



## *SEC Adopts Money Market Fund Reforms*

BY THE INVESTMENT MANAGEMENT PRACTICE

On July 23, 2014, the Securities and Exchange Commission ("SEC"), in a 3-2 vote, approved amendments to Rule 2a-7 ("Rule 2a-7") under the Investment Company Act of 1940, as amended (the "1940 Act"); the rule that governs money market funds. The rule amendments were the result of a multi-year effort by the SEC "... to address money market funds' susceptibility to heavy redemptions in times of stress, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, their benefits."<sup>1</sup> These amendments primarily:

- Prohibit institutional non-government money market funds from using a stable net asset value; instead requiring them to execute purchase and sale transactions based on the current market-based value of their individual portfolio securities rounded out to the fourth decimal place (floating net asset value ("NAV")); and
- Require all non-government money market funds to impose a liquidity fee on redemptions and/or restrict redemptions by imposing a redemption "gate," if a fund's weekly liquid assets falls below the requirements in Rule 2a-7, unless the board of directors of a fund affirmatively determines that imposing such a fee or implementing such a gate would not be in the best interests of the fund.

In addition, the Adopting Release includes a number of other amendments that apply to certain types of money market funds in order to enhance the safety of money market funds and the disclosure of the risks of money market funds to investors. These other amendments include: (i) stronger diversification limits, (ii) enhanced stress testing requirements, (iii) additional disclosure requirements, (iv) a new current event reporting form that will require funds to make immediate public disclosure of certain events, (v) amendments to Form N-MFP, and (vi) amendments to Form PF for investment advisers of certain private liquidity funds.

Additionally, the SEC has re-proposed certain rule changes, which it initially proposed in 2011, that would remove references to credit ratings from two rules and four forms under the 1940 Act.

We review each of these amendments, as well as the re-proposal, in more detail below.

## Amendments

### I. Categories of Money Market Funds

The amendments create three general categories of money market funds that are affected to differing extents by the amendments: retail money market funds, government money market funds and institutional money market funds.

#### ***Retail Money Market Funds***

Under amended Rule 2a-7(a)(25), a “Retail Money Market Fund” is a money market fund that is intended to be available only to natural persons. A Retail Money Market Fund should disclose in its prospectus that it limits investments to natural persons and must adopt policies and procedures that are reasonably designed to limit all beneficial owners of the fund to natural persons (“natural persons test”).<sup>2</sup>

The Adopting Release notes that funds will have flexibility in conducting the natural persons test and provides some examples of how the test might be conducted. For example, funds may confirm ownership directly, such as by requiring investors to provide a social security number to the fund when opening an account; or indirectly, such as when the investor’s social security number is provided to the fund by a third party intermediary, such as a retirement plan recordkeeper or a trust account fiduciary. For omnibus accounts, the Adopting Release states that funds must still determine that the underlying beneficial owners are natural persons but notes that funds may enter into contractual arrangements with intermediaries which require intermediaries to limit purchases to natural persons and/or require periodic certifications from intermediaries as to the natural person test.<sup>3</sup>

All amendments in the Adopting Release, other than the Floating NAV amendment, will apply to Retail Money Market Funds, except those that meet the definition of a Government Money Market Fund (see below).

#### ***Government Money Market Funds***

Under amended Rule 2a-7(a)(16), a “Government Money Market Fund” is a money market fund that invests 99.5% or more of its total assets in cash, government securities (as defined in section 2(a)(16) of the 1940 Act), and/or repurchase agreements that are collateralized fully (as defined in Rule 2a-7).<sup>4</sup> A money market fund may not call itself, or include in its name, “government money market fund” or similar names unless it complies with this requirement.

While many of the amendments adopted will apply to Government Money Market Funds, the two major changes—those related to fees and gates and those related to floating NAV—will not apply to Government Money Market Funds, whether they are offered to retail or institutional investors. However, a Government Money Market Fund is allowed to utilize liquidity fees and gates if the ability to do so is disclosed in such fund’s prospectus.<sup>5</sup>

#### ***Institutional Money Market Funds***

Under amended Rule 2a-7, an institutional money market fund is any money market fund whose beneficial owners are not limited to natural persons. All amendments adopted will apply to Institutional Money Market Funds except for those that meet the definition of a Government Money Market Fund.

