SEC Proposes Money Market Fund Reforms

July 8, 2013

Introduction

On June 5, 2013, the Securities and Exchange Commission ("SEC") voted unanimously to propose amendments and new rules that aim to reform the operation and regulation of money market funds (the "Proposals").[1] The overarching goal of the Proposals is to make money market funds less susceptible during periods of economic stress to runs that could harm investors. The SEC stated in the Release that the Proposals are designed to "address money market funds' susceptibility to heavy redemptions, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, the benefits of money market funds."

The Release begins with an extensive discussion of the history, economics and operation of money market funds and the effects of events on money market funds during the 2007-2008 period. During this period and its aftermath, a large money market fund "broke the buck" and there was a run on money market funds, as well as ancillary problems such as a freezing-up of the commercial paper market. The U.S. Department of the Treasury (the "Treasury") was forced to take action to support money market funds through its temporary guarantee program, and many money market fund sponsors were required to provide financial support to their funds to avoid "breaking the buck". The Release also discusses the 2010 money market reforms, the SEC study of money market funds' role in the 2008 financial crisis, the 2012 proposals supported by former SEC Chairman Mary Schapiro, and the Financial Stability Oversight Council's ("FSOC") announcement that it would act if the SEC did not.

Following the background discussion, the SEC sets forth in the Release two alternative proposals for regulating money market funds (the "Proposed Alternatives"). Comments on the Proposals are due to the SEC by September 17, 2013.

The Release is lengthy with over 1,000 footnotes and includes numerous requests for comments and questions. In this Memorandum, we focus on the Proposals and some of the related requests for comment. We also highlight certain concerns related to the Proposed Alternatives. This Memorandum begins with a summary of the Proposals and is followed by an analysis of the Proposals.

Summary of Proposals

The Proposals include the Proposed Alternatives that could be adopted, separately or in combination, as amendments to Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act"). The first alternative would require a floating net asset value per share ("NAV") for prime and tax-exempt institutional money market funds, with exemptions for U.S. government and Retail money market funds (as defined below). A second alternative would require money

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[1] The Proposing Release is available at: http://www.sec.gov/rules/proposed/2013/33-9408.pdf (the "Release").

market funds to put in place liquidity fees, subject to certain exceptions, and permit them to impose redemption gates, as appropriate, if "weekly liquid assets" fall below 15%. Additionally, the SEC proposed enhanced disclosure requirements, new forms, certain amendments to Rule 2a-7's diversification limits and certain other requirements as part of the Proposals that would apply under either of the Proposed Alternatives.

The Proposed Alternatives

1. Floating NAV Alternative

a. Institutional Money Market Funds

Under the SEC's floating NAV alternative, prime and tax-exempt institutional money market funds ("Institutional money market funds") would be required to sell and redeem shares at a floating NAV based on the current market value of securities in their underlying portfolios. The intent of this proposal is 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. The SEC estimates that Institutional money market funds constitute about 30% of money market fund assets.

Rule 2a-7 currently 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. Rule 2a-7 currently requires a money market fund using the amortized cost method to also calculate its NAV using market prices or to "shadow price" its securities and compare that amount to amortized cost NAV to ensure it does not differ by more than $.005, or 50 basis points. Many money market funds shadow price daily, particularly when markets are stressed.

Most money market funds maintain a stable NAV of $1.00 per share through the amortized cost method of valuation. Institutional money market funds would no longer be permitted to sell and redeem shares using the amortized cost method of valuation or the penny rounding method of pricing, except in the case of debt securities with maturities of 60 days or less, but would instead be required to use the daily market value of their shares. Amortized cost valuation is an efficient means of pricing shares and settling share purchases and redemptions daily because funds do not have to strike a daily market-based NAV. Use of a floating NAV requiring market pricing daily may extend the settlement cycle for purchases and redemptions of money market fund shares from same-day settlement to next-day settlement and adversely affect one of the key benefits of many money market fund transactions. The SEC requested comment on this issue.

The floating NAV alternative would 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 would be a more precise pricing mechanism and more accurately reflect the risks of money market funds for investors.

The risk limiting provisions (maturity, quantity, diversification and concentration requirements) under Rule 2a-7 would 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 also proposed to retain (i) Rule 17a-9, which permits an affiliated person of a money market fund to purchase portfolio securities from a fund under certain circumstances, and (ii) Rule 22e-3, with modifications, which permits a fund to suspend redemptions and postpone payment of redemption proceeds followed by liquidation of the fund.

