SEC Proposes Reforms for Money Market Funds

On June 5, 2013, the Securities and Exchange Commission (the "SEC") voted unanimously to propose significant new reforms for money market funds ("MMFs") primarily in response to the risk of runs on MMFs during times of economic stress. The unanimous vote by the SEC Commissioners, who were previously divided on the need for MMF reform, signals that some version of the proposal will be adopted in the relative near term.

The lengthy SEC proposing release (covering nearly 700 pages) covers many technical areas of MMF regulation that go beyond the coverage and scope of this alert.[1] The key feature, however, proposes two alternative amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the "1940 Act"), either of which would take the significant step of prohibiting all MMFs from using the amortized cost method to value their portfolios[2] for purposes of maintaining a stable share price (*e.g.*, $1.00 per share). All MMFs would instead be required to calculate daily net asset value ("NAV") per share using market prices of portfolio holdings, together with an NAV rounding component. The full text of the SEC's proposing release can be found here.

Floating NAV Proposal (for Non-Government Institutional MMFs)

- The first alternative (the "Floating NAV Proposal") would require that prime/non-government "institutional" MMFs operate with a floating, market-based NAV rounded to the fourth decimal place (*e.g.*, $1.0004 or $0.9997) in the case of a fund with a $1.00 target share price or an equivalent level of precision (*i.e.*, rounded to the nearest 0.01%) if a fund prices its shares at a different target price.

- The Floating NAV Proposal would not apply to "government" or "retail" MMFs. Although these types of MMFs could no longer use amortized cost to value their portfolios, they could continue to round NAVs to the nearest penny (the "penny-rounding method" under Rule 2a-7), thereby allowing "government" and "retail" MMFs to continue to sell and redeem shares at a constant $1.00 per share under normal circumstances.

- "Government" MMFs would be defined as funds that invest at least 80% or more of their assets in cash, government securities and/or repurchase agreements that are fully collateralized.

- "Retail" MMFs would be defined as funds that limit each shareholder's redemptions to no more than $1 million for each business day.[3] A retail MMF would also include a fund that allows a shareholder to redeem more than $1 million in a single business day if the shareholder is a broker, dealer, bank or other person that holds securities issued by the fund in nominee name (an "omnibus account holder") and if the fund has policies and procedures reasonably designed to allow the fund to conclude that the omnibus account holder does not permit any beneficial owner, or the omnibus account holder itself investing for its own account, to redeem, directly or indirectly, more than $1

[1] For example, this alert does not address the tax or accounting implications, which are discussed in the SEC's proposing release, of certain parts of the proposal. The proposing release does suggest that certain of these implications could be lessened if the U.S. Department of the Treasury and the Internal Revenue Service make conforming changes to current rules or regulations.
[2] The proposal would continue to allow MMFs to use amortized cost to value securities maturing within 60 days, as is allowed for all mutual funds.
[3] This alert refers to MMFs that are not "retail" as "institutional" MMFs.

million in a single day.[4] In its proposing release, the SEC states that a retail exemption could also include a provision permitting an investor to redeem in excess of the fund's daily redemption limit, provided the investor gives advance notice of the investor's intent to redeem in excess of the limit.

- The SEC acknowledges in its release that MMFs often have separate share classes for different types of investors. Thus, one practical implication for many MMFs is that if a fund wishes to offer a stable NAV to retail investors while allowing redemptions for institutional investors above the $1 million daily limit, the fund must reorganize the share classes into separate funds.

Fees and Gates Proposal

- The second alternative (the "Fees and Gates Proposal") would require that MMFs (other than government MMFs as noted below) impose a 2% liquidity fee on future redemptions if a fund's weekly liquid assets[5] fall below 15% of its total assets, unless the fund's board determines that it is in the fund's best interest not to impose the liquidity fee or to impose a lower fee. Any such liquidity fee imposed would be lifted automatically once the MMF's weekly liquid assets rise to or above 30% and could be lifted at any time by the board.

- The Fees and Gates Proposal would also give the board authority to temporarily suspend redemptions for up to 30 days (so-called "redemption gates") if a fund's weekly liquid assets fall below 15% of its total assets, provided the board determines that doing so would be in the best interests of the fund.

- Although the Fees and Gates Proposal sets forth certain maximum liquidity fees and triggers for redemption gates, the proposal would ultimately give boards of MMFs broad discretion in setting such fees or implementing such gates.

- Government MMFs (retail or institutional) would be exempt from the requirements of the Fees and Gates Proposal, but would be permitted to impose liquidity fees and/or redemption gates in the circumstances described above if the ability to do so is disclosed in the government MMF's prospectus.

- Under the Fees and Gates Proposal, all MMFs, including non-government institutional MMFs, could use the penny-rounding method to maintain a stable $1.00 share price under normal circumstances, but could no longer generally use the amortized cost method to calculate NAVs.

The proposing release clearly contemplates that the SEC could adopt either alternative or a combination of both and asked for comment as to the benefits and costs of instead moving forward with a single combined approach with elements of both the Floating NAV Proposal and the Fees and Gates Proposal.

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[4] The SEC states in its proposing release that methods of verification could include agreements with the omnibus account holders or certifications from omnibus account holders to allow the fund to reasonably conclude that an omnibus account holder is not permitting any beneficial owner to redeem more than $1 million per business day.

[5] "Weekly liquid assets" generally include cash, direct obligations of the U.S. government, certain other government securities that are issued at a discount to the principal amount to be repaid at maturity without provision for the payment of interest and have remaining maturities of 60 days or less, and securities that convert into cash within one week.

