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white paper

The New Era of Money Market Fund Regulation

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On July 23, 2014, the U.S. Securities and Exchange Commission (SEC) voted 3–2 to significantly amend the regulatory framework of money market mutual funds (MMFs), particularly Rule 2a-7 under the Investment Company Act of 1940, as amended (the 1940 Act).[1] These changes come four years after the SEC last adopted several amendments to Rule 2a-7 and follow a lengthy debate surrounding MMF reform among regulators and industry participants. The amendments and related regulations will drastically alter the MMF industry and force MMFs and their boards of directors and advisers to make substantial changes to their product offerings, operations, and compliance processes.

The reforms can be grouped into four general categories, each of which is further discussed herein:

- A requirement that certain MMFs trade at a floating net asset value (NAV)
- Rules regarding the imposition of liquidity fees and redemption gates
- Changes to disclosure and reporting obligations
- Changes that will affect fund operations and investment strategies

We also discuss the effect of the new MMF reforms on boards of directors/trustees, other noteworthy guidance from the SEC in the Adopting Release, and additional rules that were simultaneously proposed.

Definitions

The application of the rule revisions depends, in part, on the type of MMF. In the Adopting Release, the SEC focuses on three types of MMFs:

- **Government money market funds (including Treasury money market funds).**[2] Government MMFs are defined in the amendments as MMFs that invest 99.5% or more of their total assets in cash, government securities, and/or repurchase agreements that are collateralized fully.[3] Government MMFs are not subject to the liquidity fee and redemption gate provisions and also are not required to trade at a floating NAV, so they may continue to be sold at a stable NAV of $1.00. Government MMFs may voluntarily impose liquidity fees and redemption gates in accordance with the new rules.
- **Retail money market funds.**[4] Retail MMFs are defined in the amendments as MMFs with policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.[5] "Beneficial ownership" typically means having voting and/or investment power. Retail MMFs are subject to the liquidity fee and redemption gate provisions, but they will not be required to trade at a floating NAV and may continue to be sold at a stable NAV of $1.00.
- **Institutional prime money market funds.** Throughout the Adopting Release, the SEC uses the term "institutional prime" MMFs, but the term is not defined in Rule 2a-7 or the Adopting Release. Instead, these

1. *See* SEC, Money Market Fund Reform; Amendments to Form PF, Release No. 33-9616 (July 23, 2014) [hereinafter Adopting Release], *available at* http://www.sec.gov/rules/final/2014/33-9616.pdf. To view a blackline of the changes to Rule 2a-7, visit https://www.morganlewis.com/documents/BlacklineRule2a-7Revisions_July%202014.pdf.

2. The adopted definition of "government MMFs" differs from the definition as proposed. As proposed, government MMFs were defined as MMFs that invest at least 80% or more of their assets in cash, government securities, and/or repurchase agreements that are fully collateralized, which is consistent with the requirements of Rule 35d-1 under the 1940 Act.

3. A government MMF's investment in another government MMF falls into this qualifying asset category.

4. The adopted definition of "retail MMFs" differs significantly from the definition as proposed. As proposed, retail MMFs were defined as MMFs that limit daily redemptions to no more than $1,000,000.

5. As further discussed herein, a retail MMF with certain retirement plan investors will be required to look through such accounts to be able to reasonably conclude that all of its beneficial owners are natural persons. Accordingly, retirement plans that use retail MMFs as investment options may now be asked to provide certifications to the funds about the natural person status of plan participants.

We also note that Rule 2a-7 does not directly apply to many types of retirement products, including, but not limited to, bank collective trust funds, U.S. private funds, offshore MMFs, and separately managed accounts. Many such products are primarily regulated outside the purview of the SEC, and it is not yet clear whether such other regulators (e.g., the Office of the Comptroller of the Currency) will impose new requirements on these products similar to the revisions to Rule 2a-7 adopted by the SEC.

funds will effectively be regulated by their inability to qualify as either government MMFs or retail MMFs. For example, the SEC characterized institutional prime MMFs as different from government MMFs because institutional prime MMFs hold short-term obligations issued by corporations and banks, repurchase agreements, and asset-backed commercial paper, and they are different from retail MMFs because institutional prime MMFs are held by institutional investors and not natural persons. These institutional prime MMFs are subject to the liquidity fee and redemption gate provisions and must also trade at a floating NAV.

Background

The reforms adopted on July 23 stem primarily from the 2008 financial crisis, when the Reserve Primary Fund "broke the buck" by dropping below the customary $1.00 stable NAV as a result of its securities holdings issued by Lehman Brothers. The Reserve Primary Fund breaking the buck then triggered a marketwide run on institutional prime MMFs.

In response to these events, in 2010, the SEC adopted several reforms by amending Rule 2a-7 but indicated that more fundamental reforms could follow at a later date.[6] The 2010 reforms tightened the risk-limiting conditions of Rule 2a-7 by restricting the amount of lower-quality securities that MMFs can hold, shortening maturity limits at both single-position and average portfolio levels, and requiring MMFs to maintain liquidity buffers in the form of specified levels of daily and weekly liquid assets. The 2010 reforms also required MMFs to report their portfolio holdings to the SEC on a monthly basis on Form N-MFP, required MMFs to undergo stress tests on a periodic basis, and permitted suspension of redemptions if an MMF was at risk of "breaking the buck" to allow for the orderly liquidation of fund assets.

