SEC Adopts Money Market Fund Reforms

August 28, 2014

Introduction

On July 23, 2014, the Securities and Exchange Commission ("SEC") adopted amendments to the rules that govern the operation and regulation of money market funds (the "Rules").[1] According to the SEC, the Rules are intended to address structural and operational aspects of money market funds, aiming to make them less susceptible during periods of economic stress to runs that could harm investors. The adoption of the Rules follows consideration by the SEC staff of more than 1,400 comment letters on the proposal issued in 2013.

The Rules require a floating net asset value ("NAV") for institutional prime money market funds and provide money market fund boards new tools—liquidity fees and redemption gates—to address runs. This Memorandum begins with a summary of the Rules and is followed by an analysis of the Rules.

Summary

The Rules consist primarily of amendments to Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act"). The Rules require prime and tax-exempt institutional money market funds ("Institutional money market funds") to value their securities at market value, rather than amortized cost, which will result in a floating NAV that allows the daily share prices of these funds to fluctuate along with changes in the market-based value of fund assets. U.S. government and Retail money market funds (as defined below) are exempt from these requirements and may continue to value their securities using amortized cost. The Rules also allow money market funds to impose liquidity fees, subject to certain exceptions, and redemption gates, as appropriate, when "weekly liquid assets" fall below 30%. Additionally, the SEC adopted enhanced disclosure requirements, new forms, certain amendments to Rule 2a-7's diversification limits and certain other requirements as part of the Rules.

The SEC concurrently issued a related notice proposing exemptions from certain confirmation requirements for transactions effected in shares of floating NAV money market funds. The SEC also re-proposed amendments to certain rules and forms to address provisions that reference credit ratings.

Analysis

I. Floating NAV Required for Certain Money Market Funds

a. Institutional Money Market Funds

Under the Rules, Institutional money market funds will be required to sell and redeem shares at a floating NAV based on the current market value of securities in their underlying portfolios.

[1] The Adopting Release is available at: http://www.sec.gov/rules/final/2014/33-9616.pdf (the "Release").

These amendments are intended to discourage or limit money market fund redemptions by institutional investors to the detriment of other, primarily retail, money market fund investors, in times of economic stress.

Currently, Rule 2a-7 permits money market funds to use amortized cost to value their shares although they may also use market values, and penny rounding, to price their shares. Under the amortized cost method of valuation, a security is valued at cost, with any premium or discount amortized over the period until the security matures. The penny rounding method of pricing permits a fund to round the fund's NAV to the nearest penny. Most money market funds maintain a stable NAV of $1.00 per share through the amortized cost method of valuation. Pursuant to the Rules, Institutional money market funds will no longer be permitted to sell and redeem shares using the amortized cost method of valuation or the penny rounding method of pricing, except to value debt securities with maturities of 60 days or less, but will instead be required to use the daily market value of their shares.

The Rules require Institutional money market funds to price their shares using "basis point" rounding that is calculated to the fourth decimal place for shares with a target NAV of $1.00 (*i.e.*, $1.0000) rather than the penny rounding method of pricing. The SEC believes that basis point rounding is more accurate and will better reflect portfolio gains and losses.

The risk limiting provisions (maturity, quantity, diversification and concentration requirements) under Rule 2a-7 continue to apply to Institutional money market funds. To address liquidity issues that could occur despite the proposed floating rate requirement and protect shareholder interests, the SEC chose to retain Rule 22e-3, with modifications, which permits a money market fund in certain circumstances to suspend redemptions and postpone payment of redemption proceeds followed by liquidation of the fund.

b. Tax and Accounting Implications

The U.S. Department of Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") released proposed guidance permitting net information reporting by Institutional money market funds of realized gains and losses for sales of fund shares rather than recognizing gains and losses on a transaction basis. The guidance would also permit the use of a simplified tax accounting method by shareholders. Even so, shareholders would be required to recognize and report net gains and losses on redemptions of fund shares. The proposed guidance was published in the Federal Register for public comment on July 28, 2014.

The Treasury Department and the IRS also released a new revenue procedure that provides relief from "wash sale" rules[2] for any losses on shares of a floating NAV money market fund.