## II. Liquidity Fees and Redemption Gates

As amended, Rule 2a-7 now generally requires money market funds to impose liquidity fees on redemptions and/or limit redemptions by imposing gates (“fees and gates”) in certain circumstances, unless the board of directors of a fund affirmatively determines otherwise. Liquidity fees would be assessed against redeeming shareholders from their redemption proceeds and paid to the fund. The fees and gates amendments apply to all money market funds except Government Money Market Funds, which are permitted, but not required, to impose fees and gates.<sup>6</sup>

- Liquidity Fees
  - A fund may impose a liquidity fee of up to 2% on all redemptions if (i) the fund’s weekly liquid assets falls below 30% of its total assets and (ii) the fund’s board of directors (including a majority of its independent directors) determines that it is in the best interests of the fund to impose such a liquidity fee (“Discretionary Liquidity Fee”).
    - Such a Discretionary Liquidity Fee will be charged until the earlier of: (i) the beginning of the next business day following a business day that ended with the fund’s weekly liquid assets at 30% or more of its total assets; or (ii) until the board of the fund (including a majority of its independent directors) determines that is in the best interests of the fund to cease charging the Discretionary Liquidity Fee.
  - A fund must impose a 1% liquidity fee on all redemptions if its weekly liquid assets falls below 10% of its total assets, unless the board of directors (including a majority of its independent directors) determines that imposing such fee would not in the best interests of the fund (“Default Liquidity Fee”). The board (including a majority of its independent directors) may decide that, in such circumstances, it would be in the best interests to impose a lower or a higher Default Liquidity Fee; however, the fee may not exceed 2%. If the fund imposes a Default Liquidity Fee that differs from the 1%, the board (including a majority of its independent directors) may vary the fee at any time if it determines that it would be in the best interests of the fund. A Default Liquidity Fee will be charged until the earlier of: (i) the beginning of the next business day following a business day that ended with the fund’s weekly liquid assets at 30% or more of its total assets; or (ii) until the board of the fund (including a majority of its independent directors) determines that is in the best interests of the fund to cease charging the Default Liquidity Fee.
- Gates
  - A fund may temporarily suspend redemptions (“gate”), if (i) the fund’s weekly liquid assets falls below 30% of its total assets and (ii) if the fund’s board of directors (including a majority of its independent directors) determines that it is in the best interests of the fund to impose such a gate.
    - Such gate must be lifted at the earlier of: (i) the beginning of the next business day following a business day that ended with the fund’s weekly liquid assets at 30% or more of its total assets; (ii) such time as the board of the fund (including a majority of its independent directors) determines that is in the best interests of the fund to remove the gate; or (iii) the beginning of the next business day following ten business days after the gate was imposed.

- A fund may not suspend redemptions for more than ten business days in any rolling ninety calendar day period.

As stated in the Adopting Release, the fees and gates amendments “allow a fund board the flexibility to determine when a restriction is necessary, and thus allows the board to trigger the fee or gate based on current market conditions and the specific circumstances of the fund.”<sup>7</sup> The Adopting Release further notes that while a fund’s adviser will provide information for the directors to use in their determination, the adviser is not charged with any specific duties under these amendments. Nevertheless, the Adopting Release also states that the adviser, as a fiduciary of the fund, should provide the board with any information it needs in its analysis.

The amendments provide a “best interests” standard for a board to use in determining whether to impose the fees and gates, and if so, in the case of fees, what level of fee. While the Adopting Release did not proscribe a list of factors that boards should consider in making this finding, it did provide its views as to “certain guideposts” to assist boards in their analysis. According to these “guideposts,” a board may want to consider the following factors:

- Relevant indicators of liquidity stress in the markets and why the weekly liquid assets of the fund have fallen (*e.g.*, is the fund experiencing large redemptions in a time of financial stress or did a few large shareholders redeem shares unrelated to market conditions);
- The liquidity profile of the fund and expectations as to how the profile might change in the immediate future, including any expectations as to how quickly a fund’s liquidity may decline and whether the drop in weekly liquid assets is likely to be very short-term (*e.g.*, cured in the next few days when securities currently held in the portfolio will qualify as weekly liquid assets);
- For Retail Money Market Funds and Government Money Market Funds, whether the fall in weekly liquid assets has been accompanied by a decline in the fund’s shadow price<sup>8</sup>;
- The make-up of the fund’s shareholder base and previous shareholder redemption patterns; and/or
- The fund’s experience, if any, with the imposition of fees and/or gates in the past.

