 days. See *supra* note 94. These estimates are based on a random sample of 10% of the securities that have demand features that were reported in April 2015 Form N-MFP filings.

<sup>260</sup> See, e.g., Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, a report by staff of the Division of Risk, Strategy, and Financial Innovation (Nov. 30, 2012), available at <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>, at 14-16 (discussing events such as credit rating downgrades that have led money market fund sponsors to choose to provide support to the fund or to seek staff no-action assurances permitting such support). Staff continues to monitor credit rating downgrades among portfolio securities and other issues concerning money market funds through the monthly information provided on Form N-MFP.

<sup>261</sup> See *supra* note 116 and accompanying text.

<sup>262</sup> Current rule 2a-7(g)(8).

<sup>263</sup> See 2014 Money Market Fund Adopting Release, *supra* note 6, at section IV.A.5.

<sup>264</sup> See 2014 Money Market Fund Adopting Release, *supra* note 6, at n.202 and accompanying text.

<sup>265</sup> See, e.g., 2010 Money Market Fund Adopting Release, *supra* note 84, at section II.A.1 (discussing tradeoff between risk and yield for second tier securities). We do not believe fund managers are likely to invest in securities rated below the second highest short-term rating category of an NRSRO (or comparable unrated securities) because those securities would not satisfy the standard for eligible securities that the security present minimal credit risks to the fund. See discussion *infra* section V.2.ii.

<sup>266</sup> As of February 2014, 179 money market funds, representing approximately 59% of all money

expect that these money market funds will change current policies and procedures they have adopted that limit their investments to those assigned the highest NRSRO ratings. We also noted above that according to Form N-MFP filings from April 30, 2015, fund assets in second tier securities represented 0.14 percent of total money market fund assets and that 18 funds (out of a total of 537) currently hold the maximum amount of second tier securities permissible under current rule 2a-7. We do not anticipate that money market funds representing the significant majority of assets under management are likely to increase substantially their investments in riskier securities as a result of our rule because these funds do not currently invest in second tier securities to the extent permitted now.

Second, as discussed above, the 2014 amendments to rule 2a-7 should reduce the potential that funds will invest in riskier securities. Under the 2014 reforms, money market funds other than government money market funds are allowed to impose fees and gates, while institutional prime money market funds will be required to transact at a floating NAV.<sup>267</sup> We believe that those reforms may encourage non-government funds to more closely monitor fund liquidity and hold more liquid securities to increase the level of daily and weekly liquid assets in the fund to lessen the likelihood of needing to impose a fee or gate. These newly adopted money market fund reforms also require each fund to disclose daily its market value rounded to four decimal points (or an equivalent level of accuracy for a fund using a share price other than

market fund assets (88% of all institutional money market fund assets) were themselves rated by credit rating agencies, and approximately 98% of rated money market funds were rated in the top credit quality category by an NRSRO. For a money market fund to receive this top rating, credit rating agencies generally require the fund to limit its portfolio securities to first tier securities. *See, e.g.,* FitchRatings, Global Money Market Fund Rating Criteria (Mar. 26, 2013), available at [http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=704145](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=704145) (registration required) (stating that its "AAAmmf" top rating requires that a money market fund have 100% of its portfolio securities rated first tier ("F1+" or "F1")); Standard & Poor's, Methodology: Principal Stability Fund Ratings (Jun. 8, 2011), available at [https://www.sbafla.com/prime/portals/8/RiskMan\\_Oversight/FundProfile/201106\\_SPPPrincipalStabilityFundRatingsMethodology.pdf](https://www.sbafla.com/prime/portals/8/RiskMan_Oversight/FundProfile/201106_SPPPrincipalStabilityFundRatingsMethodology.pdf) (stating that "[i]n order for a fund to be eligible for an investment-grade rating, all investments should carry a Standard & Poor's short-term rating of 'A-1+' or 'A-1' (or SP-1+ or SP-1), or Standard & Poor's will consider all of the investments to be of equivalent credit quality").

<sup>267</sup> Rule 2a-7(a)(14) defines a government money market fund as a money market fund that invests 99.5% or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully.

\$1.0000<sup>268</sup>) and to depict historical information about its daily NAV for the previous six months. These disclosures may increase informational efficiency by allowing investors to see variations in share value that are not apparent in the current share price and compare the volatility of share values among funds over time. As a result, to the extent that institutional investors continue to value price stability and can see these variations in share value, we believe that institutional prime funds will endeavor to reduce NAV fluctuations.

Third, under the final rule funds are permitted to refer to credit ratings while making their minimal credit risk determinations. A credit rating in the top short-term credit quality category by an NRSRO might help support the fund's determination that the security is an eligible security, while a credit rating in a lower category might not support the same determination. Thus, fund managers may have to perform additional credit research and analysis on the issuers of second tier securities in order to determine whether the investment is permitted under the adopted amendments. We believe that many fund managers may not wish to invest in the additional resources necessary to make this assessment with respect to second tier securities unless the fund believes that the expected risk-adjusted return of doing so would be greater than the expected costs. Thus, the demand for securities rated second tier will likely be lower.

The final rule would eliminate the current limitations on fund investments in second tier securities.<sup>269</sup> As a result, funds may increase their holdings of second tier securities despite the considerations discussed above. Commenters on the 2014 Proposing Release were mixed in their opinions as to whether the proposed changes would have this effect. Some believed that the standard proposed would appropriately limit funds' purchases of riskier securities,<sup>270</sup> while others thought that it would not.<sup>271</sup> The Commission believes that the changes to the proposed standard made in this final rule should reduce the likelihood of increased credit risk because funds will have to perform a rigorous analysis using the codified factors and consider a security's potential addition to the aggregate risk of the portfolio. We also believe that, to the extent money market

<sup>268</sup> Rule 2a-7(h)(10)(iii).

<sup>269</sup> *See supra* note 30 and accompanying text and note 62.

<sup>270</sup> *See, e.g.,* Invesco Comment Letter; MFDF Comment Letter.

<sup>271</sup> *See, e.g.,* BlackRock Comment Letter; CFA Comment Letter; Vanguard Comment Letter.

funds increase investments in riskier securities, institutional prime funds are more likely than stable-NAV funds to do so because stable-NAV funds will need to maintain stability to avoid falling below \$1 per share. Although some shareholders may continue to value price stability more than yield from institutional prime funds, if enough shareholders value yield more than price stability, institutional prime funds will be incentivized to increase their investments in second tier securities. Allocative efficiency may improve if such preferences result in relatively riskier securities moving from the portfolios of stable NAV funds to the portfolios of institutional prime funds, allowing money market fund shareholders to choose funds that better match their preferences for risk and return. We do not, however, know whether institutional prime funds with floating NAVs, which will have to compete with other money market funds, including stable-NAV government funds, will focus on maintaining comparatively stable NAVs or on generating comparatively high yields.

If we were to assume that money market funds increase their relative holdings of second tier securities with the adoption of the amendments, the effects on competition and capital formation would depend, in part, on whether the increased demand for second tier investments comes from new assets that investors bring to money market funds, which are then disproportionately invested in second tier securities, or whether the increased second tier investments would come from a shift of existing money market fund assets from first tier securities to second tier securities. If the former, the effects on competition between issuers of first and second tier securities might be small, and capital formation might improve in the second tier market as the size of the new investment increases. If the latter, an increase in capital formation from issuers of second tier securities may result in a corresponding decrease in capital formation from issuers of first tier securities, which, in turn, may lead to increased competition between issuers of first and second tier securities. We are unable to estimate these effects because we do not know how shareholders and funds will respond to the elimination of the current limitation on fund investments in second tier securities and no commenters provided any estimates.

The amendments to Form N-MFP, which are discussed in more detail below, may make it easier for fund shareholders and other third parties to

monitor the level of credit risk borne by funds that use credit ratings. As a result, this increased transparency may reduce the likelihood that fund boards (or managers) increase significantly fund investments in second tier securities. We are requiring each money market fund to disclose on Form N-MFP those NRSRO ratings the fund's board (or its delegate) has considered, if any, in determining whether a security presents minimal credit risks.<sup>272</sup> The disclosure to investors of these ratings may have the effect of reducing the demand for funds that assume a level of risk that is different from that which is desired by their shareholders.

As discussed above, the vast majority of money market funds held no second tier securities on April 30, 2015, and few funds held the maximum permissible 3 percent. We therefore believe that a reduction or even elimination of second tier securities from the money market fund industry's aggregate portfolio will not likely have a material effect on issuers of either first or second tier securities. However, removing second tier securities from the portfolios of individual money market funds may negatively affect yields in certain funds, especially during periods when second tier securities offer substantially higher yields than the yields offered by first tier securities.

