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A Legal Update from Dechert's Financial Services Group

U.S. SEC Approves Sweeping Amendments to Rules Governing Money Market Funds

The U.S. Securities and Exchange Commission (SEC or Commission) on July 23, 2014 approved, by a vote of 3-2, sweeping amendments to Rule 2a-7 and other rules that govern money market funds (money funds) under the Investment Company Act of 1940 (1940 Act) (Amendments).[1] The Amendments generally combine the two alternatives set forth in the proposing release issued in 2013 (Proposing Release)[2] – (i) requiring "institutional" money funds to operate with a floating net asset value (NAV), rounded to the fourth decimal place (*e.g.*, $1.0000) and (ii) permitting (and, under certain circumstances, requiring) all money funds to impose a "liquidity fee" (up to 2%) and/or "redemption gate," once weekly liquidity levels fall below the required regulatory threshold. At the meeting approving the Amendments, SEC Chair White stated that the Amendments "fundamentally change the way that most money market funds operate [and] will reduce the risk of runs in money market funds and provide important new tools that will help further protect investors and the financial system in a crisis."

The Amendments also included other notable changes, such as tightening the diversification requirements under Rule 2a-7, enhancing disclosure requirements and strengthening the stress testing standards of money fund portfolios. The Amendments also revised Form PF to increase reporting obligations of registered investment advisers to unregistered money funds, which includes requirements for those advisers to disclose the funds' portfolio holdings and certain other information. Finally, the Amendments contained a number of revisions to clarify certain provisions of Rule 2a-7.

This *DechertOnPoint* briefly discusses the background and the events leading up the Amendments and describes each of the reforms made by the Amendments.

Background

During the 2008 financial crisis, the Reserve Primary Fund became the second money fund in history to "break the buck" when its shares dropped from $1.00 to $0.97 in the wake of the Lehman Brothers' bankruptcy. This led to a "flight to quality" as shareholders moved investments out of institutional prime money funds and into government money funds. The redemptions from institutional prime money funds

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

2 *See* Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (June 5, 2013) (Proposing Release). For further information regarding the Proposing Release, please refer to *DechertOnPoin*t, SEC Proposes Sweeping Amendments to Rules Governing Money Market Funds (June 2013).

aggravated a lack of liquidity in the commercial paper market, which some have argued led to further distress in the financial system.

In September 2008, the U.S. Department of the Treasury (Treasury) announced a temporary guarantee program to support money funds and the Board of Governors of the Federal Reserve System authorized a temporary extension of credit to banks to buy money fund assets, providing additional liquidity to money funds. These measures helped stem the tide of redemptions from money funds and alleviated some of the liquidity pressure on the commercial paper market.

In response to the financial crisis, in January 2010 the SEC adopted amendments to Rule 2a-7 and other rules governing money funds (2010 Amendments).[3] These reforms, which incorporated many suggestions made by the Investment Company Institute's Money Market Working Group,[4] included enhanced liquidity requirements and tighter maturity, diversification and credit quality standards for money fund investments. Notwithstanding the breadth of the 2010 Amendments, then-SEC Chairman Schapiro described them at the time as "an important first step in our efforts to strengthen the money market regime."

In 2012, the SEC Staff prepared for the Commission's consideration a proposal that would have required money funds to either: (i) convert to a floating NAV; or (ii) maintain a stable NAV while maintaining a capital buffer and imposing certain restrictions on redemptions (2012 Staff Proposals). However, Chairman Schapiro was unable to reach a consensus with other SEC Commissioners and announced in late August 2012 that the SEC would not be moving forward with the 2012 Staff Proposals.[5]

Prompted by the SEC's failure to act on the 2012 Staff Proposals, on November 13, 2012, the U.S. Financial Stability Oversight Council (FSOC) issued proposed recommendations for action by the SEC under Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) (FSOC Recommendations).[6] The FSOC Recommendations included three alternatives: (i) a floating NAV (together with money funds pricing their shares at $100.00 as opposed to $1.00 per share); (ii) a stable NAV subject to a capital buffer of up to 1% of a money fund's assets combined with a holdback requirement, or minimum balance at risk, applicable to certain redemptions for investors with account balances in excess of $100,000; and (iii) a stable NAV subject to a buffer of 3%. During the FSOC meeting at which the FSOC Recommendations were issued, several members of the FSOC expressed the view that the SEC should adopt its own set of reforms for money funds before the FSOC took further action.

