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OVERVIEW OF SEC'S RECENT MONEY MARKET FUND REFORMS

The SEC's sweeping amendments to the rules governing money market funds include new provisions relating to the imposition of liquidity fees and redemption gates, as well as a floating NAV requirement for certain money market funds. The authors discuss these provisions in detail and then turn to the new disclosures, enhanced diversification, more stringent stress testing, and the clarifying rule changes. They close with a discussion of the likely impact of the amendments on the money market fund industry.

By Jack W. Murphy, Stephen T. Cohen, Brenden P. Carroll, and Justin A. Goldberg *

On July 23, 2014, the U.S. Securities and Exchange Commission approved, by a vote of 3-2, sweeping amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended ("1940 Act"), and other rules that govern money market funds ("money funds").[1] The amendments combine the two alternatives set forth in the proposing release issued in 2013[2] – (i) permitting (and, under certain circumstances, requiring) money funds to impose a "liquidity fee" (up to 2%) and/or a "redemption gate," if weekly liquidity levels fall below the required regulatory threshold and (ii) requiring "institutional" money funds to operate with a floating net asset value ("NAV") rounded to the nearest 1/100th of one percent (*e.g.*, $1.0000). At the SEC meeting approving the amendments, SEC Chair Mary Jo White stated emphatically that the amendments "fundamentally change the way most money market funds operate."

The amendments also included other significant reforms, such as enhanced diversification, disclosure and stress testing requirements. In addition, the Commission revised Form PF to strengthen reporting obligations of registered investment advisers to private liquidity funds (also called unregistered money funds), requiring those advisers to disclose those funds' portfolio holdings and other supplementary information. The amendments also included revisions to clarify certain provisions of Rule 2a-7.

The amendments will significantly impact the money fund industry and the way in which money funds

[1] *Money Market Fund Reform; Amendments to Form PF, Inv. Co. Act Rel. No. 31166* (July 23, 2014) ("Adopting Release"). SEC Chair White and Commissioners Aguilar and Gallagher voted in favor of the Amendments; Commissioners Stein and Piwowar voted against the Amendments.

[2] *Money Market Fund Reform; Amendments to Form PF, Inv. Co. Act Rel. No. 30551* (June 5, 2013) ("Proposing Release").

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operate. This article will review the amendments and discuss some of the potential implications for the money fund industry.

BACKGROUND

In September 2008, in the wake of the Lehman Brothers' bankruptcy, the Reserve Primary Fund's share price dropped from $1.00 to $0.97, making it the second money fund in history to "break the buck." This event triggered a "flight to quality" as institutional shareholders moved their investments from prime money funds into government money funds or bank accounts. The large scale redemptions from prime money funds exacerbated a lack of liquidity in the commercial paper market, which many have argued led to further distress in the financial system.

The Board of Governors of the Federal Reserve System subsequently authorized a temporary extension of credit to banks to facilitate the purchase of money fund assets by banks, providing supplementary liquidity to money funds. Combined with the temporary guarantee program created by the U.S. Department of the Treasury, this measure alleviated some of the liquidity pressure on the commercial paper market and helped stem the tide of redemptions from institutional prime money funds.

In response to the issues money funds experienced during the financial crisis, in January 2010, the SEC adopted amendments to Rule 2a-7 and other rules that govern money funds (the "2010 Amendments").[3] The 2010 Amendments introduced new liquidity requirements and enhanced maturity, diversification, and credit quality standards for money fund investments. However, then SEC Chairman Mary Schapiro described the 2010 Amendments as "an important first step in [the SEC's] efforts to strengthen the money market regime."

On June 5, 2013, the SEC issued the Proposing Release. The SEC indicated that it had considered all available options, including comments from the money fund industry and investors, as well as possible reforms suggested by, among others, the President's Working Group on Financial Markets, which published a report on money market fund reform options in 2010.[4] The SEC received over 1,400 comments on the Proposing Release and, approximately one year after the Proposing Release was issued, the SEC adopted the amendments on July 23, 2014.

THE AMENDMENTS

Liquidity Fees and Redemption Gates

In order to provide money funds with new tools to help curb heavy redemptions during times of stress, the SEC amended Rule 2a-7 to provide all money funds with the ability to impose liquidity fees (of up to 2%) and/or redemption gates (for up to 10 business days during any 90-day period). Under the amendments, a money fund board will be authorized (although not required) to impose a liquidity fee and/or a redemption gate after a money fund's "weekly liquid assets"[5] have fallen below 30% of its total assets, if the board (including a majority of the independent directors) determines that doing so will be in the best interests of the fund.[6] Moreover, the amendments will *require* a money fund to impose a 1% liquidity fee if the fund's weekly liquid assets fall below 10% of its total assets, unless the board (including a majority of the independent directors) determines that (i) imposing a fee would *not*

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[3] *Money Market Fund Reform, Inv. Co. Act Rel. No. 29132* (Feb. 23, 2010).

[4] *See* Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options (Oct. 2010).

[5] The 2010 Amendments added to Rule 2a-7 a requirement that every money fund must maintain a level of "weekly liquid assets" that is at least 30% of the fund's total assets. The term is defined in amended Rule 2a-7(a)(34) to include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, securities that convert into cash within five business days, and amounts receivable and due unconditionally within five business days pending sales of portfolio securities.