We believe that most money market funds are not likely to change their current investment policies in response to the adopted amendments. Nevertheless, we recognize that some fund boards might choose not to consider NRSRO ratings in their credit assessments or as noted above, fewer securities may be rated. If, as a result, the demand for NRSRO ratings were significantly reduced, NRSROs might invest less in producing quality ratings. The importance attached to NRSRO ratings currently as a result of the history of their use in regulatory requirements may impart franchise value to the NRSRO rating business. By eliminating references to NRSRO ratings in federal regulations, Section 939A of the Dodd-Frank Act could reduce these franchise values and reduce NRSROs' incentives to produce credible and reliable ratings. If the quality and accuracy of NRSRO ratings were adversely affected, yet the ratings continued to be used by enough other parties, the capital allocation process

and economic efficiency might be impaired as investors make investment decisions using lower-quality information.

Conversely, the removal of ratings requirements in Commission rules may enhance incentives for NRSROs to produce credible and reliable ratings, in order to remain competitive, maintain revenue, and protect franchise value. In addition, certain industry commenters on the 2014 Proposing Release expressed support for the continued use of ratings as a tool in determining creditworthiness.<sup>273</sup> Thus, we believe that a large majority of institutional money market funds will continue to consider credit ratings in their evaluation of securities, at least as a screening measure, and will continue to be rated themselves. To the extent that funds continue to use ratings, which we believe most will, investors would be able to determine the ratings, and the extent to which funds are considering those ratings, of fund portfolio securities from the disclosures required under the amendments to Form N-MFP. Consequently, we believe it is unlikely that the capital allocation process and economic efficiency will be materially impaired.

The Proposing Release provided the credit analysis factors as guidance, rather than in rule text, and required that the fund make a finding that the issuer of a security had an "exceptionally strong capacity" to meet its short-term financial obligations.<sup>274</sup> Because the final rule is largely codifying the analysis that the staff believes money market fund managers currently take into account, as discussed above,<sup>275</sup> the economic analysis for this final rule is similar to that of the proposed rule. In this adopting release, we have incorporated into the rule credit analysis factors, as well as providing asset-specific factors as guidance. As we noted in the discussion above, based on staff observations in examinations and prior staff guidance, we believe that most money market fund managers currently take these factors into account, as appropriate, when they determine that a portfolio security presents minimal credit risks. Moreover, the factors listed in the rule are to be considered "to the extent appropriate"<sup>276</sup> and are not intended to rigidly define the parameters of an appropriate credit quality assessment; that is for the fund's board and its

adviser to determine with respect to each particular security and the fund's overall risk profile. Thus, we do not anticipate that the rule's inclusion of factors that a fund manager should consider will significantly change the process for evaluating credit quality or that consideration of the factors listed in the rule and discussed in the release will significantly affect the holdings in money market fund portfolios. For these reasons, we continue to believe that the factors will not have a material effect on efficiency, competition, or capital formation. Funds may, however, consider whether their policies and procedures for credit quality assessment should be revised in light of the factors as codified, and, as a result, may need to update them.

Finally, we note that Commission staff engages in ongoing monitoring of money market fund risks and operations, through review of Form N-MFP filings, examinations, and other outreach efforts, and provides regular updates to the Commission about relevant issues. As part of these ongoing monitoring efforts, the staff also will undertake to study and report to the Commission no later than 3 years following the adoption of these amendments to rule 2a-7 and Form N-MFP the impact of these amendments on capital formation and investor protection. The study will include, but not be limited to, a review of any changes in the risk profile of money market fund portfolio security investments during the period studied and whether any additional measures, including further investor protections, may be necessary.

#### ii. Conditional Demand Feature

The final rule provides the same credit quality standard for securities with a conditional demand feature as for other portfolio securities. The fund's board (or its delegate) must determine that a security with a conditional demand feature presents minimal credit risks to the fund. We do not believe that fund managers will likely interpret this standard in a manner that results in funds increasing the risk profiles of their underlying securities. First, as discussed above, we do not believe that securities that are rated by NRSROs in the third-highest category for long-term ratings (or comparable unrated securities) would satisfy the standard that underlying securities present minimal credit risks to the fund. We also note that funds currently can invest exclusively in underlying securities rated in the second-highest category if the instrument meets the other

<sup>272</sup> Because the fund may only choose to consider one or two ratings, the specific rating or ratings disclosed by a fund on Form N-MFP may not always be indicative of the overall universe of ratings for that security. However, investors who wish to have a larger sample may choose to subscribe to other ratings themselves.

<sup>273</sup> See IDC Comment Letter; Invesco Comment Letter; MFD Comment Letter.

<sup>274</sup> See proposed rule 2a-7(a)(11).

<sup>275</sup> See *supra* section IV.A.1.

<sup>276</sup> Rule 2a-7(a)(11).

conditions for eligibility.<sup>277</sup> We estimate that most underlying securities held by money market funds (77 percent) are rated in the second-highest long-term category, and a smaller portion (23 percent) are rated in the highest long-term category.<sup>278</sup> For these reasons, we do not currently anticipate that funds are likely to increase the portion of their underlying securities that are rated in the second-highest long-term category as a result of the adopted amendments since these funds do not currently invest in these securities to the extent permitted under existing rules.

For the reasons explained above, and because the minimal credit risk standard is largely the same as what we understand that many funds apply now, and also the same as will be required for all eligible portfolio securities, we believe that our rule will result in only small changes to the practices of funds with respect to investments in securities with conditional demand features. In addition, the elimination of the “very strong capacity” standard presented in the proposal should result in little or no change to this analysis, as discussed above.<sup>279</sup> Thus, we continue to believe that the conditional demand feature provision will result in little or no effect on efficiency, competition, or capital formation for either funds or issuers.

As discussed above, we believe that the amendments to rule 2a–7 will cause money market fund complexes to incur certain costs in reviewing and updating their policies and procedures.

Specifically, each complex is likely to review the amendments to the credit quality standards in rule 2a–7 and, as it determines appropriate in light of the amendments, revise its policies and procedures to incorporate the amended credit quality evaluation method to be used in determining the eligibility of a money market fund’s portfolio securities, including securities that are subject to a conditional demand feature.

### iii. Ongoing Monitoring of Minimal Credit Risk

The Commission is adopting the ongoing monitoring provision as proposed. As discussed above, we believe that the requirement that each money market fund adopt written policies and procedures for ongoing monitoring of minimal credit risks for each portfolio security essentially codifies the current practices of fund managers.<sup>280</sup> Although based on staff experience we believe that most, if not

all, money market funds currently monitor portfolio securities for minimal credit risk on an ongoing basis (as rule 2a–7 requires<sup>281</sup>), we note that money market funds are not currently required to maintain written policies and procedures that specifically address monitoring. We believe that to the extent that some money market funds may not have written procedures to regularly monitor minimal credit risks, our provision to require such procedures is designed to ensure that funds are better positioned to identify quickly potential risks of credit impairment that could impact portfolio security prices. The costs associated with the minimal credit risk monitoring requirement, as discussed above, will vary based on the extent to which funds’ existing procedures need to be transcribed and reviewed.<sup>282</sup> We continue to believe that the requirement for written procedures in the final rule will not materially affect efficiency, competition, or capital formation because we expect no material changes in how funds invest.

### iv. Stress Testing

The Commission is adopting the stress testing provision as proposed. As discussed above, the amendments are designed to retain similar standards for stress testing as under current rule 2a–7. Specifically, the amendments will remove the current reference to ratings downgrades in the rule 2a–7 stress testing requirement, and instead require funds to test for an event indicating or evidencing credit deterioration of particular portfolio security positions, with a downgrade or default provided as examples of such an event. Consequently, we recognize that a money market fund could use its current policies and procedures for stress testing, including testing for a downgrade, to comply with the amendments. We believe that funds will do so because a downgrade by a relevant NRSRO may impact the price of a portfolio security.<sup>283</sup> Commenters on the stress testing provision of the Proposing Release were uniformly supportive of this approach,<sup>284</sup> and one specifically stated that the amendments would not significantly change the substance of current stress tests.<sup>285</sup> We

believe this provision thus provides a clear benefit by reducing any perceived endorsement of NRSRO ratings. Because we believe that funds will not change their stress testing policies and procedures in response to these amendments, we also believe there will be little or no costs associated with them.<sup>286</sup> Thus we do not anticipate that these amendments are likely to affect efficiency, competition, or capital formation.