Although many industry participants argued that the 2010 reforms adequately addressed the MMF risks exhibited during the 2008 financial crisis, the SEC proposed further reforms on June 5, 2013 aimed at reducing MMFs' vulnerability to heavy redemptions during periods of financial stress.[7] Despite receiving approximately 1,400 comments on the Proposing Release, the final adopted rules are, in many ways, similar to the Proposing Release's main provisions.

Floating NAV: Requires Action for All MMFs Other Than Government and Retail MMFs

Under the reforms, certain MMFs will no longer be allowed to rely on the regulatory exemption that permitted them to maintain a stable NAV of $1.00 without regard to small variations in the market value of their portfolio securities. The reforms require all MMFs, other than government and retail MMFs, to move to a floating NAV, which requires the daily share prices of these nonexempted funds to fluctuate along with changes in the current market-based value of fund assets. Floating NAV funds will no longer be permitted to use amortized cost valuation, which values an MMF's portfolio securities at cost plus any amortization of premium or accumulation of discount, to maintain a stable $1.00 NAV.[8] Additionally, floating NAV MMFs must now "basis point round" their sales and redemption prices to the nearest 1/100 of 1% (i.e., the fourth decimal place in the case of a fund with a $1.0000 share price).[9] Previously, MMFs were allowed to "penny round" their share price to the nearest 1% (i.e., to the nearest penny in the case of a fund with a $1.00 share price). MMFs subject to the floating NAV requirement will have until October 14, 2016 to comply.

6. *See* SEC, Money Market Fund Reform, Release No. IC-29132 (Feb. 23, 2010) [hereinafter 2010 Release], *available at* http://www.sec.gov/rules/final/2010/ic-29132.pdf.

7. *See* SEC, Money Market Fund Reform; Amendments to Form PF, Release No. 33-9408 (June 5, 2013) [hereinafter Proposing Release], *available at* http://www.sec.gov/rules/proposed/2013/33-9408.pdf.

8. Floating NAV MMFs may continue to use amortized cost to value debt securities with remaining maturities of 60 days or fewer if the fund's board, in good faith, determines that the fair value of the debt securities is their amortized cost value.

9. As a point of reference, currently non-MMFs transact in fund shares at a precision of 1/10th of 1% or 10 basis point rounding, which is generally three decimal places at a $10.00 share price.

The SEC adopted a floating NAV because it was concerned that, during extreme market circumstances, many institutional investors redeem because of the “first-mover advantage” created by MMFs’ $1.00 stable NAV convention, which allows shareholders to redeem at $1.00, even if the fund’s actual portfolio value is less than $1.00. As a result, nonredeeming shareholders may absorb losses equal to the difference between the market-based value of the fund’s shares and the $1.00 price at which redeeming shareholders transact. If a fund then “breaks the buck,” the remaining investors will be left with less than $1.00 per share when the fund’s assets are distributed at the fund’s liquidation.

MMFs that are subject to the floating NAV requirement may face substantial operational changes. In the Adopting Release, the SEC noted that many MMFs and transfer agents are already set up to use floating NAVs because they were already required under Rule 2a-7 to have the capacity to redeem and sell fund shares at prices based on a fund’s current NAV pursuant to Rule 22c-1 (as opposed to the $1.00 stable NAV convention). Still, some MMFs and transfer agents, and many others in the distribution chain, do not currently have the capacity to process transactions at floating NAVs on a continuous basis and will need to develop and overlay additional controls and procedures to continuously process transactions at floating NAVs.

The floating NAV reforms likely will affect retail MMFs as well, even though they are exempt from the floating NAV requirement. Funds that want to qualify as retail MMFs will be required to adopt and implement policies and procedures reasonably designed to restrict beneficial ownership to natural persons, which could include having to “look through” certain accounts to be able to reasonably conclude that a fund’s beneficial owners are natural persons. Additionally, as discussed below, for MMFs currently owned by both retail and institutional investors (such as an MMF with both retail and institutional class shares) to qualify as retail MMFs, they will have to restructure into separate MMFs for retail and institutional investors.

Liquidity Fees and Redemption Gates: Requires Action for All MMFs Other Than Government MMFs

As revised, Rule 2a-7 will provide both institutional prime MMFs and retail MMFs with the flexibility to impose liquidity fees and/or redemption gates on shareholders under certain circumstances. Government MMFs may voluntarily impose liquidity fees and redemption gates in accordance with the new rules, provided that their ability to do so is disclosed in their prospectuses. Liquidity fees are structured to reduce the frequency of redemptions but still allow shareholders to access their investments while requiring redeeming shareholders to bear some of the liquidity costs that relate to their redemption. Redemption gates are structured to provide MMF boards with a tool to stop heavy redemptions in times of fund stress, which will give boards the opportunity to assess the condition of their funds to determine the proper strategy to meet redemptions and create liquidity buffers as well as provide time for market volatility to decrease and investors to reevaluate their investments.