The SEC has also outlined factors that boards may want to consider when determining the level of liquidity fee to implement, which may include, but are not limited to:

- Changes in spreads for portfolio securities (based on actual sales, dealer quotes, pricing, vendor mark-to-model or matrix pricing, or otherwise);
- The maturity of the fund’s portfolio securities;
- Changes in the liquidity profile of the fund in response to redemptions and expectations regarding that profile in the immediate future;
- Whether the fund and its intermediaries are capable of rapidly putting in place a fee of a different amount from a previously set discretionary or default liquidity fee;

- If the fund is a floating rate NAV fund (non-government Institutional Money Market Fund), the extent to which liquidity costs are already built into the NAV of the fund; and
- The fund's experience, if any, with the imposition of fees in the past.<sup>9</sup>

### III. Floating NAV

In addition to the fees and gates amendments discussed above, the Adopting Release also sets forth amendments to Rule 2a-7 to now prohibit institutional non-government money market funds ("Institutional Prime and Institutional Tax-Exempt Money Market Funds") from maintaining a stable price by using amortized cost valuation and/or penny rounding pricing. Institutional Prime and Institutional Tax-Exempt Money Market Funds are now required to value their securities using market-based factors, and investors will purchase and redeem shares based on a floating NAV. All such funds will process transactions out to four decimal places in the case of a fund with a \$1.00 target share price or the equivalent, or a more precise level of accuracy for a money market fund with a different share price. The Adopting Release notes that this "basis point rounding" to the nearest 1/100th differs from the 1/10th basis point rounding ("10 basis point rounding") required for non-money market funds.

Importantly, Retail and Government Money Market Funds will be able to continue maintaining a stable NAV by using amortized cost and/or the penny-rounding method of pricing.<sup>10</sup> As a result, Government Money Market Funds may continue to be offered to institutional investors who are unwilling or unable to invest in a floating NAV product.

#### Exemptive Relief to Restructure Money Market Funds in Light of the Amendments

If a money market fund has separate classes of the same fund that it offers to retail and institutional investors or offers a single class to both types of shareholders, such fund will need to reorganize into two separate money market funds.<sup>11</sup> The Adopting Release notes that, notwithstanding the prohibitions in Sections 17(a), 18(f)(1) and 18(i) of the 1940 Act, in order to separate retail and institutional money market funds when implementing these amendments, the SEC is of the view that a reorganization of a class of a fund into a new fund may take place without separate exemptive relief, provided that the 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.<sup>12</sup> However, the Adopting Release notes that the SEC believes a fund will only choose to rely on this exemptive relief to separate an existing share class into a new fund where the fund's adviser believes it would result in cost savings as compared with the costs of establishing entirely new funds.

#### Operational Implications of Floating NAV

From an operational standpoint, the Adopting Release acknowledges that Institutional Prime and Institutional Tax-Exempt Money Market Funds, intermediaries and shareholders will likely incur significant costs in order for systems to be modified to accommodate pricing and transacting money market fund shares rounded to four decimal places since currently, virtually all mutual funds round their NAV to the nearest penny. The Adopting Release also acknowledges that, to the extent intermediaries determine to continue offering sweep accounts with Institutional Prime and Institutional Tax-Exempt Money Market Funds as an investment option, there would be significant operations costs in order to adapt sweep platforms to be able to accommodate a floating NAV product.



## Tax and Accounting Implications of Floating NAV

In connection with the adoption of the floating NAV amendment for Institutional Prime and Institutional Tax-Exempt Money Market Funds, the Treasury Department and the Internal Revenue Service ("IRS") on July 23, 2014, issued a Notice of Proposed Rulemaking<sup>13</sup> that would provide for a simplified method of tax accounting for shareholders of floating NAV money market funds under the Internal Revenue Code ("NAV method"). The NAV method would allow investors to calculate gains and losses by calculating the change in aggregate value of the money market fund shares over a specified period of time rather than on each separate purchase and sale.<sup>14</sup> The comment period for this proposal will end 90 days from the publication in the Federal Register.

