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Securities and Exchange Commission Raises the Bar for Money Fund Managers Agency adopts tougher investment regulations to protect funds during stress periods

The Securities and Exchange Commission (SEC) has significantly strengthened the regulatory requirements governing the management of money market funds in a bid to increase the resilience of money funds to market crises.

The more stringent requirements, many of which Columbia Management already has incorporated into its investment processes, are captured through changes to Rule 2a-7 of the Investment Company Act of 1940, which governs money market funds. The SEC adopted the changes on January 27, 2010. To date, the SEC has not posted the changes to its Web site, so it is not yet known when the new requirements will take effect. In the past, the SEC has provided a transition period that enabled fund managers to gradually adjust their portfolio holdings and investment practices.

Collectively, the changes likely will reduce the risk profile of money market funds, whose vulnerability to market crises became painfully apparent at the height of the financial crisis in the fall of 2008. The SEC is seeking to insulate funds from that kind of market volatility through the following reforms:

Portfolio Maturity Limits

The SEC has limited the maximum weighted average maturity of money market funds' portfolios to 60 days (versus 90 days previously), a move that should reduce funds' exposure to certain risks, such as sudden interest rate movements. The SEC also restricted the maximum weighted average life of funds' portfolios to 120 days (previously there was no limit). The effect of that restriction is to limit investments in long-term floating-rate securities.

Liquidity Requirements

Under the new regulatory framework, no more than 5% of a fund's assets can be invested in "illiquid securities" — defined as instruments that cannot be sold or disposed of at their carrying value within seven days. The limit was 10% previously. Additionally, the SEC established minimum percentages of money fund assets that must be in highly liquid securities:

- **Daily requirement:** Taxable money market funds must hold at least 10% of their assets in cash, U.S. Treasury securities or securities that can be converted into cash within one day.
- **Weekly requirement:** All money market funds must hold at least 30% of assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less or securities that can convert to cash within one week.

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Credit Quality Enhancements

The new rules restrict fund managers from holding more than 3% of their funds' assets in "second-tier," i.e., lower-quality, less liquid securities (versus 5% previously), and the maturities of those securities must not exceed 45 days (the limit had been 397 days). In addition, funds may not invest more than 0.5% of their assets in second-tier securities from a single issuer; the previous limit was the greater of 1% of assets or \$1 million.

Portfolio Stress Testing

As part of the new regulatory regime, the SEC is requiring fund managers to examine their funds' ability to maintain a stable NAV in the event of systemic shocks, such as a jump in interest rates, high redemption activity or sizeable changes to a portfolio's credit quality. Prior to the recent changes, there was no requirement to "stress test" money fund portfolios.

"Know Your Investor" Procedures

Money market funds now are required to implement procedures to identify investors whose redemption requests potentially could present a risk to a fund. The new rule requires fund managers to gauge the likelihood of large redemptions and plan accordingly. Fund managers would need to increase their allocations to highly liquid securities if a given investor increases the risk of significant redemption activity.

Disclosure Enhancements

Going forward, money market funds must post their portfolio holdings on their Web sites (updating them monthly). They also must report their portfolio holdings to the SEC each month in a format the SEC can use to create a database that will enable the agency to better oversee the funds' activities. Included in this report would be a funds "shadow" NAV ("mark-to-market"). Information would be made available to the public on a 60-day delay. Previously, funds reported their shadow NAVs twice a year, with a 60-day lag.

Operational Improvements

The SEC will allow a fund's board of directors to authorize the suspension of redemptions if the redemptions threaten to pull the fund's NAV below \$1 per share." The board also has the authority to liquidate distressed securities. These provisions represent a departure from past practice, in which a board had to request an order from the SEC to suspend redemptions or liquidate investments. In addition, affiliates of money market funds, such as bank holding companies, can purchase a broader range of distressed assets from a fund before a ratings downgrade or default to protect the fund from losses. The fund need not clear the purchase of distressed assets with the SEC in advance of the purchase, but it must notify the agency if such a transaction occurs. Previously the SEC's approval was required to go beyond what the 1940 act exemptive rule permitted.

The operational changes include one new requirement, which is that money market funds and their service providers must be able to process redemptions at a price other than \$1 per share.

Repurchase Agreements

The changes to Rule 2a-7 enhance provisions that enable funds to "look through" to the collateral backing repurchase agreements. Said collateral must be cash instruments or government securities (prior to the changes, the collateral could consist of highly rated corporate debt. With the added transparency comes a requirement that fund managers must evaluate the creditworthiness of the repurchase agreements' counterparties.

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While extensive, the rule changes adopted by the SEC may not be inclusive. The SEC has cautioned that there may be additional changes coming, although they did not release specific details on its Web site. Columbia Management will continue to closely monitor the regulatory environment and will notify our clients and partners of relevant changes as they occur. While the final language around the changes described above has not been established, we applaud the direction of these changes, as their ultimate goal is to further safeguard the money market fund industry and the interests of shareholders.

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More details on the SEC money market reform announcement are available at: <http://www.sec.gov/news/press/2010/2010-14.htm>

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