On June 5, 2013, nearly seven months after the FSOC Recommendations were issued, the SEC issued the Proposing Release. Although some aspects of the proposed amendments were similar to those in the 2012 Staff Proposals and the FSOC Recommendations, the SEC indicated that it had considered all available

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3 Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010). For further information regarding the 2010 Amendments, please refer to *DechertOnPoint*, Amendments to the Regulatory Structure Governing Money Market Funds (Mar. 2010).

4 *See* Report of the Money Market Working Group, Investment Company Institute (Mar. 17, 2009).

5 *See* Statement on Money Market Fund Reform by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission (Aug. 22, 2012). For further information regarding the Staff Proposals and the debate surrounding them, please refer to *DechertOnPoint*, SEC Will Not Vote on Money Market Fund Reform (Aug. 2012).

6 *See* Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012). For additional information on the FSOC Recommendations, please refer to *DechertOnPoint*, U.S. Financial Stability Oversight Council Proposes Recommendations for Money Market Fund Reform (Dec. 2012).

options, including comments from the money fund industry as well as possible reforms suggested by the President's Working Group on Financial Markets, which published a report on money market fund reform options in 2010 (PWG Report).[7] The SEC received over 1,400 comments on the Proposing Release and, approximately one year after the Proposing Release was issued, the SEC adopted the Amendments on July 23, 2014.

The Amendments

Liquidity Fees and Redemption Gates

Overview

In order to provide money funds with new tools to help curb heavy redemptions during times of stress, the SEC amended Rule 2a-7 to provide all money funds with the ability to impose liquidity fees (of up to 2%) and/or redemption gates (for up to 10 business days during any 90-day period). Under the Amendments, a money fund board is authorized (although not required) to impose a liquidity fee and/or a redemption gate after a money fund's "weekly liquid assets"[8] have fallen below 30% of its total assets, if the board (including a majority of the independent directors) determines that doing so will be in the best interests of the fund.[9] Moreover, the Amendments *require* a money fund to impose a 1% liquidity fee if the fund's weekly liquid assets fall below 10% of its total assets, unless the board (including a majority of the independent directors) determines that imposing a fee would not be in the best interests of the fund or determines that a lower or higher fee (subject to the 2% cap) would be appropriate. The Amendments also amended Rule 22e-3 to permit a board to permanently suspend redemptions and liquidate a money fund if the fund's weekly liquid assets drop below 10% of its total assets.

A "government" money fund is permitted – *but not required* – to implement liquidity fees and/or redemption gates. However, any government money fund that reserves the authority to impose liquidity fees and/or redemption gates must disclose that authority in its prospectus and must give shareholders at least 60 days notice before reserving that authority.[10] However, the Amendments do *not* exempt "retail" money funds from the requirements regarding liquidity fees and redemption gates. Government and retail money funds are discussed below.

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

8 "Weekly liquid assets" are defined in amended Rule 2a-7(a)(34) and include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, securities that convert into cash within five business days and amounts receivable and due unconditionally within five business days pending sales of portfolio securities.

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

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

Lifting of Fees and Gates

The Amendments require a money fund to lift a liquidity fee and redemption gate automatically after the fund's level of weekly liquid assets rises to or above 30% of its total assets. A money fund may also lift a liquidity fee and redemption gate under any circumstances if the fund's board (including a majority of the independent directors) decides to modify the fee or gate, or determines that the fee or gate is no longer in the best interests of the fund.

Board Considerations

Despite some commenters' requests for additional clarification regarding the factors that a money fund's board should consider when evaluating whether a liquidity fee or redemption gate is in the best interests of the fund, the SEC declined to provide a definitive list of relevant factors.[11] Nevertheless, the Adopting Release provided a non-exhaustive list of "guideposts" that a board should consider. These include:

- relevant indicators of market liquidity stress and reasons why the money fund's weekly liquid assets have fallen;
- the current and expected liquidity profile of the fund;
- whether the fall in weekly liquid assets has been accompanied by a decline in the fund's shadow NAV (for retail and government money funds);
- the composition of the fund's shareholder base and historical shareholder redemption patterns; and
- the fund's experience, if any, with fees and gates.[12]

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

Floating NAV

Overview

Under the Amendments, money funds (other than "government" or "retail" money funds, as defined below)[13] are required to convert to a floating NAV, calculating their market-based NAV per share to the nearest basis

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[11] In addition, although some commenters requested that the Commission explicitly acknowledge that a board's determination would be subject to the business judgment rule, the Commission declined to make such a pronouncement, noting that the business judgment rule is a construct of state law and not the federal securities laws.