- **Liquidity fees.** Under the revisions to Rule 2a-7, an MMF’s board will have the discretion to impose liquidity fees of up to 2% on all redemptions if a fund’s weekly liquid assets drop to less than 30% of its total assets and the board (including a majority of its independent directors) determines that doing so is in the MMF’s best interests.
  - Additionally, an MMF will be required to impose a liquidity fee of 1% on all redemptions if its level of weekly liquid assets falls below 10% of its total assets. However, a liquidity fee would not be required under these circumstances if the fund’s board (including a majority of its independent directors) determines that imposing such a fee is not in the fund’s best interests. The board could also impose a different fee if it determined that a higher (not to exceed 2%) or a lower fee would be in the fund’s best interests.
- **Redemption gates.** An MMF’s board now also has the discretion to impose redemption gates if a fund’s weekly liquid assets drop to less than 30% of its total assets and the board (including a majority of its independent directors) determines that doing so is in the MMF’s best interests. An MMF that imposes a gate would be required to lift that gate within 10 business days and could not impose gates for more than 10 total business days within any 90-day period, which is measured on a rolling basis.

An MMF's board may impose a fee or gate the same day that the fund's level of weekly liquid assets drops below 30% of its total assets (i.e., the board does not have to wait until the next business day to act). Any fee or gate imposed must be lifted automatically after the MMF's level of weekly liquid assets rises to or above 30% of its total assets or can be voluntarily lifted (or varied) at any time by the board if determined to be in the fund's best interests. MMFs will have until October 14, 2016 to comply with the fees and gates reforms.

The adopted reforms were modified slightly from how they were presented in the Proposing Release. Most notably, the Proposing Release called for MMFs to be required to impose a 2% liquidity fee on all redemptions and would have permitted the imposition of redemption gates for up to 30 days in a 90-day period after a fund's weekly liquid assets fell below 15% of its total assets. Comments on the Proposing Release expressed concern that mandatory fees and gates could start preemptive runs and that lengthy gating periods could be problematic due to the effect of an extended loss of access to cash on investors with liquidity needs. In response, the SEC modified the proposal to allow the imposition of fees and gates to be more discretionary, based on board decisions, which the SEC believes makes it less likely that investors will be able to front run the imposition of a fee or gate.

In the Adopting Release, the SEC listed the following nonexclusive factors that an MMF board may want to consider, in consultation with the fund's adviser, when determining whether a fee or gate is in an MMF's best interests**:**

- Relevant indicators of liquidity stress in the markets and why the fund's weekly liquid assets have fallen (e.g., Have weekly liquid assets fallen because the fund is experiencing mounting redemptions during a time of market stress or because a few large shareholders unexpectedly redeemed shares for idiosyncratic reasons unrelated to current market conditions or the fund?)
- The fund's liquidity profile and expectations as to how the profile may change in the immediate future, including any expectations as to how quickly a fund's liquidity may decline and whether the drop in weekly liquid assets is likely to be very short-term (e.g., Will the decline in weekly liquid assets be cured in the next day or two when securities currently held in the fund's portfolio qualify as weekly liquid assets?)
- For retail and government MMFs, whether the fall in weekly liquid assets has been accompanied by a decline in the fund's shadow price
- The makeup of the fund's shareholder base and previous shareholder redemption patterns
- The fund's past experience, if any, with the imposition of fees and/or gates
- Any other factor that the board considers appropriate

The SEC also listed the following nonexclusive factors that an MMF board may want to consider, in consultation with the fund's adviser, when determining what level of liquidity fee is appropriate:

- Changes in spreads for portfolio securities (whether based on actual sales, dealer quotes, pricing vendor mark-to-model or matrix pricing, or otherwise)
- The maturity of the fund's portfolio securities
- Changes in the fund's liquidity profile in response to redemptions and expectations regarding that profile in the immediate future
- Whether the fund and its intermediaries are capable of rapidly putting in place a fee different from a previously set liquidity fee or the default liquidity fee
- If the fund is a floating NAV fund, the extent to which liquidity costs are already built into the fund's NAV
- The fund's past experience, if any, with the imposition of fees

The below graphic summarizes the application of liquidity fees and redemption gates for various types of MMFs, including the role of the board.

Types of MMFs

- Government MMFs can, but are not required to, impose liquidity fees or redemption gates.
- Institutional prime and retail MMFs will be required to impose liquidity fees under certain circumstances (unless the board determines otherwise) and will have the ability to impose redemption gates.

Liquidity Levels

- For any MMF with weekly liquid assets less than **30% of total assets**, the board may
  - impose a liquidity fee of up to 2%; and/or
  - impose a redemption gate (but a redemption gate may be imposed only up to 10 business days in a rolling 90-day period).
- For any institutional prime or retail MMF with weekly liquid assets less than **10% of total assets**, the fund
  - **must** impose a liquidity fee equal to 1% (unless the board has determined to not impose a fee or to impose a different fee of up to 2%); and
  - **may** impose a redemption gate (but a redemption gate may be imposed only up to 10 business days in a rolling 90-day period).