### v. Policies and Procedures

As discussed above, money market funds have written policies and procedures for complying with rule 2a–7, including policies and procedures for determining and reassessing minimal credit risk and for stress testing the portfolio.<sup>287</sup> Although our final rule should not require changes to these policies and procedures for most money market funds, we anticipate that funds will likely review them and may revise them in consideration of the uniform credit quality standard provided in the rule. We also anticipate that after such a review, many fund boards and advisers will retain investment policies that reference NRSRO ratings.<sup>288</sup> Although we cannot predict the number of funds that will review and revise their policies and procedures or the extent to which funds may do so, we estimate that each fund will incur, at a minimum, the collection of information costs discussed in the Paperwork Reduction Act section for a total average one-time cost of approximately \$2,838 per fund complex.<sup>289</sup> These minimum costs assume that a fund will review its policies and procedures in consideration of the amendments and make minor changes to conform with the revised rule text, but will not change significantly the policies and procedures relating to the fund’s credit quality assessments, monitoring for minimal credit risk or stress testing,

<sup>286</sup> See *supra* note 236 and accompanying text.

<sup>287</sup> See rule 38a–1(a); rule 2a–7.

<sup>288</sup> See *supra* note 213 and accompanying text.

We also note that most commenters on the 2011 proposal supported permitting funds to continue to use ratings, and some asked us to clarify that ratings continue to be a permissible factor for boards or their delegates to consider in making credit quality determinations. See, e.g., 2011 Comment Letter of BlackRock Inc. (Apr. 25, 2011) (“2011 BlackRock Comment Letter”); Comment Letter of the Independent Directors’ Council (Apr. 25, 2011). Commenters on the 2014 proposal continued to stress the usefulness of credit ratings. See IDC Comment Letter; Invesco Comment Letter; MFDF Comment Letter. Our amendments to Form N–MFP, discussed above, reflect our clarification that ratings continue to be a permissible tool to use in making credit quality determinations.

<sup>289</sup> See *supra* note 218.

<sup>277</sup> Current rule 2a–7(d)(2)(iv).

<sup>278</sup> See *supra* note 258 and accompanying text.

<sup>279</sup> See *supra* section IV.A.1.

<sup>280</sup> See *supra* section II.C.

<sup>281</sup> See *id.*

<sup>282</sup> See *supra* note 226 and accompanying text.

<sup>283</sup> See Comment Letter of Investment Company Institute (Apr. 25, 2011) on the 2011 Proposing Release.

<sup>284</sup> See Barnard Comment Letter; BlackRock Comment Letter; ICI Comment Letter; Vanguard Comment Letter; CFA Institute Comment Letter; MFDF Comment Letter.

<sup>285</sup> See MFDF Comment Letter.

which currently include consideration of NRSRO ratings.

As noted above, we believe that while funds currently monitor for minimal credit risks on an ongoing basis, we assume that funds do not have written policies and procedures to address monitoring.<sup>290</sup> We estimate the average one-time costs to adopt those written policies will be \$3,619 per fund.<sup>291</sup> Because we anticipate that our rule is not likely to change these fund policies significantly, we believe it is not likely to have a significant impact on efficiency, competition, or capital formation.

### 3. Alternatives

The Commission chose not to adopt certain credit quality standards and requirements from the Proposing Release. First, the proposed rule would have required that a portfolio security not only present minimal credit risks, but also that its issuer has an “exceptionally strong capacity” to meet its short-term financial obligations.<sup>292</sup> As many commenters suggested,<sup>293</sup> we now believe that this determination could create an unclear standard for determining eligible securities that might change the current credit quality profile of money market funds, possibly creating risk profiles in money market funds that are even more stringent than the current rule provides for, as the discussion above details.<sup>294</sup> We believe that the rulemaking goal associated with this aspect of the proposal of ensuring that only very high quality securities are purchased by money market funds is more effectively carried out instead by the second change we have made from the proposed rule, the codification of the general credit analysis factors.<sup>295</sup>

The Proposing Release provided two lists of credit analysis factors for use in determining whether a security presented only minimal credit risks to a fund.<sup>296</sup> The first was a list of general factors for use with any security, and the second was an asset-specific list. The final rule incorporates the list of general factors into the rule text, and we discuss in this release the asset-specific list as guidance.<sup>297</sup> As discussed

above,<sup>298</sup> we believe that codifying the general factors will help provide a uniform and objective check on credit risk that can be verified by our examiners. We also believe that incorporating these factors into the rule text will further promote effective and uniform application of the risk standard. These two changes together, elimination of the “exceptionally strong capacity” language and codification of the factors, should help to ensure that the rule will maintain the current risk characteristics of money market funds and thus is not likely to have a significant effect on efficiency, competition, or capital formation.

In addition to the changes to the primary risk standard, the final rule also changed the risk standard for securities with conditional demand features.<sup>299</sup> The proposed rule would have required that the issuer of the underlying security or the provider of a conditional demand feature have a “very strong” capacity to meet its financial obligations.<sup>300</sup> As with the proposed “exceptionally strong capacity” standard, some commenters felt that this standard could be interpreted very differently by different funds.<sup>301</sup> In order to reduce confusion and preserve a similar degree of credit quality to that currently present in fund portfolios, the Commission determined instead to require that the issuer of the underlying security and the provider of the conditional demand feature meet the same “minimal credit risks” standard.

In developing this final rule, we also considered changes consistent with the amendments we proposed in 2011. The 2011 proposal would have required fund boards first to determine whether securities are eligible securities based on minimal credit risks, and second to distinguish between first and second tier securities based on subjective standards similar to those the ratings agencies have developed to describe their ratings. However, we were persuaded by the concerns some commenters expressed on the 2011 proposal,<sup>302</sup> and did not adopt these alternatives. In particular, as several commenters noted, a two-tier approach could be confusing without reference to objective standards, and fund advisers are likely to make many of the same

considerations in evaluating first and second tier securities.<sup>303</sup> In addition, we believe that the adopted single standard will better reflect the risk limitation in the current rule. The 2011 proposal described the standard for second tier securities in language similar to the descriptions NRSROs use for second tier securities, which fund managers might interpret as permitting funds to invest in riskier second tier securities to a greater extent than under our final rule, which is designed to limit investments to very high quality second tier securities. Such increased investments in riskier second tier securities would have had the potential to increase the risk profile of money market funds.

The two industry commenters on the 2014 proposal who discussed the elimination of the first and second tier distinction supported it.<sup>304</sup> However, two other commenters expressed concern that removal of the distinction and the limit on second tier securities could lead to funds purchasing more risky securities.<sup>305</sup> As discussed above,<sup>306</sup> we believe that the codification of the credit analysis factors in the final rule, combined with market discipline and staff oversight of required N-MFP disclosures, should reduce this possibility.

The two-tier approach discussed above could have had different effects on competition and capital formation than the effects on competition and capital formation stemming from the adopted approach, as a result of ensuing increased or decreased investments in second tier securities. However, we are unable to estimate the relative effects on competition or capital formation because we do not know how shareholders and funds would respond to this approach as compared to the final rule, and no commenters provided any estimates.

With respect to replacing the reference to ratings in determining the eligibility of underlying securities (*i.e.*, those that are subject to a conditional demand feature), we considered a qualitative standard that NRSROs use to articulate long-term securities in the highest rating category. We note generally that few issuers or guarantors have received long-term ratings in the highest category.<sup>307</sup> Moreover, issuers

<sup>290</sup> See *supra* notes 116 and 226 and accompanying text.

<sup>291</sup> See *supra* note 228.

<sup>292</sup> Proposed rule 2a-7(a)(11).

<sup>293</sup> See, *e.g.*, Dreyfus Comment Letter; NYC Bar Comment Letter; Schwab Comment Letter.

<sup>294</sup> See *supra* section II.A.

<sup>295</sup> Rule 2a-7(a)(11).

<sup>296</sup> Proposing Release, *supra* note 3, at 47991-47993.

<sup>297</sup> The general factors have also been amended based on comments received, with one new factor added. See rule 2a-7(a)(11). We chose not to codify the asset-specific factors. See *supra* section II.A.2.

<sup>298</sup> See *supra* section II.A.2.

<sup>299</sup> See rule 2a-7(d)(2)(iii).

<sup>300</sup> See proposed rule 2a-7(d)(2)(iii).

<sup>301</sup> See, *e.g.*, Dreyfus Comment Letter; Fidelity Comment Letter. Some commenters also felt that the need to apply two different standards would add to compliance costs without providing benefits in improving credit quality. See, *e.g.*, Dreyfus Comment Letter; ICI Comment Letter; IDC Comment Letter.