[12] The Adopting Release also included a list of factors that a board should consider in determining the *level* of liquidity fees (*e.g.,* changes in spreads for, or maturity of, portfolio securities).

[13] For the purposes of this *DechertOnPoint*, money funds that are required to convert to a floating NAV are referred to as "institutional prime money funds," although they could also include institutional municipal/tax-exempt money funds (municipal money funds) that do not qualify as "retail" money funds. As noted in the Adopting Release, the SEC did not specifically exempt municipal money funds from the floating NAV requirement, explaining that the tax advantages of municipal money funds are primarily applicable to individuals, and that many municipal money funds should be able to qualify under the retail money fund exemption discussed below.

point (*e.g.,* $1.0000, on a share price of $1.00).[14] This level of precision (basis point rounding) is 10 times greater than the level of precision required for other mutual funds and is 100 times greater than the penny rounding method currently utilized by money funds.[15] Government money funds and retail money funds, as discussed below, are exempt from the requirement to convert to a floating NAV and, unlike under the Proposing Release, may continue to use the amortized cost method of valuation[16] and/or penny rounding pricing method[17] to price their shares.

The floating NAV requirement is intended to reduce the perceived "first mover advantage,"[18] which some have credited with contributing to heavy redemptions from institutional prime money funds during the financial crisis, by removing the ability of investors to redeem their shares at $1.00 per share when the shadow NAV of the money fund is below $1.00 per share. The floating NAV requirement also is intended to reduce investor dilution.[19] In addition, the floating NAV requirement is intended to increase the transparency of institutional prime money fund pricing, demonstrating to investors that they, and not fund sponsors or the federal government, will bear the risk of loss. While the SEC conceded that the floating NAV requirement does not address other justifications for redemptions during periods of market stress, including the flight to higher quality assets (*i.e.,* "rational risk management"), the SEC concluded that the liquidity fees and redemption gates portion of the Amendments adequately address these other concerns.

Tax and Accounting Implications of the Floating NAV Requirement

The SEC, in the Proposing Release, noted that there would be several tax consequences associated with the floating NAV requirement. Particularly, the SEC stated that, if institutional prime money funds adopted a floating NAV, those money funds and their investors would be required to track the timing, purchase price and sales price of shareholder transactions, for reporting of capital gains and losses. In addition, as proposed, institutional prime money fund shareholders would be subject to the so called "wash sale" tax rules, generally prohibiting the tax benefit of losses, when shareholders buy and sell substantially similar

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

15 The SEC stated that its rationale for having this requirement was that basis point rounding is more likely to produce price fluctuations in institutional prime money funds and, by extension, provide investors with the ability to better understand the risks of investing in institutional prime money funds than the penny rounding method. The SEC cited a study by its Staff, which concluded that between November 2010 and November 2013, 53% of institutional prime money funds' NAVs fluctuated using the basis point rounding method, while over the same period only 5% of these funds' NAVs fluctuated using the penny rounding method. *See* Adopting Release at III.B.4.

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

17 Under the penny rounding pricing method, a money fund's market-based NAV per share is calculated and rounded to nearest cent on a share price of one dollar. Currently, there are very few money funds that rely *solely* on the penny rounding method to price their shares.

18 "First mover advantage" is a concept under which some institutional investors may be incentivized to redeem their shares of an institutional prime money fund at a $1.00 share price when, during times of market crisis, the actual market-based NAV (shadow NAV) of the fund is below $1.00.

19 Investor dilution would occur if money fund shareholders redeem their shares at $1.00 when the fund's shadow NAV is below $1.00. This would lower the value of the fund for the remaining shareholders since the redeeming shareholders received more than their shares were actually worth.

securities within 30 days. In order to alleviate these concerns, the SEC requested that the Treasury and the Internal Revenue Service (IRS) issue guidance and regulations. The Adopting Release based its support of the floating NAV requirement on the assumption that the Treasury and the IRS would eliminate the application of the wash sale rules and adopt a simplified method for tracking gains and losses, for transactions in floating NAV money funds. On the same day the Amendments were adopted by the SEC, the Treasury and the IRS released guidance and a simplified accounting procedure relating to floating NAV money funds.[20]

