SEC Adopts Reforms for Money Market Funds

On July 23, 2014, the Securities and Exchange Commission (the "SEC") voted three-to-two to adopt significant new reforms for money market funds ("MMFs") (the "Final Rule"). The reforms are intended to reduce the susceptibility of MMFs to heavy redemptions during times of economic stress, mitigate potential contagion to the financial system stemming from such redemptions, increase the transparency of the risks of MMFs, and according to the SEC, preserve, "as much as possible," the benefits currently afforded by MMFs.

The lengthy SEC adopting release (covering more than 850 pages) covers many technical areas of MMF regulation.[1] Key features of the Final Rule include amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the "1940 Act"), that require institutional prime MMFs to use a floating NAV, impose default liquidity fees on non-governmental MMFs when certain conditions are present (unless the board determines otherwise), and give MMFs the flexibility to institute liquidity fees and/or redemption gates under certain conditions if the board determines they are in the best interest of the fund. The full text of the SEC's adopting release can be found here.[2] A chart comparing certain key features of the Final Rule with the SEC's Proposed Rule[3] issued on June 19, 2013, is attached as Appendix A.

Floating NAV

- The Final Rule requires that prime (*i.e.*, 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 if a fund prices its shares at a different target price (the "Floating NAV Rule"). This important and controversial feature eliminates the long-standing ability of this category of MMFs to maintain a stable \$1.00 share price.

- The Floating NAV Rule does not apply to "government" or "retail" MMFs.

- "Retail" MMFs are defined as MMFs that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. This represents a significant departure from the proposed rules, in which the SEC had proposed to define "retail" MMFs as those that limit daily redemptions to \$1 million per investor. The SEC opted for this new formulation which limits investors to natural persons in response to industry concerns regarding operational difficulties that would have resulted from the proposed formulation. One implication of the new formulation is that a non-government MMF that has both retail and institutional investors will have to reorganize in some way in order to allow retail investors in the MMF to continue to invest in a stable NAV MMF. See "Fund Reorganizations to Avoid Floating NAV Requirements" below.

- Retail and government MMFs are permitted to continue to use the amortized cost method or round their NAVs to the nearest penny (the "penny-rounding method") under Rule 2a-7, thereby allowing

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[1] This alert does not address tax or accounting implications, some of which are mentioned in the Final Rule adopting release. The adopting release notes that the U.S. Department of the Treasury and the Internal Revenue Service have released proposed rule-making which they indicate would, if adopted, alleviate or mitigate many of the tax-based concerns regarding the new regulations. Information concerning these developments can be found here.
[2] The SEC is also re-proposing, with certain amendments, a rule which was initially proposed in March 2011 related to the removal of credit rating references in Rule 2a-7, which includes proposed amendments to Rule 2a-7's issuer diversification provisions. The proposed amendments, a copy of which can be found here, would eliminate an exclusion from these provisions currently available for securities subject to a guarantee issued by a non-controlled person.
[3] Our alert discussing the Proposed Rule can be found here.

government and retail MMFs to continue to sell and redeem shares at a stable $1.00 per share under normal circumstances. Government MMFs are defined as MMFs that invest at least 99.5% or more of their assets in cash, government securities and/or repurchase agreements that are fully collateralized with cash or government securities.

- Government MMFs (both retail and institutional)[4] are exempt from the Final Rule's mandatory liquidity fees and redemption gates provisions (discussed below), but are permitted to impose liquidity fees and/or redemption gates in the circumstances described below if disclosed in the government MMF's prospectus.

Fees and Gates

- The Final Rule permits the board of any type of MMF to impose liquidity fees – fees assessed on amounts redeemed from the MMF – if a MMF's weekly liquid assets[5] fall below 30% of its total assets. In such circumstances, the fund's board may, if it determines it to be in the best interest of the fund, impose a discretionary liquidity fee on redeeming shareholders up to a maximum of 2% of the redemption amount. Any such liquidity fee imposed must be lifted by the next business day after the MMF's weekly liquid assets equal or exceed 30% and could be lifted at any time by the board.

- In addition, the Final Rule requires that all non-governmental MMFs (whether institutional or retail) must impose a "default" 1% liquidity fee on redemptions if a fund's weekly liquid assets fall below 10% of its total assets, unless the fund's board (i) determines that it is not in the fund's best interest to impose the liquidity fee, or (ii) imposes a lower or higher fee, up to a maximum of 2%, as the board determines to be in the best interest of the fund. Any such liquidity fee would be lifted automatically once the MMF's weekly liquid assets rise to 30% or more of total assets, and could be lifted at any time by the board.