[2] Special "wash sale" rules typically apply when shareholders sell securities at a loss and, within 30 days before or after the sale, buy substantially identical securities. Losses from wash sales cannot be deducted, and instead must be applied to the basis of the new securities purchased. Because many money market fund investors automatically reinvest their daily, weekly or monthly dividends, virtually all redemptions by these investors would be within 30 days of a dividend reinvestment and, absent relief, constitute wash sales.

c. Exemptions from the Floating NAV Requirement for Government and Retail Money Market Funds

Government money market funds and Retail money market funds, as defined below, would be exempt from the floating NAV requirement and would be allowed to continue to use the amortized cost method of valuation and/or the penny rounding method of pricing.

Government money market funds are defined as those holding at least 99.5% of their total assets in cash and obligations of the U.S. government, including obligations of the U.S. Treasury and federal agencies and instrumentalities, as well as repurchase agreements collateralized by U.S. government securities. Government money market funds do not include tax-exempt municipal bond funds, which will instead be considered either Institutional or Retail money market funds.

Retail money market funds are defined as those that have policies and procedures reasonably designed to limit all beneficial owners of a fund to natural persons. The SEC expects that a fund that intends to qualify as a Retail money market fund would disclose in its prospectus that it limits investments to accounts beneficially owned by natural persons.

The SEC acknowledged in the Release that funds with separate share classes for different types of investors and single-class funds for both types of investors will need to reorganize into separate money market funds for retail and institutional investors. To facilitate such reorganizations, the SEC provided exemptive relief from Sections 17(a) and 18 of the 1940 Act that might otherwise prohibit a fund from separating retail and institutional investors. In order for such exemptive relief to apply, a fund's board, including a majority of its independent directors (together, the "Board"), must determine that the reorganization results in a fair and approximately pro rata allocation of the fund's assets between the retail and institutional classes. The SEC also provided exemptive relief from Section 22(e) to facilitate involuntary redemptions for investors that will no longer be eligible to invest in the fund, provided such shareholders are notified at least 60 days in advance.

d. Valuation Guidance

The Release states that floating NAV money market funds, like all registered investment companies, may continue to use amortized cost valuation for debt securities with remaining maturities of 60 days or less if a fund's board determines that such securities' fair value is their amortized cost, unless particular circumstances warrant otherwise. The Release clarifies that a fund may use the amortized cost method to value such a security only if it can reasonably conclude each time it makes such a determination that the amortized cost value of the security is "approximately the same" as the fair value of such security determined without the use of amortized cost valuation.

The Release also contains guidance on the fair valuation of thinly traded securities and the use of third-party pricing services to determine fair value. With respect to thinly traded securities, the Release acknowledges that most money market fund securities are not actively traded in the secondary markets, and thus are valued largely on "mark-to-model" or "matrix pricing" estimates. The Release also states that funds holding such securities generally should not fair value these securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the current sale of those securities under current market conditions. With respect to pricing services, the Release states that fund boards should not place undue reliance on pricing services in determining the fair values of portfolio securities. Rather, boards should considering the inputs, methods, models, and assumptions used by a service and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change.

e. Notice of Proposed Rule 10b-10 Exemptive Relief

The SEC issued a proposal for Rule 10b-10 exemptive relief, which, if adopted, would exempt broker-dealers from the written notification requirement under Rule 10b-10(a) of the Securities Exchange Act of 1934 for transactions effected in shares of floating NAV money market funds.

II. Liquidity Fees and Redemption Gates

The Rules allow a money market fund to impose a liquidity fee of up to 2% and permit the fund to implement a redemption gate if its weekly liquid assets fall below 30%, subject to a determination by the Board that a fee and/or gate is in the best interests of the fund.

Government money market funds are exempt from the liquidity fees and gates requirements, but could opt to impose such measures voluntarily, if disclosed to investors. To permit liquidity fees and gates, the SEC provided exemptions to Section 22(e) of the 1940 Act, which prohibits a fund from suspending redemptions or postponing the payment of redemption proceeds for more than 7 days, and Rule 22c-1 (together with Section 22(c) of the 1940 Act), which requires each redeeming shareholder to receive a pro rata portion of a fund's net assets.