Board Determinations

- In determining that a fee or gate is in a fund's best interest, or in determining the level of liquidity fee to impose, the board should consider any factors it deems appropriate.
- The "best interests" standard recognizes that each fund is different.
- The board is prohibited from adopting in advance a policy to not allow a fee or gate to ever be imposed on the fund.

Disclosure Obligations: Requires Action for All MMFs

The SEC also revised the disclosure requirements for MMFs to help change the expectations of MMF investors and correct the misperception that MMFs are riskless investments. The below disclosure statements will be required, with some exceptions, to be clearly stated in any MMF advertisement or sales literature as well as in the summary section of any MMF prospectus.

Government MMFs that choose to impose liquidity fees and/or gates and retail MMFs with stable NAVs must include the following disclosure:

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

MMFs with floating NAVs must include the following disclosure:

> You could lose money by investing in the Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

The SEC also made the following changes to Form N-1A:

- MMFs will be required to disclose in their statements of additional information (SAIs) occasions when they have considered (i.e., when the MMF has fallen below the 30% and 10% liquidity thresholds) or imposed fees or gates during the last 10 years and the size of any liquidity fee imposed and the length of time of the gate imposed. MMFs will also be required to disclose in their SAIs historical instances within the last 10 years when they (or any predecessor fund) have received "financial support" from an affiliate. These disclosure requirements do not apply to events that occurred before the compliance date of the Rule 2a-7 amendments.
- The SEC clarified that "redemption fees" in prospectus fee tables will not include any liquidity fees.

One result of the 2010 amendments to Rule 2a-7 was the requirement that MMFs have websites. In the current amendments, the SEC leveraged this prior reform to adopt further website disclosure requirements for MMFs. MMFs must now maintain and provide six months of specified data in a prominent place on their websites, with disclosure required on a rolling daily basis, stated as of the end of the preceding business day. Among the data that will have to be provided are (i) the percentages of a fund's total assets that are invested in daily and weekly liquid assets, (ii) a fund's daily net inflows or outflows, and (iii) a fund's daily current NAV per share, calculated based on current market factors and rounded to the appropriate decimal place.[10]

If applicable, an MMF also must disclose prominently on its website, on the same business day that it files an initial report with the SEC on new Form N-CR (discussed below), a summary of any imposition and removal of

10. For these items, the six-month look-back period for disclosure on an MMF's website would encompass fund data that occurs prior to the compliance date.

liquidity fees or redemption gates as well as the provision of any financial support to the fund. These liquidity fee, redemption gate, and financial support disclosures must be maintained on the website for at least one year following the filing date of Form N-CR. The MMF also must include disclosure on its website that notifies shareholders that additional information about these disclosures is included in the MMF's Form N-CR and inform shareholders how to obtain the Form N-CR.

As a result of these enhanced website disclosure requirements, MMFs will be required to amend and enhance their policies and procedures that oversee the creation, review, and posting of website content. The new data requirements are substantial and will require complex calculations on a daily basis. As with any public disclosure mandate, MMFs may be liable for any misstatements or omissions in this web-based content.

Additionally, although it did not adopt specific requirements, the SEC expressed the following expectations with respect to registration statement disclosures:

- Floating NAV MMFs should include disclosures in their prospectuses and SAIs about the tax consequences for shareholders of buying, holding, and exchanging floating NAV shares and the effects, if any, on fund operations that result from the transition to a floating NAV.
- Any MMF that intends to qualify as a retail MMF should disclose in its prospectus that it limits investments to accounts beneficially owned by natural persons.
- MMFs transitioning to floating NAVs should give notification to shareholders of the transition through a post-effective amendment or sticker. On this point, the SEC seemed to imply that this would be a material change. However, the SEC stopped short of requiring all MMFs to introduce these changes in a post-effective amendment made pursuant to Rule 485(a) under the Securities Act of 1933, which it had previously done for prior amendments to Form N-1A that relate to mutual fund valuation and frequent or excessive trading disclosures.
- An MMF subject to fees and/or gates should disclose in its registration statement the effects and operations of the fees and gates, including the potential effects on a shareholder's ability to redeem shares, the board's discretionary power regarding the imposition of fees and gates, and the various situations in which the fund may impose a fee or gate.

Reporting Requirements: Requires Action for All MMFs

Introduction of Form N-CR

MMFs must now file a report with the SEC when certain significant events occur. Usually, within one business day of a significant event, an MMF must file a brief summary report on new Form N-CR and then file a follow-up Form N-CR report within four business days that includes more detail about the event. Significant events that trigger the filing of a Form N-CR are the default of a portfolio security, the provision of "financial support"[11] by an affiliate, a significant decline in shadow price, the imposition of liquidity fees or redemption gates, the lifting of liquidity fees or redemption gates, or the decision to not impose liquidity fees or redemption gates when a fund passes the relevant liquidity thresholds.