[6] With respect to money funds in a master/feeder structure, the ability to impose liquidity fees and redemption gates applies to the master fund only and feeder funds will be expected to pass through to shareholders the effects of any fees and gates that have been imposed by the master fund.

be in the best interests of the fund or (ii) that imposing a lower or higher fee (subject to the 2% cap) would be appropriate.[7]

A "government" money fund (as defined below) will be permitted – *but not required* – to implement liquidity fees and/or redemption gates. However, any government money fund that reserves the authority to impose liquidity fees and/or redemption gates must disclose that authority in its prospectus and, based on the guidance in the Adopting Release, should give shareholders at least 60 days' notice before reserving that authority.[8]

Any liquidity fee or redemption gate imposed by a money fund must be lifted automatically if the fund's level of weekly liquid assets rises to or above 30% of its total assets. A money fund also may lift or modify a liquidity fee or redemption gate under any circumstances if the fund's board (including a majority of the independent directors) decides that it is in the best interests of the fund to do so.

Despite some commenters' requests for additional clarification regarding the factors that a money fund's board should consider when evaluating whether a liquidity fee or redemption gate is in the best interests of the fund, the SEC declined to provide a definitive list of relevant factors.[9] The Adopting Release did, however, provide the following non-exhaustive list of "guideposts" that a board should consider:

- relevant indicators of market liquidity stress and the reasons why the money fund's weekly liquid assets have fallen;
- the current and expected liquidity profile of the fund;
- whether the fall in weekly liquid assets has been accompanied by a decline in the fund's shadow NAV (for retail and government money funds, as discussed below);
- the composition of the fund's shareholder base and historical shareholder redemption patterns; and
- the fund's experience, if any, with fees and gates.[10]

It is important to note that, according to the Commission, the amendments do not permit the board of a money fund to make a blanket determination in advance that a liquidity fee and/or redemption gate will *never* be in the best interests of the fund, and, thus, that the fund will never impose a fee and/or gate. Rather, a board will be required to consider the imposition of fees and/or gates and make its determination after the relevant thresholds have been breached, in light of the surrounding circumstances at that time.

Floating the NAV of Money Fund Shares

Under the amendments, money funds (other than "government" and "retail" money funds)[11] will be required to convert to a floating NAV, calculating their market-based NAV per share to the nearest basis point or 1/100th of one percent (*e.g.*, $1.0000, on a share price

[7] The Amendments also amended Rule 22e-3 to permit a board to permanently suspend redemptions and liquidate a money fund if, at the end of a business day, the fund's weekly liquid assets drop below 10% of its total assets.

[8] Adopting Release at n.630 (stating that before reserving this authority, a government money fund "may wish" to provide written notice to shareholders, and that at least 60 days' notice would be appropriate). Government money funds that choose to impose liquidity fees and redemption gates should implement these measures consistently with the way in which non-government money funds do so.

[9] In addition, although some commenters requested that the Commission explicitly acknowledge that a board's determination would be subject to the "business judgment rule," the Commission declined to make such a pronouncement, noting that the business judgment rule is a construct of state law and not the federal securities laws. Notwithstanding that statement, the federal courts have historically applied a variation of the business judgment rule in cases brought under Section 36(a) of the 1940 Act, which empowers the Commission to bring an action against directors (and other specified parties) for a breach of fiduciary duty involving personal misconduct. *See, e.g., Burks v. Lasker*, 441 U.S. 471 (1979); *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1976).

[10] The Adopting Release also included a list of factors that a board should consider in determining the appropriate *level* of liquidity fees, such as changes in spreads for, or maturity of, portfolio securities.

[11] For the purposes of this article, money funds that are required to convert to a floating NAV are referred to as "institutional" money funds. Although this term primarily describes institutional prime money funds, it could also include institutional municipal/tax-exempt money funds and other funds that do not qualify as "retail" money funds. As noted in the Adopting Release, the SEC did not specifically exempt municipal money funds from the floating NAV requirement, explaining that the tax advantages of municipal money funds are primarily applicable to individuals, and that municipal money funds should be able to qualify under the retail money fund exemption.

of $1.00).[12] This level of precision (referred to as basis-point rounding) is 10 times greater than the level of precision required for other mutual funds and is 100 times greater than the penny-rounding method currently utilized by money funds.[13] Government money funds and retail money funds are exempt from the requirement to convert to a floating NAV and may continue to use the amortized cost method of valuation[14] and/or penny-rounding pricing method[15] to price their shares.

The floating NAV requirement is intended to reduce the perceived "first mover advantage," which some have credited with contributing to heavy redemptions from institutional prime money funds during the financial crisis.[16] The requirement removes the ability of investors to redeem their shares at $1.00 per share when the market-based or "shadow" NAV of the money fund is below $1.00 per share. The requirement also is intended to reduce investor dilution.[17] In addition, the floating NAV requirement is intended to increase the transparency of institutional money fund pricing, demonstrating to investors that they, and not fund sponsors or the federal government, will bear the risk of loss. While the SEC conceded that the floating NAV requirement does not address other justifications for redemptions during periods of market stress, including the flight to higher quality assets (also referred to as, "rational risk management"), the SEC concluded that these concerns would be adequately addressed by the liquidity fees and redemption gates portion of the amendments.