In particular, the IRS and the Treasury issued Revenue Procedure 2014-45, which provides that the wash sale rules will not be applied to any losses on the redemption of shares of a floating NAV money fund. The revenue procedure applies to redemption of shares on or after the effective date of the Amendments. The IRS and the Treasury also issued Proposed Regulation Section 1.446-7, which would provide a simplified method for computing gains and losses from transactions with respect to shares of a floating NAV money fund (NAV method). Under such method, a taxpayer's net gain or loss from shares in a floating NAV money fund during a computation period (which may be a taxpayer's taxable year or certain shorter periods) generally equals the value of the taxpayer's shares in the money fund at the end of the period, minus the value of the taxpayer's shares at the end of the prior period, reduced by the taxpayer's net investment in the money fund during the period. The NAV method simplifies tax computations by basing them on the aggregate of all transactions in a period and on aggregate fair market values.[21]

In addition, the SEC noted that many commenters to the Proposing Release had expressed concern that floating NAV money fund shares would no longer be considered as "cash equivalents" on corporate balance sheets. The SEC, in the Adopted Release, reiterated its position that shares of floating NAV money funds meet the definition of "cash equivalents" under normal circumstances. The SEC noted that it did not need a formal pronouncement from the Financial Accounting Standards Board (FASB) or the Government Accounting Standards Board (GASB) to make this declaration, because, under the federal securities laws, the SEC has the authority to set the accounting and reporting standards for the financial statements filed by public companies with the SEC.[22]

Definition of a Government Money Fund and the Government Money Fund Exemption

The floating NAV requirement exempts government money funds from the requirement to convert to a floating NAV. Under the Amendments, a government money fund is defined as a money fund that invests 99.5%[23] or more of its totals assets in cash, U.S. government securities (as defined in Section 2(a)(16) of

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

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

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

[23] The Proposing Release would have defined a government money fund by reference to an 80% threshold rather than a 99.5% threshold. The Adopting Release stated that the threshold was increased to 99.5% because an 80%

the 1940 Act) and/or repurchase agreements "collateralized fully"[24] in cash or government securities. The Adopting Release reiterated the proposition outlined in the Proposing Release, that, unlike institutional prime money funds, government money funds did not experience heavy redemptions during the financial crisis and the SEC also noted that government money funds did not experience serious redemptions during the Eurozone crisis in 2011. Accordingly, under the Amendments, government money funds are able to continue to use the amortized cost method of valuation and/or penny rounding pricing method.

Definition of a Retail Money Fund and the Retail Money Fund Exemption

The Amendments also exempt retail money funds from the requirement to convert to a floating NAV. The Amendments define a "retail" money fund as a money fund that "has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons."[25] The Adopting Release echoed the position outlined in the Proposing Release that, unlike institutional prime money funds, retail money funds did not experience heavy redemptions during the financial crisis of 2008. The Amendments permit retail money funds to continue to use the amortized cost method of valuation and/or the penny rounding pricing method.

In the Adopting Release, the Commission agreed with certain commenters and stated that the "natural person" test adopted in the Amendments provides a simpler and more cost-effective way to accomplish the Commission's goals of imposing a floating NAV only on those money funds that exhibited the greatest redemption risk in times of financial stress. The Adopting Release also noted that a money fund can still qualify as a retail money fund, even if it has an institutional decision maker – such as an investment adviser managing discretionary investment accounts or a plan sponsor in the case of certain retirement arrangements – that eliminates or changes investment options.[26]

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

The Adopting Release noted that many investors hold shares of retail money funds through omnibus accounts[27] and that money funds are generally not able to look through these accounts to determine the

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threshold could lead to a type of hybrid money fund whose existence would be not consistent with the intent of the Amendments.

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

[25] In the Proposing Release, a retail money fund would have been defined as a money fund that did not permit any of its shareholders to redeem more than $1 million of redeemable securities in any business day. The Adopting Release noted that the definition of a retail money fund in the Amendments is consistent with the definition of a "retail customer" in Dodd-Frank (defining a retail customer as among other things, a natural person). *See* Adopting Release at n. 679.

[26] *See* Adopting Release at III.C.2(b)(ii).