Notably, Form N-CR will require a description of the primary considerations or factors that the board took into account when deciding whether or not to impose a fee or gate. On this point, the SEC cautioned that funds should avoid using "boilerplate" disclosures and instead should provide information tailored to a fund's particular situation

11. The term "financial support" is defined to include customary actions taken by affiliates to provide liquidity to MMFs, such as capital contributions and entering into letters of credit. Excluded from the definition of financial support are routine fee waivers and expense reimbursements and routine interfund lending and interfund share purchases. Also excluded from the financial support definition is any action that otherwise would qualify as financial support that an MMF's board has determined to not be reasonably intended to increase or stabilize the value or liquidity of the MMF's portfolio. Although seemingly a broad exclusion, the Adopting Release notes that the exclusion is unavailable if any intent of the action, even if it is not the primary intent, is to increase or stabilize the value or liquidity of the fund's portfolio. Such an action would still qualify as "financial support" and be reportable on Form N-CR, even though providing stability or liquidity was not the primary intent.

and the context in which the decision was made, including considering both present circumstances and potential future risks and contingencies. Form N-CR will also require the disclosure of information about when the fee or gate was imposed, a fund's liquidity levels at the time, and the size of the liquidity fee. These new disclosure requirements emphasize the importance of boards' deliberative processes and their roles as overseers of MMFs and are also consistent with recent emphasis placed on disclosure of board considerations in other contexts.[12]

Amendments to Form N-MFP

The SEC also made the following changes to Form N-MFP, which was previously implemented as a result of the 2010 reforms and is used to report MMF portfolio holdings and other information to the SEC on a monthly basis:

- The current 60-day delay on public availability of reported data will be eliminated.
- Although MMFs will continue to be required to file Form N-MFP on a monthly basis, an MMF's NAV per share (and shadow price), daily and weekly liquid assets, and shareholder flows will now be required to be reported on a weekly basis within the monthly filing.
- To help the SEC identify individual portfolio securities, MMFs will be required to provide the legal entity identifier and at least one other security identifier (if available) in addition to the Committee on Uniform Securities Identification Procedures number.
- Each MMF will be required to disclose whether its adviser or a third party paid for or waived all or part of the fund's operating expenses or management fees during a given reporting period.

Operational and Investment Portfolio Changes: Requires Action for All MMFs

Valuation

The Adopting Release includes a substantial discussion of fund valuation and related board responsibilities, which is noteworthy because of the industry's long-sought guidance in the area of valuation from the SEC and its Staff. In its discussion of valuation, the SEC stated that its guidance is applicable to all registered investment companies and business development companies and also cited guidance from the 1970s, indicating that it still reflects the current position of the SEC and its Staff. The SEC noted that all funds, including floating NAV funds, may use amortized cost to value debt securities with remaining maturities of 60 days or fewer if fund directors, in good faith, determine that the fair value of the debt securities is their amortized cost value.

The SEC also cautioned that the fair value of such securities may not always accurately be reflected through the use of amortized cost valuation, in which case it is incumbent for the board to recognize this and take into account market factors that could impair the effectiveness of amortized cost valuation. For example, with respect to thinly traded MMF portfolio securities, the SEC stated that a fund generally should not fair value these securities at par or amortized cost, based on the expectation that the fund will hold those securities until maturity, if the fund could not reasonably expect to receive approximately that value on the current sale of those securities under current market conditions. This guidance reminds boards of their nondelegable duty to oversee valuation and be continuously informed of market factors that could affect the fair value of fund portfolio securities.

Additionally, the SEC stated in the Adopting Release that a board "should have readily available market-based

12. *See* Northern Lights Compliance Services, LLC, Gemini Fund Services, LLC, Michael Miola, Lester M. Bryan, Anthony J. Hertl, Gary W. Lanzen, and Mark H. Taylor, Investment Company Act of 1940 Release No. 30502 (May 2, 2013) (settled order found that directors made inaccurate statements to trustees with regard to their approval of advisory contracts); In the Matter of J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman; R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie W. Willis III, Investment Company Act Release No. 30557 (June 13, 2013) (settled order found that directors bore responsibility for determining securities' fair value but entrusted duties to valuation committee without providing "meaningful substantive guidance" on calculating valuations or making any significant effort to understand valuation methods).

data to assist it in monitoring any potential deviation between a security's amortized cost and fair value determined using market-based factors." To do so, it may be appropriate for a board to ensure that a fund's adviser is actively monitoring developments that may indicate that the market-based fair value of a security has changed during the day. This could indicate an increased emphasis on intra-day monitoring of valuation for MMFs. The SEC also acknowledged that matrix pricing and similar pricing methods could provide meaningful information to assist in market-based valuation of more thinly traded securities.

The SEC also took the opportunity to remind boards that they cannot passively rely on third-party pricing services to determine valuation. Still, the SEC acknowledged that, in the absence of amortized cost methodology, floating NAV funds may rely more heavily on third-party pricing services. The clear message to boards from the SEC in the Adopting Release is that, regardless of the valuation source, it is a board's nondelegable responsibility to determine, on a continuous basis, whether a price constitutes a fair value for a fund's portfolio security. Accordingly, the SEC stated that, before a board decides to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities, the board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change. When choosing a particular pricing service, the SEC stated that boards may want to assess the quality of the evaluated prices provided and the extent to which the service determines its evaluated prices as close as possible to the time the fund calculates its NAV.

