

Overview of the SEC's Proposal to Amend Rules Governing Money Market Funds and Possible Impact on Compliance Professionals

By: Stephen T. Cohen¹

The Securities and Exchange Commission ("SEC") recently proposed amendments to Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act") and other rules relating to money market funds ("money funds").² The Proposal included two alternatives that could be adopted separately or in combination. The first alternative would require "institutional" money funds to operate with a floating net asset value ("NAV") ("Alternative 1"), and the second would require money funds (other than "government" money funds) to impose a 2% liquidity fee during times of stress and allow money funds to temporarily suspend redemptions during such times ("Alternative 2"). The SEC also proposed additional reforms to be adopted under either Alternative, including more stringent disclosure, diversification and stress testing requirements.

If adopted, the Proposal would not only have a tremendous impact on the money fund industry, but also on chief compliance officers ("CCOs") and other compliance professionals of money funds and their investment advisers and distributors. This article will (i) review the Proposal and (ii) discuss potential issues for CCOs and compliance professionals.

THE PROPOSAL

Alternative 1 – Floating NAV

Under Alternative 1, money funds (other than "government" and "retail" money funds, as defined below)³ would be required to operate with a floating NAV, calculating their market-based NAV per share to the nearest basis point. If adopted, Alternative 1 would require an institutional money fund to calculate its share price to the fourth decimal place if it prices its shares initially at one dollar per share using "basis point" rounding (e.g., \$1.0000). However, under Alternative 1, *all* money funds would no longer be permitted to use the amortized cost method of valuation, except to value securities that mature in 60 days or less.⁴ Government money funds and retail money funds would be exempt from the requirement to convert to a floating NAV and could continue to use the penny rounding method⁵ to price their shares.

Alternative 1 would exempt government and retail money funds from the floating NAV requirement. Under the Proposal, government money funds would be defined as money funds

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that maintain at least 80 percent of their total assets in cash, US government securities⁶ or repurchase agreements that are "collateralized fully" (as defined in Rule 2a-7). Retail money funds would be defined as those that do not permit a shareholder to redeem more than \$1 million of fund shares on any one business day.

Alternative 2 – Liquidity Fees and Gates

Under Alternative 2, money funds would be provided with tools to better manage redemption requests during periods of market illiquidity. When "weekly liquid assets"⁷ (required by Rule 2a-7 to constitute at least 30% of a money fund's assets) of a money fund (other than a government money fund) fall below 15% of total assets, the fund would be *required* to impose a 2% liquidity fee on all redemptions, *unless* the fund's board (including a majority of the disinterested board members) determines that imposing such a fee would not be in the fund's best interests or determines that imposing a lower liquidity fee would be in the fund's best interests.⁸ Under these circumstances, a board also would be *permitted* to temporarily suspend redemptions for a limited period of time.⁹

Under Alternative 2, all money funds would continue to be permitted to maintain a stable price per share through the use of the penny rounding method. However, money funds would no longer be permitted to use amortized cost to value their holdings, except for securities with maturities of 60 days or less. Government money funds would be permitted, but not required, to impose liquidity fees and redemption gates under the circumstances described above.

Combination of Alternatives

Any final rule may combine features of the Alternatives by requiring institutional money funds to convert to a floating NAV and requiring money funds to impose liquidity fees (and permitting them to impose gates), or permitting a money fund to choose to either transact with a floating NAV or be able to impose liquidity fees and gates.

Enhanced Disclosure Requirements

Rule 30b1-8 and Form N-CR

The SEC proposed new Rule 30b1-8, which would require money funds to report certain material events on new Form N-CR. Under either Alternative, a money fund would be required to disclose on Form NCR: (i) any instances of default (other than an immaterial default unrelated to the issuer's

financial condition) or an event of insolvency of a portfolio security that, immediately before the default or event of insolvency, accounts for one-half of 1% of the fund's total assets; (ii) any "financial support"¹⁰ by a fund sponsor; and (iii) any instance in which the fund's market-based NAV per share falls below \$0.9975. The SEC also proposed the inclusion of information relating to the imposition of liquidity fees and gates if Alternative 2 is adopted. Money funds would be required to file a Form N-CR within one business day following the triggering material event, which would be publicly available on the SEC's EDGAR website immediately upon filing.