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

identity of the underlying investor. The SEC did not prescribe a way for a retail money fund to conclude that an omnibus account consists solely of natural persons. However, the SEC noted that, although it is the money fund's obligation to comply with the natural person test, a fund intermediary can be held liable for violations of other federal securities laws, including the anti-fraud provisions, if institutional investors are improperly funneled into retail money funds through omnibus accounts.[28] Thus, a retail money fund can have policies and procedures that rely on periodic representations from fund intermediaries to verify that fund shares are being held only by natural persons. The Adopting Release noted the SEC's expectation that funds will rely on intermediaries to implement such policies.[29]

Fund Reorganizations

The Adopting Release noted that retail and institutional investors currently invest in many of the same money funds. These money funds currently rely on Rule 18f-3 to offer multiple share classes to separate classes of investors. The definition of a retail money fund under the Amendments may require a money fund with separate share classes for different classes of investors to reorganize into separate funds for each share class. The SEC provided exemptive relief under Sections 17 and 18 of the 1940 Act to the extent necessary to allow these "one-time" reorganizations to be consummated, provided that a retail money fund's board (including a majority of the independent directors) determines that the reorganization "results in a fair and *approximately* pro rata allocation of the fund's assets between the class being reorganized and the class remaining in the fund."[30] In addition, to facilitate the involuntary redemption of shares held by shareholders who are no longer eligible to invest in a newly created or existing retail money fund, the SEC provided exemptive relief under Section 22(e) of the 1940 Act, subject to the fund notifying the investors who become ineligible to invest in the fund at least 60 days before any redemption occurs.

Impact of Amendments on Unregistered Money Funds Operating under Rule 12d1-1

Unregistered money funds operating under Rule 12d1-1 will be subject to the requirements regarding liquidity fees and redemption gates, as well as the floating NAV requirement.[31] Commenters urged the Commission to exempt these funds from the Amendments, particularly the floating NAV requirement. However, in the Adopting Release, the SEC stated its belief that unregistered money funds are susceptible to the same market forces as institutional prime money funds (*e.g.,* large scale redemptions), and therefore declined to specifically exempt these funds from the Amendments. The Adopting Release also acknowledged that, because an unregistered money fund's adviser typically performs the function of the fund's board of directors, potential conflicts of interest could arise when the adviser makes a determination as to whether to impose liquidity fees and/or redemption gates. The SEC stated that these advisers should therefore adopt policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940, including the anti-fraud provisions thereunder.

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[28] *See* Adopting Release at n. 715.

[29] The SEC also expects money funds to periodically review the policies and procedures that seek to limit all beneficial owners of the fund to natural persons, as well as the effectiveness of the implementation of such policies and procedures.

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

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

Valuation Guidance

As discussed above, the Amendments will continue to permit government money funds and retail money funds to use the amortized cost method of valuation and/or the penny rounding pricing method. In addition, an institutional prime money fund would be permitted to use amortized cost valuation to the same extent as other mutual funds – where the board determines, in good faith, that the fair value of debt securities with remaining maturities of 60 days or less is their amortized cost – unless particular circumstances, such as the impairment of the creditworthiness of an issuer or other factors, warrant otherwise. The Adopting Release provided guidance with respect to amortized cost valuation, and stated that:

> [The Commission] generally believe[s] that a fund may only use the amortized cost method to value a portfolio security with a remaining maturity of 60 days or less when it can reasonably conclude, at *each time* it makes a valuation determination, that the amortized cost value of the portfolio security is *approximately the same* as the fair value of the security as determined without the use of amortized cost valuation. Existing credit, liquidity, or interest rate conditions in the relevant markets and issuer specific circumstances at each such time should be taken into account in making such an evaluation.[32]

Accordingly, as a result of the requirement to disclose a money fund's daily shadow share price on its website, the SEC "believe[s] that each money market fund should have readily available market-based data to assist it in monitoring any potential deviation between a security's amortized cost and fair value determined using market-based factors." However, the Adopting Release noted that, under certain circumstances (*e.g.,* intraday), a money fund "may rely on the last obtained market-based data to assist it when valuing its portfolio securities using amortized cost." A money fund should therefore adopt policies and procedures that are designed to actively monitor both market and issuer specific developments, which may indicate whether the market-based fair value of a portfolio security has changed during the day. These changes may indicate whether the use of amortized cost valuation for that security remains appropriate.