The floating NAV alternative would be accompanied by enhanced disclosure obligations specific to the alternative that would, among other things, require a bulleted disclosure statement in fund advertisements, sales literature, websites and prospectuses, as well as certain key information about the proposed new features in the summary section of the statutory prospectus and additional detailed information elsewhere in the statutory prospectus and statement of additional information ("SAI"). The bulleted disclosure statement would 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.

b. Tax and Accounting Considerations for the Floating NAV Alternative

i. Tax Implications

The Release discusses the tax implications of the floating NAV alternative. The SEC acknowledges that money market funds' current ability to maintain a stable value simplifies tax compliance for shareholders because purchases and sales generate no capital gains or losses for shareholders to report. Shareholders in a money market fund with a floating NAV would experience gains and losses, and consequently could owe taxes for gains on sales of their shares and could realize tax benefits from any losses. These tax consequences would be burdensome for money market investors and for money market funds, because, among other things, their recordkeeping arrangements do not currently capture this information. The SEC has had discussions with staff at the Treasury and the Internal Revenue Service ("IRS"), who have indicated that floating NAV money market funds would no longer be excluded from the information reporting requirements currently applicable to other mutual funds. The Release notes, however, that the Treasury and IRS are considering alternatives for modifying forms and guidance to include net information reporting by such funds of realized gains and losses for sales of all money market fund shares and to allow summary income tax reporting by shareholders. Even so, shareholders would be required to recognize and report gains and losses on redemptions of fund shares.

Additionally, special "wash sale" rules may 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. The SEC has discussed this issue with the IRS and the IRS has recently announced a proposed revenue procedure under which redemptions in such funds below a *de minimis* threshold would not be subject to the wash sale rules. Under the revenue procedure,

funds would incur operational costs to establish systems to identify wash sale transactions, assessing whether they fall below the *de minimis* threshold, and adjusting shareholder basis when they do not.

ii. Accounting Implications

The Release states that investments in a floating NAV money market fund would generally still meet the definition of a "cash equivalent" under generally accepted accounting principles ("GAAP") because fluctuations in the amount of cash received upon redemption would likely be insignificant. If events occurred 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.

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. These exempt funds would no longer be permitted to use the amortized cost method of valuation to facilitate their stable NAV, relying instead solely on daily market values and the penny rounding method of pricing.

i. Government Money Market Funds

Government money market funds are defined in the Release as those which principally hold (at least 80% of total assets) 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 government securities. The Release notes that such an exception is warranted because the securities primarily held by government money market funds typically have a lower credit default risk than commercial paper and are highly liquid in even the most stressful market scenario. Government money market funds would not include tax-exempt municipal bond funds, which would instead be either Institutional or Retail money market funds.

ii. Retail Money Market Funds

Retail money market funds would be defined in amended Rule 2a-7 as those that do not permit a shareholder of record to redeem more than $1 million in a single day. This exemption would preserve a stable NAV product for retail investors.

The SEC acknowledges the operational challenges of implementing an exemption for retail investor funds, but believes that the "daily redemption limit method . . . is an objective criterion intended to encourage self-identification of retail investors." According to the SEC, the daily redemption limit should be simple to implement, requiring Retail money market funds to establish one-time, across-the-board redemption policies. The SEC also acknowledges that some prime money market funds that currently have both institutional and retail share classes may need to reorganize into separate funds or series (institutional and retail) in order for the Retail fund to qualify for the exemption.

In the Release, the SEC discusses a potential issue in distinguishing between Retail and Institutional money market funds given the extent to which shares in money market funds are held by investors through omnibus accounts maintained at the funds by financial intermediaries. In an omnibus account arrangement, orders for fund shares from customers of the financial intermediary are aggregated by the financial intermediary each day into a single buy or single sale order, which is delivered to the fund. The financial intermediary acts as the shareholder of record. Under the proposal, a Retail money market fund could allow redemptions of more than $1 million from omnibus accounts if the fund had policies and procedures reasonably designed to allow the fund to conclude that any omnibus account holder did not permit any beneficial owner directly or indirectly to redeem more than $1 million in a single day. Intermediaries with omnibus accounts would have to provide a level of transparency regarding underlying shareholders, such as the sizes of the underlying shareholder accounts, or agree to implement a fund's policies and impose the redemption limit itself. Otherwise, a fund would be required to impose the $1 million daily redemption limit on the omnibus account as a whole. The proposal would not require funds to enter into explicit agreements or contracts with financial intermediaries and other omnibus account holders, but would instead allow funds to manage such accounts in a way that best suits their circumstances. The Release acknowledges the challenges of implementing fund policies through omnibus accounts, but notes that reliance on intermediaries already exists with respect to certain fund policies and that service providers offer services designed to facilitate compliance and evaluation of intermediary activities.