Website Disclosure

The Proposal would require a money fund to disclose on its website substantially the same information regarding financial support that would be required on Form N-CR. Additionally, the following items would be required to be posted on a money fund's website, current as of the end of the previous business day: (i) the percentage of total assets that are invested in daily and weekly liquid assets; (ii) net inflows and outflows; and (iii) daily market-based NAV per share, rounded to the fourth decimal place in the case of a fund with a \$1.00 share price. The Proposal also would require: (i) a money fund to include a schedule, chart, graph or other depiction on its website showing certain historical information; and (ii) the posting of other information regarding a fund's portfolio holdings. This posting would occur at the same time that the information becomes publicly available on Form N-MFP. Finally, the SEC would require the posting of new risk disclosures.

Form N-1A

The SEC proposed that money funds include new bulleted statements in their registration statements relating to the risks associated with a floating NAV and/or the imposition of liquidity fees and gates. Additionally, a money fund would be required to disclose, among other things: (i) that the fund's sponsor has no legal obligation to provide financial support to the fund and that an investor should not expect that the sponsor will provide financial support to the fund at any time; and (ii) any financial support received during the last 10 years.

Advertisements

The Proposal would update Rule 482, which requires that money funds include certain risk disclosure in advertisements to reflect the risks of the Alternatives.

Form N-MFP

Money funds currently file a monthly report on Form N-MFP, which is not made public until 60 days after the end of the month for which the filing is made. The Proposal would eliminate the current 60-day delay and make other changes to Form N-MFP to require additional information.

Enhanced Diversification Requirements

Grouping of Affiliates

A money fund generally may not invest more than five percent of its assets in one issuer. The Proposal would require a money

fund to aggregate affiliates for purposes of applying this limit. Under the Proposal, entities are "affiliates" if one is controlled by the other or they are under common control. "Control" would be defined as ownership of more than 50% of an entity's voting securities.

Asset-Backed Securities ("ABS") Sponsors

Rule 2a-7 mandates that a money fund limit its investments in securities subject to demand features or guarantees from any one provider to no more than 10% of the fund's assets, subject to the exception discussed below. The Proposal would require that a money fund include the sponsor of a special purpose entity ("SPE") that issues ABS as a guarantor of the ABS, unless the board or its delegate determines that the fund is not relying on the sponsor's financial strength or ability to provide support when determining the ABS's quality or liquidity. Absent such a finding, this restriction would limit a money fund to investing no more than 10% of fund assets in ABS issued by any one sponsor's SPEs.

Removal of the 25% Basket

Rule 2a-7 provides an exception to the 10% limitation described above, under which 25% of a fund's assets may be subject to guarantees or demand features from one institution. The Proposal would eliminate this 25% basket.

Enhanced Stress Testing

Under the Proposal, the SEC would enhance stress testing requirements and require a money fund to consider a number of additional, specific factors in determining whether the fund could maintain a stable share price under heavy redemption pressure.

Changes to Form PF

The Proposal recommends changes to Form PF, the form used by registered investment advisers to report information regarding the private funds they advise. These private funds include "liquidity funds," which are similar to money funds except that they are not registered investment companies. "Large liquidity fund advisers" would be required to file portfolio holdings information on Form PF similar to the information required to be filed on Form N-MFP.

POTENTIAL ISSUES FOR CCOs AND COMPLIANCE PROFESSIONALS

Potential Issues Raised by Alternative 1

Market-Based Pricing Valuation for All Money Funds: Under Alternative 1 (and Alternative 2), money funds would no longer be permitted to use the amortized cost method of valuation, except to value securities that mature in 60 days or less. If Proposal 1 is adopted, CCOs and compliance professionals would need to modify and update existing procedures to value portfolio securities using market prices for the purposes of calculating a money fund's NAV.

Basis Point Rounding for Institutional Money Funds: An institutional money fund would be required to calculate its share price to the fourth decimal place if it prices its shares initially at

one dollar per share using “basis point” rounding and would need to monitor a shareholder’s tax basis for capital gains reporting purposes. If Proposal 1 is adopted, CCOs and compliance professionals would need to modify procedures and systems applicable to money funds to account for the proposed “basis point” rounding and to ensure compliance with tax reporting requirements that would apply.