Tax and Accounting Implications of the Floating NAV Requirement

In the Proposing Release the SEC noted that there would be several tax consequences that could result from the floating NAV requirement. Particularly, the SEC stated that, if institutional money funds moved to a floating NAV, those money funds and their investors would be required to track the timing, purchase price, and sales price of shareholder transactions, in order to report capital gains and losses to investors. In addition, as proposed, institutional money fund shareholders would be subject to the so called "wash sale" tax rules, which generally deny an investor the tax benefit of realized losses, when the investor buys and sells substantially similar securities within 30 days. In order to alleviate these concerns, the SEC coordinated with the Treasury and the Internal Revenue Service on the issuance of guidance and regulations. The Commission based its support of the floating NAV requirement on the assumption that the Treasury and the IRS would eliminate the application of the wash sale rules and adopt a simplified method for tracking gains and losses

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[12] A money fund with a different target share price (*i.e.*, $10.00) would be required to price its shares at "an equivalent or more precise level of accuracy" (*e.g.*, $10.000). Adopting Release at III.B.2. Floating NAV money funds will also need to disclose, by means of a post-effective amendment or "prospectus supplement," the transition from a stable NAV money fund to a floating NAV money fund. *Id.* at III.E.3.

[13] The SEC stated that its rationale for this requirement was that basis-point rounding is more likely to produce price fluctuations in institutional money funds and, by extension, provide investors with the ability to better understand the risks of investing in institutional money funds. The SEC cited a study by its staff, which concluded that between November 2010 and November 2013, 53% of institutional prime money funds' market-based NAVs would have fluctuated using the basis-point rounding method, while over the same period only 5% of these funds' NAVs would have fluctuated using the 10 basis-point rounding. *Id.* at III.B.4.

[14] Under the amortized cost method of valuation, portfolio securities are valued by reference to acquisition cost, as adjusted for amortization of premium or accretion of discount, rather than at their value based on current market factors. Under the Amendments, an institutional money fund would still be permitted to use amortized cost valuation to the same extent that other mutual funds are able to do so (*i.e.*, for securities that mature in 60 days or less). *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Inv. Co. Act Rel. No. 9786* (May 31, 1977).

[15] Under the penny-rounding pricing method, a money fund's market-based NAV per share is calculated and rounded to the nearest cent on a share price of one dollar. While money funds currently use penny-rounding in combination with amortized cost, very few money funds rely solely on the penny-rounding method to price their shares.

[16] The "first mover advantage" is a concept under which some institutional investors may be incentivized to redeem their

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shares of an institutional money fund at a $1.00 share price when, during times of market crisis, the actual market-based NAV of the fund is below $1.00.

[17] Investor dilution would occur if money fund shareholders redeem their shares at $1.00 when the fund's market-based NAV is below $1.00. Paying a redeeming shareholder more than the current market-based NAV of the shares redeemed would lower the net asset value of the fund for the remaining shareholders since the redeeming shareholders received more than their shares were actually worth.

for transactions in floating NAV money funds.[18] On the same day the amendments were adopted by the SEC, the Treasury and the IRS released guidance and a simplified accounting procedure relating to floating NAV money funds.

Specifically, the IRS and the Treasury issued Revenue Procedure 2014-45, which provides that the wash sale rules will not be applied to any losses realized on the redemption of shares of a floating NAV money fund. The revenue procedure applies to redemption of shares on or after the effective date of the amendments. The IRS and the Treasury also issued Proposed Regulation Section 1.446-7, which would provide a simplified method for computing gains and losses from transactions with respect to shares of a floating NAV money fund. Under this method, a taxpayer's net gain or loss from shares in a floating NAV money fund during a computation period (which may be a taxpayer's taxable year or certain shorter periods) generally equals the value of the taxpayer's shares in the money fund at the end of the period, minus the value of the taxpayer's shares at the end of the prior period, reduced by the taxpayer's net investment in the money fund during the period. This method will simplify tax computations by basing them on the aggregate of all transactions in a period and on aggregate fair market values.[19]

Finally, the SEC noted that many commenters to the Proposing Release had expressed concern that floating NAV money fund shares may no longer be considered as "cash equivalents" on corporate balance sheets. The SEC, in the Adopted Release, stated its position that shares of floating NAV money funds would meet the definition of "cash equivalents" under normal circumstances. The SEC noted that it did not need a formal pronouncement from the Financial Accounting Standards Board ("FASB") or the Government Accounting Standards Board ("GASB") to make this declaration, because, under the federal securities laws, the SEC has the authority to set the accounting and reporting standards for the financial statements filed by public companies with the SEC.[20]

The Government and Retail Money Fund Exemptions

As noted above, the SEC exempted government money funds from the requirement to use a floating NAV to price their shares. Under the amendments, a government money fund is defined as a money fund that invests 99.5%[21] or more of its total assets in cash, U.S. government securities (as defined in Section 2(a)(16) of the 1940 Act), and/or repurchase agreements "collateralized fully" in cash or government securities.[22] The Adopting Release reiterated the proposition outlined in the Proposing Release, that, unlike institutional prime money funds, government money funds did not experience heavy redemptions during the financial crisis. The SEC also noted that government money funds did not experience serious redemptions during the Eurozone crisis in 2011. Accordingly, under the amendments, government money funds are able to continue to use the amortized cost method of valuation and/or penny-rounding pricing.

The amendments also will exempt retail money funds from the requirement to use a floating NAV to price their shares. The amendments define a retail money fund as a money fund that "has policies and procedures

[18] Several Commissioners specifically predicated their approval of the floating NAV requirement on receiving this guidance, and a simplified accounting procedure from the Treasury and the IRS. Additionally, the Adopting Release stated that "[w]ere the [Treasury] and IRS to withdraw or materially limit the relief in the proposed regulations, the Commission would expect to consider whether any modifications to the reforms we are adopting today may be appropriate." Adopting Release at III.B.6(a)(i).