The Treasury Department and IRS also concurrently adopted a Revenue Procedure that provides that the IRS will not apply the wash sale rule to floating NAV money market funds that are regulated under Rule 2a-7.<sup>15</sup>

## Rule 10b-10 Confirmations

Rule 10b-10 under the Securities Exchange Act of 1934 provides that broker-dealers must provide customers with information relating to their investment decisions at or before the completion of a securities transaction. Rule 10b-10(b), however, provides an exception for certain transactions in money market funds that attempt to maintain a stable NAV and where no sales load or redemption fee is charged. This exception allows broker-dealers to provide transaction confirmations to investors in money market funds on a monthly basis, if certain conditions are met, rather than provide immediate confirmations on all purchase and sale transactions in such funds. Since Institutional Prime and Tax-Exempt Money Market Funds will no longer have a stable NAV, broker-dealers will no longer have such relief; however, the SEC has also, at the same time as issuing the Adopting Release, provided notice and requested comment on a proposed order that, subject to certain conditions, will grant exemptive relief from the immediate confirmation delivery requirements of Rule 10b-10 for transactions effected in shares of any open-end investment management company registered under the 1940 Act that holds itself out as a money market fund and operates in compliance with Rule 2a-7(c)(1).<sup>16</sup>

## **IV. Stronger Diversification Requirements and Enhanced Stress Testing**

### Issuer Diversification

The rule amendments make the following changes to certain diversification requirements of Rule 2a-7:

- Certain affiliated entities are now treated as single issuers when applying the 5% issuer diversification limit under Rule 2a-7<sup>17</sup>;
- The sponsors of asset-backed securities ("ABS") are treated as guarantors subject to Rule 2a-7's 10% diversification limit applicable to guarantees and demand features, unless the 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 ABS's quality or liquidity;
- Except for tax-exempt money market funds (including single state funds), eliminate the 25% basket that allowed up to 25% of a fund's assets to be subject to guarantees or demand features from a single institution. Tax-exempt money market funds have such basket limited at 15% of their total assets.

## Stress Testing

Funds will have to test their ability to maintain 10% weekly liquid assets and their ability to minimize principal volatility (and for Retail and Government Money Market Funds, ability to maintain the stable price per share) against certain specified hypothetical events that include but are not limited to: (a) increases in the general level of short-term interest rates, in combination with various levels of shareholder redemptions; (b) a downgrade or default of particular portfolio securities (with varying assumptions about the resulting loss), in combination with various levels of shareholder redemptions; (c) widening of spreads compared to the indexes to which portfolio securities are tied in various sectors of a fund's portfolio, in combination with varying levels of shareholder redemptions; and (d) any additional combinations of events that the adviser deems relevant.

In addition, the adviser's reports to the board must include: the date the test was performed; an assessment of the fund's ability to have invested at least 10% of its assets in weekly liquid assets and to minimize principal volatility (and in the case of a Retail or Government Money Market Fund, to maintain a stable price per share); and an assessment by the adviser of the fund's ability to withstand the events and concurrent occurrences of these events that are reasonably likely to occur within the following year, including any information as may reasonably be necessary for the board to evaluate the stress testing conducted by the adviser and the results of the testing. The adviser must also include a summary of the significant assumptions made when conducting the stress tests.

## **V. Amendments to Disclosure Requirements**

### Required Disclosure Statements

The SEC has adopted amendments to Rule 482 under the Securities Act of 1933 ("1933 Act") and Item 4 of Form N-1A to revise the disclosure statement requirements concerning the risks of investing in money market funds in advertisements or other sales material (including on a fund website) and in the summary section of the prospectus.

#### **Current Disclosure**

##### *All Money Market Funds*

An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

#### **Amended Disclosure**

##### *For Retail Money Market Funds and Government Money Market Funds*

You could lose money by investing in the fund. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it cannot guarantee it will do so. The fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below required minimums because of market conditions or other factors.<sup>18</sup> An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.<sup>19</sup>

##### *For Institutional Prime and Institutional Tax Exempt Money Market Funds*

You could lose money by investing in the fund. Because the share price of the fund will fluctuate, when you sell your shares they may be worth more or less than what you

originally paid for them. The fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.<sup>20</sup>

Certain disclosures will also need to be amended, depending on the category of money market fund.