Compliance with the Retail Money Fund Exemption: As noted above, a retail money fund would be exempt from the floating NAV requirement, if the fund restricts a shareholder to redeeming no more than \$1 million per day. The Proposal noted that many investors hold shares of money funds through omnibus accounts and that most money funds are not able to look through those accounts to determine underlying investors’ redemptions. Under Alternative 1, a retail money fund would not be required to impose the \$1 million daily redemption limit on shareholders of record that hold omnibus accounts, if the fund has put into place policies and procedures reasonably designed to allow the conclusion to be drawn that an omnibus account holder will not permit any underlying beneficial owner to “directly or indirectly” redeem more than \$1 million per day. To ensure compliance with this requirement, CCOs and compliance professionals would need to develop omnibus account-specific policies and procedures to monitor compliance with the \$1 million daily redemption limit. For example, CCOs and compliance professionals would need to consider entering into agreements with, or requesting certifications from, omnibus account holders under such procedures.

Potential Issues Raised by Alternative 2

Imposition of Liquidity Fees and Redemption Gates. The imposition of liquidity fees and/or redemption gates would require updates to existing procedures and systems. Also, because many shareholders hold their money fund shares through omnibus accounts, CCOs and compliance personnel would need to consider reviewing and, to the extent necessary, updating existing arrangements with intermediaries in order to ensure that the liquidity fee and/or gate would be administered consistently on underlying shareholders.

Monitoring of Weekly Liquid Assets and Early Notification Procedures: If a money fund’s weekly liquid assets fall below 15% of its total assets *as of the end of a business day*, the fund would be required to impose, *on the next business day*, a 2% liquidity fee on each shareholder redemption, *unless* the fund’s board determines otherwise, as discussed above. If a money fund is operating at or near (but not below) the 15% threshold, the fund could experience substantial “preemptive” redemptions by shareholders. Such redemptions would be effective immediately, while liquidity fees and gates could not be imposed until the first business day after the fund’s weekly liquid assets fall below the 15% threshold. CCOs and compliance professionals should consider adopting policies and procedures for monitoring liquidity for these purposes. For example, CCOs and compliance professionals may wish to consider implementing “trigger points” at which the money fund board and portfolio managers would be notified (*e.g.*, when the level of weekly liquid assets reaches 20%). These early notification procedures would enable money fund boards and portfolio managers to consider all of the relevant facts and circumstances and take necessary actions, as appropriate.

Potential Issues Raised by the Other Proposed Reforms

Disclosure, Diversification, Reporting and Other Requirements: CCOs and compliance professionals would need to develop policies and procedures to comply with the Proposal’s enhanced disclosure, diversification, reporting and other requirements. For example, CCOs and compliance professionals should consider developing, or engaging a third-party service provider to provide, automated systems to enable money funds to accurately and timely disclose on their websites or report with the SEC the additional information required by the Proposal. Stress testing procedures may also need to be enhanced to include the specific items that would be required by the Proposal.

Enhanced Credit Review: Because the new diversification requirements could cause a money fund to invest in a broader universe of issuers, including potentially less creditworthy issuers (by Rule 2a-7 standards), CCOs and compliance professionals should consider whether current policies and procedures for determining creditworthiness remain adequate.

CONCLUSION

Overall, the Proposal sets forth sweeping potential changes to money fund regulation, which would pose a number of issues for the industry and CCOs and compliance professionals. The comment period on the Proposal ends on September 17, 2013. ♦

(Endnotes)

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2 *Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Release No. 30551 (June 5, 2013) (the “Proposal”).

3 For the purposes of this article, such funds are referred to as “institutional money funds,” which include prime money funds and municipal/tax-exempt money funds (“municipal money funds”) that do not qualify as retail money funds under Alternative 1. As noted in the Proposal, the SEC did not specifically exempt municipal money funds from the floating NAV requirement on the basis that such funds *should* be able to qualify as retail money funds. However, it is likely that certain municipal money funds marketed to high net worth individuals would *not* be able to qualify as retail money funds.

4 Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors. Under the Proposal, a money fund would be permitted to use amortized cost valuation to the same extent that other mutual funds are able to do so – where the board determines, in good faith, that the fair value of debt securities with remaining maturities of 60 days or less is their amortized cost, unless particular circumstances warrant otherwise.

5 Under penny rounding pricing, a money fund’s market-based NAV per share is rounded to the nearest cent on a share price of one dollar.

6 A “government security” is any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by the U.S. Congress, and any certificate of deposit for such securities.

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 one week.