[19] The NAV method would take into account changes in aggregate value of shares in a floating NAV money fund without regard to the realization of actual gains or losses. Any net gain or loss under the NAV method is generally treated as a short-term capital gain or loss. Dividends during the period will generally be taxed as ordinary income, and reinvested dividends will be taken into account in determining the net investment in shares during the period. There would still be some complexity since a taxpayer would need to make computations of changes in value and net investments over particular periods, and any net short-term capital gains and losses would then need to be aggregated with other capital gains and losses to determine the overall tax impact.

[20] *Id.* at III.B.6(b). Additionally, the SEC amended the Codification of Financial Reporting Policies to reflect its interpretation of GAAP. *Id.* at n.553.

[21] The Proposing Release would have defined a government money fund by reference to an 80% threshold rather than a 99.5% threshold. The Adopting Release stated that the threshold was increased to 99.5% because an 80% threshold could lead to a type of hybrid money fund whose existence would be not consistent with the intent of the Amendments.

[22] Rule 2a-7 defines "collateralized fully" by reference only to a portion of the definition of that term in Rule 5b-3(c)(1) under the 1940 Act, with the result that, under Rule 2a-7, a repurchase agreement would be considered to be "collateralized fully" only if the collateral consists entirely of cash items or government securities.

reasonably designed to limit all beneficial owners of the fund to natural persons."[23] The Adopting Release echoed the statement made in the Proposing Release that, unlike institutional prime money funds, retail money funds did not experience heavy redemptions during the financial crisis of 2008. The amendments will permit retail money funds to continue to use the amortized cost method of valuation and/or the penny-rounding pricing method.

In the Adopting Release, the Commission agreed with certain commenters and stated that the "natural person" test adopted in the amendments would provide a simpler and more cost-effective way to accomplish the Commission's goals of imposing a floating NAV only on those money funds that exhibited the greatest redemption risk in times of financial stress. The Adopting Release also noted that a money fund can still qualify as a retail money fund, even if an investor has an institutional decision maker – such as an investment adviser managing discretionary investment accounts or a plan sponsor in the case of certain retirement arrangements – that has the power to eliminate or change investment options.[24]

The Adopting Release described various policies and procedures that a retail money fund could implement to comply with the natural person test. For example, a retail money fund's board could require that ownership of fund shares be limited to: (i) investors that submit a social security number when they open an account (or, for non-U.S. investors, some other form of government-issued identification, such as a passport); (ii) investors that provide a social security number in connection with recordkeeping for a retirement plan; and (iii) investors that provide information regarding individual beneficiaries when opening a trust account.

The Adopting Release noted that many investors hold shares of retail money funds through omnibus accounts[25] and that money funds are generally not able to look through these accounts to determine the identity of the underlying investor. The SEC did not prescribe a way for a retail money fund to conclude that an omnibus account consists solely of natural persons. However, the Commission did note its expectation that many retail money funds would comply by implementing policies and procedures that rely on periodic representations from fund intermediaries to verify that fund shares are being held only by natural persons. In this regard, the SEC noted that, although it is the money fund's obligation to comply with the natural person test, a fund intermediary that invests client money through an omnibus account could be held liable for violations of the federal securities laws, including the anti-fraud provisions, if institutional investors were improperly funneled into retail money funds through an omnibus account.

Fund Reorganizations and Involuntary Redemptions

The Adopting Release noted that many money funds do not currently distinguish between retail and institutional investors and, consequently, may have both types of investors in the same fund. Some of these money funds may rely on Rule 18f-3 to offer separate share classes to institutional and retail investors, while others may have both types of investors holding shares of the same class (whether in a multiple class structure or not).

Under the amendments, money funds that have both retail and institutional investors will be required to move institutional investors out of their shareholder base in order to qualify as a retail fund and continue to maintain a stable share price. This may require a money fund with separate share classes for different classes of investors to reorganize those classes into separate funds. The SEC provided exemptive relief under Sections 17 and 18 of the 1940 Act to the extent necessary to allow these "one-time" reorganizations to be consummated, provided that a retail money fund's board (including a majority of the independent directors) determines that the reorganization "results in a fair and *approximately* pro rata allocation of the fund's assets between the class being reorganized and the class remaining in the fund."[26]

In addition, to facilitate the involuntary redemption of shares held by shareholders who are no longer eligible to invest in a newly created or an existing money fund that wishes to qualify as a money fund going forward, the SEC provided exemptive relief under Section 22(e) of

[23] In the Proposing Release, a retail money fund would have been defined as a money fund that did not permit any of its shareholders to redeem more than $1 million of redeemable securities in any business day.

[24] Adopting Release at III.C.2(b)(ii).

[25] An omnibus account may consist of holdings from thousands of investors in retirement plans and brokerage accounts, a number of institutional accounts, or a mix of both. Typically, an omnibus account aggregates the beneficial owners' orders each day, by netting purchases and redemptions, and may often provide only a single purchase or sale order to a money fund.

[26] *Id.* at III.C.2(b)(ii) (emphasis added). The Commission recognized that a 100% pro rata allocation may not be possible. The SEC stated that a board's findings must be fully documented in the board's minutes.

the 1940 Act, conditioned on the fund's notification of its investors who become ineligible to invest in the fund at least 60 days before any redemption occurs.