- The Final Rule also gives a MMF board authority to temporarily impose redemption gates (*i.e.*, suspend redemptions) for up to 10 business days if a fund's weekly liquid assets fall below 30% of its total assets, provided the board determines that doing so would be in the best interests of the fund. Once imposed, a fund must lift a suspension of redemptions within 10 business days or once its weekly liquid assets increase above 30% of total assets, whichever is earlier. Further, a fund may not impose a redemption gate for more than a total of 10 business days in any 90-day period.

- A MMF which is a "feeder fund" (*i.e.*, that owns, pursuant to section 12(d)(1)(E) of the 1940 Act, shares of another "master" MMF) may not separately impose liquidity fees or impose redemption gates, and must pass through to its investors any fee or gate on the same terms and conditions as are imposed by the master fund.

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[4] The SEC expressly declined to provide similar treatment to funds that invest primarily in municipal securities.
[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 Topics

The Final Rule institutes 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. The Final Rule includes amendments to Rule 482[6] under the Securities Act of 1933, as amended, and to Form N-1A regarding additional disclosures relating to the risk factors of investing in stable and/or floating NAV MMFs, including the potential imposition of liquidity fees and/or redemption gates. Under the Final Rule, a MMF will be required to post prominently on its website certain information that the MMF will be required to report to the SEC on new Form N-CR, as discussed below, on the same business day that a Form N-CR is filed.

The Final Rule amends Rule 2a-7 and Form N-1A to require enhanced registration statement and website disclosure about any type of financial support provided to a MMF by the fund's sponsor or an affiliated person of the MMF. An MMF is also required to disclose on its website the fund's daily and weekly liquidity levels as well as its net inflows or outflows (on a daily basis). In addition, all MMFs, including stable price MMFs, are 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).

New Form N-CR. The SEC has adopted a new Form N-CR which MMFs must file with the SEC within one business day after certain events occur. Such events include the imposition or lifting of liquidity fees or redemption gates or failure to impose a liquidity fee despite passing certain liquidity thresholds; portfolio security defaults; sponsor support of funds; a decline in the MMF's NAV below $0.9975 for a MMF that maintains a stable share price; and other material events. Among the required disclosures is a description of the primary considerations or factors taken into account by the fund's board in its decision to impose (or not to impose) a liquidity fee or redemption gate in applicable circumstances.

Amendments to Form N-MFP Reporting Requirements. The Final Rule includes modifications to Form N-MFP, the portfolio holdings schedule MMFs are required to file with the SEC. Such filings must be made on a weekly basis under the Final Rule. The changes to this form reflect the amendments to Rule 2a-7 set forth in the Final Rule, and require MMFs to provide additional information intended to help the SEC and investors better identify a MMF portfolio's securities and certain risk characteristics. Additionally, the Final Rule provides that the information filed on Form N-MFP will be made available to the public on the SEC's website immediately after the filing, in contrast to the current 60-day delay before the public availability of such information.

Amendments to Form PF Reporting Requirements. The Final Rule amends Form PF which applies to 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 (*i.e.*, a large liquidity fund adviser). 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.

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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.

Amended Form PF requires a large liquidity fund adviser to provide quarterly, for each liquidity fund it manages and with respect to each portfolio security, virtually the same information with respect to its holdings on Form PF as publicly offered MMFs are required to provide on Form N-MFP.

Diversification. The Final Rule amends Rule 2a-7's current diversification provision which generally provides that, except with respect to 25% of the value of securities held in the MMF's portfolio (the "25% basket"), a MMF must limit its 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 its investments in securities subject to a demand feature or a guarantee from any one provider to no more than 10% of fund assets. For all MMFs, except tax-exempt MMFs, the Final Rule eliminates the 25% basket such that the 5%/10% limitations apply to the fund's entire portfolio. The 25% basket is reduced to 15% for tax-exempt MMFs, including single state MMFs. The Final Rule also tightens these limitations as follows: (i) certain entities that are affiliated are treated as a single issuer when applying Rule 2a-7's 5% issuer diversification requirement; and (ii) sponsors of asset-backed securities are treated as guarantors subject to Rule 2a-7's diversification requirements unless the board determines that the MMF is not relying on the sponsor's financial strength or its ability or willingness to provide liquidity, credit or other support to assess the asset-backed security's quality or liquidity.