The Release discusses alternative methods of defining Retail money market funds, including distinguishing such funds through maximum account balance limits or shareholder concentration characteristics, and requests comment on whether such alternatives should be adopted in place of a definition based on the redemption limit.

d. Questions and Concerns Raised by the SEC

The Release raises a variety of questions relating to the floating NAV alternative. Among other things, the SEC asks whether the implementation of the proposal would have the intended effect of lessening the incentive to redeem shares in times of economic stress that can result from the use of amortized cost valuation and penny rounding pricing by money market funds today. The SEC specifically asks if investors would be more inclined to redeem heavily if a fund experienced losses in excess of investors' expectations because any loss would be immediately reflected in the floating NAV, or whether investors would refrain from redemptions because losses would be shared pro rata by all shareholders.

2. Liquidity Fees and Redemption Gates Alternative

The SEC's Proposed Alternative to a floating NAV would require a money market fund to impose a 2% liquidity fee (unless a Board determined that a lower fee or no fee was in the best interests of the fund) and permit a fund to implement a redemption gate if its weekly liquid assets fell below 15%. If this alternative were adopted on its own, all money market funds would be permitted to use the penny rounding method of pricing to maintain a stable NAV so long as funds complied with the conditions of the amended Rule 2a-7, but would not be permitted to use the amortized cost method of valuation. As discussed below, these proposals impose significant new responsibilities on a fund Board.

The SEC believes that liquidity fees would reduce shareholders' incentives to redeem when it becomes more costly for a fund to sell its investments to meet redemption requests by making redeeming shareholders bear some of the liquidity costs of their redemption rather than transferring those costs to remaining shareholders. In addition, optional redemption gates would directly respond to runs by halting redemptions. According to the SEC, a redemption gate could be used by a fund to assess the viability of the fund, provide time for market panic to subside, create a period for more fund assets to mature and provide internal liquidity to the fund.

a. Liquidity Fees

Under this alternative, when a fund's level of "weekly liquid assets"[2] falls below 15% of total assets on any business day, the fund would be required to impose a 2% liquidity fee on all redemptions on the next business day, unless the fund's Board (including a majority of independent directors) determined that the 2% liquidity fee would not be in the best interest of the fund or that a lower liquidity fee would be in the best interest of the fund. The liquidity fee would automatically terminate when the money market fund's weekly liquid assets returned to or above 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.

In the Release, the SEC discusses factors that a Board could consider in determining whether a liquidity fee would not be in the best interest of a fund, such as the reasons why weekly net assets may have declined, *e.g.*, because of market stress or large redemptions by a few shareholders that were unrelated to market conditions. Other considerations could include whether the drop in weekly liquid assets was accompanied by changes in a fund's shadow price or whether the drop was likely to be short term due to anticipated changes in the portfolio's maturity structure.

b. Redemption Gates

Once a money market fund's weekly liquid assets fell below 15%, a fund Board could also impose a temporary suspension of redemptions (referred to as a "gate"), effectively halting all redemptions. The gate would need to be removed within 30 days and, in any event, lifted automatically when the fund's weekly liquid assets had risen above 30%. A money market fund could not impose a gate for more than 30 days in a 90-day period.

c. General Considerations Under the Liquidity Fees and Gates Alternative

- Government money market funds would be exempt from the liquidity fees and gates requirements, but could opt to impose such measures voluntarily.

- To permit liquidity fees and gates, the SEC proposes exemptions to Section 22(c) of the 1940 Act, which prohibits a fund from suspending redemptions or postponing the

[2] 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.

payment of redemption proceeds for more than 7 days, and Rule 22c-1 thereunder, which requires each redeeming shareholder to receive a pro rata portion of a fund's net assets.

- The SEC recognizes that the liquidity fee proposal 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.

- This alternative would be coupled with enhanced disclosure obligations specific to the reform that would, among other things, provide shareholders with information regarding the operations and risks of liquidity fees and gates, along with current and historical information regarding the imposition of liquidity fees and gates. As with the floating NAV alternative, funds would be required to include certain disclosures in their statutory prospectuses (and summary prospectuses, if used) and SAIs, as well as in fund advertisements and sales literature (including fund websites).[3] A bulleted disclosure statement would be required to inform investors generally of the risk of investing in a fund that may impose liquidity fees and gates, 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. In addition, a fund would be expected to supplement its prospectus promptly after imposition of a liquidity fee or gate.

- The SEC discusses several alternative redemption restrictions such as stand-alone liquidity fees or gates, partial gates and in-kind redemptions. The SEC concluded that these alternatives did not provide the same benefits and brought with them unwarranted operational difficulties. The SEC requests comment on these alternatives and whether there are other alternatives to consider.