DISCLOSURE REQUIREMENTS

New Rule 30b1-8 and New Form N-CR

Under the amendments, a money fund will be required by new Rule 30b1-8 to disclose on new Form N-CR: (i) any instances of default or an event of insolvency of a portfolio security that, immediately before the default or event of insolvency, accounts for ½ of 1% or more of the money fund's total assets;[27] (ii) any financial support by a sponsor or affiliate of the money fund;[28] (iii) any instance in which the money fund's market-based NAV per share falls below its intended stable price by more than ¼ of 1% (*e.g.*, below $0.9975 in the case of a fund with a $1.00 price per share); (iv) a decline in weekly liquid assets below 10% of total fund assets; (v) a decline in weekly liquid assets below 30% of total fund assets if the money fund imposes a liquidity fee; and (vi) whenever a money fund imposes a liquidity fee or redemption gate, or lifts/modifies a liquidity fee or redemption gate.[29] Money funds will be required to file an initial report on Form N-CR, which will be publicly available on EDGAR immediately upon filing, within one business day, followed by a second filing on Form N-CR within four business days that includes a "brief summary" of the triggering event.

Website Disclosure

The amendments will require a money fund to disclose on its website substantially the same information that is required in the "brief summary" on Form N-CR, as well as the following information as of the end of each business day during the preceding six months: (i) the percentage of total assets invested in daily and weekly liquid assets; (ii) net inflows and outflows; and (iii) its current NAV per share and market-based NAV per share, each rounded to the fourth decimal place or equivalent level of precision. This information must be presented in the form of a schedule, chart, graph, or other depiction.[30]

Form N-1A

The amendments will require money funds to include a new generic risk statement in their registration statements relating to the risks associated with money funds. Among other things, a money fund will be required to state: (i) that the fund cannot guarantee to preserve the value of a share at $1.00 (or, in the case of institutional money funds, a statement that the share price will fluctuate); (ii) that the fund may impose liquidity fees or redemption gates (unless it is government money fund that has not elected the ability to do so); and (iii) that the fund's sponsor has no legal obligation to provide support to the fund and that an investor should not expect that the sponsor will provide financial support to the fund at any time. Also, the amendments will require a money fund to include in its Statement of Additional Information ("SAI") additional disclosure regarding any occasion during the past 10 years[31] in which: (i) the fund's weekly liquid assets have fallen below 10 % of its total assets, and with respect to each occasion, whether the fund's board

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[27] The Amendments will also require additional information about the defaulted securities, including at least two legal identifiers (such as a CUSIP or LEI number), if available.

[28] The term "financial support" is defined to include any: (i) capital contribution; (ii) purchase of a security from the fund in reliance on Rule 17a-9; (iii) purchase of defaulted or devalued security at par; (iv) execution of a letter of credit or letter of indemnity; (v) capital support agreement (whether or not the fund ultimately received support under the agreement); (vi) performance guarantee; or (vii) other similar action reasonably intended to increase or stabilize the value or liquidity of the fund's portfolio. The definition excludes any: (i) routine waiver of fees or reimbursement of fund expenses; (ii) routine inter-fund lending; (iii) routine inter-fund purchases of fund shares; or (iv) action that would qualify as financial support, as defined above, that the board of directors has otherwise determined not to be reasonably intended to increase or stabilize the value or liquidity of the fund's portfolio. The definition of "financial support" was modified from the proposed amendments in response to comments that suggested the proposed definition would capture routine transactions that occur in the ordinary course of business, but which do not indicate stress on the money fund. *See, e.g., Comment Letter of UBS Global Asset Management* (Sept. 16, 2013).

[29] Over commenters' objections, the Amendments will also require inclusion of a "brief discussion of the primary considerations or factors taken in account by the board of directors in its decision to impose or not impose a liquidity fee or gate." This brief discussion will need to be included if a

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money fund is required to impose a liquidity fee, if the fund imposes a redemption gate, or if the fund's board decides that imposing a mandatory liquidity fee is not in the best interests of the fund.

[30] This required disclosure will necessarily include money fund data that occurred prior to the compliance date of this portion of the Amendments.

[31] This requirement excludes events that occurred prior to the Effective Date of this portion of the Amendments.

determined to impose a fee or gate;[32] and (ii) any financial support received.[33]

Advertisements

The amendments also amended Rule 482 to require disclosure of the risks of the floating NAV requirement and liquidity fees, and redemption gates in fund "omitting prospectus" advertisements.[34] These new disclosure requirements are generally the same as those discussed above.

Form N-MFP

The amendments amended Rule 30b1-7 under the 1940 Act, which requires money funds to file electronically a monthly report on Form N-MFP. Prior to the amendments, Form N-MFP was not made public until 60 days after the end of the month for which the filing was made. However, the amendments will eliminate this 60-day delay, making the form publicly available immediately upon filing.

In addition to changes to Form N-MFP to reflect the amendments to Rule 2a-7, the amendments included structural, reporting, and clarifying changes to current instructions and items of Form N-MFP. There also will be new reporting requirements, including, but not limited to, reporting: (i) NAV and shadow price; (ii) daily and weekly liquid assets; and (iii) shareholder flows. This information will include week-end information (as opposed to only month-end information) within the monthly filing period covered by the form. Additionally, the amendments will require that a money fund disclose whether its adviser or a third party paid for or waived all or part of its operating expenses or management fees during a given reporting period. The amendments do not include certain new reporting items that were proposed in the Proposing Release (such as disclosures regarding the top-20 shareholders or lot-level portfolio securities). The amendments also do not change the period of time after the end of the month within which the filing needs to be made.

[32] A liquidity fee need not be disclosed in a money fund's fee table as a redemption fee due to the slight likelihood of such fee ever being imposed. Adopting Release at IV.G.

[33] This requirement excludes events prior to the Effective Date of this portion of the Amendments.