- Retail Money Market Funds will need to update their disclosure to state that they limit investments to beneficial owners that are natural persons.
- Institutional Prime and Institutional Tax Exempt Money Market Funds will have to update their disclosure regarding tax implications of buying, holding, selling and exchanging fund shares, as well as any other disclosure that is impacted by a floating NAV. Institutional Money Market Funds that transition to a floating NAV may amend their registration statement by either a post-effective amendment or a supplement.
- All money market funds (other than Government Money Market Funds that decide not to rely on fees and gates) must disclose in their registration statements the effects that the potential imposition of fees and gates, including the board's discretionary power to implement such fees and gates, may have on an investor's ability to redeem shares.<sup>21</sup> Any additional disclosure about the operations of fees and/or gates could properly be placed in a fund's statement of additional information ("SAI").
- All money market funds, to the extent applicable, must disclose in their SAI historical occasions in which it has considered or imposed fees and/or gates.<sup>22</sup>

## Website Disclosures

Money market funds will be required to disclose daily on their websites the levels of daily and weekly liquid assets, net shareholder inflows and outflows, and market-based NAVs using basis point rounding.<sup>23</sup> In addition, the imposition of a fee and/or gate and any sponsor support that must be disclosed on Form N-CR (discussed below) must also be disclosed on a fund's website.

## New Form N-CR

Funds will be required to disclose certain events on new Form N-CR within one business day of the triggering event. Triggering events include: portfolio security defaults; sponsor or fund affiliate support<sup>24</sup> (including the amount and reason for such support); the imposition or removal of fees and/or gates; and for Retail and Government Money Market Funds, a decline in the market-based NAV below \$0.9975. Funds will also have to file a follow-up N-CR filing within four business days to give more information about the triggering event. If the event is the imposition of fees and/or gates, the follow-up Form N-CR must disclose a brief discussion of the primary considerations or factors taken into account by the board in its decision to impose (or not impose in the case of weekly liquid assets that have fallen below 10%) a fee or gate.<sup>25</sup>



## Amendments to Form N-MFP

Certain amendments to Form N-MFP reflect the amendments adopted for Rule 2a-7. In addition, they include, among other things:

- Reporting of a fund's NAV per share (and shadow price), daily and weekly liquid assets, and shareholder flows on a weekly basis within the monthly form;
- Whether a security is level 1, level 2 or level 3 in the fair value hierarchy under U.S. GAAP;
- Liquidity and shareholder flow data; and
- Whether a fund's adviser or a third party paid for or waived all or part of its operating expenses or management fees during a given reporting period.

In addition, there will no longer be a 60 day delay in making Form N-MFP publicly available.

## Amendments to Form PF

The Adopting Release also includes amendments to Form PF, which is used by registered investment advisers to report information to the SEC regarding liquidity funds (private funds that seek to maintain a stable NAV or minimize fluctuations in their NAV). Large liquidity fund advisers (registered advisers with \$1 billion or more in combined money market fund and liquidity fund assets) must file, on a quarterly basis, virtually the same information with respect to its holdings as a registered money market fund reports on Form N-MFP.

## **VI. Valuation Guidance<sup>26</sup>**

The Adopting Release recognizes that many money market fund portfolio holdings (*e.g.*, commercial paper, repurchase agreements, CDs) are thinly traded and are therefore valued using "mark-to-model" or "matrix pricing." The Adopting Release further notes that these types of securities should generally not be valued at par or amortized cost based on the expectation that the fund will hold these securities until maturity, unless the fund reasonably expects it could receive approximately that value upon the current sale of those securities under current market conditions.

The Adopting Release also notes that many funds, including money market funds, use evaluated prices provided by pricing services to assist in the fair valuation of portfolio securities. The SEC states in the Adopting Release that evaluated prices provided by pricing services are not, by themselves, "readily available" market quotations or fair values "as determined in good faith by the board of directors" as required under the 1940 Act. Therefore, the SEC gives the below guidance on a board's responsibilities when utilizing a pricing service to assist in fair valuation.