The Release notes that the fees and gates amendments are intended to allow funds to moderate redemption requests by allocating liquidity costs to redeeming shareholders, providing fund boards with additional tools to manage significant redemptions in times of market stress.

a. Liquidity Fees

When a fund's level of "weekly liquid assets"[3] falls below 30% of total assets on any business day, the fund would be allowed to impose up to a liquidity fee of up to 2% on all redemptions, subject to the Board's determination that a liquidity fee would be in the best interests of the fund. If the fund's level of weekly liquid assets falls below 10%, the fund will be required to impose a liquidity fee of 1% on all redemptions, unless the Board determines that no liquidity fee or a lower or higher (up to 2%) liquidity fee is in the fund's best interests. The liquidity fee would automatically terminate when the money market fund's weekly liquid assets met or exceeded the required level of 30% of net assets under Rule 2a-7. The Board could also choose to remove the fee at any time if it determined to impose a different fee or if it determined the liquidity fee was no longer in the best interest of the fund.

[3] Under Rule 2a-7, weekly liquid assets include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, and securities that convert into cash within 7 days. A fund is required to maintain weekly liquid assets equal to 30% of its net assets.

b. Redemption Gates

When a money market fund’s weekly liquid assets fall below 30%, a Board may also impose a temporary suspension of redemptions (referred to as a “gate”) at any point during a day for up to 10 business days in a 90-day rolling period, effectively halting all redemptions. The gate would need to be removed within 10 business days and, in any event, lifted automatically when the fund’s weekly liquid assets had risen above 30%.

Amended Rule 22e-3 will permit (but not require) the permanent suspension of redemptions and liquidation of a money market fund if the fund’s level of weekly liquid assets falls below 10%.

c. Tax and Accounting Implications

The Release acknowledged that liquidity fees could have certain tax implications for shareholders. If receipt of liquidity fees increased a fund’s assets and caused its market value per share or shadow price to exceed $1.0050, the fund would “break the buck” because penny rounding would result in an NAV of $1.01. The fund would need to make a distribution to shareholders to avoid this result. If the fund has sufficient earnings and profits, such a distribution would constitute ordinary income to shareholders. If not, the distribution would be a return of capital and would reduce a shareholder’s basis. The fund, shareholders and other intermediaries would thus be subject to tax-payment and tax-reporting that ordinarily does not occur in the current stable NAV money market fund market. In order to address this issue, the Treasury Department and IRS have proposed regulations exempting all money market funds from certain transaction reporting requirements.

The Release states that investments in a money market fund that has the ability to impose a fee or gate would, under normal conditions, meet the definition of a “cash equivalent” under GAAP. If events occurred, such as the imposition of a fee or gate, to cause shareholders to determine that such investments were not cash equivalents, the shares would need to be classified as investments and treated as trading securities or available-for-sale securities.

III. Enhanced Disclosure Requirements

Various amendments under the Rules enhance the requirements for disclosure of money market fund operations and risks in fund advertisements, sales literature and registration statements. The disclosures must include a bulleted disclosure statement about the features of the money market fund in the summary section of a statutory prospectus and additional detailed information elsewhere in the statutory prospectus and statement of additional information (“SAI”). The bulleted disclosure statement will inform investors generally of the risks of such investments, emphasizing that fund sponsors are not obligated to provide financial support and that the investments may not be an appropriate option for investors who are not able to tolerate losses. A fund will be expected to supplement its prospectus promptly after the imposition of a liquidity fee or redemption gate, and will be required to promptly and publicly disclose instances in which the fund’s level of weekly liquid assets falls below the 10% threshold. Other disclosure requirements include:

- <u>Website Disclosure</u>. A money market fund will be required to disclose daily on its website the fund’s daily and weekly liquid assets, the fund’s net inflows or outflows, and market-based NAVs, including graphic or other depiction of this information for the past 6 months, as well as the imposition of fees and gates and any use of affiliate sponsor support;

- New Form N-CR. A money market fund will be required to publicly disclose certain material events promptly on new Form N-CR pursuant to new Rule 30b1-8 and concurrently on its website under an amendment to Rule 2a-7. Such disclosures include, among other things, notifications when a fund's weekly liquid assets falls below 30%, whether a liquidity fee or gate is imposed or lifted and a description of a Board's review regarding that decision, portfolio security defaults, sponsor or fund affiliate financial support[4], and, with respect to Retail and Government money market funds, a fall in the fund's market-based NAV per share below $0.9975. The filing must be made within one business day of a triggering event, and a follow-up filing with a more complete description of the reported event must be made within four business days of the initial filing;

- Additional SAI Reporting. A fund will be required to provide SAI disclosure regarding any occasion during the last 10 years (but not prior to the compliance date) in which the fund received sponsor or fund affiliate support;

- Form N-MFP. Form N-MFP is amended to clarify its requirements and to request additional information relevant to assessing fund risk. Form N-MFP information will be publicly available immediately upon filing, departing from the 60-day delay in public availability currently in place; and

- Form PF. Form PF, currently used by private fund advisers to report certain information, is amended to require that large liquidity fund advisers managing at least $1 billion in combined money fund and liquidity fund assets provide the same security-level reporting information that registered money market funds currently report on Form N-MFP.