The Adopting Release also acknowledged that most money funds use "mark-to-model" or "matrix pricing" to estimate the value of securities that do not actively trade in the secondary markets (*e.g.,* commercial paper, repurchase agreements and certificates of deposit). In response to a number of comments regarding the "utility" of market-based valuations for these securities, the Adopting Release stated that "funds holding debt securities generally should not fair value these securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the current sale of those securities under current market conditions."[33] The Adopting Release also noted that a money fund's board, before hiring a pricing service to assist in portfolio security valuations, should consider "the inputs, methods, models, and assumptions used by [a] pricing service to determine its evaluated prices" and how those inputs, methods, and assumptions "are affected (if at all) as markets change."[34] In addition, the Adopting Release stated that another consideration fund boards should use in evaluating pricing services is the time between when the pricing service reports its values to the money fund and the time at which the fund strikes its NAV.

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

33 Adopting Release at III.D.2(a).

34 Adopting Release at III.D.2(b).

Disclosure Requirements

General Risk Disclosure

The changes to money funds' disclosure obligations as a result of the Amendments are generally the same as those outlined in the Proposing Release. Money funds will be required to include a paragraph-long risk disclosure in their sales materials and prospectus summary section that sets forth the following: (i) investors may lose money investing in a money fund; (ii) the fund cannot guarantee to preserve the value of a share at $1.00 (or, in the case of institutional prime money funds, a statement that the share price will fluctuate); (iii) the fund may impose redemption fees and gates (unless it is a government money fund that has not elected the ability to do so); (iv) the fund is not guaranteed by the Federal Deposit Insurance Corporation; and (v) the fund's sponsor has no legal obligation, and should not be expected, to provide financial support to the fund at any time. Although the Proposing Release would have required this disclosure to appear as a bulleted list, the Amendments require this disclosure to appear in paragraph form.

Disclosure of Floating NAV

With respect to institutional prime money funds subject to a floating NAV, the Adopting Release noted that the SEC expected that the fund's prospectus and Statement of Additional Information (SAI) will be updated to reflect the changes to the purchase, redemption and pricing of fund shares as well as the tax consequences of investing in a money fund with a floating NAV. However, the Amendments do not prescribe a specific format for these disclosures, which are already required by Form N-1A. The SEC noted that it expects a money fund to update its registration statement to include disclosure relating to the transition to a floating NAV, by means of a post-effective amendment or prospectus supplement.

Disclosure of Liquidity Fees and Redemption Gates

With respect to liquidity fees and redemption gates, the Adopting Release noted that Form N-1A currently requires that any restrictions on fund redemptions be disclosed in both the prospectus and the SAI. Although the Amendments do not make any specific changes to the form of the prospectus, the Adopting Release noted that the SEC expects non-government money funds to disclose "the effects that the potential imposition of fees and/or gates, including a board's discretionary powers regarding the imposition of fees and gates, may have on a shareholder's ability to redeem shares of the fund."[35] Furthermore, the SEC expected a money fund to disclose in its prospectus the various circumstances under which it may impose a liquidity fee or redemption gate. More specifically, the Adopting Release listed the following items that the SEC would generally consider to be appropriately included in prospectus disclosure: (i) the means of notifying shareholders about the imposition and lifting of a liquidity fee and/or redemption gate; (ii) the timing of the imposition of fees and gates; (iii) the fund's use of proceeds generated from liquidity fees; (iv) the tax consequences to the fund and its shareholders of its receipt of liquidity fees; and (v) a general description of the process of fund liquidation if the board determines that it would not be in the best interests of the fund to continue operating.[36] A government money fund that later decides to rely on its ability to impose fees and gates would also be expected to file a prospectus supplement or post-effective amendment to its registration statement to that effect.

[35] Adopting Release at IV.G.

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

The Amendments also revise Form N-1A to require additional SAI disclosure regarding any occasion in the past 10 years[37] on which: (i) the money fund's weekly liquid assets have fallen below 10%, and with respect to each such occasion, whether the fund's board determined to impose a fee or gate; or (ii) the fund's weekly liquid assets have fallen below 30% (but not less than 10%) and the board determined to impose a fee or gate. With respect to each such occasion, the Amendments require a money fund to disclose: (i) the length of time for which the fund's weekly liquid assets remained below 10% (or 30%, as applicable); (ii) the dates and length of time for which the board determined to impose a fee or gate; and (iii) the size of any fee imposed. These requirements are less onerous than those in the Proposing Release, which would have also required SAI disclosure of the board's analysis regarding its decision whether to impose a fee or gate.[38]