<sup>302</sup> See Proposing Release, *supra* note 3, at 47988-47989.

<sup>303</sup> See *id.*

<sup>304</sup> See Fidelity Comment Letter; MFDF Comment Letter.

<sup>305</sup> See Better Markets Comment Letter; CFA Comment Letter.

<sup>306</sup> See *supra* section II.A.2.

<sup>307</sup> See Vipal Monga & Mike Cherney, *CFO Journal: Lose your Triple-A Rating? Who Cares?*, Wall St. J. (Apr. 29, 2014) (noting the decline in companies with triple A long-term ratings).

assigned a short-term credit rating in the top category by an NRSRO may have received a long-term rating in the second-highest (or lower) category.<sup>308</sup> Because of the limited NRSRO assignments of the highest long-term ratings to issuers, managers might have interpreted this alternative to preclude fund investments in a security subject to a conditional demand feature (that is itself an eligible security) if the underlying security's issuer or guarantor is rated in the second-highest category. Such an interpretation could significantly deviate from the credit quality standards in the current rule, which was not our intent. It also would likely reduce money market fund investments in these securities.

In choosing to eliminate the current reference to ratings downgrades in the monitoring standard of rule 2a-7, we considered the rule 2a-7 amendments that we proposed in 2011.<sup>309</sup> These proposed amendments would have required that, in the event the money market fund adviser (or any person to whom the board has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the board or its delegate would have to promptly reassess whether the security continues to present minimal credit risks.<sup>310</sup> Most of those who commented on this proposed amendment objected to it as an inefficient method of notifying funds if a portfolio security is potentially

impaired. We were persuaded by these commenters' concerns.<sup>311</sup>

Finally, we also considered removing the current reference to ratings downgrades in the stress testing provisions of rule 2a-7 and replacing this reference with the requirement that money market funds stress test their portfolios for an adverse change in the ability of a portfolio security issuer to meet its short-term credit obligations. We had proposed this alternative in 2011, and commenters on the 2011 proposal who addressed this issue uniformly advocated against removing the reference to a downgrade in the stress testing conditions.<sup>312</sup> We believe that the 2011 proposed standard, as compared to the standard we are adopting today, was less clear and that it would lead to more burdensome monitoring and greater inefficiencies in developing hypothetical events for stress testing. In light of these commenters' concerns, we thus decided to adopt stress testing provisions in rule 2a-7 that would permit funds to continue to test their portfolios against a potential downgrade or default, as discussed in more detail above.<sup>313</sup> As also discussed above, commenters uniformly supported this provision.<sup>314</sup>

Form N-MFP

The final rule's amendments to Form N-MFP will require money market funds to disclose NRSRO ratings that they use in their evaluations of portfolio securities. Specifically, a fund will have to disclose for each portfolio security any NRSRO rating that the fund's board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating. NRSRO ratings provide one indicator of credit risk of a fund's portfolio securities and, as discussed above, we anticipate that they will continue to be considered by many money market fund managers in performing credit quality assessments. We believe this ratings information will be useful to the Commission, to investors, and to various third parties as they monitor and evaluate the risks that fund managers take in both stable-NAV and institutional prime funds.

#### 1. Economic Baseline

Under the economic baseline outlined above, money market funds are required

to disclose in Form N-MFP the credit ratings for each portfolio security.<sup>315</sup> More specifically, funds are currently required to identify whether a portfolio security is a first or second tier security or is unrated, and to identify the "designated NRSROs" for each security (and for each demand feature, guarantee, or other credit enhancement). This disclosure requirement was not changed by the 2014 Money Market Fund Adopting Release.

As noted above, based on Form N-MFP filings from April 30, 2015, the Commission estimates that 98.26 percent of aggregate money market fund assets are invested in first tier securities, 0.14 percent of aggregate money market fund assets are invested in second tier securities, and 1.6 percent of aggregate money market fund assets are invested in unrated securities. Among the 537 funds that filed that month, 412 funds reported that they held only first tier securities, 477 funds reported that they held no second tier securities, and 447 funds reported that they held no unrated securities.

#### 2. Economic Analysis

We anticipate that our amendments are likely to have two primary benefits. First, they should reduce perceived government endorsement of NRSROs, particularly when considered together with other amendments the Commission has adopted that remove credit ratings references in this rule and other rules and forms under the federal securities laws. Second, they will provide transparency on whether or not specific funds use credit ratings when making investment decisions, and might make it easier, if ratings are used, for shareholders and other interested parties to also use those ratings as part of their own risk assessments.

We anticipate that our amendments are likely to have two primary costs. First, they may impose administrative costs on funds that need to re-program their Form N-MFP filing software.<sup>316</sup> Second, because only funds that choose to consider credit ratings in assessing minimal credit risk will be permitted to disclose NRSRO ratings on Form N-MFP, our final rule may reduce transparency into one measure of the credit risk associated with securities purchased by funds that do not choose

<sup>308</sup> See Moody's Investors Service, Rating Symbols and Definitions, Apr. 2014, [https://www.moody.com/researchdocument/contentpage.aspx?docid=PBC\\_79004](https://www.moody.com/researchdocument/contentpage.aspx?docid=PBC_79004), at 6 (showing the linkage between short-term and long-term ratings when such long-term ratings exist and indicating that long-term ratings of "A3" or higher are compatible with the highest short-term rating of "P-1"); Standard & Poor's, About Credit Ratings (2012), [http://www.standardandpoors.com/aboutcreditratings/RatingsManual\\_PrintGuide.html](http://www.standardandpoors.com/aboutcreditratings/RatingsManual_PrintGuide.html) (each short-term rating corresponds to a band of long-term ratings. "For instance, the A-1 short-term rating generally corresponds to the long-term ratings of 'A+,' 'A,' and 'A-.'"); FitchRatings, Ratings Definitions (2014), [https://www.fitchratings.com/jsp/general/RatingsDefinitions.faces?context=5&detail=507&context\\_ln=5&detail\\_ln=500](https://www.fitchratings.com/jsp/general/RatingsDefinitions.faces?context=5&detail=507&context_ln=5&detail_ln=500) (indicating the relationship between short-term and long-term ratings with a table and acknowledging that "lower relative short-term default risk, perhaps through factors that lend the issuer's profile temporary support, may coexist with higher medium-or longer term default risk").

<sup>309</sup> See 2011 Proposing Release, *supra* note 4, at section II.A.3.

<sup>310</sup> *Id.*

<sup>311</sup> See 2014 Proposing Release, *supra* note 3, at section II.A.3.

<sup>312</sup> We had proposed this alternative in 2011 and received comments on it at that time. See *id.*, section II.A.4.

<sup>313</sup> See *supra* section V.A.2.iv.

<sup>314</sup> See *supra* notes 284-285 and accompanying text.

<sup>315</sup> Although some money market funds voluntarily disclose security credit ratings, money market funds often rely on a staff no-action letter in not disclosing security credit ratings and "designated NRSROs." See *supra* note 142 and accompanying text.

<sup>316</sup> See *supra* notes 243-244 and accompanying text (discussion of re-programming costs in PRA analysis).

to consider credit ratings. This loss of transparency could create additional servicing costs for such funds if shareholders demanded new communications regarding the credit quality of the portfolio,<sup>317</sup> though this problem may be mitigated by the fact that sophisticated shareholders will often be aware of the ratings and other measures of credit risk, even if they are not disclosed on Form N–MFP.

The net effect of the amendments to Form N–MFP is that funds will not be required or permitted to disclose credit ratings if credit ratings are not considered in determining whether a security is eligible for the portfolio. However, as discussed above, we believe that our amendments will not result in any material changes for the majority of funds because they will, we believe, continue to refer to credit ratings. We believe, therefore, that the amendments' effects on efficiency, competition, and capital formation will likely be negligible. To the extent that money market funds continue to consider NRSRO ratings in making their minimal credit risk determinations, the amendments to Form N–MFP may reduce the potential that fund managers will increase significantly fund investments in riskier second tier securities; a fund will be required to disclose ratings considered in those credit determinations, and the ratings will reflect that increased risk. As a result, the disclosure to investors of these risk indicators may have the effect of penalizing funds that assume more risk.

Although this final rule reflects a change from the proposal by not requiring disclosure of every rating that a fund subscribes to, we believe that it will have a negligible impact on the overall costs and benefits of these amendments to Form N–MFP. Just as in the proposed rule, funds will still have to report the ratings they considered, and adjust their compliance programs to ensure such reporting. The extra reporting that would have been required under the proposed rule would likely only have caused a very small burden on funds because funds would incur the same reprogramming costs under either approach.