3. Relation Between or Combination of the Proposed Alternatives

The SEC could adopt either of the principal reforms set forth in the Proposals alone or it could combine the two alternatives in one comprehensive rule. The SEC acknowledges that the two principal reforms achieve many of the same goals, but that they do so to different degrees and with different tradeoffs; therefore, a combination of the two might address the individual limitations of each reform. The SEC could require that all non-government money market funds use both a floating NAV (excluding Retail money market funds) and be required to to impose liquidity fees and permitted to impose gates in times of economic stress. Another possibility would be for all non-government money market funds to choose whether to use a floating NAV or to impose liquidity fees and gates.

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[3] The Release notes that funds would not be required to include a liquidity fee in the disclosure of redemption fees in the prospectus fee table.

Other Amendments

1. 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 Proposals would 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 for purposes of the 5% issuer concentration limit;
- meet modified concentration limits for guarantors and "put" providers that would eliminate the 25% basket that permits a single provider to guarantee a quarter of a money market fund's assets but would continue to limit any one provider to 10% 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 diversification requirement, unless the fund Board determined that the fund was not relying on the sponsor.

2. Enhanced Disclosures

Under the Proposals, various other amendments would apply to enhance the disclosure of money market fund operations and risks. As discussed above, funds would be required to include additional disclosures in prospectuses and SAIs, including disclosure of historical sponsor support, as well as in advertisements and sales literature, to reflect the new regulatory requirements. Other disclosure requirements would include:

- <u>Website Disclosure</u>. A money market fund would 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 NAV's, including graphic or other depiction of this information for the past 6 months;
- <u>New Form N-CR</u>. A money market fund would be required to publicly disclose certain material events promptly on new Form N-CR pursuant to proposed new Rule 30b1-8 and concurrently on its website under an amendment to Rule 2a-7. Such disclosures would include, among other things, notifications when a fund's weekly liquid assets fell below 15%, whether a liquidity fee or gate was imposed or lifted and a description of the Board's review regarding that decision, portfolio security defaults, and sponsor support;
- <u>Form N-MFP</u>. This form would be amended to clarify its requirements and to request additional information relevant to assessing fund risk. The SEC would make Form N-MFP information publicly available immediately upon filing, thus making a fund's "shadow pricing" immediately available, departing from the 60-day delay in public availability currently in place. The proposed changes to the reporting requirements, other than those addressing the Proposed Alternatives, may be adopted regardless of whether the broader proposed reforms are adopted; and

- Form PF. Form PF, currently used by private fund advisers to report certain information, would be 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.

3. Other Requirements Under the Proposals

- The Proposals would impose enhanced stress-testing requirements under Rule 2a-7 for money market funds. A Fund would be required to stress test against the fund's level of weekly liquid assets falling below 15% of total assets, and fund advisers would be required to report such results to the fund Board.

- The Proposals also contain certain clarifying amendments to the provisions of Rule 2a-7 adopted in 2010, including a clarification of the definitions of "daily liquid assets" and "weekly liquid assets."

Other Alternatives Considered

The SEC discusses in the Release certain other reforms that have been considered since the financial crisis of 2008, and provides reasons for not including such reforms in the Proposals, including the following:

- The FSOC has previously suggested implementation of NAV buffers in combination with other measures, including a floating NAV, to reform money market funds. The SEC noted that it did not include buffers in the Proposals, as such measures could potentially be costly for money market fund shareholders and harmful to the industry because they could result in a contraction in the industry that could harm short-term financing markets and capital formation.

- The Release discusses the option of a private emergency liquidity facility, organized as a state chartered bank or trust company, that could provide redemption liquidity to prime money market funds. Such an option was not included in the Proposals, primarily due to concern that such a facility would not sufficiently prevent widespread runs on money market funds.

Economic Impact of the Proposals

The SEC integrates discussion of the economic analysis of the Proposals throughout the Release. The SEC acknowledges that, while the Proposals preserve money market funds as an option for investors, the magnitude of the effects of the reforms lies in the extent to which investors might reallocate to other forms of investments as a result of the reforms. The SEC requests comments regarding the likelihood of changing investment preferences, and also whether any change or consolidation of the money market industry might result.

Proposed Compliance Periods

Money market funds would be subject to the new requirements, if adopted:

- **Two years** from the date of adoption of the floating NAV alternative;
- **One year** from the date of adoption of the liquidity fees and gates alternative; and
- **Nine months** for adoption of amendments not specifically related to the principal reforms.

Conclusion

The Proposals would result in significant changes to the money market fund regulatory landscape and have consequences for the financial industry generally. The proposed changes would affect both institutional and retail investors and impose additional responsibilities on a money market fund's Board. The SEC has requested comment on the amendments proposed in the Release, as well as empirical data to support commentors' views. We anticipate that the SEC will receive many comments on the Proposals.

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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.