Stress Testing. The Final Rule includes a variety of amendments and enhancements to Rule 2a-7's stress testing requirements. Currently, MMFs are required to adopt procedures providing for periodic testing of the fund's ability to maintain a stable share price assuming the occurrence of certain events. The Final Rule expands upon existing requirements by requiring MMFs to periodically test their ability to maintain weekly liquid assets of at least 10% and to minimize principal volatility in response to specified hypothetical events. The hypothetical events include (i) increases in the level of short-term interest rate rates, (ii) downgrades or defaults of particular portfolio positions, each representing various portions of a MMF's portfolio, and (iii) the widening of spreads in various sectors to which the MMF's portfolio is exposed. Each of the hypothetical events is to be tested in combination with varying levels of shareholder redemptions. Under the Final Rule, the stress tests must include any additional combinations of events that may be determined to be relevant by the fund's adviser. Additionally, the Final Rule requires a report be provided to the MMF's board on the results of the stress tests, that includes the dates on which testing was performed, the MMF's ability to have invested at least 10% of its total assets in weekly liquid assets and to minimize principal volatility (and, in the case of a stable NAV MMF, its ability to maintain the stable price per share established by the board of directors), any significant assumptions made when performing the stress tests, and any information as may reasonably be necessary for the board to evaluate the stress testing conducted by the MMF.

Exemptive Relief from Immediate Confirmation Delivery Requirements of Exchange Act Rule 10b-10. The SEC has also filed a Notice of a Proposed Exemptive Order that would permit broker-dealers to continue to rely on the current exception under Rule 10b-10(b) with respect to transactions in floating NAV MMFs. Rule 10b-10(b) permits broker-dealers to provide transaction information to MMF shareholders on a monthly basis (subject to certain conditions set forth in Rule 10b-10(b)(2) and (3)) in lieu of immediate confirmations for all purchases and redemptions of shares of such funds.

Fund Reorganizations to Avoid Floating NAV Requirements. As the SEC noted in the adopting release, a MMF may currently be owned by both retail and institutional investors, and may have separate retail and institutional share classes. To avoid subjecting the retail portion of a non-governmental MMF to a floating NAV, such funds will need to reorganize in some manner into separate MMFs for retail and institutional investors. The SEC acknowledged that such a separation of a MMF may implicate Section 17 and 18 of the

1940 Act, and expressed the view that a reorganization of a class of a MMF into a new MMF may take place without separate exemptive relief, provided that the fund's board of directors, including a majority of the directors who are not interested persons of the fund, 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. However, a reorganization of a fund's retail and institutional share classes into different funds will not work for these purposes if the institutional class includes any natural persons as shareholders, which may well be the case for many MMFs. In such circumstances, other more complicated means of reorganization would need to be pursued.

Valuation Guidance. The SEC also took the opportunity in the adopting release to provide expanded guidance regarding the use of amortized cost valuation and other valuation issues, including fair values for thinly-traded securities and the use of evaluated prices provided by third-party pricing services, which go beyond the scope of this alert.

Compliance Dates and Comments

The SEC adopted the following compliance dates for the Final Rule: two years after the effective date of the adoption of the amendments specifically relating to the Floating NAV Rule and the amendments specifically relating to liquidity fees and redemption gates; 18 months after the effective date of the adoption of the amendments relating to diversification, stress testing, disclosure, Form PF, Form N-MFP and any clarifying amendments; and nine months after the effective date of adoption of Form N-CR.

MMF FINAL RULE ALERT

APPENDIX A

Comparison of Certain Key Features of Proposed and Final Rules

Topic	Proposed Rule	Final Rule
Application of floating NAV	Institutional prime MMFs (excludes government and retail MMFs)	Institutional prime MMFs (excludes government and retail MMFs)
Definition of retail fund	MMFs that limit daily redemptions to no more than $1,000,000	MMFs that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons
Definition of government fund	MMFs that invest at least 80% or more of their assets in cash, government securities and/or repurchase agreements that are fully collateralized	MMFs that invest at least 99.5% or more of their assets in cash, government securities and/or repurchase agreements that are fully collateralized
Redemption gates	Board may suspend redemptions for up to 30 days in a rolling 90 calendar day period if a fund's weekly liquid assets fall below	Board may suspend redemptions for up to 10 business days in a rolling 90 calendar day period if weekly

	15% Gates automatically lifted once the fund's weekly liquid assets increase above 30% of the fund's assets	liquid assets fall below 30% Gates automatically lifted once the fund's weekly liquid assets increase above 30% of the fund's assets
Liquidity fees	Requires imposition of 2% liquidity fee if fund's weekly liquid assets fall below 15% - unless the MMF Board determines that imposing the liquidity fee is not in the fund's best interest	Requires imposition of 1% liquidity fee if fund's weekly liquid assets fall below 10% - unless the MMF Board determines that imposing the liquidity fee is not in the fund's best interest

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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