<sup>317</sup> See Comment Letter of the Dreyfus Corporation (Apr. 25, 2011) (“2011 Dreyfus Comment Letter”) (opposing the elimination of credit ratings disclosures in Form N–MFP because of the potential that the fund would bear increased shareholder servicing costs to provide additional communications regarding the credit quality of the portfolio).

### 3. Alternatives

In the 2014 Proposing Release, the Commission presented an alternative to the now adopted amendments to Form N–MFP that would have required greater disclosure of credit ratings. Specifically, a fund would have had to disclose not only the ratings that it considered in evaluating a security and the name of the NRSRO providing the rating, but also each rating assigned by any NRSRO if the fund or its adviser subscribed to that NRSRO's services, and the name of that NRSRO. Several commenters on the proposed rule objected strongly to this requirement, stating that it would be costly, onerous and that mere subscription to an NRSRO's services was not a good indication that a particular rating was part of the evaluation of a particular security.<sup>318</sup> In developing this final rule, we were persuaded by these commenters and now believe that requiring this level of disclosure is unnecessary. In addition, as noted by commenters, requiring disclosure based on subscription might have increased costs and therefore created a financial disincentive to the use of ratings subscriptions by funds. As a result, this alternative might have decreased the amount of information used by fund managers to monitor risk in the market. For all of these reasons, we believe that the alternative chosen in the final rule is less likely than the other alternatives to impair efficiency, competition, and capital formation.

In developing this final rule, we also considered the 2011 proposal to completely eliminate the following two form items: the item that requires a fund to identify whether a portfolio security is a first tier security, a second tier security, or an unrated security; and the item that requires the fund to identify the “requisite NRSROs” for each security (and for each demand feature, guarantee, or other credit enhancement). Although we have eliminated the terminology “requisite NRSRO”, we did not adopt this alternative because we now believe that completely eliminating such disclosure requirements masks not only the credit ratings but also information on whether or not the fund uses credit ratings when making its investment decisions.

We also considered not removing the current disclosure requirement as recommended by several commenters to the 2011 Proposing Release.<sup>319</sup> We

<sup>318</sup> See, e.g., SIFMA Comment Letter; BlackRock Comment Letter.

<sup>319</sup> See 2011 BlackRock Comment Letter; 2011 Dreyfus Comment Letter; Comment Letter of Federated Investors, Inc. (Apr. 25, 2011); Comment

Letter of the Securities Industry and Financial Markets Association (Apr. 18, 2011).

elect not to leave the current disclosure requirements as is, but instead to adopt the required disclosure of NRSRO ratings only in certain circumstances, with the final rule narrowing those circumstances to situations where the fund actually uses the rating in its evaluation of credit quality. We believe these final amendments are more in keeping with Congressional intent underlying Section 939A of the Dodd-Frank Act to reduce perceived government endorsement of credit ratings.

### B. Exclusion From the Issuer Diversification Requirement

#### 1. Economic Baseline

As discussed above, most money market fund portfolio securities that are subject to a guarantee by a non-controlled person are currently subject to a 10 percent diversification requirement on guarantors but no diversification requirement on issuers, while non-government securities with guarantors that do not qualify as non-controlled persons are generally subject to both a 5 percent diversification requirement with respect to issuers and a 10 percent diversification requirement with respect to guarantors.<sup>320</sup> In July 2014, we adopted amendments to rule 2a–7 that deem sponsors of asset-backed securities to be guarantors of the asset-backed security (unless the fund's board rebuts the presumption).<sup>321</sup> As a result, under rule 2a–7's definition of a guarantee issued by a non-controlled person, both non-asset-backed securities and asset-backed securities subject to such a guarantee (including asset-backed securities with a presumed sponsor guarantee) are excluded from the rule's issuer diversification requirement. That is, non-asset-backed securities and asset-backed securities subject to a guarantee by a non-controlled person are subject to a 10 percent diversification requirement on guarantors, but they are not subject to a 5 percent issuer diversification requirement on the issuer.<sup>322</sup> This forms

Letter of the Securities Industry and Financial Markets Association (Apr. 18, 2011).

<sup>320</sup> We note that single state funds may invest up to 25 percent of fund assets in securities of any single issuer, and tax-exempt funds may have as much as 15 percent of the value of portfolio securities invested in securities subject to guarantees or demand features issued by a single provider that is a non-controlled person. Rule 2a–7(d)(3)(i)(B); rule 2a–7(d)(3)(iii)(B).

<sup>321</sup> We also adopted an amendment to rule 2a–7's diversification provisions to provide that money market funds limit their exposure to affiliated groups, rather than to discrete issuers. See rule 2a–7(d)(3)(ii)(F).

<sup>322</sup> See current rule 2a–7(a)(18) (definition of guarantee); current rule 2a–7(a)(19) (definition of

the economic baseline for the new diversification amendments that we are adopting today.

## 2. Economic Analysis

We believe that a small number of money market funds rely on the issuer diversification exclusion for securities subject to a guarantee by a non-controlled person. In the Proposing Release, staff's analysis of February 2014 Form N-MFP data showed that only 8 out of 559 money market funds held securities with a guarantee by a non-controlled person that exceeded the 5 percent diversification requirement for issuers. We stated in the Proposing Release that we believed that these funds in February 2014 relied on the exclusion from the 5 percent issuer diversification requirement with respect to issuers of securities that are subject to a guarantee issued by a non-controlled person.

In response to commenters, staff supplemented its analysis using October 2014 and April 2015 Form N-MFP data to review the number of funds that exceeded the 5 percent diversification limit.<sup>323</sup> Staff found, as discussed above, that as of October 2014 and April 2015, only 0.0482 percent and 0.0624 percent, respectively, of total money market fund assets were above the 5 percent issuer diversification threshold. As noted above, Commission staff found that only tax-exempt money market funds appeared to be relying on the 5 percent issuer diversification exclusion in October 2014 and April 2015. For October 2014 and April 2015, staff found that only 0.1 percent and 0.5 percent, respectively, of national tax-exempt money market fund assets were exposed to issuers above the 5 percent threshold.

Commission staff also separately analyzed the number of single state money market funds that appear to be relying on the issuer diversification exclusion.<sup>324</sup> Because single state funds have a 25 percent issuer diversification basket, staff analyzed issuer exposure above this 25 percent limit, which would suggest that the fund may be relying on the 5 percent issuer diversification exclusion in order to obtain additional issuer exposure. In their analysis, staff recognized that a single state money market fund could be relying on the issuer diversification exclusion even when a fund's exposure

to a single issuer is below 25 percent. For example, using the 25 percent issuer basket, a single state fund technically could have a 10 percent exposure to Issuer A and a 15 percent exposure to Issuer B, while having an additional 7 percent exposure to Issuer B using the 5 percent issuer diversification exclusion. In this scenario the total amount of exposure to Issuer B is less than 25 percent, but the money market fund is nonetheless relying on the issuer diversification exclusion. Staff analysis suggests that for October 2014, 44 single state money market funds out of 97 total single state money market funds were potentially relying on the 5 percent issuer diversification exclusion, and for April 2015, 38 single state money market funds out of 90 total single state money market funds were potentially relying on the 5 percent issuer diversification exclusion. However, for October 2014 and April 2015, staff found that only 1.7 percent and 1.3 percent, respectively, of single state money market fund assets were above the 5 percent issuer diversification threshold (while taking into account the 25 percent issuer diversification basket). Therefore, while a number of single state money market funds may be affected by the amended rule, a very small portion of their assets will be affected.

We recognize that changes in fund assets could mask which funds rely on the issuer diversification exclusion at acquisition: A fund might be above the 5 percent limit today solely due to a decline in fund assets after acquisition, and a fund might be below the 5 percent limit today solely due to an increase in fund assets after acquisition.<sup>325</sup> Whatever the cause, a money market fund that has invested more than 5 percent of its assets in an issuer of securities subject to a guarantee issued by a non-controlled person in reliance on the exclusion under current rule 2a-7 would, when those investments mature, have to reinvest the proceeds over 5 percent elsewhere. Based on the additional analysis of Form N-MFP filings, we believe that a small percentage of all money market funds (including a higher proportion of single state funds) would have to make changes to their portfolios to bring them

into compliance with the amendments. These changes may or may not require the funds to invest in alternative securities, and the alternative securities may or may not be inferior because they offer, for example, lower yields, lower liquidity, or lower credit quality.

