

SEC Adopts Money Market Fund Reforms with Floating NAV and Gates

Highlights

- ✓ After a two-year transition period, institutional prime money market funds will be required to transact at a floating NAV, instead of at a \$1.00 stable share price.
- ✓ Government and retail money market funds will be allowed to continue to maintain a stable share price.
- ✓ Boards of directors will have discretion to impose liquidity fees and redemption gates if liquidity levels fall below a threshold.
- ✓ The rules also include enhanced diversification, disclosure, and stress-testing requirements.
- ✓ The SEC views a liquidity fund as essentially an unregistered money market fund.
- ✓ The final rules include a number of changes to the diversification requirements for money market funds' portfolios.
- ✓ The final rules enhance the stress testing requirements adopted by the SEC in 2010.
- ✓ BlackRock supports the SEC's efforts to improve the resiliency of U.S. money market funds during times of stress.

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In the U.S., home to the world's largest market for money market funds, the SEC has adopted final regulations designed to address money market funds' susceptibility to heavy redemptions in times of stress, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, their benefits.

The SEC removed the valuation exemption that permitted institutional non-government money market funds, whose investors historically have made the heaviest redemptions in times of stress, to maintain a stable net asset value per share (NAV), and is requiring those funds to sell and redeem shares based on the current market-based value of the securities in their underlying portfolio, that is, transact at a floating NAV. The SEC also gave the boards of directors of money market funds discretion to impose a liquidity fee if a fund's weekly liquidity level falls below the required regulatory threshold and to suspend redemptions temporarily — that is, to gate funds — under the same circumstances (*Release No. IC-31166*).

With a floating NAV, institutional prime money market funds (including institutional municipal money market funds) are required to value their portfolio securities using market-based factors. These funds will no longer be allowed to use the special pricing and valuation conventions that currently permit them to maintain a constant share price of \$1.00. Effectively, the SEC is requiring money market funds to price shares in a way that more accurately reflects the market value of the funds' underlying portfolios.

The final rules also include enhanced diversification, disclosure and stress testing requirements, as well as updated reporting by money market funds and private funds that operate like money market funds. The rules provide a two-year transition period to enable both funds and investors time to fully adjust their systems, operations and investing practices.

While the money market fund regulations were not mandated by the Dodd-Frank Act, they were certainly driven by the financial crisis and adopted at the urging of a body created by Dodd-Frank: the Financial Stability Oversight Council. In a report to Congress signed by all the members of the Council, including SEC Chair Mary Jo White, FSOC urged the reform of money market funds to prevent runs that could destabilize the financial system by triggering fire sales of assets, impairing the flow of short-term financing, and creating strains throughout the financial system.

While FSOC voted unanimously to seek public comment on a set of alternative structural reforms of money market funds, the Council invited the SEC to take action and said that it would defer to the SEC, the expert regulator. But there was general agreement that FSOC had the authority to act in this matter if the SEC did not. In a colloquy with then-Treasury Secretary Tim Geithner (the Treasury Secretary is the permanent chair of FSOC) during

his appearance before the Senate Banking Committee, Senator Robert Corker (R-Tenn) said that FSOC can act if the SEC fails to move forward with money market fund reforms. Like FSOC, Senator Corker was concerned that a run on money market funds could create systemic risk. Secretary Geithner said that the basic vulnerabilities and design of money market funds tended to exacerbate the financial crisis of 2008.

Echoing these comments, former Fed Chair Ben Bernanke has noted the appropriateness of the SEC's making the ultimate regulations on money market reform. He noted that a run on prime money market funds added significantly to the distress of the financial crisis. Extraordinary federal intervention was needed, he said, via powers that are no longer available. The SEC's 2010 reforms were useful but only a first step, he noted, since they did not address the fixed NAV issue, which maintains the incentive for first movers to propagate a run.

The expert regulator, the SEC, has now acted to address these concerns. The SEC noted that a lack of investor understanding and lack of complete transparency concerning the risks posed by particular money market funds can contribute to heavy redemptions during periods of stress.

Historic Regulation of Money Market Funds and Rule 2a-7

A money market fund is a type of investment company registered under the Investment Company Act of 1940 and regulated as a money market fund under SEC Rule 2a-7 under the 1940 Act. Unlike other types of mutual funds, money market funds have historically sought to keep stable (typically at \$1.00) the prices at which their shares are distributed, redeemed, and repurchased. To hold itself out to investors as a money market fund, an investment company must meet the requirements specified in Rule 2a-7, which, among other things, establishes limitations as to the maturity, quality, diversification, and liquidity of a fund's investments. Generally, a money market fund must hold a diversified portfolio of short-term, low-risk, liquid securities. The perceived safety and simplicity of money market funds have led to their widespread use for cash management purposes.

Floating NAV

Under the floating NAV amendments adopted by the SEC, institutional prime money market funds would be required to transact at a floating NAV, instead of at a

\$1.00 stable share price. The floating NAV amendments are designed to reduce the first mover advantage inherent in a stable NAV fund, by disincentivizing redemption activity that can result from investors attempting to exploit the possibility of redeeming shares at the stable share price even if the portfolio has suffered a loss. They are also intended to reduce the chance of unfair investor dilution and make it more transparent to certain of the impacted investors that they, and not the fund sponsors or the federal government, bear the risk of loss.

Thus, institutional prime money market funds would no longer be able to use amortized cost to value their portfolio securities. Daily share prices of these money market funds would fluctuate along with changes in the market-based value of their portfolio securities. Institutional prime money market funds would be required to price their shares using a more precise method so that investors are more likely to see fluctuations in value.