Diversification

Currently under Rule 2a-7, MMFs generally must limit their investments in the following:

- Securities of any one issuer of a first-tier security, other than government securities and securities subject to a guarantee by a noncontrolled person, to no more than 5% of fund assets (5% diversification limit)
- Securities subject to a demand feature or a guarantee to no more than 10% of fund assets from any one provider (10% diversification limit)

As a result of the amendments to Rule 2a-7, when applying the 5% diversification limit, MMFs must now treat affiliated entities as single issuers. Entities are "affiliated" with one another if one controls or is controlled by or under common control with the other, where "control" is defined as ownership of more than 50% of an entity's voting securities. However, MMFs are not required to aggregate asset-backed commercial paper (ABCP) special-purpose entities and certain of their majority owners for purposes of the 5% diversification limit. According to the Adopting Release, by requiring diversification of exposure to entities that are affiliated with one another, the SEC is attempting to mitigate credit risk to an MMF by limiting the fund from assuming a concentrated amount of risk in a single economic enterprise.

The amendments to Rule 2a-7 also require MMFs to treat the sponsors of asset-backed securities as guarantors subject to the 10% diversification limit, unless a board (or its delegate) determines that a fund is not relying on the sponsor's financial strength or its ability or willingness to provide liquidity, credit, or other support to determine the asset-backed security's quality or liquidity.[13] The Adopting Release states that the sponsor of ABCP will typically be the financial institution that provides explicit liquidity and/or credit support and also provides administrative services to the ABCP conduit. With respect to tender option bond (TOB) programs in which the liquidity provider for the TOB program or its affiliate holds the residual interest in the TOB trust, the SEC believes the entity that provides the liquidity support and holds the residual interest typically will be the sponsor. For TOB programs in which the liquidity provider or its affiliate does not also own the residual interest in the TOB trust, the SEC believes that the financial institution that sets up the TOB program, markets and remarkets the TOBs, transfers the municipal security into the TOB trust, and/or provides liquidity typically will be the sponsor.

13. In cases where a security is subject to a fractional demand feature or guarantee by the sponsor, as defined in Rule 2a-7, an MMF may count the fractional demand feature or guarantee in place of deeming the sponsor as a guarantor of the entire principal amount of the asset-backed security.

In addition, Rule 2a-7 currently permits an MMF to invest as much as 25% of its total assets in the first-tier securities of a single issuer and have up to 25% of its total assets subject to guarantees or demand features from a single institution. As amended, Rule 2a-7 eliminates the ability of MMFs, other than tax-exempt MMFs, to rely on the 25% basket rule for guarantees or demand features. With respect to tax-exempt MMFs,[14] amended Rule 2a-7 reduces the 25% basket to a 15% basket, such that up to 15% of a tax-exempt MMF's (including single-state MMFs) total assets may be subject to guarantees or demand features from a single institution, provided that any demand feature or guarantee acquisition in excess of 10% of a fund's total assets must be a demand feature or guarantee issued by a noncontrolled person.

Stress Testing

The SEC also amended the stress-testing provisions of Rule 2a-7. In the Adopting Release, the SEC stated that, through its examination process, it observed disparities in the quality and comprehensiveness of MMF stress tests, the types of hypothetical circumstances tested, and the effectiveness of materials produced by MMF advisers to explain the stress-testing results to their boards. The SEC noted that some MMFs currently test for combinations of events as well as for correlations between events and between portfolio holdings, whereas other MMFs do not. As revised, the stress-testing provisions under Rule 2a-7 reflect the SEC's belief that an evaluation of combinations of events and correlations among portfolio holdings is an important part of an MMF's stress testing.

Under the new stress-testing provisions, MMFs will now have to periodically test their ability to maintain weekly liquid assets of at least 10% of total assets and to minimize principal volatility (and, with respect to stable NAV MMFs, their ability to maintain a stable $1.00 NAV) when faced with specified hypothetical events in combination with various increases in shareholder redemptions. These hypothetical events include (i) increases in the level of short-term interest rates, (ii) the downgrade or default of various portfolio security positions representing varying exposures in a fund's portfolio, and (iii) the widening of spreads in sectors to which a fund's portfolio is exposed. Additionally, the SEC indicated that an MMF should test for any additional combination of events that its adviser deems relevant, and the MMF is not required to test for combinations of every permutation of the events listed in the final rule. The results of the stress testing must be reported to the board, and such reports must include information as may be reasonably necessary for the board to evaluate the stress-testing results, including a summary of the significant assumptions made when performing the stress tests.

In the Adopting Release, the SEC provided the following guidance to MMFs and their boards regarding the implementation of the new stress-testing requirements:

- MMFs are not required to separately test for interest rate increases, a downgrade or default, a spread shift, or shareholder redemptions in isolation.
- With respect to floating NAV MMFs, MMFs and their boards are best suited to determine the amount of principal volatility that investors in their funds will likely tolerate and, accordingly, what volatility threshold or thresholds should be used in their stress testing.
- With respect to the new stress-testing requirement relating to the MMF's level of weekly liquid assets, the SEC acknowledged that MMFs need to make some basic assumptions about how the fund obtains cash to satisfy redemptions. For example, an MMF could assume all redemptions are satisfied first by weekly liquid assets, or it could assume redemptions are satisfied with a combination of weekly liquid assets and sales of portfolio securities. The SEC stated that the new rule does not specify which assumptions the MMF must make, leaving that to the discretion of the adviser, who should determine the most appropriate assumptions to use for the MMF by taking into account, among other things, how the MMF has satisfied redemptions historically and the composition of the MMF's portfolio.

