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What You Need to Know About Money Market Fund Reform

By Joan Ohlbaum Swirsky and Amy G. Smith

SEC Adopts Floating NAV for Institutional Prime and Institutional Municipal Money Market Funds; Liquidity Fees and Redemption Gates for Non-U.S. Government Money Market Funds

At an open meeting on July 23, the Securities and Exchange Commission (the SEC) adopted amendments to the rules that govern money market mutual funds that operate under Rule 2a-7 under the Investment Company Act of 1940. The new rules were adopted on a 3-2 vote, with Commissioners Michael S. Piwowar and Kara Stein dissenting. The SEC's rules will require institutional prime and institutional municipal money market funds to replace their current \$1 stable share price with a floating net asset value (NAV). The reforms also will authorize fund boards to impose a liquidity fee of up to 2 percent and/or a redemption gate (for no more than 10 business days in any 90-day period) if weekly liquid assets¹ in the fund fall below 30 percent of assets. A liquidity fee of 1 percent would be imposed if weekly liquid assets fall below 10 percent of assets, unless the fund board takes action to eliminate, reduce or increase the fee.

The adoption of these rules has been much anticipated since the proposed reforms were announced in June 2013 to build upon the reforms adopted by the SEC in February 2010, which were intended to reduce the interest rate, credit and liquidity risks of money market fund portfolios. Regulators have sought to reduce the susceptibility of money market funds, particularly institutional money market funds, to destabilizing runs during times of market stress. Commissioner Luis A. Aguilar called the path to the final rules "one of the most flawed and controversial rulemaking processes," apparently referring to the August 2012 disagreements surrounding the SEC's failure to adopt fundamental reforms, advocated by then-Chairman Mary Schapiro.

The reforms require the following:

1. Floating NAV for Institutional Prime and Institutional Municipal Money Market Funds; Basis Point Rounding

Institutional prime money market funds and institutional municipal money market funds will be required to value their portfolio securities at market value and sell and redeem shares based on a floating NAV. These funds may no longer use amortized cost to value their portfolio securities (other than for securities that mature within 60 days),² which currently permits them to attempt to maintain a constant share value of \$1. Daily share values of these money market funds will fluctuate along with changes in the market-based value of their portfolio securities.

Further, these funds will be required to “basis point round” their share value to the nearest 1/100th of 1 percent (the fourth decimal place in the case of a fund with a \$1.0000 share price). This rounding is 100 times more sensitive than currently in effect for a money market fund (which rounds share value to the nearest penny) and 10 times more sensitive than currently in effect for a non-money market fund with a \$1 share value (which would be required to round to the nearest tenth of a penny).

2. Stable NAV permitted for Retail and U.S. Government Money Market Funds

Retail money market funds and U.S. government funds may continue to seek to maintain a stable NAV by use of amortized cost valuation and/or penny-rounding the share value, as is currently permitted under Rule 2a-7.³ The SEC considers runs on those funds to be less likely than a run on an institutional prime or institutional municipal money market fund.

- New Definition for U.S. Government Money Market Fund: A U.S. government money market fund will be defined as any money market fund that invests 99.5 percent (proposed to be 80 percent) or more of its total assets in cash, government securities and/or repurchase agreements that are collateralized solely by government securities or cash.⁴
- Retail Money Market Fund Defined: A retail money market fund will be defined as a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the money market fund to natural persons.⁵ A municipal money market fund may qualify as “retail” if it satisfies this definition.
- Exemptive Relief Granted to Allow Restructuring as a Retail Fund: The SEC recognizes that many funds include both retail and institutional shareholders, and that some funds may wish to undertake reorganizations to separate retail and institutional shareholders. Certain of these reorganizations may require exemptive relief from the SEC. The adopting release itself sets forth exemptive relief from certain Investment Company Act provisions that might forbid a reorganization to separate retail and institutional shareholders. (See p. 223 et seq.) This blanket relief may avoid the need for the SEC staff to deal with a flood of similar exemptive applications relating to money market fund reorganizations.

Tax Issues – On the date of the SEC’s open meeting, the U.S. Treasury Department issued proposed regulations and a revenue procedure intended to address the tax complexities of the floating NAV. The SEC’s press



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summary at the open meeting stated that the guidance will allow floating NAV money market fund investors to use a simplified tax accounting method that will eliminate the need to track individual purchase and sale transactions for tax reporting purposes (that is, to report gains and losses). The press summary also reported that the revenue procedure provides relief from the “wash sale” rules that would otherwise disallow losses on sales of shares of floating NAV money market funds within 30 days before or after a purchase of substantially similar shares. Commissioner Gallagher said at the open meeting that this new relief goes beyond the earlier revenue procedure, which many in the industry critiqued as providing inadequate relief.