In response to commenters' suggestion that the Commission consider a broader sample of data, as discussed above, and to assess the amendment's effect on yield, our staff examined whether the 7-day gross yields of funds that use the 5 percent issuer diversification exclusion were higher than the 7-day gross yields for funds that do not. Our staff found: (i) For national tax-exempt money market funds in October 2014, the average yield for funds using the 5 percent issuer diversification exclusion was 0.10 percent as compared to the average yield for funds that did not use the 5 percent issuer diversification exclusion of 0.08 percent; (ii) for national tax-exempt money market funds in April 2015, the average yield for funds using the 5 percent issuer diversification exclusion was 0.12 percent as compared to the average yield for funds that did not use the 5 percent issuer exclusion of 0.11 percent; (iii) for single state money market funds in October 2014, the average yield for funds using the 5 percent issuer diversification exclusion was 0.10 percent as compared to the average yield for funds that did not use the 5 percent issuer exclusion of 0.08 percent; and (iv) for single state money market funds in April 2015, the average yield for funds using the 5 percent issuer diversification exclusion was 0.12 percent as compared to the average yield for funds that did not use the 5 percent issuer exclusion of 0.07 percent. Although we do not believe the above differences in yield are material, we do recognize that funds that appear to be relying on the exclusion have, on average, a higher yield than money market funds that do not rely on the exclusion. In addition, we acknowledge that the current low-interest rate environment may cause the yield spread in each comparison above to be less than if we were measuring the yield spreads in a higher interest rate environment.

It appears that the elimination of the exclusion would affect the 63 money market funds out of a total of 542 money market funds (or approximately 11.6 percent of all money market funds) that exceeded the 5 percent issuer diversification limit as of April 2015, and would affect the 0.0624 percent of total money market fund assets that were above the 5 percent issuer diversification threshold, such that

guarantee issued by a non-controlled person); current rule 2a-7(d)(3)(i) (issuer diversification).

<sup>323</sup> See *supra* note 191 and accompanying text.

<sup>324</sup> As noted above, rule 2a-7 currently permits a single state fund to invest up to 25 percent of its assets in any single issuer. See *supra* note 161 and accompanying text.

<sup>325</sup> All of rule 2a-7's diversification limits are applied at the time of acquisition. For example, a fund may not invest in a particular issuer if, after acquisition, the fund's aggregate investments in the issuer would exceed 5 percent of fund assets. But if the fund's aggregate exposure after making the investment was less than 5 percent, the fund would not be required to later sell the securities if the fund's assets decreased and the fund's investment in the issuer came to represent more than 5 percent of the fund's assets.

when those investments mature, the affected funds would have to reinvest the proceeds over 5 percent elsewhere. Because of the minimal amount of money market fund assets that would be affected by our amendment, we believe that the potential lower yields, less liquidity or increased risks associated with the amendment will be small for the affected funds.<sup>326</sup>

A couple commenters expressed concern regarding the amendment's impact on the supply of available securities for all money market funds.<sup>327</sup> One of these commenters suggested that imposing further diversification limits could artificially lower the supply of available issuers.<sup>328</sup> The second commenter suggested that the amendment would unnecessarily restrict the amount of asset-backed securities, and particularly asset-backed commercial paper, available for purchase by money market funds.<sup>329</sup> In addition, a couple of commenters argued that the proposed amendment would cause certain issuers to experience decreased demand and increased financing costs.<sup>330</sup> Another commenter argued that removing the issuer diversification exclusion may increase the number of guarantors held in a fund's portfolio, some of which may present marginally greater credit risks.<sup>331</sup> This commenter further argued that repealing the exclusion to increase

diversification may actually diminish the percentage of the portfolio subject to credit enhancement as well as the overall credit quality of the guarantors.<sup>332</sup>

We recognize that the removal of the issuer diversification exclusion and tightening of issuer diversification requirements for securities subject to a guarantee by a non-controlled person may impact issuers of these securities and the fund's risk profile. We also recognize that the amendment may occasionally prevent some issuers from selling securities to a money market fund that would otherwise invest in the issuer's securities above the 5 percent diversification requirement, but we believe, as discussed below, that the effect on such issuers would be negligible. In addition, while we recognize that removing the exclusion may cause some money market funds to invest in securities with higher credit risk, we note that a money market fund's portfolio securities must meet certain credit quality requirements, such as posing minimal credit risks, as discussed above.<sup>333</sup> We therefore continue to believe that the substantial risk limiting provisions of rule 2a-7 would mitigate the potential that these money market funds would significantly increase their investments in securities with higher credit risk. We also continue to believe that eliminating this exclusion would more appropriately limit money market fund risk exposures by limiting the concentration of exposure that a money market fund could have otherwise had to a particular issuer. We assume that all funds will incur costs associated with updating their systems to reflect the amendment, as well as the associated compliance costs, if their systems already incorporate this issuer diversification exclusion. We requested comment on operational costs that funds would incur in connection with the amendment. No commenters specifically addressed operational costs associated with the amendment. Accordingly, we continue to believe that these costs will be small for all funds because we believe that all funds currently have the ability to monitor issuer diversification to comply with rule 2a-7's limits on issuer concentration.

Our diversification amendment offers two primary benefits. First, by requiring greater issuer diversification for those funds that rely on the exclusion, the amendment will reduce concentration risk in those funds and may make it

easier for funds to maintain or generate liquidity during periods when they impose fees and/or gates. Second, the amendment simplifies rule 2a-7's diversification requirements by eliminating the exclusion for securities with a guarantee issued by a non-controlled person, which should lower certain compliance and operational costs to the extent that funds no longer have to keep track of the securities that have such guarantees and would be eligible for the exclusion.

Because we believe that the universe of affected funds and issuers is small, we continue to believe that our amendment will have only negligible effects on efficiency, competition, and capital formation. Although we recognize that this amendment may constrain more funds (and issuers) in the future that otherwise would have less issuer diversification, we estimate, based on our staff's analysis of data from April 2015, that it will affect 63 funds, or approximately 11.6 percent of all money market funds today. Based on our staff's analysis we also estimate that, as of April 2015, our amendment will affect the 0.0624 percent of total money market fund assets that were above the 5 percent issuer diversification threshold. Based on staff analysis of Form N-MFP data and the amount of high quality securities available to tax-exempt money market funds, we continue to believe that the affected funds will find comparable alternative securities for the amount that exceeds 5 percent, and we believe that the affected issuers, to the extent applicable, will find other investors willing to buy the amount that exceeds the 5 percent for a comparable price.

### 3. Alternatives

As an alternative to eliminating the exclusion from issuer diversification for securities with a guarantee issued by a non-controlled person, at the proposal stage we considered requiring money market funds to be more diversified by lowering a fund's permitted exposure to any guarantor or provider of a demand feature from 10 percent to 5 percent of total assets. We discussed potential benefits and costs of this alternative approach, and we requested comment on it in the 2013 Money Market Fund Proposing Release.<sup>334</sup> As discussed in

<sup>326</sup> Consider, for example, how reducing a position from 7 percent to 5 percent might affect fund yields. The effect could be as small as 0 percent if the 2 percent of assets are reinvested in securities that offer the same yield as the original 7 percent of assets. On the other hand, the portfolio change could decrease fund yields by as much as approximately 29 percent if all of the portfolio yield came from the 7 percent security. We believe that funds will choose alternative securities that have similar yields as the securities replaced.

<sup>327</sup> As discussed above, some commenters also voiced supply concerns specifically with respect to tax-exempt money market funds.

<sup>328</sup> See BlackRock Comment Letter. This commenter suggested that many changes to the money market fund market may occur as a result of both the 2014 money market fund amendments and the 2014 proposed amendments relating to NRSRO ratings removal and suggested that the Commission wait to see the effects of those amendments before adopting additional diversification amendments.

<sup>329</sup> See SFIG Comment Letter. SFIG stated that, as of June 30, 2014, money market funds held over \$89 billion of asset-backed commercial paper, representing approximately 36 percent of the overall asset-backed commercial paper market. SFIG also argued that the creditworthiness of any single obligor of an asset-backed security would be less significant if that security was guaranteed and suggested that an obligor of an asset-backed security only be treated as an issuer of that security if its obligations constitute 20 percent of the obligations of that security rather than apply the 10 percent obligor provision under rule 2a-7(d)(3)(B).

<sup>330</sup> See Fidelity Comment Letter; SIFMA Comment Letter.

<sup>331</sup> See ICI Comment Letter.