14. The Adopting Release notes that tax-exempt MMFs are MMFs that are typically owned by institutional investors and that primarily hold obligations of state and local governments and their instrumentalities, which pay interest that generally is exempt from federal income taxes. A tax-exempt MMF is subject to the liquidity fee and redemption gate provisions and, unless it qualifies as a retail MMF, also must trade at a floating NAV.

- With respect to the new stress-testing requirement relating to increases in shareholder redemptions, the SEC specifically did not include any mandatory redemption levels that MMFs must include in their stress testing. The SEC believes that the appropriate level of redemptions to test will vary among MMFs and will depend, for example, on the composition of an MMF's investor bases and shareholder redemption preferences as well as historical redemption activity in the MMF.
- With respect to the new stress-testing requirement relating to downgrades or defaults of various portfolio security positions, the SEC stated that, although the rule gives MMFs general discretion when making the determination of which securities to test, they believe it is appropriate to require MMFs to select particular security positions that represent varying portions of the portfolio when making such determinations so that the adviser and the board can better compare the differing results to the MMF depending on the security that is tested. The SEC further stated that it believes the most appropriate security to test for a hypothetical default will vary among MMFs depending on several factors, including the composition of the MMF's portfolio and contemporaneous market events.
- With respect to reporting the results of the stress tests to the board, the SEC stated that advisers are not required to provide the details and supporting information for every stress test that the MMF administered. The SEC noted that a thoughtful summary of stress-testing results with sufficient context for understanding the results may be preferable to providing the details of every test. In addition, the SEC indicated that information regarding any contemporaneous market stresses to particular portfolio sectors could be helpful to a board's consideration of stress-testing results.

Other Noteworthy Items

- Retail MMFs are defined as MMFs that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.[15] Under this natural person test, many tax-advantaged savings accounts (such as individual retirement accounts (IRAs)) and ordinary trusts are beneficially owned by natural persons. Retail MMFs can put in place policies and procedures that will enable a fund to "look through" these types of accounts and reasonably conclude the beneficial owners are natural persons. MMFs will have flexibility in how they choose to reach this conclusion. For example, this conclusion can be reached by the fund adviser directly being provided a Social Security number by the investor when an account is opened through the adviser's affiliates or indirectly being provided a Social Security number in connection with recordkeeping for a retirement plan.
- The SEC notes in the Adopting Release that most MMFs do not have the ability to look through omnibus accounts to determine whether any of the underlying beneficial owners are retail investors. The Adopting Release, therefore, does not prescribe the manner in which MMFs may determine that beneficial owners underlying an omnibus account are natural persons. The Adopting Release notes that MMFs, for example, could enter into contractual arrangements with or obtain periodic certifications from the intermediaries. The SEC, when analyzing the cost of complying with such a requirement, assumed that most funds would simply rely on intermediaries to implement their policies rather than enter into contractual arrangements.[16]
- Government MMFs have the ability to invest a *de minimis* amount (up to 0.5% of total assets) in nongovernment assets. Nongovernment assets include all "eligible securities" permitted under Rule 2a-7 other than cash, government securities, or repurchase agreements that are "collateralized fully." Previously, such MMFs were permitted to invest up to 20% of their total assets in nongovernment assets.
- Concurrent with the SEC's adoption of the MMF regulatory reforms, the Internal Revenue Service (IRS) and the Department of the Treasury released two new pieces of tax guidance that apply to MMFs and their shareholders. In Revenue Procedure 2014-45, the IRS eliminated the 0.5% *de minimis* test for wash sales that result from redemptions of floating NAV MMFs. The new IRS guidance now provides that redemptions of

15. The SEC expects that retail MMFs will periodically review the adequacy of these policies and procedures and the effectiveness of their implementation.

16. The SEC also noted that, although a retail MMF is responsible for ensuring that it qualifies as a retail MMF, an intermediary could nonetheless be held liable for violations of other federal securities laws, including the antifraud provisions, where institutional investors are improperly funneled into retail MMFs.

a floating NAV MMF that result in a loss will not be treated as wash sales under section 1091 of the Internal Revenue Code of 1986, as amended. The IRS also issued proposed regulations (REG-107012-14) that permit investors in floating NAV MMFs to elect to use a simplified aggregate accounting method (the NAV method). Pursuant to the NAV method, investors would determine gain or loss by looking at the change in the aggregate value of the investor's shares in the MMF, instead of tracking individual lots or the adjusted cost basis of the fund shares. A change from another method to the NAV method, however, is a change of accounting subject to the rules under section 446. These proposed regulations also revise Treasury Regulation section 1.6045-1 to clarify that the exemption that applies to MMFs with respect to information reporting will continue to apply to floating NAV MMFs. Although the proposed regulations will not become effective until published as final, the regulations indicate that taxpayers may rely on the regulations before they are finalized.