3. Liquidity Fees and Redemption Gates for Non-U.S. Government Money Market Funds

For all money market funds except U.S. government money market funds, the fund board will have the authority to address runs by imposing liquidity fees and redemption gates when weekly liquid assets of a fund are depleted to below 30 percent of its total assets (15 percent was proposed).⁶ Government money market funds are not subject to the new fees and gates provisions. However, these funds may voluntarily opt into them, if previously disclosed to investors.⁷

Two Percent Fee Option When Weekly Liquid Assets Fall Below 30 Percent – If a money market fund’s weekly liquid assets fall below 30 percent, the board can impose a fee of up to 2 percent on all redemptions if the money market fund’s board of directors determines that such a fee is in the best interests of the fund.

One Percent Fee Imposed, Subject to Board Decision Otherwise, When Weekly Liquid Assets Fall Below 10 Percent – If a money market fund’s level of weekly liquid assets falls below 10 percent, the money market fund would be required to impose a liquidity fee of 1 percent on

all redemptions. However, such a fee would not be imposed if the fund's board of directors determines that such a fee is not in the best interests of the fund or that a lower or higher (up to 2 percent) liquidity fee is in the best interests of the fund.

Redemption Gates/10 Business Days – Under the reform, if a money market fund's weekly liquid assets fall below 30 percent, a money market fund's board could in its discretion temporarily suspend redemptions (gate). To impose a gate, the board of directors would find that imposing a gate is in the money market fund's best interests. A money market fund that imposes a gate would be required to lift that gate within 10 business days, although the board of directors could determine to lift the gate earlier. Money market funds are forbidden to impose a gate for more than 10 business days in any 90-day period. (The proposal had a longer maximum gate period of 30 business days.)⁸

Public Disclosure of Drop in Weekly Liquid Assets or Use of Liquidity Fees and Gates – These money market funds will be required to disclose promptly and publicly instances in which the fund's level of weekly liquid assets falls below the 10 percent threshold and the imposition and removal of any liquidity fee or gate.

Disclosure of the board's consideration in imposing the liquidity fee or redemption gate will also be required.

4. Enhanced Disclosure Requirements

The final rules also include enhanced diversification, disclosure and stress-testing requirements, as well as updated reporting by money market funds and private funds that operate like money market funds.

Website Disclosure – Money market funds are required to disclose on their website, on a daily basis, their levels of daily and weekly liquid assets, net shareholder inflows or outflows, market-based NAVs per share, imposition of fees and gates, and any use of affiliate sponsor support.

New Material Event Disclosure – Money market funds are required to promptly disclose certain events on a new Form N-CR. These events would include the imposition or removal of fees or gates and the primary considerations or factors taken into account by a board of directors in its decision related to fees and gates; portfolio security defaults; sponsor or fund affiliate support, including the amount of support and a brief description of the reason for support; and — for retail and government funds – a fall in the fund's market-based NAV per share below \$0.9975.

Disclosure of Sponsor Support – Money market funds are required to provide in their statements of additional

information disclosure regarding any occasion during the last 10 years (but not for occasions that occurred before the compliance date) in which the money market fund received sponsor or fund affiliate support. This disclosure is in addition to the current-event disclosures required on Form N-CR.

Immediate Reporting of Fund Portfolio Holding – The current 60-day delay on public availability of information filed on Form N-MFP will be eliminated, and the form will become publicly available immediately upon filing.

Private Liquidity Fund Reporting – A liquidity fund adviser managing at least \$1 billion in combined money market fund and liquidity fund assets will be required to report substantially the same portfolio information on Form PF as registered money market funds are required to report on Form N-MFP. A liquidity fund is essentially an unregistered money market fund.

5. Stronger Diversification Requirements

The final rules included several changes to the diversification requirements for money market funds' portfolios.

Elimination of 25 Percent Basket – Currently, money market funds have a "25 percent basket" relating to exposure to providers of guarantees and demand features on portfolio securities. This "basket" is a 25 percent portion of the portfolio that is not subject to the 10 percent diversification limit on exposure to any one guarantor or provider of a demand feature.

- **10 Percent Diversification Limit for Nonmunicipal Money Market Funds:** For money market funds other than municipal money market funds, the final rule requires that all of a money market fund's assets meet the 10 percent diversification limit for guarantors and demand feature providers, thereby removing the 25 percent basket.
- **15 Percent Diversification Limit for Municipal Money Market Funds:** For municipal money market funds, the 25 percent basket is reduced to 15 percent so that no more than 15 percent of the value of securities held in a municipal money market fund's portfolio is subject to guarantees or demand features from a single institution.

Aggregation of Affiliates – Money market funds are required to treat certain entities that are affiliated with each other as single issuers for purposes of determining whether they are complying with money market funds' 5 percent issuer diversification limit. Under this limitation, a fund generally could not invest more than 5 percent of its assets in any one issuer or group of affiliated issuers.

Asset-Backed Securities – Money market funds would be required to treat the sponsors of asset-backed securities as guarantors subject to the 10 percent diversification limit applicable to guarantees and demand features, unless the money market fund’s board of directors (or its delegate) determines that the fund is not relying on the sponsor’s financial strength or its ability or willingness to provide liquidity, credit or other support to determine the asset-backed security’s quality or liquidity.

