SEC Proposes Amendments to Money Market Fund Rules

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Prime Institutional MMFs

The SEC describes prime institutional MMFs as MMFs that cater to institutional investors and that invest in a variety of short-term debt obligations issued by corporations and banks, as well as U.S. government securities, repurchase agreements and asset-backed commercial paper.

Under the proposal, a prime institutional MMF is an MMF that does not qualify as a "government MMF" or "retail MMF" as those terms are described below.

On June 5, 2013, the Securities and Exchange Commission (the "**SEC**") proposed amendments to rules under the Investment Company Act of 1940 (the "**Investment Company Act**") and related requirements that govern money market funds ("**MMFs**"). The SEC's proposal is the latest action taken by U.S. regulators as part of the ongoing debate about systemic risks posed by MMFs and the extent to which previous reform efforts have addressed these concerns.

The proposal sets out two alternative reforms to Rule 2a-7 under the Investment Company Act. Under the first of the two alternative reforms, prime institutional MMFs (as described in the sidebar) would no longer be permitted to rely on the provisions in Rule 2a-7 that allow them to maintain a stable $1 per share net asset value ("**NAV**"). Under the second alternative, all MMFs could maintain a stable NAV but could, subject to action by the fund's board of directors, impose liquidity fees and gates against investor redemptions if the fund's weekly liquid assets, as defined in the proposal, fell below 15% of its total assets. The proposal also would modify other requirements for all MMFs, including the Rule 22e-3 provisions relating to suspension of redemptions, and would impose new disclosure and reporting requirements on MMFs.

Notably, the proposal contains a detailed analysis of, but does not include, several of the MMF reforms proposed by the Financial Stability Oversight Council in 2012, including NAV buffer and minimum balance at risk requirements. The SEC also considered, but did not propose, the establishment of a private emergency liquidity facility or the regulation of MMFs as special purpose banks, as put forth by the 2009 President's Working Group Paper on MMF reform. The proposal would not modify the ability of an MMF sponsor to support the fund's operations through affiliate purchases of the MMF's securities, though it would require additional disclosure with respect to such support. The proposal also does not address issues raised in the SEC's 2011 proposal to remove references to credit ratings in Rule 2a-7 and other Investment Company Act rules, but the SEC indicated that it expects to address this issue in the future.

The proposal is of interest not only to sponsors and operators of MMFs, but also to institutional and retail MMF investors and to firms that issue commercial paper and other types of short-term debt securities that currently are widely held by MMFs. The proposal contains more than 1,000 questions and requests for comments with respect to the reforms included in the proposal as well as those not proposed by the SEC.

This memorandum provides an overview of the SEC's proposal, highlighting those areas that have been the focus of debate among regulators and market participants. Comments to the SEC on the proposal are due within 90 days after its publication in the *Federal Register*.

Background

The proposed reforms stem primarily from the 2008 financial crisis and come on the heels of several years of vigorous debate between regulators and industry participants, as well as among regulators themselves, regarding the optimal way to regulate the roughly $2.9 trillion MMF industry. The perception of MMFs as a potential source of systemic risk requiring heightened regulation became prevalent following the announcement in September 2008 that the Reserve Primary Fund would “break the buck” and the subsequent run on MMFs. Given the broad economic importance of MMFs in the short-term financing markets and their wide use as vehicles for savings, the U.S. government temporarily intervened to halt the run. Amendments to MMF regulations were adopted by the SEC in 2010 to reduce the interest rate, credit and liquidity risks of MMF portfolios and prevent the occurrence of similar runs in the future. Reforms advocated last year by former SEC Chairman Mary Shapiro, such as capital buffers and redemption holdbacks, were strongly opposed by industry participants and by three SEC Commissioners and were never brought to a Commission vote. The Financial Stability Oversight Council separately issued proposed recommendations for further MMF reform in November 2012, which suggested the adoption of one or a combination of three alternative frameworks for additional MMF regulation.