We note that a fund's board of directors has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security. In addition, we have stated that "it is incumbent upon the [fund's] board of directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered," and that fund directors "must . . . continuously review the appropriateness of the method used in valuing each issue of security in the [fund's] portfolio." Although a fund's directors cannot delegate their statutory duty to determine the fair value of fund portfolio

securities for which market quotations are not readily available, the board may appoint others, such as the fund's investment adviser or a valuation committee, to assist them in determining fair value, and to make the actual calculations pursuant to the fair valuation methodologies previously approved by the directors.

Before deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities, the fund's board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change. In choosing a particular pricing service, a fund's board may want to assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value. In addition, the fund's board should generally consider the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities where, for example, the fund's board of directors does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions.<sup>27</sup>

## ***Compliance Dates***

The compliance date for the floating NAV and liquidity fees and gates amendments is October 14, 2016. The compliance date for new Form N-CR is July 14, 2015 and the compliance date for the diversification, stress testing, disclosure, Form PF, Form N-MFP, and clarifying amendments is April 14, 2016.

## **Re-Proposal**

The SEC has re-proposed amendments to Rule 2a-7 and Form N-MFP to remove references to credit ratings.<sup>28</sup>

The Re-proposal would affect the following provisions of Rule 2a-7: (i) determination of whether a security is an eligible security and the distinction between first and second tier securities, (ii) credit quality standards for securities with a conditional demand feature, (iii) requirements for monitoring securities for ratings downgrades and other credit events and (iv) stress testing.

The Re-proposal would amend the definition of "eligible security" to remove references to credit ratings provided by nationally recognized statistical rating organizations (NRSROs) and to redefine it to be: a security with a remaining maturity of 397 calendar days or less that a money market fund's board of directors (or its delegate) determines presents minimal credit risks, which determination includes a finding that the security's issuer has an exceptionally strong capacity to meet its short-term obligations.<sup>29</sup>

With respect to securities with a conditional demand feature, the Re-proposal states that references to NRSRO ratings would be replaced with a requirement that a money market fund's board of directors (or its delegate) evaluate the long-term risk of the underlying security and determine that it "has a very strong capacity for payment of its financial commitments."<sup>30</sup>

The Re-proposal also states that references to credit rating downgrades would be removed from the “stress test” requirements by replacing the hypothetical event of a downgrade with a requirement that money market funds stress test for an event indicating or evidencing credit deterioration of particular portfolio security positions. The proposed rule amendments would describe the types of hypothetical events money market funds should stress test for, including downgrades or defaults as examples.

The Re-proposal also includes amendments to Form N-MFP to require money market funds to disclose, for each portfolio security, (1) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO’s services, as well as the name of the agency providing the rating and (2) any other NRSRO rating that the fund’s board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.

The Re-proposal also includes amendments to the diversification requirements under Rule 2a-7 which would eliminate an exclusion that is currently available for securities subject to guarantees issued by a non-controlled person (i.e., a person not controlling, controlled by or under common control with the issuer of the security subject to the guarantee). Currently, under Rule 2a-7, money market funds may not invest more than 5% of their total assets in any one issuer and they must limit investments in securities subject to a demand feature or a guarantee to no more than 10% of their total assets from any one institution. Therefore, although Rule 2a-7 requires diversification with respect to providers of guarantees or demand features, it does not require diversification with respect to issuers of securities that are guaranteed by a non-controlled person. The Re-proposal would eliminate this exclusion by requiring money market funds that invest in securities subject to guarantees to comply with the 5% diversification requirement for issuers.