[34] The amendments to Rule 482 also apply to supplemental sales literature by reason of the cross-reference to Rule 482 in Rule 34b-1 under the 1940 Act.

ENHANCED DIVERSIFICATION REQUIREMENTS

Grouping of Affiliates

Under Rule 2a-7, a money fund generally may not invest more than 5% of its assets in a single issuer. The amendments will require a money fund to aggregate affiliates of issuers for purposes of applying this 5% issuer diversification limit. This aggregation requirement aims to further mitigate credit risk to a money fund by restricting the fund's ability to assume a concentrated amount of risk in a single economic enterprise. Similar to the Proposing Release, under the amendments, entities are deemed "affiliates" for purposes of this aggregation requirement if one is controlled by the other or they are under common control. For this purpose only, "control" is defined to mean ownership of more than 50% of an entity's voting securities. In a change from the Proposing Release, the amendments excluded certain equity owners of asset-backed commercial paper conduits (special purpose entities or "SPEs") from the new aggregation requirement for purposes of the 5% issuer diversification limitation.

Asset-Backed Securities ("ABS") Sponsors

Rule 2a-7 currently requires 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 a 25% basket exception discussed below. Under the amendments, a money fund will be required to include the sponsor of an SPE that issues ABS as a "guarantor" of the ABS, unless the fund's 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. In the absence of such a finding, this restriction will limit a money fund to investing no more than 10% of its assets in ABS issued by any one sponsor's SPEs.

Removal of the 25% Basket

Rule 2a-7 currently provides an exception to the 10% limitation described above, under which 25% of a money fund's assets may be subject to guarantees or demand features from a single institution ("25% basket"). The amendments will eliminate this 25% basket for most money funds. However, for municipal money funds, the amendments will not remove the 25% basket but rather will reduce it to 15% (the Proposing Release would have limited it to 10%). Therefore, up to 15% of a municipal money fund's assets may be subject to guarantees or demand features from a single institution. The SEC cited data suggesting that the

majority of money funds have not used the 25% basket to the full extent permitted under Rule 2a-7. This data, however, also suggested that municipal money funds use the 25% basket to a greater extent than money funds as a whole. The SEC also noted that commenters had expressed concerns about liquidity, given the limited availability of demand feature providers and guarantors for municipal money funds.

CHANGES TO FORM PF

The amendments included changes to Form PF, the form SEC-registered investment advisers are required to file to report information regarding the private funds they advise. These changes aim, in part, to assist the SEC to better track any shift in assets from registered money funds to funds that are not required to register as investment companies under the 1940 Act (such as "liquidity funds," which are private funds that seek to maintain a stable NAV). The changes to Form PF primarily impact "large liquidity fund advisers," which the SEC defined as "registered advisers with $1 billion or more in combined money market fund and liquidity fund assets." The changes to Form PF, which were adopted largely as proposed, will require these large liquidity fund advisers to file substantially the same information with respect to the portfolio holdings of their private liquidity funds on Form PF, as money funds are required to file on amended Form N-MFP.

ENHANCED STRESS TESTING

The amendments also add requirements to enhance Rule 2a-7's stress testing. Under the amended requirements, money funds will be specifically required to periodically test both their ability to maintain weekly liquid assets of at least 10% and their ability to minimize principal volatility in response to specified hypothetical events. These hypothetical events include: (i) increases in short-term interest rates; (ii) downgrades or defaults of specified portfolio security positions; and (iii) widening spreads in various sectors. The amendments will require each hypothetical event to be tested assuming varying levels of shareholder redemptions. Further, money fund advisers will be required to include additional information in the stress testing reports to the money fund boards, including a summary of the significant assumptions made when performing the stress tests.

CLARIFYING AMENDMENTS

The SEC, noting questions that have arisen regarding the application of certain provisions under Rule 2a-7, adopted a number of amendments to clarify those provisions.

Daily and Weekly Liquid Assets

The SEC clarified certain attributes of instruments that qualify as daily and weekly liquid assets. In particular, the amendments: (i) made it clear that money funds cannot use the maturity-shortening provision set forth in current Rule 2a-7(d) regarding interest rate readjustments when determining whether a security satisfies the maturity requirements of a daily or weekly liquid asset; (ii) established that an agency discount note with a remaining maturity of 60 days or less qualifies as a weekly liquid asset only if the note is issued without an obligation to pay additional interest on the principal amount; and (iii) included in the definition of daily and weekly liquid assets amounts receivable that are due unconditionally within one or five business days, respectively, pending settlement of sales of portfolio securities.

Demand Features

The definition of "demand feature" currently requires that a demand feature be exercisable at any time on no more than 30 calendar days' notice. The definition in the amendments will eliminate the 30-day notice requirement and defines a demand feature as a feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus interest, if any, at the time of exercise, paid within 397 calendar days of exercise.

Short-Term Floating Rate Securities

The amendments provided that, for the purposes of determining the dollar-weighted life to maturity, a short-term floating rate security that is subject to a demand feature shall have a maturity equal to the period remaining until the principal amount can be recovered through demand. This revised provision is designed to ensure that money funds apply the maturity-shortening provision for short-term floating rate securities in a manner consistent with the intent of the 2010 amendments and in a similar manner as that applied to short-term variable rate securities.[35]

[35] This clarifying amendment is consistent with informal guidance that the SEC staff has provided. Investment Company Institute, *Request for Interpretation under Rule 2a-7* (Aug. 10, 2010). Also, the SEC noted that most money funds currently determine the maturity of short-term floating rate securities in a way that is consistent with the revised provision. Adopting Release at III.M.3.