The SEC issued its current proposal by unanimous approval of the Commissioners. In the proposal, the SEC highlighted five key factors that make MMFs susceptible to runs like the one experienced in 2008: (i) stable value pricing methods that create incentives for investors to redeem before others in the event of potential instability; (ii) limited sources of internal liquidity to meet redemption requests; (iii) imperfect transparency regarding MMF risks, including the likelihood of government or sponsor support; (iv) the generally high risk aversion of MMF investors and corresponding desire to avoid loss in times of stress; and (v) the potential for liquidity-induced contagion across the MMF industry. The purpose of the proposed reforms, as described by the SEC in the proposing release, is to mitigate MMFs’ susceptibility to heavy redemptions, improve MMFs’ ability to manage and thwart possible contagion from redemptions and increase the transparency of risks, while preserving, as much as possible, the benefits of MMFs for investors and the short-term financing markets.

As described below, the proposal contains two principal alternative reforms for enhanced regulation of MMFs that the SEC may adopt individually or in combination and includes proposed changes to certain MMF portfolio requirements as well as certain disclosure and reporting requirements.

Two Alternative Reform Proposals

The SEC proposal contains two alternative amendments to Rule 2a-7 under the Investment Company Act, which the SEC is considering adopting either alone or in combination.

First Alternative: Floating NAV

The first reform alternative proposed by the SEC would require prime institutional MMFs to price and transact in their shares using a "floating" NAV by amending certain provisions under Rule 2a-7 that currently permit all MMFs to maintain a stable $1 share price through the use of amortized cost valuation and penny-rounding pricing of their portfolio holdings, as described in the sidebar.

Prime institutional MMFs would instead need to sell and redeem their shares at prices reflecting mark-to-market portfolio valuations, except in circumstances where the SEC has permitted use of amortized cost valuation by all mutual funds. Thus, the daily share prices of prime institutional MMFs, and the amount investors would pay and receive for those shares, would float in accordance with the mark-to-market value of the MMF's portfolio.

To potentially increase the visibility of a fund's share price sensitivity to fluctuations in the market values of portfolio securities, the floating NAV alternative would require a prime institutional MMF to use a more precise "basis point" pricing method and round its share prices to the nearest 1/100th of one percent (i.e., to the fourth decimal place in the case of a fund with a $1 share price).

The SEC explained that the floating NAV alternative is intended to address the incentive for shareholders to redeem shares ahead of other investors in times of fund and market stress and to improve the transparency of funds' investment risks through more transparent valuation and pricing methods. At the same time, the SEC highlighted several potential limitations of the floating NAV alternative, such as that it may not deter shareholder redemptions driven by a flight to quality or a desire to avoid further losses, and stated that it would therefore consider combining the floating NAV alternative with the second proposed alternative involving liquidity fees and gates, which is described in more detail below.

Exemptions for Government MMFs and Retail MMFs

Given the relative safety of government MMFs' portfolio holdings and the historically lower susceptibility of retail MMFs to runs as compared to prime institutional MMFs, the SEC's proposal would not subject government and retail MMFs (as described in the sidebar) to the floating NAV requirement, in order to retain stable share price MMF options for investors. However, the proposal would not permit government and retail MMFs to rely on amortized cost valuation, so they would need to maintain a stable NAV in reliance on the penny-rounding method of pricing.

Amortized Cost Valuation and Penny-Rounding Pricing

The amortized cost method of valuation allows an MMF to value its portfolio securities at cost, plus any amortization of premium or accumulation of discount.

The penny-rounding method of pricing allows an MMF to round its share price to the nearest one percent (i.e., to the nearest penny in the case of a fund with a $1 share price).

Government MMFs and Retail MMFs

A government MMF would be defined as an MMF that holds at least 80% of its total assets in cash, U.S. government securities or repurchase agreements collateralized with U.S. government securities.

A retail MMF would be defined as an MMF that prohibits any shareholder from redeeming more than $1 million from the fund in a single business day. The proposal would provide exemptions from certain provisions of the Investment Company Act to permit MMFs to limit shareholder redemptions to the extent necessary to qualify as a retail MMF. The SEC considered other approaches to defining the types of MMFs that would qualify as retail MMFs, including based on maximum per investor account balance and shareholder concentration limits.