Comments on the Re-proposal are due 60 days after publication in the Federal Register.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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- <sup>1</sup> See Investment Company Act Release No. IC-31166 (July 23, 2014) (the "Adopting Release").
  - <sup>2</sup> The Adopting Release notes that "beneficial ownership" typically means having voting and/or investment power.
  - <sup>3</sup> The SEC notes that although it is the fund's obligation to satisfy the retail fund definition, an intermediary could nonetheless be held liable for violations of other federal securities laws, including the antifraud provisions, where institutional investors are improperly funneled into retail funds.
  - <sup>4</sup> A Government Money Market Fund may invest up to 0.5% of its total assets in non-government assets which would include all "eligible securities" permitted under Rule 2a-7 other than cash, government securities, and/or repurchase agreements that are collateralized fully.
  - <sup>5</sup> The Adopting Release notes that if a Government Money Market wishes to implement fees and gates, and it is not currently disclosed to shareholders, that at least 60 days written notice of the change would be appropriate.
  - <sup>6</sup> With respect to any money market fund that is a feeder fund in a master/feeder structure, amended Rule 2a-7(c)(2)(v) does not allow a feeder fund to impose fees and/or gates, but if the master fund in which such feeder fund invests imposes fees and/or gates, the feeder fund shall pass the same onto its investors.
  - <sup>7</sup> Adopting Release, page 78.
  - <sup>8</sup> Board of non-government Institutional Money Market Funds may want to consider any drops in the fund's NAV.

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- <sup>9</sup> In order to implement the fees and gates proposals, the SEC adopted certain technical rule amendments, including amendments to Rule 22e-3 to permit (but not require) the permanent suspension of redemptions and liquidations of a money market fund if the fund's level of weekly liquid assets falls below 10% of its total assets (this amendment will apply to all money market funds, not just those that maintain a stable NAV). In addition, Retail Money Market Funds and Government Money Market Funds will continue to be able to suspend redemptions and liquidate the fund if the board determines that the deviation between its amortized cost price per share and its market-based NAV per share may result in material dilution or other unfair results to investors or existing shareholders.
- In addition, Rule 2a-7 has been amended to clarify that, notwithstanding Section 27(i) of the 1940 Act, a variable insurance contract issued by a registered separate account funding variable insurance contracts or the sponsoring insurance company of such separate account may apply a liquidity fee or temporary suspension of redemptions pursuant to Rule 2a-7(c)(2) to contract owners who allocate all or a portion of their contract value to a subaccount of the separate account that is either a money market fund or that invests all of its assets in shares of a money market fund.
- <sup>10</sup> In the "Guidance on the Amortized Cost Method of Valuation and Other Valuation Concerns" section of the Adopting Release, the SEC notes that all registered investment companies (including floating NAV money market funds) 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. Additionally existing credit, liquidity or interest rate conditions as well as issuer specific circumstances must be taken into account.
- <sup>11</sup> The Adopting Release notes that because each series of a series investment company is a separate investment company, the retail money market fund and institutional money market fund may each be a separate series of the same corporation or trust.
- <sup>12</sup> As part of complying with the new amendments to Rule 2a-7, the SEC's position is that notwithstanding section 22(e) of the 1940 Act, during a one time reorganization to distinguish between retail and institutional money market funds (either in separating classes into new funds or ensuring that an existing fund only has retail or institutional investors), a fund may involuntarily redeem investors who no longer meet that fund's eligibility requirements without separate exemptive relief, provided that the fund notifies in writing such investors who become ineligible to invest at least 60 days before the redemption occurs.
- <sup>13</sup> Method of Accounting for Gains and Losses on Shares in Certain Money Market Funds; Broker Returns with Respect to Sales of Shares in Money Market Funds. 79 FR 43694. July 28, 2014.
- <sup>14</sup> Under the proposed NAV method, gains and losses in a floating NAV money market fund would generally equal (i) the aggregate fair market value of the investor's shares in the fund at the end of the computation period, (ii) minus the aggregate fair market value of the investor's shares in the fund at the end of the prior period, (iii) minus the investor's "net investment" in the fund. "Net investment" is equal to the aggregate cost of shares purchase during the period (including reinvested dividends) minus the aggregate amount received upon taxable redemptions during the same period. The computation period can be the investor's taxable year or any shorter period, as long as the computation periods are of equal duration and contain days from only one taxable year.
- <sup>15</sup> IRS Rev. Proc. 2014-45.
- <sup>16</sup> See Notice of Proposed Exemptive Order Granting Permanent Exemptions Under the Securities Exchange Act of 1934 from the Confirmation Requirements of Exchange Act Rule 10b-10 for Certain Money Market Funds, Exchange Act Release No. 34-72658 (July 23, 2014).
- <sup>17</sup> Amended Rule 2a-7(d)(3)(ii)(F)—entities are affiliated with one another if one controls the other entity or is controlled by it or is under common control with it; provided that "control" for this purpose means ownership of more than 50% of the issuer's voting securities.
- <sup>18</sup> Government Money Market Funds that do not choose to be subject to fees and gates may omit this sentence.
- <sup>19</sup> If an affiliated person, promoter, or principal underwriter of the fund, or an affiliated person of such person has contractually committed to provide financial support to the fund, the fund would be permitted to omit this sentence from advertisements and sales materials during the term of the agreement. In addition, if they have contractually committed to such arrangement for at least one year from the effective date of the fund's registration statement, they can omit this sentence from the prospectus.