Second Tier Securities

Currently, Rule 2a-7 allows money funds to invest in second tier securities with remaining maturities of 45 days or less. The amendments revise Rule 2a-7 to specify that the 45-day limit applicable to second tier securities must be determined without reference to the maturity-shortening provision of Rule 2a-7 for interest rate readjustments.

COMPLIANCE DATES

The compliance dates for the amendments are as follows:

- floating NAV/liquidity fees and redemption gates requirements: October 14, 2016;
- adoption of Form N-CR: July 14, 2015; and
- diversification, stress testing, disclosure, Form PF, Form N-MFP, and clarifying amendments: April 14, 2016.

IMPACT OF AMENDMENTS

Updated Compliance Procedures and Systems

The amendments will necessitate the adoption of revised Rule 2a-7 procedures, as well as new compliance procedures, and the implementation of technology systems for compliance with the various new requirements. These compliance systems will impose costs, some of which may be borne, directly or indirectly, by the money fund. A fund and its board will have to oversee the implementation of new compliance systems, satisfying themselves that the procedures and systems put into place are reasonably designed to prevent violations of the new requirements.

Impact on Institutional Money Funds

Under the amendments, institutional money funds must operate with a floating NAV. This change will have a dramatic impact on those funds, and, quite possibly, on their investors. For example, there may be significantly reduced demand for institutional money funds once their NAVs are required to float. In addition, under the amendments, institutional money funds will no longer be able to use the amortized cost method of valuation to value portfolio securities (except for securities with maturities of 60 days or less). Also, a floating NAV may not be compatible with intra-day settlements, given the current inability of fund service providers to value a money fund's assets during the trading day. As a result, institutional money funds will need to consider and adopt changes to, among other things: (i) Rule 2a-7 procedures; (ii) valuation procedures; (iii) arrangements with pricing services; and (iv) intra-day and, potentially, same-day pricing and settlement features of redemptions. Accounting systems will have to be modified or replaced so as to permit the pricing of purchases and sales of fund shares at a floating NAV with the new level of precision required by basis-point rounding.

Government and Retail Fund Definitions

A government money fund will need to qualify under the new government money fund definition. Currently, a money fund that holds itself out as a "government" fund under Rule 35d-1 is required to invest at least 80% of its net assets (plus borrowings for investment purposes) in government securities. As a result of the amendments, a government money fund that currently has the ability to take advantage of the flexibility provided by the 80% test, but wants to continue to qualify as a government fund under the amended rule, will need to modify its principal investment strategies to require the fund to invest at least 99.5% of its assets in cash, government securities, and/or repurchase agreements collateralized fully by cash or government securities.

A non-government money fund that wishes to avoid the floating NAV requirement will need to consider whether it will be able to qualify under the retail money fund definition. In order to qualify as a retail money fund, the fund will need to implement policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. This may require significant discussions (and possibly negotiations) with intermediaries, as well as with service providers, such as the money fund's transfer agent.

Many investors hold shares of money funds through omnibus accounts held in the name of a financial intermediary for the benefit of its customers. As a result, most money funds are not able to look through those accounts to determine whether the underlying investors are individuals. The amendments did not set forth a specific method to address the issues associated with omnibus accounts, but most retail money funds will likely need to put in place procedures that include requesting certifications and/or entering into agreements with financial intermediaries in order to obtain their confirmation that only natural persons are the beneficial owners of the omnibus accounts held by the intermediary.

Fund Reorganizations and Involuntary Redemptions

If a money fund has both institutional and retail share classes, the fund may seek to reorganize its institutional

share class into a separate fund in order for the fund to comply with the retail money fund definition. Money fund reorganizations can be costly and complex because of, among other things, the difficulty of soliciting proxies from money fund shareholders (assuming such approval is required). If a money fund has institutional and retail shareholders in the same share class, the fund will need to involuntary redeem all of its institutional investors in order for the fund to meet the retail money fund definition. The Adopting Release noted that a money fund should notify investors who become ineligible to invest in the fund at least 60 days before any redemption occurs.

Liquidity Fees and Redemption Gates

Under the amendments, a non-government money fund will be required to impose a 1% liquidity fee on all redemptions when weekly liquid assets fall below 10% of the fund's total assets, unless the fund's board determines that imposing such a fee would not be in the fund's best interests or decides that a lower or higher (up to 2%) fee would be appropriate. The amendments also will permit a fund's board to impose liquidity fees or redemption gates when weekly liquid assets fall below 30% of a money fund's total assets. Board findings relating to both the liquidity fees and redemption gates under the amendments would have to be approved by the board as a whole, as well as by a majority of the disinterested board members. The "trigger" to impose liquidity fees is based on the level of weekly liquid assets as of the end of a business day. A fund and its board may, therefore, be called upon to consider on short notice whether to impose liquidity fees.

The Adopting Release described certain guideposts that fund boards may wish to consider in determining whether to impose or lift liquidity fees or redemption gates, as discussed above. However, a money fund board's determinations likely will involve highly fact-specific considerations. If a board decides to impose a liquidity fee and/or a redemption gate, it may need to meet multiple times during the period when the fees or gates are in effect, in order to monitor their operation, and consider whether the fees or gates continue to be appropriate. Moreover, even if a board decides not to impose fees or gates, it may have to revisit that decision if the level of the fund's weekly liquid assets remains below 30% and there is a change in the surrounding circumstances.