Second Alternative: Liquidity Fees and Gates

The second alternative reform proposed by the SEC would permit all MMFs to continue using the penny-rounding pricing method (but not amortized cost valuation) to maintain a stable share price, but would enable prime institutional MMFs and retail MMFs to impose liquidity fees and gates for redemptions during times of market stress, subject to determinations by an MMF's board of directors.

Weekly Liquid Assets

Weekly liquid assets include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less and securities that convert into cash within one week.

- *Liquidity Fees*. Rule 2a-7 would be amended to require a prime institutional MMF and a retail MMF to impose a two percent liquidity fee on all redemptions in the event that the MMF's weekly liquid assets, as defined in the sidebar, fall below 15% of its total assets (the "**liquidity threshold**"). Such a fee would not be imposed (and could be lifted) if the fund's board of directors, including a majority of its independent directors, determined that the liquidity fee was not in the fund's best interest or that a lower liquidity fee was in the fund's best interest. Any liquidity fee imposed would be automatically lifted if the MMF's weekly liquid assets increased to or above 30% of its total assets.
- *Gates*. If an MMF's weekly liquid assets fell below the liquidity threshold, the MMF's board of directors, including a majority of its independent directors, could impose a temporary suspension of redemptions (a "**gate**") if the board determined that such a gate would be in the fund's best interest. Any gate imposed would have to be lifted within 30 days, and a gate would be automatically lifted if the MMF's weekly liquid assets increased to or above 30% of its total assets. A gate could also be lifted at any time by the board of directors. The proposal would not allow an MMF to impose a gate for more than 30 days in any 90-day period.

The SEC's proposal would impose certain additional disclosure requirements related to liquidity fees and gates, including a requirement for an MMF to publicly disclose in its Form N-1A statement of additional information any occasion during the last 10 years when the fund's weekly liquid assets fell below the liquidity threshold, and, with respect to each such occasion, whether the fund's board of directors imposed a liquidity fee or gate.

The SEC stated in its proposal that liquidity fees could mitigate the risks of runs on MMFs in times of market stress by requiring redeeming shareholders to shoulder at least some of the liquidity costs of their redemption and thus reducing their incentive to redeem during such periods. The proposed gates could serve to halt runs by blocking redemptions long enough to allow (i) fund managers time to determine a strategy to meet redemptions, (ii) liquidity buffers to increase as portfolio securities mature and (iii) shareholders to assess the fund's liquidity and for any shareholder panic or contagion to subside. As with the floating NAV alternative, the SEC highlighted several potential limitations of the liquidity fees and gates alternative, including the possibility that it may not sufficiently address the lack of valuation transparency in the pricing of MMFs, and stated that it would therefore consider combining the two principal alternative reforms.

Exemption for Government MMFs

Government MMFs would be exempt from the proposed liquidity fees and gates alternative and its corresponding requirements. A government MMF, however, would be permitted to voluntarily impose fees and gates as described above if the fund's prospectus disclosed its ability to do so. According to the SEC's proposal, the purpose of exempting government MMFs from the liquidity fees and gates alternative would be to retain an MMF option for investors who may no longer choose or be able to invest in MMFs subject to liquidity fee or gate requirements. Unlike the first alternative, there would be no exemption for retail MMFs from the liquidity fee and gate requirements.

Suspension of Redemptions and Liquidation of MMFs

Rule 22e-3 under the Investment Company Act provides an exemption for MMFs from the Act's Section 22(e) provisions limiting the ability of registered funds to suspend redemptions of their shares. The proposal would permit, but not require, an MMF's board of directors to permanently suspend redemptions and liquidate the MMF under certain conditions. This additional flexibility to suspend redemptions would be available under both the floating NAV and liquidity fees and gates alternatives.

- *Floating NAV MMFs*. The SEC's proposal would permit the board of directors of a floating NAV fund (i.e., a prime institutional MMF under the floating NAV alternative) to suspend redemptions and liquidate the fund in the event that the fund, at the end of a business day, had less than 15% of its total assets in weekly liquid assets (which is the same liquidity threshold that is used in the context of the liquidity fees and gates alternative).
- *Stable NAV MMFs*. The SEC's proposal would permit the board of directors of a non-floating NAV fund (i.e., a government MMF or a retail MMF under the floating NAV alternative or any MMF under the liquidity fees and gates alternative) to suspend redemptions and liquidate the fund when either (i) the fund, at the end of a business day, had less than 15% of its total assets in weekly liquid assets or (ii) the fund's price per share as computed for purposes of distribution, redemption and repurchase was no longer equal to its stable share price or the fund's board, including a majority of disinterested directors, determined that such a change is likely to occur.

