Client Alert

Current Issues Relevant to Our Clients

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SEC Proposed Revisions to Rule 2a-7 and their effect on Tax-Exempt VRDNs

On June 5, 2013, the SEC proposed certain amendments to Rule 2a-7, which is the primary rule governing money market mutual funds under the Investment Company Act of 1940. Among other things, the proposed amendments would modify the asset diversification requirements for money market funds. Of particular relevance to banks and other financial institutions that provide credit and liquidity support for tax-exempt VRDNs, the proposed amendments would eliminate the so-called twenty-five percent basket, which currently allows up to 25% of the value of a fund's portfolio to be subject to guarantees or demand features from a single provider. Funds that currently use that 25% basket to hold assets supported by a guarantee or demand feature from one (or more) providers would be subject to a 10% cap on assets that can be supported by any given provider under the proposed amendments.

There are relatively few institutions that are able to provide high quality guarantees and demand features to enhance tax-exempt VRDNs (one leading analyst estimates that there are, practically speaking, fewer than 30 such providers). The tax-exempt funds are also heavier users of the 25% basket when compared with taxable money funds. As a result, if the 25% basket is eliminated, tax-exempt money market funds may find themselves with insufficient investment options (whether in terms of number or credit quality or both) to maintain their current size.

Comments on the proposed amendments are due on September 17, 2013. We encourage tax-exempt VRDN enhancement providers to consider the effects of the proposed amendments on their customers, the issuers of tax-exempt securities, which may find themselves paying more for traditional guarantees and demand features to enhance their VRDNs, or seeking (even more) alternatives to issuing VRDNs in the first instance.

What are the current diversification requirements relevant to tax-exempt money market funds under Rule 2a-7?

In general, Rule 2a-7 restricts money market funds from investing more than 5% of their portfolios in any single issuer, and allows no more than 10% of their portfolios to be invested in securities issued by, or subject to guarantees or demand features (e.g., puts) from, any one institution. The 10% diversification limit on guarantees and demand features, however, only applies to 75% of a money market fund's total assets, creating the so-called 25% basket, which allows up to 25% of the value of a fund's assets to be subject to guarantees or demand features from a single institution.

How will the current diversification requirements change if the proposed amendments are adopted?

The proposed amendments would, in the SEC's words, "(1) require money market funds to treat certain entities that are affiliated with each other as single issuers when applying rule 2a-7's 5% issuer diversification requirement; (2) require funds to treat the sponsors of asset-backed securities as guarantors subject to rule 2a-7's diversification requirements unless the fund's board makes certain findings; and (3) remove the twenty-five percent basket." The last change, elimination of the 25% basket, may have a particular impact on tax-exempt money market funds, and the issuers and enhancers of securities held by them, for reasons described below.

How would the proposed amendments affect demand for guarantees and demand features issued by banks and other financial institutions?

In July of this year the SEC issued a memo analyzing the exposure of money market funds to parents of Guarantors

(the institutions providing guarantees and demand features). The data indicate that the issuance of such enhancements is concentrated among a small number of parents, and that the large majority of such enhancements support VRDNs. The top ten parents account for more than half of all such enhancements, while the next 40 parents account for approximately 35%.

Money has been flowing out of tax-exempt funds at a steady pace since 2008 due in large measure to issuer dissatisfaction with VRDNs. The general decline in credit quality of the enhancers, which issuers believe increases the put risk of VRDNs, the attractiveness of long-term fixed rates since 2008, and the high costs of issuance and disclosure requirements have combined to make enhanced VRDNs less appealing to many issuers of tax-exempt debt. That circumstance has in turn contributed to the concentration of enhancement instruments among a few high-quality providers.

If the proposed amendments are adopted, and tax-exempt money funds have more than 10% of their assets supported by a guarantee or demand feature issued by a single institution, the overage will either need to be enhanced by a provider that will keep the fund under the 10% cap, or invested in assets that do not have a guarantee or demand feature. The former option may be challenging because of the credit quality requirements that Rule 2a-7 and the rating agencies impose on assets held by the funds–in other words, any replacement enhancement provider would have to have credit ratings comparable to the other large providers and be willing and able (i.e., under the 10% limit) to extend credit to the underlying issuer.

The latter option, reinvesting in unenhanced assets, may not be realistic either. The vast majority of tax-exempt debt is long-term in nature, preventing a money market fund from holding it without a demand feature.

What questions should enhancement providers ask themselves and their customers as they consider the proposed amendments?

The SEC's proposing release asked market participants to respond to a number of questions regarding the elimination of the 25% basket. Of particular interest to the providers of guarantees and demand features are:

1. Are there enough guarantors and demand feature providers (of requisite quality) to allow tax-exempt money market funds to meet proposed diversification limitations?

2. To what extent would issuers of securities with guarantees or demand features be required to broaden their investor base or seek alternative providers?

3. Would some issuers reduce their reliance on guarantees and demand features?

4. Would eliminating the 25% basket make it difficult for issuers of securities subject to demand features or guarantees to find money market fund investors to purchase their securities?

For More Information

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