The SEC expects that a money fund's investment adviser will provide the fund's board with all the relevant information it would need to evaluate whether to impose or continue fees or gates. Finally, the events that led to the imposition of a fee or a gate, including the considerations taken into account by the board, will need to be documented carefully and reported to the SEC on the follow-up Form N-CR filing.

A money fund's board may wish to consider adopting self-imposed trigger points and other procedures under which the fund's investment adviser would notify the fund's board (for example, when the fund's weekly liquid assets fall below 35% of total assets), so that the board members can be prepared to meet immediately and consider all of the relevant facts and circumstances. These early warning triggers could be put into place for both the mandatory 10% threshold for liquidity fees, as well as the discretionary 30% threshold for liquidity fees and redemption gates. Although there is no requirement for a fund board to meet if the discretionary 30% threshold is crossed, a board may wish to adopt policies and procedures providing that the investment adviser will notify the board or certain board members if the 30% threshold is crossed to make sure the board is aware of the circumstances, and can consider whether a board meeting is necessary to consider the imposition of liquidity fees and/or redemption gates.

A money fund and/or its investment also may wish to put into place policies and procedures to monitor and address shareholder concentration and shareholder flows in order to reduce the possibility that shareholder redemptions will cause the money fund's weekly liquid assets to cross the discretionary or mandatory thresholds. A money fund or its adviser also may wish to implement internal investment policies to maintain, under normal market conditions, weekly liquid assets at a level higher than the discretionary 30% threshold (such as 40%), in order to reduce the possibility that the fund may have to consider imposing liquidity fees and/or redemption gates.

Other New Requirements

A money fund will need to comply with the amendments' enhanced disclosure, diversification, reporting, stress testing, and other requirements. For example, a money fund's adviser should take steps to implement a system to accurately, and in a timely manner, disclose and report to the SEC the additional information required by the proposal (*e.g.*, website, prospectus, SAI, and advertisement disclosure).[36] In

[36] As noted above, the new website disclosure requirements will require six months of data to be disclosed starting on the effective date (April 14, 2016). To comply with this requirement, a money fund's adviser will need to take steps to make sure that the necessary data are captured and recorded during the six-month period prior to the effective date.

addition, the money fund's policies and procedures will need to be updated to reflect the new diversification requirements and other clarifying changes made to the rule. Finally, a money fund will be required to review and, if necessary, update its stress testing procedures to include the specific items required by the amendments.

Potential Issues for Unregistered Money Funds Operating under Rule 12d1-1

Unregistered money funds operating under Rule 12d1-1 will be subject to the requirements regarding liquidity fees and redemption gates, as well as the floating NAV requirement.[37] Commenters urged the Commission to exempt these funds from the amendments, particularly the floating NAV requirement. However, in the Adopting Release, the SEC stated its belief that unregistered money funds are susceptible to the same market forces as institutional money funds (*e.g.*, large scale redemptions), and therefore declined to specifically exempt these funds from the amendments. The Adopting Release also acknowledged that, because an unregistered money fund's adviser typically performs the function of the fund's board of directors, potential conflicts of interest could arise when the adviser makes a determination as to whether to impose liquidity fees and/or redemption gates. The SEC stated that these advisers should therefore adopt policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940, including the anti-fraud provisions thereunder.

Valuation Guidance

The Commission included in the Adopting Release certain statements about valuation relating to the use of amortized cost and pricing services by money funds, as well as by other mutual funds. With respect to the SEC guidance relating to the use of amortized cost, the Adopting Release stated that:

> [The Commission] generally believe[s] that a fund may only use the amortized cost method to value a portfolio security with a remaining maturity of 60 days or less when it can reasonably conclude, at each time it makes a valuation determination, that the amortized cost value of the portfolio security is *approximately the same* as the fair value of the security as determined without the use of amortized cost valuation. Existing credit, liquidity, or interest rate conditions in the relevant markets and issuer specific circumstances at each such time should be taken into account in making such an evaluation.[38]

The Adopting Release also included certain statements regarding the use of pricing services. The Release noted that a money fund's board, before hiring a pricing service to assist in portfolio security valuations, should consider "the inputs, methods, models, and assumptions used by [the] pricing service to determine its evaluated prices," and how those inputs, methods, and assumptions "are affected (if at all) as markets change."[39] In light of the SEC's valuation guidance with respect to the use of the amortized cost method of valuation and pricing services, money funds (and other mutual funds) may wish to consider whether they should modify their valuation policies to incorporate these concepts, to the extent the procedures do not already address these points.

CONCLUSION

The amendments set forth sweeping changes to money fund regulation and will have a profound effect on the money fund industry for years to come. Although the most significant provisions of the amendments – the floating NAV requirement and the imposition of liquidity fees and redemption gates – will not go into effect for two years, money fund advisers and their boards would be well-advised to consider the amendments and the issues discussed above well in advance of the compliance dates in order to make sure that their funds are on track to comply with the amendments by the time they become effective. ■

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[37] Rule 12d1-1 permits an investment company to invest in affiliated and unaffiliated unregistered money funds without having to comply with the affiliated transaction restrictions under Section 17 of the 1940 Act (*i.e.*, Section 17(a) and 17(d)), provided the unregistered money fund operates in compliance with Rule 2a-7, among other things.

[38] Adopting Release at III.D.1 (emphasis in original; internal citations omitted). The Adopting Release also stated that "it would not be appropriate for a fund to use amortized cost to value a debt security with a remaining maturity of 60 days or less and thereafter not continue to review whether amortized cost continues to be approximately fair value until, for example, there is a significant change in interest rates or credit deterioration." *Id.*

[39] *Id.* at III.D.2(b).