These proposed amendments would further modify Rule 22e-3, which was amended in 2010 to allow an MMF's board of directors to suspend redemptions based on a difference between amortized cost and market-based NAV.

Portfolio Requirements

Portfolio Diversification

The SEC's proposal would also seek to increase the diversification of MMF portfolios. In particular, the reforms would alter the current diversification requirements of Rule 2a-7 by making the following three changes, which would apply under either of the two principal alternative reforms described above:

- *Aggregation of Affiliates*. The proposal would generally require an MMF to aggregate its exposure to affiliated entities when applying the issuer diversification limit under Rule 2a-7, which prohibits an MMF from investing more than five percent of its assets in any single issuer. Entities would be considered "affiliates" for these purposes if one entity controlled or was controlled by the other entity or if the entities were under common control. "Control" would be defined as ownership of more than 50% of an entity's voting securities.
- *Treatment of sponsors of asset-backed securities as guarantors*. The proposal would require MMFs to treat a sponsor of asset-backed securities ("**ABS**") issued by special purpose entities as a guarantor of the ABS. The Rule 2a-7 diversification limitations for guarantors would thus apply, preventing an MMF from investing more than 10% of its total assets in securities issued by or subject to guarantees or demand features from the ABS sponsor. The proposal would allow an exception from this treatment, however, in cases where an MMF's board of directors (or its delegate) determined that the fund was not relying on the ABS sponsor's financial strength or its ability or willingness to provide liquidity, credit or other support when determining the ABS's quality or liquidity.
- *Removal of the twenty-five percent basket*. The SEC's proposal would amend Rule 2a-7 to remove the so-called "twenty-five percent basket," under which a single institution could guarantee up to 25% of the value of securities held in an MMF's portfolio. Instead, Rule 2a-7's 10% diversification limit for guarantors and demand feature providers would apply.

Portfolio Stress Testing

The SEC's proposed reforms include various amendments to enhance the stress testing requirements for MMF portfolios that were adopted as part of the 2010 SEC amendments to Rule 2a-7. For example, under both the floating NAV alternative and the liquidity fees and gates alternative, an MMF would need to stress test its ability to avoid triggering the liquidity threshold employed as part of the liquidity fees and gates alternative. In addition, an MMF (other than a prime institutional MMF under the floating NAV alternative, if adopted) would need to stress test its ability to maintain a stable share price. These stress testing requirements are designed to evaluate the stresses that could lead an MMF to "break the buck" or to have a liquidity issue.

Disclosure and Reporting Requirements

Various additional MMF disclosure and reporting requirements are also included in the proposal, such as:

- disclosure of historic instances of support provided by the MMF sponsor;
- daily website disclosure of both daily and weekly liquid asset levels as well as the fund's current, market-based NAV;
- disclosure of certain significant events on new Form N-CR including, for example, portfolio security defaults;
- additional reporting on Form PF by advisers that advise a liquidity fund (as defined in Form PF) and manage at least $1 billion in MMF and liquidity fund assets combined, to include information required for MMFs on Form N-MFP; and
- additional reporting on Form N-MFP, to include, for example, the amount of cash and daily and weekly liquid assets the MMF holds.

Compliance Timing

The SEC's proposal would provide a conformance period of two years from the effective date of adoption by the SEC for MMFs to comply with the floating NAV alternative. Until the expiration of this two-year period, MMFs could continue to maintain their stable share prices through the use of amortized cost valuation and penny-rounding pricing of their portfolio holdings. The SEC proposed to provide a one-year conformance period from the effective date of adoption by the SEC for MMFs to comply with the liquidity fees and gates alternative. A compliance period of nine months would apply to any amendments not specifically related to either of the two principal alternative reforms, such as the portfolio diversification, stress testing and new disclosure requirements.

➢ **See a copy of the SEC's proposed reforms**

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