<sup>332</sup> See *id.*

<sup>333</sup> See rule 2a-7(d)(2) (portfolio quality); see *supra* section II.A.

<sup>334</sup> See 2013 Money Market Fund Proposing Release, *supra* note 16, at section III.J.4. We received no comments on this alternative approach. We also requested comment in 2009 on whether to reduce rule 2a-7's current diversification limits. See 2009 Money Market Fund Proposing Release, *supra* note 160, at section II.D. Most commenters opposed these reforms because, among other reasons, the reductions could increase risks to

more detail above, we decided that the current requirements for diversification of guarantors and providers of demand features together with the issuer diversification requirement if applied generally to all securities, as under the adopted amendment, appropriately address our concerns relating to money market fund risk exposures.<sup>335</sup> We also believe that the potential costs of this alternative approach would likely be more significant than the costs of our adopted amendment. As of the end of April 2015, we estimate that approximately 110 (of 214) prime money market funds had total exposure to a single entity (including directly issued, asset-backed commercial paper sponsorship, and provision of guarantees and demand features) in excess of 5 percent. Under the alternative, any fund that had exposure to an entity greater than 5 percent when those assets matured would have to reinvest the proceeds of the securities creating that exposure in different securities or securities with a different guarantor. Those changes may or may not require those funds to invest in alternative securities, and those securities might present greater risk if they offered lower yields, lower liquidity, or lower credit quality. The alternative approach would appear to affect many more funds than would the amendment we are adopting today. As a result, we continue to believe that a better approach to achieving our reform goal would be to restrict risk exposures to all non-government issuers of securities subject to a guarantee in the same way, and to require money market funds (other than tax-exempt and single state funds as described above) that invest in non-government securities subject to a guarantee to comply with the 5 percent issuer diversification requirement and the 10 percent diversification requirement on guarantors.

#### 4. Technical Amendments

As discussed above, we are making technical amendments to certain diversification provisions in rule 2a–7. Due to the nature of these amendments, we believe that the amendments will have no effect on efficiency, competition, or capital formation.

### VI. Regulatory Flexibility Act Certification

The Commission certified, pursuant to section 605(b) of the Regulatory

funds by requiring the funds to invest in relatively lower quality securities. See *id.* at n.909.

<sup>335</sup> See *supra* text preceding and accompanying note 182.

Flexibility Act of 1980<sup>336</sup> that the proposed amendments to rule 2a–7 and form N–MFP under the Investment Company Act, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>337</sup> We included this certification in Section VI of the Proposing Release. Although we encouraged written comments regarding this certification, no commenters responded to this request.

#### Statutory Authority

The Commission is adopting amendments to rule 2a–7 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), 80a–37(a)] and Section 939A of the Dodd-Frank Act. The Commission is adopting amendments to Form N–MFP under the authority set forth in sections 8(b), 30(b), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a–8(b), 80a–29(b), 80a–30(a) and 80a–37(a)] and Section 939A of the Dodd-Frank Act.

#### List of Subjects in 17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

#### Text of Rule and Form Amendments

In accordance with the foregoing, title 17, chapter II of the Code of Federal Regulations is amended as follows:

### PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

■ 1. The authority citation for part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, 80a–39, and Pub. L. 111–203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

\* \* \* \* \*

■ 2. Section 270.2a–7 is amended by:

- a. In paragraph (a)(5), removing the words “and (D)”;
- b. Removing paragraph (a)(11);
- c. Redesignating paragraphs (a)(12) and (13) as paragraphs (a)(11) and (12);
- d. Revising newly designated paragraph (a)(11);
- e. Removing paragraph (a)(14);
- f. Redesignating paragraphs (a)(15) through (21) as paragraphs (a)(13) through (19);

<sup>336</sup> 5 U.S.C. 603(b).

<sup>337</sup> Under the Investment Company Act, an investment company is considered a small business or small organization if, together with other investment companies in the same group of related investment companies, it has net assets of \$50 million or less as of the end of its most recent fiscal year. See 17 CFR 270.0–10.

- g. In newly designated paragraph (a)(16)(ii), removing the references “(a)(12)(iii)” and “(d)(2)(iii)” and adding in their places “(a)(11)” and “(d)(2)(ii)”, respectively.
- h. Removing paragraph (a)(22);
- i. Redesignating paragraph (a)(23) as paragraph (a)(20);
- j. Removing paragraph (a)(24);
- k. Redesignating paragraph (a)(25) as paragraph (a)(21);
- l. Removing paragraph (a)(26);
- m. Redesignating paragraphs (a)(27) through (31) as paragraphs (a)(22) through (26);
- n. Removing paragraph (a)(32);
- o. Redesignating paragraphs (a)(33) and (34) as paragraphs (a)(27) and (28);
- p. In paragraph (c)(2)(i), removing the reference to “(c)(i)(A)” and adding in its place “(c)(2)(i)(A)”.
- q. Revising paragraph (d)(2);
- r. Revising paragraph (d)(3)(i);
- s. In paragraph (d)(3)(iii) introductory text, removing the words “paragraphs (d)(3)(iii) and (d)(3)(iv)” and adding in their place “paragraphs (d)(3)(i), (iii), and (iv)”;
- t. In paragraph (d)(3)(iii)(A), removing the words “paragraphs (d)(3)(iii)(B) and (d)(3)(iii)(C)” and adding in their place “paragraphs (d)(3)(i) and (d)(3)(iii)(B)”;
- u. Removing paragraph (d)(3)(iii)(C);
- v. Revising paragraph (f);
- w. Revising paragraph (g)(3);
- x. In paragraph (g)(8)(i)(B), at the beginning of the paragraph removing the word “A” and adding in its place “An event indicating or evidencing credit deterioration, such as a”;
- y. Revising paragraph (h)(3); and
- z. Revising paragraph (j).

The revisions read as follows:

#### § 270.2a–7 Money market funds.

(a) \* \* \*

(11) *Eligible security* means a security:

(i) With a remaining maturity of 397 calendar days or less that the fund’s board of directors determines presents minimal credit risks to the fund, which determination must include an analysis of the capacity of the security’s issuer or guarantor (including for this paragraph (a)(11)(i) the provider of a conditional demand feature, when applicable) to meet its financial obligations, and such analysis must include, to the extent appropriate, consideration of the following factors with respect to the security’s issuer or guarantor:

(A) Financial condition;

(B) Sources of liquidity;

(C) Ability to react to future market-wide and issuer- or guarantor-specific events, including ability to repay debt in a highly adverse situation; and

(D) 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.

(ii) That is issued by a registered investment company that is a money market fund; or

(iii) That is a government security.

**Note to paragraph (a)(11):** For a discussion of additional factors that may be relevant in evaluating certain specific asset types see Investment Company Act Release No. IC-31828 (9/16/15).

\* \* \* \* \*

(d) \* \* \*

(2) *Portfolio quality*—(i) *General*. The money market fund must limit its portfolio investments to those United States dollar-denominated securities that at the time of acquisition are eligible securities.

(ii) *Securities subject to guarantees*. A security that is subject to a guarantee may be determined to be an eligible security based solely on whether the guarantee is an eligible security, provided however, that the issuer of the guarantee, or another institution, has undertaken to promptly notify the holder of the security in the event the guarantee is substituted with another guarantee (if such substitution is permissible under the terms of the guarantee).

(iii) *Securities subject to conditional demand features*. A security that is subject to a conditional demand feature ("underlying security") may be determined to be an eligible security only if:

(A) The conditional demand feature is an eligible security;

(B) The underlying security or any guarantee of such security is an eligible security, except that the underlying security or guarantee may have a remaining maturity of more than 397 calendar days.

(C) At the time of the acquisition of the underlying security, the money market fund's board of directors has determined that there is minimal risk that the circumstances that would result in the conditional demand feature not being exercisable will occur; and

(1) The conditions limiting exercise either can be monitored readily by the fund or relate to the taxability, under federal, state or local law, of the interest payments on the security; or

(2) The terms of the conditional demand feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the demand feature in accordance with its terms; and

(D) The issuer of the conditional demand feature, or another institution, has undertaken to promptly notify the

holder of the security in the event the conditional demand feature is substituted with another conditional demand feature (if such substitution is permissible under the terms of the conditional demand feature).

(3) \* \* \*

(i) *Issuer diversification*. The money market fund must be diversified with respect to issuers of securities acquired by the fund as provided in paragraphs (d)(3)(i) and (ii) of this section, other than with respect to government securities.