Prior Financial Support of Money Funds

The Amendments also revise Form N-1A to require SAI disclosure of each time that an affiliate, promoter or principal underwriter of a fund (or an affiliate of such person) provided any "financial support"[39] to the fund in the past 10 years.[40] This information must include: (i) the nature, date and amount of support; (ii) the person providing the support and its relationship with the fund; and (iii) the security supported and its value on the date the support began.[41]

Website Disclosure

The Amendments require a money fund to "prominently" disclose on its website the following information as of the end of each business day during the preceding six months: (i) the percentage of its total assets invested in daily and weekly liquid assets; (ii) its daily net inflows and outflows; and (iii) its current NAV per share rounded to four decimal places (as well as the market-based NAV for stable NAV money funds). This information, which would include fund data that occurred prior to the compliance date, may be presented in the form of a schedule, chart, graph or other depiction. With respect to liquidity fees and redemption gates, a money fund will also be required to disclose on its website when its weekly liquid assets drop below 10% of its total assets or when it imposes or removes a fee or gate. If a money fund receives sponsor support, it will also be required to post on its website generally the same information that it is required to disclose on the new Form N-CR.

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37 This requirement excludes events prior to the Effective Date (as defined below) of this portion of the Amendments.

38 However, the Amendments do require a fund to disclose, on new Form N-CR, the primary factors its board considered. *See* discussion of Form N-CR below.

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

40 This requirement excludes events prior to the Effective Date of this portion of the Amendments.

41 This requirement also applies to a money fund's predecessor fund in the event of a merger or other fund reorganization.

Form N-CR

The Amendments require information regarding certain material events to be reported to the SEC on new Form N-CR pursuant to new Rule 30b1-8. Rule 30b1-8 was adopted largely as proposed, and requires money funds to disclose, among other things: (i) any instances of default or an event of insolvency of a portfolio security that, immediately before the default or event of insolvency, accounts for ½ of 1% of the money fund's total assets;[42] (ii) any financial support by a sponsor or affiliate of the money fund; (iii) any instance in which the money fund's market-based NAV per share falls below its intended stable price by more than ¼ of 1%; (iv) a decline in weekly liquid assets below 10% of total fund assets; (v) a decline in weekly liquid assets below 30% of total fund assets *and* the money fund imposes a liquidity fee; and (vi) when a money fund imposes a redemption gate, or lifts a liquidity fee or redemption gate.[43] In a change from the Proposing Release, the Amendments also include a new Part H of Form N-CR, on which a money fund may disclose any other information that it chooses to include.

Money funds will be required to file a "brief summary" Form N-CR within one business day following the triggering material event and a follow-up filing within four business days that includes more complete information. In response to commenters' concerns about the one-day filing requirement, the SEC reduced the number of items included in the initial filing, and moved to the follow-up filing certain disclosures that would require more time to complete.

The SEC stated that it intends to use the information provided on Form N-CR in the Commission's regulatory, disclosure review, inspection and policymaking roles. The information will be publicly available on the SEC's EDGAR website immediately upon filing, which the SEC contended will also allow market observers to better monitor the fund industry.

Amendments to Form N-MFP

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

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

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

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

Amendments to Form PF

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

Diversification

The Amendments include changes to the diversification provisions of Rule 2a-7, which require that money fund portfolios be diversified as to the issuers of securities, as well as any guarantors and demand feature providers related to those securities. Largely as proposed, the Amendments: (i) require the grouping of affiliates of issuers in calculating the 5% issuer diversification limitation; (ii) require each money fund to treat the sponsors of asset-backed securities (ABS) as guarantors unless the board of the money fund (or its delegate) makes certain determinations; and (iii) remove the exception that allows 25% of a money fund's portfolio to be subject to guarantees or demand features from a single institution.

Grouping of Affiliates for 5% Issuer Diversification Limitation

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

Sponsor of ABS as Guarantor

Rule 2a-7 mandates that a money fund limit its investments in securities subject to demand features or guarantees from any one provider to no more than 10% of the fund's assets (10% limitation). The Amendments require that a money fund include the sponsor of a SPE that issues ABS as a guarantor for purposes of calculating the 10% limitation. Under the Amendments, there is an exemption from this requirement if the money fund's board (or its delegate) finds that the fund is not relying on the ABS sponsor's financial strength or ability to provide support when determining the quality or liquidity of the ABS. An ABS sponsor additionally is not considered a guarantor in the case of fractional guarantees.