IV. Additional Diversification Requirements in Rule 2a-7

Rule 2a-7 currently imposes certain diversification requirements with respect to the issuers of securities that a money market fund acquires and providers of guarantees and demand features related to those securities. The Rules strengthen the portfolio diversification requirements under Rule 2a-7, which are intended to limit money market fund risk, by requiring a fund to:

- aggregate affiliates (excluding certain equity owners of asset-backed commercial paper conduits) for purposes of the 5% issuer concentration limit;

[4] As adopted, the term "financial support" includes any (i) capital contribution, (ii) purchase of a security from the fund in reliance on Rule 17a-9, (iii) purchase of any defaulted or devalued security at par, (iv) execution of letter of credit or letter of indemnity, (v) capital support agreement (whether or not the fund ultimately received support), (vi) performance guarantee, or (vii) any similar action reasonably intended to increase or stabilize the value or liquidity of the fund's portfolio; excluding, however, any (i) routine fee waiver or expense reimbursement, (ii) routine inter-fund lending, (iii) routine inter-fund purchases of fund shares, or (iv) any action that would qualify as financial support that the board has otherwise determined not to be reasonably intended to increase or stabilize the value or liquidity of the fund's portfolio.

- meet modified concentration limits for guarantors and "put" providers, eliminating (for money market funds other than tax exempt money market funds), and reducing to 15% (for tax exempt money market funds), the 25% basket that permits a single provider to guarantee a quarter of a money market fund's assets, but limiting any one provider to 15% of a fund's assets; and

- aggregate all asset-backed securities vehicles sponsored by the same entity as a guarantor for the purposes of Rule 2a-7's 10% diversification limit applicable to guarantees and demands, unless a Board determines that the fund was not relying on the sponsor.

V. Stress Testing

The Rules impose enhanced stress-testing requirements under Rule 2a-7 for money market funds. A fund will be required to stress test the fund's ability to maintain weekly liquid assets of at least 10% of total assets and to minimize principal volatility (or the fund's ability to maintain a stable price per share) in response to certain hypothetical events, including (i) increases in the level of short term interest rates, (ii) the downgrade or default of particular portfolio security positions, and (iii) the widening of spreads in various sectors to which a portfolio is exposed, each in combination with various increases in shareholder redemptions. Fund advisers will be required to report such results to the Board.

Compliance Dates

The Rules will become effective on October 14, 2014. Money market funds will be subject to the new requirements on:

- **October 14, 2016** with respect to the floating NAV and fees and gates requirements;

- **July14, 2015** with respect to new Form N-CR; and

- **April 14, 2016** for amendments to diversification, stress testing, disclosure, Form PF, Form N-MFP and clarifying amendments.

New and Amended Proposals

The SEC also issued a related notice proposing exemptions from certain confirmation requirements for transactions effected in shares of floating NAV money market funds.

The SEC re-proposed amendments to Rule 2a-7 and Form N-MFP to address provisions that reference credit ratings. The re-proposed amendments would remove credit rating references from the Rule and allow a money market fund to invest in a security only if the Board (or its delegate) determined that it presents minimal credit risks (requiring a determination that a security's issuer has an exceptionally strong capacity to meet its short-term obligations. The re-proposed amendments would no longer require money market funds to report information regarding credit ratings assigned to portfolio securities, but instead would require a fund to disclose any credit ratings that the Board considered in determining that a portfolio security presents minimal credit risk.

The SEC also proposed an amendment to the issuer diversification provisions of Rule 2a-7 to eliminate an exclusion from the issuer diversification provisions for securities subject to a guarantee issued by a non-controlled person.

Conclusion

The Rules result in significant changes to the money market fund regulatory landscape. The changes affect both institutional and retail investors and impose additional responsibilities on a money market fund's Board. The long-term effects of the Rules, including whether they will discourage or encourage runs, have yet to be seen.

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If you have any questions concerning the matters discussed in this memorandum, please contact Kathleen Clarke, Paul Miller or Bibb Strench at Seward & Kissel at (202) 737-8833.