Rule 10b-10 Exemptive Relief – At the open meeting, the SEC also issued a related notice proposing exemptions from certain confirmation requirements for transactions effected in shares of floating NAV money market funds. This exemption would ease the requirement that brokers provide confirmation of money market fund share transactions when money market funds move to a floating NAV.

Reproposed Elimination of Reliance on Credit Ratings – Additionally, the SEC reproposed amendments to the SEC’s money market fund rules and Form N-MFP to eliminate references to credit ratings. The reproposed amendments would implement Section 939A of the Dodd-Frank Wall Street and Consumer Protection Act of 2010, which requires the SEC to review its rules that use credit ratings as an assessment of creditworthiness and replace those credit-rating references with other appropriate standards.

6. Enhanced Stress-Testing

The reforms call for enhanced stress-testing requirements in order to improve the quality of reports that money market funds’ boards of directors receive. In particular, a money market fund would be required to test its ability to maintain weekly liquid assets of at least 10 percent and to minimize principal volatility in response to certain specified hypothetical stress scenarios.

7. Compliance Dates

Although the amendments will become effective 60 days after the date of publication of the rules in the Federal Register, the compliance dates will be as follows:

Floating NAV/Liquidity Fees/Redemption Gate – Two years after the date of publication of the adopting release in the Federal Register.

New Form N-CR – Nine months after the date of publication of the adopting release in the Federal Register.

Diversification, Stress-Testing, Disclosure, Form PF, Form N-MFP and Clarifying Amendments – 18 months after the date of publication of the adopting release in the Federal Register.

Some Questions That May Arise

We expect many questions to arise from the implementation of the new rules and interpretation of the 869-page adopting release. The following are a few issues funds and boards may consider regarding the fundamental reforms.

- Will the money market funds fit within the retail or U.S. government exemptions from reform, and if not, will the funds seek to restructure to fit within the exemption?
- How prepared is the money market fund for possible migration of assets from the fund? Will migration of assets from the money market fund affect the fund family in general or the adviser?
- Will service provider expenses increase (for example, services to value assets at market value rather than amortized cost)? What other operational and expense burdens will the money market funds bear?
- Will intermediaries be unwilling to change systems to offer money market funds subject to the floating NAV or fees/gates, so that distribution channels will shrink?
- Will yields be reduced by increased operational and compliance costs and potential increased demand for U.S. government securities?
- How will funds communicate with shareholders about upcoming changes? Are there adequate methods to monitor shareholder flows? What are expectations about shareholder flows?

In addition, as the compliance dates approach, boards will be asked to approve revised fund procedures and to review revised board reports. We look forward to keeping you informed as the landscape unfolds.⁹

¹ Weekly liquid assets include cash, direct obligations of the U.S. government, certain U.S. government discount notes with maturities within 60 days, and accounts receivable on securities sales unconditionally due within five business days.

² Non-money market funds can value securities that mature within 60 days at amortized cost under normal circumstances. The adopting release states that floating NAV money market funds will continue to be permitted to use amortized cost value for securities maturing in 60 days. The SEC says, “Accordingly, even for floating NAV money market funds, amortized cost will continue to be an important part of the valuation of money market fund portfolio securities.” (See text at footnote 872.) It is possible that certain money market funds will choose to limit their investments to such very short-term securities.

³ The proposed rules would have forbidden amortized cost valuation. Many in the industry will welcome the permission to use amortized cost valuation, because a move to market valuations may have impeded

the ability to provide same-day settlement of money market fund share transactions or multiple share transaction times intraday.

⁴ This narrow definition of a U.S. government money market fund may require shifting a fund's investment approach to satisfy this exemption. A money market fund might consider changing to a U.S. government money market fund or restructuring as a retail money market fund as an alternative to complying with fundamental reform requirements (or as an alternative to the floating NAV in the case of a retail money market fund).

⁵ If a retail money market fund includes one stray institutional shareholder in an otherwise retail fund, that may not result in a requirement that the fund reclassify itself as "institutional" and float its NAV — assuming the fund's procedures are reasonably designed. However, repeated misclassification of shareholders as retail under the procedures may raise challenging questions for the fund and its board. Funds may need to consider additional issues regarding whether their shareholders are natural persons. The SEC states that natural persons often invest through a variety of tax-advantaged accounts and trusts and states that many of these "are beneficially owned by natural

persons and therefore would likely qualify under the natural person test." However, accounts of small businesses, defined benefit plans or endowments would not qualify for a retail money market fund if not beneficially owned by natural persons. (See footnote 697.)

⁶ The higher trigger means that the fund board may need to begin considering fees/gates at an earlier stage in a fund's financial difficulties.

⁷ Government money market funds may wish to consider whether to opt-in to the requirements and whether and at what intervals to reconsider the opt-in option.

⁸ The shorter period may be more tolerable for certain shareholders, but it provides less time for a troubled fund to address its depleted liquidity before the gate must be lifted.

⁹ This alert generally is based on the summary of the amendments made available at the SEC's open meeting, which is incomplete, and review of selected portions of the final adopting release.



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