(A) *Taxable and national funds*. Immediately after the acquisition of any security, a money market fund other than a single state fund must not have invested more than:

(1) Five percent of its total assets in securities issued by the issuer of the security, provided, however, that with respect to paragraph (d)(3)(i)(A) of this section, such a fund may invest up to twenty-five percent of its total assets in the securities of a single issuer for a period of up to three business days after the acquisition thereof; provided, further, that the fund may not invest in the securities of more than one issuer in accordance with the foregoing proviso in this paragraph (d)(3)(i)(A)(1) at any time; and

(2) Ten percent of its total assets in securities issued by or subject to demand features or guarantees from the institution that issued the demand feature or guarantee, provided, however, that a tax exempt fund need only comply with this paragraph (d)(3)(i)(A)(2) with respect to eighty-five percent of its total assets, subject to paragraph (d)(3)(iii) of this section.

(B) *Single state funds*. Immediately after the acquisition of any security, a single state fund must not have invested:

(1) With respect to seventy-five percent of its total assets, more than five percent of its total assets in securities issued by the issuer of the security; and

(2) With respect to seventy-five percent of its total assets, more than ten percent of its total assets in securities issued by or subject to demand features or guarantees from the institution that issued the demand feature or guarantee, subject to paragraph (d)(3)(iii) of this section.

\* \* \* \* \*

(f) *Defaults and other events*—(1) *Adverse events*. Upon the occurrence of any of the events specified in paragraphs (f)(1)(i) through (iii) of this section with respect to a portfolio security, the money market fund shall dispose of such security as soon as practicable consistent with achieving an

orderly disposition of the security, by sale, exercise of any demand feature or otherwise, absent a finding by the board of directors 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 disposition of the portfolio security);

(i) The default with respect to a portfolio security (other than an immaterial default unrelated to the financial condition of the issuer);

(ii) A portfolio security ceases to be an eligible security (e.g., no longer presents minimal credit risks); or

(iii) An event of insolvency occurs with respect to the issuer of a portfolio security or the provider of any demand feature or guarantee.

(2) *Notice to the Commission*. The money market fund must notify the Commission of the occurrence of certain material events, as specified in Form N-CR (§ 274.222 of this chapter).

(3) *Defaults for purposes of paragraphs (f)(1) and (2) of this section*. For purposes of paragraphs (f)(1) and (2) of this section, an instrument subject to a demand feature or guarantee shall not be deemed to be in default (and an event of insolvency with respect to the security shall not be deemed to have occurred) if:

(i) In the case of an instrument subject to a demand feature, the demand feature has been exercised and the fund has recovered either the principal amount or the amortized cost of the instrument, plus accrued interest;

(ii) The provider of the guarantee is continuing, without protest, to make payments as due on the instrument; or

(iii) The provider of a guarantee with respect to an asset-backed security pursuant to paragraph (a)(16)(ii) of this section is continuing, without protest, to provide credit, liquidity or other support as necessary to permit the asset-backed security to make payments as due.

(g) \* \* \*

(3) *Ongoing Review of Credit Risks*. The written procedures must require the adviser to provide ongoing review of whether each security (other than a government security) continues to present minimal credit risks. The review must:

(i) Include an assessment of each security's credit quality, including the capacity of the issuer or guarantor (including conditional demand feature provider, when applicable) to meet its financial obligations; and

(ii) Be based on, among other things, financial data of the issuer of the portfolio security or provider of the

guarantee or demand feature, as the case may be, and in the case of a security subject to a conditional demand feature, the issuer of the security whose financial condition must be monitored under paragraph (d)(2)(iii) of this section, whether such data is publicly available or provided under the terms of the security's governing documents.

\* \* \* \* \*

(h) \* \* \*

(3) *Credit risk analysis.* For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record must be maintained and preserved in an easily accessible place of the determination that a portfolio security is an eligible security, including the determination that it presents minimal credit risks at the time the fund acquires the security, or at such later times (or upon such events) that the board of directors determines that the investment adviser must reassess whether the security presents minimal credit risks.

\* \* \* \* \*

(j) *Delegation.* The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section other than the determinations required by paragraphs (c)(1) (board findings), (c)(2)(i) and (ii) (determinations related to liquidity fees and temporary suspensions of redemptions), (f)(1) (adverse events), (g)(1) and (2) (amortized cost and penny rounding procedures), and (g)(8) (stress testing procedures) of this section.

(1) *Written guidelines.* The board of directors must establish and periodically review written guidelines (including guidelines for determining whether securities present minimal credit risks as required in paragraphs (d)(2) and (g)(3) of this section) and procedures under which the delegate makes such determinations.

(2) *Oversight.* The board of directors must take any measures reasonably necessary (through periodic reviews of fund investments and the delegate's procedures in connection with investment decisions and prompt review of the adviser's actions in the event of the default of a security or event of insolvency with respect to the issuer of the security or any guarantee or demand feature to which it is subject that requires notification of the Commission under paragraph (f)(2) of this section by reference to Form N-CR (§ 274.222 of this chapter)) to assure that

the guidelines and procedures are being followed.

#### § 270.12d3-1 [Amended]

■ 3. Section 270.12d3-1(d)(7)(v) is amended by removing the reference to "270.2a-7(a)(18)" and adding in its place the phrase "270.2a-7(a)(16)".

#### § 270.31a-1 [Amended]

■ 4. Section 270.31a-1(b)(1) is amended by removing the phrase "(as defined in § 270.2a-7(a)(9) or § 270.2a-7(a)(18) respectively)" and adding in its place the phrase "(as defined in § 270.2a-7(a)(9) or § 270.2a-7(a)(16) respectively)".

■ 5.

#### PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

■ 5. The authority citation for part 274 continues to read in part as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, 80a-29, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

\* \* \* \* \*

■ 6. Form N-1A (referenced in § 274.11A) is amended by revising the definition of "Money Market Fund" in General Instructions—A. Definitions to read as follows:

**Note:** The text of Form N-1A does not, and this amendment will not, appear in the Code of Federal Regulations.

#### Form N-1A

\* \* \* \* \*

"Money Market Fund" means a registered open-end management investment company, or series thereof, that is regulated as a money market fund pursuant to rule 2a-7 (17 CFR 270.2a-7) under the Investment Company Act of 1940.

■ 7. Form N-MFP (referenced in § 274.201) is amended by:

- a. Revising Item C.9;
- b. Revising Item C.10;
- c. Removing Items C.14.b and C.14.c;
- d. Redesignating Items C.14.d through C.14.f as Items C.14.b through C.14.d;
- e. Adding new Item C.14.e;
- f. Removing Items C.15.b and C.15.c;
- g. Redesignating Item C.15.d as Item C.15.b;
- h. Adding new Item C.15.c;
- i. Removing Items C.16.c and C.16.d;
- j. Redesignating Item C.16.e as Item C.16.c; and
- k. Adding new Item C.16.d.
- l. Revising the definition of "Money Market Fund" in General Instructions—E. Definitions.

The additions and revisions read as follows:

**Note:** The text of Form N-MFP does not, and this amendment will not, appear in the Code of Federal Regulations.

#### Form N-MFP

\* \* \* \* \*

Item C.9 Is the security an Eligible Security? [Y/N]

Item C.10 Security rating(s) considered. Provide 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 (together with the name of the assigning NRSRO). If none, leave blank.

\* \* \* \* \*

Item C.14 \* \* \*

e. Rating(s) considered. Provide each rating assigned to the demand feature(s) or demand feature provider(s) by any NRSRO that the board of directors (or its delegate) considered in evaluating the quality, maturity or liquidity of the security (together with the name of the assigning NRSRO). If none, leave blank.

\* \* \* \* \*

Item C.15 \* \* \*

c. Rating(s) considered. Provide each rating assigned to the guarantee(s) or guarantor(s) by any NRSRO that the board of directors (or its delegate) considered in evaluating the quality, maturity or liquidity of the security (together with the name of the assigning NRSRO). If none, leave blank.

Item C.16 \* \* \*

d. Rating(s) considered. Provide each rating assigned to the enhancement(s) or enhancement provider(s) by any NRSRO that the board of directors (or its delegate) considered in evaluating the quality, maturity or liquidity of the security (together with the name of the assigning NRSRO). If none, leave blank.

\* \* \* \* \*

E. Definitions \* \* \*

"Money Market Fund" means a registered open-end management investment company, or series thereof, that is regulated as a money market fund pursuant to rule 2a-7 (17 CFR 270.2a-7) under the Investment Company Act of 1940.

\* \* \* \* \*

By the Commission.

Dated: September 16, 2015.

**Brent J. Fields,**  
Secretary.

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