- MMFs with both retail and institutional share classes will need to reorganize into separate retail and institutional MMFs so that the retail portion of the MMF is not subject to a floating NAV. In the Adopting Release, the SEC recognized that such a reorganization could implicate sections 17 and 18 of the 1940 Act. Accordingly, the SEC set forth a view that the reorganization of a class of an MMF into a new MMF could take place without separate exemptive relief, provided that the MMF's board (including a majority of its independent directors) determines that the reorganization results in a fair and approximate pro rata allocation of the MMF's assets between the class being reorganized and the class remaining in the fund. Notwithstanding the foregoing SEC relief, MMFs should review their organizational documents and registration statements to determine whether shareholder approval of the reorganization would be required.
- MMFs with both retail and institutional shareholders invested in the same share class will not be able to take advantage of such relief and will have to restructure in another manner. The SEC recognized that, as part of such restructuring, an MMF may need to involuntarily redeem retail or institutional investors that will no longer be eligible to invest in the newly established or existing MMF. Accordingly, the SEC stated that an MMF may involuntarily redeem such noneligible investors without separate exemptive relief from section 22(e) of the 1940 Act if it notifies such investors in writing at least 60 days before the redemption occurs.
- The SEC's position is that MMF interests will still qualify as a "cash equivalent" (as opposed to an "investment") for the purposes of U.S. generally accepted accounting principles under normal circumstances. However, if events occur that give rise to credit and liquidity issues for MMFs, such as the imposition of fees or gates, shareholders will need to reassess if their investments in that MMF continue to meet the definition of a cash equivalent.
- Some commenters raised concerns about the effect of fees and gates on MMFs offered in the Employee Retirement Income Security Act and other tax-exempt plans. When consulted by the SEC, Department of Labor (DOL) staff indicated that a liquidity fee could raise issues under the conditions of prohibited transaction exemptions that require an IRA owner to be able to transfer funds to another investment within a reasonable period of time after the investor's request and without penalty to the principal amount of the investment. DOL staff advised the SEC that, "in order for a fiduciary to continue to rely on the exemptions for the prohibited transactions arising from the initial decision to roll over amounts to [an MMF] that is sponsored by or affiliated with the fiduciary, additional steps would need to be taken to protect the principal amount rolled over in the event that a liquidity fee is imposed." An example of such an additional step would be a contractual commitment by the fiduciary or its affiliates to pay any liquidity fee assessed to the IRA, to the extent that the fee would be deducted from the principal amount rolled over. DOL staff has indicated it will provide further guidance if necessary.
- Although Rule 10b-10 under the Securities Exchange Act of 1934 generally requires a broker-dealer to provide customers with confirmations at or before the completion of a securities transaction, there is an exception to this requirement for certain transactions in MMFs that attempt to maintain stable NAVs and where no sales loads or redemption fees are charged, which permits broker-dealers to provide transaction information to MMF shareholders on a monthly basis. Because institutional prime MMFs will now be priced at floating NAVs, broker-dealers will no longer be able to rely on this exception. To address this, the SEC has

filed a Notice of Proposed Exemptive Order that would permit broker-dealers to continue to rely on the current exception under Rule 10b-10 with respect to transactions in floating NAV MMFs.[17]

- Under Rule 12d1-1 of the 1940 Act, a fund may invest in an unregistered MMF without having to comply with the affiliate transaction restrictions, provided that the unregistered MMF satisfies certain conditions, including limiting its investments to those in which an MMF may invest under Rule 2a-7 and undertaking to comply with all other provisions of Rule 2a-7. As a result, unregistered MMFs operating under Rule 12d1-1 must comply with the new amendments to Rule 2a-7.
- In master-feeder structures, feeder funds will not be allowed to independently impose a fee or gate. Instead, a feeder fund is required to pass through to its investors a fee or gate imposed by the master fund in which it invests.
- Under section 165(i) of the Dodd-Frank Act, the SEC must establish stress-testing requirements for nonbank financial companies that have total assets of more than $10 billion and are regulated by a primary federal financial regulatory agency. The Adopting Release states that the SEC will engage in future rulemaking to implement these requirements.

Compliance Dates

MMFs will have to comply with the applicable provisions of Rule 2a-7 and the various other requirements in accordance with the dates set forth in the table below.

Requirement	Compliance Date
Floating NAV	October 14, 2016
Redemption fees and liquidity gates	October 14, 2016
Form N-CR	July 14, 2015
Diversification, stress testing, and disclosure	April 14, 2016
Form N-MFP	April 14, 2016

To view a blackline of the changes to Rule 2a-7, visit https://www.morganlewis.com/documents/BlacklineRule2a-7Revisions_July%202014.pdf.

17. *See* SEC, Notice of Proposed Exemptive Order Granting Permanent Exemptions Under the Securities Exchange Act of 1934 From the Confirmation Requirements of Exchange Act Rule 10b-10 for Certain Money Market Funds (July 29, 2014), *available at* https://www.federalregister.gov/articles/2014/07/29/2014-17748/notice-of-proposed-exemptive-order-granting-permanent-exemptions-under-the-securities-exchange-act.

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