Removal of the 25% Basket

Prior to the Amendments, Rule 2a-7 provided an exception to the 10% limitation, under which 25% of a fund's assets could be subject to guarantees or demand features from a single institution (25% basket). The Amendments eliminate this 25% basket for most money funds. However, for municipal money funds, the Amendments do not remove the 25% basket but rather reduce it to 15% (the Proposing Release would have limited it to 10%). Therefore, up to 15% of a municipal money fund's assets may be subject to guarantees or demand features from a single institution. The SEC cited data suggesting that the majority of money funds have not used the 25% basket to the full extent permitted under Rule 2a-7. This data, however, also suggested that municipal money funds use the 25% basket to a greater extent than money funds as a whole. The SEC also noted that commenters expressed concerns about liquidity, given the limited availability of demand feature providers and guarantors for municipal money funds.

Amendments to Stress Testing Requirements

The Amendments include reforms to enhance stress testing requirements. Specifically, money funds will now be required to periodically test both their ability to maintain weekly liquid assets of at least 10%[44] and their ability to minimize principal volatility in response to specific hypothetical events. These hypothetical events include: (i) increases in short-term interest rates; (ii) downgrades or defaults of specified portfolio security positions; and (iii) widening spreads in various sectors. The Amendments require each hypothetical event to be tested assuming varying levels of shareholder redemptions. Further, money fund advisers will be required to include additional information in the stress testing reports to the money fund boards, including a summary of the significant assumptions made when performing the stress test.

Clarifying Amendments

The SEC, noting questions that have arisen regarding the application of certain provisions of the 2010 Amendments, adopted a number of amendments to clarify these provisions.

Daily and Weekly Liquid Assets

The SEC adopted amendments to clarify certain attributes of instruments that qualify as daily and weekly liquid assets. In particular, the amendments: (i) make clear that money funds cannot use the maturity-shortening provision set forth in current Rule 2a-7(d)[45] regarding interest rate readjustments when determining whether a security satisfies the maturity requirements of a daily or weekly liquid asset; (ii) establish that an agency discount note with a remaining maturity of 60 days or less qualifies as a weekly liquid asset only if the note is issued without an obligation to pay additional interest on the principal amount; and (iii) include in the definition of daily and weekly liquid assets amounts receivable that are due unconditionally within one or five business days, respectively, pending sales of portfolio securities.

[44] This change from the 15% threshold in the Proposing Release was made to be consistent with the threshold of weekly liquid assets that will trigger a default liquidity fee. The SEC noted that this requirement encourages money funds to consider testing multiple liquidity thresholds, up to and including a 30% threshold.

[45] The amended definitions of daily liquid assets and weekly liquid assets require money funds to determine a security's maturity in the same way they must calculate maturity for determining dollar-weighted average life to maturity (WAL) under amended Rule 2a-7(d)(1)(iii). *See id.* at n. 2151.

Demand Features

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

Short-Term Floating Rate Securities

The Amendments provide that, for the purposes of determining WAL, a short-term floating rate security that is subject to a demand feature shall have a maturity equal to the period remaining until the principal amount can be recovered through demand. This revised provision is designed to ensure that money funds apply the maturity-shortening provision for short-term floating rate securities in a manner consistent with the intent of the 2010 Amendments and in a similar manner as applied to short-term variable rate securities.[46]

Second Tier Securities

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

Compliance Dates

The compliance dates for the Amendments are based on the effective date, which will be 60 days after publication in the Federal Register (Effective Date). The compliance dates are as follows:

- Floating NAV/Liquidity Fees and Gates Requirements: Two years from the Effective Date;
- Adoption of Form N-CR: Nine months from the Effective Date; and
- Diversification, Stress Testing, Disclosure, Form PF, Form N-MFP and Clarifying Amendments: 18 months from the Effective Date.

Conclusion

The Amendments set forth sweeping changes to money fund regulation and will have a profound effect on the money fund industry. While representing a more balanced and tailored approach to reform than the approach outlined in the Proposing Release, as well as the approaches outlined in the Staff Proposals, the FSOC Recommendations and the PWG Report, the Amendments nevertheless will have a tremendous impact on the money fund industry and on the markets in which money funds invest. Although the most significant provisions of the Amendments – the floating NAV requirement and the imposition of liquidity fees and redemption gates – will not go into effect for two years, the changes to the industry will be apparent

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

almost immediately. Money fund managers and boards of directors should begin assessing the potential impact of the Amendments and develop a schedule to come into compliance.

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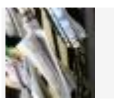

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