Other Proposed Reforms

Regardless of whether the Floating NAV Proposal and/or the Fees and Gates Proposal is adopted, the SEC proposal would institute other important reforms for MMFs, including additional disclosure and reporting requirements, tightening of diversification requirements and enhanced stress testing requirements, a number of which are summarized below.

Amendments to Disclosure Requirements. Both the Floating NAV Proposal and the Fees and Gates Proposal include amendments to Rule 482 under the Securities Act of 1933, as amended,[6] and to Form N-1A regarding additional disclosure relating to the effect of the proposal on MMFs. With respect to the Fees and Gates Proposal, the imposition of liquidity fees and redemption gates would require prompt public disclosure, and the proposal would require an MMF to post prominently on its website certain information about the imposition of liquidity fees and redemption gates that the MMF would be required to report to the SEC on new Form N-CR, as discussed below. Imposition of liquidity fees and redemption gates would also require the MMF to supplement its prospectus promptly after the MMF imposes a liquidity fee or redemption gate.

The proposal would also amend Rule 2a-7 and Form N-1A to require enhanced registration statement and website disclosure about any type of financial support provided to an MMF by the fund's sponsor or an affiliated person of the MMF. The proposal also would require disclosure on an MMF's website of its daily and weekly liquidity levels as well as the fund's net inflows or outflows (on a daily basis). In addition, all MMFs, including stable price MMFs, would be required to calculate and post on their websites on a daily basis their market value-based NAV per share rounded to the fourth decimal place for funds with a $1.0000 target share price (or an equivalent level of precision for funds with a different target share price). These amendments would complement the current requirement for an MMF to disclose its "shadow price" monthly on Form N-MFP.

New Form N-CR. The proposal includes a new rule that would require MMFs to file a new Form N-CR with the SEC when certain events occur. Such events include the imposition or lifting of liquidity fees or redemption gates, portfolio security default, sponsor support of funds, a decline in the MMF's NAV below $0.9975 for MMFs that continue to maintain a stable share price, and other similar significant events.

Amendments to Form N-MFP Reporting Requirements. The proposal includes modifications to Form N-MFP in order to reflect the amendments to Rule 2a-7 discussed above, as well as to request additional information designed to help the SEC and investors better identify MMF portfolio securities and certain risk characteristics that the form currently does not capture. Additionally, the proposal would eliminate the current 60-day delay on public availability of the information filed on Form N-MFP and would make it available to the public immediately.

Amendments to Form PF Reporting Requirements. The proposed amendments to Form PF apply to large liquidity fund advisers, which are generally SEC-registered investment advisers that advise at least one liquidity fund and manage, collectively with their related persons, at least $1 billion in combined liquidity fund and MMF assets. For purposes of Form PF, a liquidity fund is any private fund that seeks to generate income by investing in a portfolio of short term obligations in order to maintain a stable NAV per unit or minimize principal volatility for investors. The proposal would require a large liquidity fund adviser to provide

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[6] Rule 482 applies to advertisements or other sales materials with respect to securities of an investment company registered under the 1940 Act that is selling or proposing to sell its securities pursuant to a registration statement that has been filed under the 1940 Act.

quarterly, for each liquidity fund it manages and with respect to each portfolio security, virtually the same information with respect to its liquidity funds' portfolio holdings on Form PF as MMFs are required to provide on Form N-MFP.

Diversification. Generally, other than with respect to 25% of the value of securities held in the MMF's portfolio (the "25% basket"), MMFs must limit their investments in the securities of any one issuer of a first tier security (other than government securities) to no more than 5% of fund assets and must limit their investments in securities subject to a demand feature or a guarantee from any one provider to no more than 10% of fund assets. In order to tighten the diversification requirements in Rule 2a-7, the proposal would: (i) require MMFs to treat certain entities that are affiliated as a single issuer when applying Rule 2a-7's 5% issuer diversification requirement; (ii) require funds to treat the sponsors of asset-backed securities as guarantors subject to Rule 2a-7's diversification requirements unless the board makes certain findings; and (iii) eliminate the 25% basket, such that the 5%/10% limitations noted above would apply to the entire MMF portfolio.

Stress Testing. The proposal also includes a variety of amendments and enhancements to stress testing requirements. Currently, MMFs are required to adopt procedures providing for periodic testing of the fund's ability to maintain a stable price per share assuming the occurrence of certain events, including a change in short-term interest rates, an increase in redemptions, a downgrade of or default on portfolio securities, and the widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. If the Floating NAV Proposal is adopted, a non-government institutional MMF would also need to test the impact of such market events on the potential for the MMF's level of weekly liquid assets to fall below 15% of its total assets, and a government or retail MMF would be required to stress test the effect of such market events on both its ability to avoid having its weekly liquid assets fall below 15% of its total assets and its ability to maintain a stable share price. If the Fees and Gates Proposal is adopted, MMFs would need to stress test against the potential for a MMF's level of weekly liquid assets to fall below 15% of its total assets, in addition to stress testing against the fund's ability to maintain a stable share price. Enhancements aimed at strengthening how MMFs stress test their portfolios and report the result of stress tests to their boards were also proposed.

Compliance Dates and Comments

The SEC proposed the following compliance dates for the proposal: two years after the effective date of the adoption of any amendments specifically relating to the Floating NAV Proposal, one year after the effective date of the adoption of any amendments specifically relating to the Fees and Gates Proposal, and a general compliance date of nine months after the effective date of adoption for all other amendments to MMF regulation not specifically relating to either the Floating NAV Proposal or the Fees and Gates Proposal. As the topic of MMF reform has been the subject of substantial debate among regulators and within the industry, we expect there to be a substantial number of comments to the proposal from various industry participants and other interested parties. Comments to the proposal are due to the SEC 90 days after the proposal is published in the Federal Register.

If you would like to learn more about the developments discussed in this Alert, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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