- <sup>20</sup> As with Retail and Government Money Market Funds, this sentence may be omitted if there is a contractual agreement in place as discussed in footnote 19 above.
- <sup>21</sup> The SEC believes the funds would generally disclose the following information in a prospectus: (1) when a fund may impose a fee and/or a gate and the amount of such fee; (2) how shareholders would be notified about the imposition of a fund and/or gate (*e.g.*, press release, website announcement); (3) timing of the imposition and lifting of the fees and gates, including (a) an explanation that if a fund's weekly liquid assets fall below 10% of its total assets at the end of any business day, the next business day it must impose a 1% liquidity fee on shareholder redemptions unless the fund's board of directors determines that doing otherwise is in the best interests of the fund, (b) an explanation that if a fund's weekly liquid assets fall below 30% of its total assets, it may impose fees or gates as early as the same day, and (c) an explanation of the 10 business day limit for imposing gates; (iii) use of fee proceeds by the fund, including any possible return to shareholders in the form of a distribution; (iv) the tax consequences to the fund and its shareholders of the fund's receipt of liquidity fees; and (v) general description of the process of fund liquidation if the fund's weekly liquid assets fall below 10%, and the fund's board of directors determines that it would not be in the best interests of the fund to continue operating.
- <sup>22</sup> Funds would be required to disclose any occasion during the last 10 years (but not before the compliance date for these amendments) on which (i) the fund's weekly liquid assets fell below 10% and for each occasion whether the fund's board determined to impose a liquidity fee and/or suspend redemptions. Funds will also have to disclose in their SAI historical instances in which the fund's sponsor or fund affiliate has provided financial support during the last 10 years (but not before these amendments went into effect).
- <sup>23</sup> Funds will also have to keep six months of historical information on their websites.
- <sup>24</sup> "Financial support" is defined to include (i) any capital contribution, (ii) purchase of a security from the fund in reliance on Rule 17a-9 of the 1940 Act, (iii) purchase of any defaulted or devalued security at par, (iv) execution of a letter of credit or a letter of indemnity, (v) capital support agreement (whether or not the fund ultimately received support), (vi) performance guarantee, (vii) or any other similar action reasonably intended to increase or stabilize the value or liquidity of the fund's portfolio; excluding, however, 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) any 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.
- <sup>25</sup> The SEC cautions funds to avoid "boilerplate" summaries of all possible factors in addition to or in place of a more substantive narrative discussion.
- <sup>26</sup> While the Adopting Release relates specifically to money market funds, the SEC took an opportunity to issue some valuation guidance that is applicable to all registered investment companies.
- <sup>27</sup> Adopting Release at pgs. 286-288.
- <sup>28</sup> See Investment Company Act Release No. IC-31184 (July 23, 2014) (the "Re-proposal").
- <sup>29</sup> This single standard would eliminate the current distinction between first and second tier securities under Rule 2a-7 and therefore the SEC also is proposing to remove the current prohibition on money market funds from investing more than 3% of their assets in second tier securities. However, the SEC stated in the Re-proposal its belief that securities rated in the third-highest rating category would not satisfy the proposed "exceptionally strong capacity" standard and therefore would not be eligible securities under Rule 2a-7.
- <sup>30</sup> Under the Re-proposal, the current requirement for a money market fund's board of directors (or its delegate) to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks would be replaced with the requirement that a money market fund adopt written procedures requiring the fund's adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.