Currently, money market funds penny-round their share prices to the nearest 1 percent (to the nearest penny in the case of a fund with a \$1.00 share price). Under the floating NAV changes, institutional prime money market funds instead are required to basis-point-round their share price to the nearest 1/100th of 1 percent and the fourth decimal place in the case of a fund with a \$1.0000 share price.

Government and Retail Money Market Funds

Government and retail money market funds would be allowed to continue using the amortized cost method and/or penny-rounding method of pricing to seek to maintain a stable share price. A government money market fund is defined as any money market fund that invests 99.5 percent (formerly 80 percent) or more of its total assets in cash, government securities and/or repurchase agreements that are collateralized solely by government securities or cash.

A retail money market fund is defined as a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.

A municipal or tax-exempt fund would be required to transact at a floating NAV unless the fund meets the definition of a retail money market fund, in which case it would be allowed to use the amortized cost method and/or penny-rounding method of pricing to seek to maintain a stable share price.

Liquidity Fees

Under the rules, if a money market fund's level of weekly liquid assets were to fall below 30 percent of its total assets, the fund's board would be allowed to impose a liquidity fee on all redemptions. Such a fee could be imposed only if the money market fund's board of directors, including a majority of its independent directors, determined that such a fee is in the best interests of the fund.

If a money market fund's level of weekly liquid assets fell below 10 percent, the fund would be required to impose a liquidity fee of 1 percent on all redemptions. However, such a fee would not be imposed if the fund's board of directors determined that the fee is not in the best interests of the fund or that a lower or higher (up to 2 percent) liquidity fee is in the best interests of the fund. Weekly liquid assets generally 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.

Redemption Gates

Under the new rules, if a money market fund's level of weekly liquid assets fell below 30 percent, a fund's board could in its discretion temporarily suspend redemptions (gate). In order to impose a gate, the board of directors would have to make a finding that imposing a gate is in the money market fund's best interests. A money market fund that imposes a gate would be required to lift that gate within 10 business days, although the board of directors could determine to lift the gate earlier. Money market funds would not be able to impose a gate for more than 10 business days in any 90-day period. Money market funds would be required to promptly and publicly disclose instances in which the fund's level of weekly liquid assets falls below the 10 percent threshold and the imposition and removal of any liquidity fee or gate.

Government money market funds would not be subject to the new fees and gates provisions. However, these funds could voluntarily opt into them, if previously disclosed to investors.

Enhanced Disclosure

In an effort to improve the transparency of money market fund operations and risks, the SEC will require such funds to daily disclose on their website their levels of daily and weekly liquid assets, net shareholder inflows or

outflows, market-based NAVs per share, imposition of fees and gates, and any use of affiliate sponsor support.

Money market funds would also be required to promptly disclose certain events on a new Form N-CR. These events would include the imposition or removal of fees or gates and the primary considerations or factors taken into account by a board of directors in its decision related to fees and gates; portfolio security defaults; sponsor or fund affiliate support, including the amount of support and a brief description of the reason for support; and, for retail and government funds, a fall in the fund's market-based NAV per share below \$0.9975.

Money market funds would be required to provide in their statements of additional information (SAIs) disclosure regarding any occasion during the last ten years in which the money market fund received sponsor or fund affiliate support. This disclosure would be in addition to the current event disclosures required on Form N-CR.

Money market funds currently report detailed information about their portfolio holdings to the SEC each month on Form N-MFP. The final rules amend Form N-MFP to clarify existing requirements and require reporting of additional information relevant to assessing money market fund risk. In addition, the final rules eliminate the current 60-day delay on public availability of the information filed on the form and make it public immediately upon filing.

To better monitor whether substantial assets migrate to private liquidity funds in response to money market fund reforms, the final rules amend Form PF, which private fund advisers use to report information about certain private funds they advise.

Large liquidity fund advisers managing at least \$1 billion in combined money market fund and liquidity fund assets must report substantially the same portfolio information on Form PF as registered money market funds are required to report on Form N-MFP. The SEC views a liquidity fund as essentially an unregistered money market fund.

Portfolio Diversification

The final rules include a number of changes to the diversification requirements for money market funds' portfolios. For example, money market funds are required to treat certain entities that are affiliated with each other as single issuers for purposes of determining whether they are complying with money market funds' 5 percent issuer diversification limit. Under this limitation, a fund generally could not invest more than 5 percent of its assets in any one issuer, or group of affiliated issuers.

For money market funds other than tax-exempt money market funds, the final rules require that all of a money market fund's assets meet the 10 percent diversification limit for guarantors and demand feature providers, thereby removing the so-called 25 percent basket that permitted as much as 25 percent of the value of securities held in a money market fund's portfolio to be subject to guarantees or demand features from a single institution.

For tax-exempt money market funds, essentially municipal money market funds, the 25 percent guarantor basket is reduced to 15 percent so that no more than 15 percent of the value of securities held in a tax-exempt money market fund's portfolio could be subject to guarantees or demand features from a single institution.

Under the new regime, money market funds are required to treat the sponsors of asset-backed securities as guarantors subject to the 10 percent diversification limit applicable to guarantees and demand features, unless the money market fund's board of directors determines that the 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.

Enhanced Stress Testing

The final rules enhance the stress testing requirements adopted by the SEC in 2010. In particular, a money market fund would be required to test its ability to maintain weekly liquid assets of at least 10 percent and to minimize principal volatility in response to certain specified hypothetical stress scenarios. In addition, the SEC would be adopting modifications to the current reporting requirements to boards of directors regarding stress testing aimed at improving the quality of reports the boards receive.

Tax Considerations

Shareholders that frequently purchase and redeem shares, such as where the fund is used as a sweep arrangement, may experience a high volume of small gains and losses. Tax compliance might be difficult if these taxpayers had to ascertain the cost basis and gain or loss for each transaction. Thus, concomitantly with the SEC rules, Treasury and the IRS proposed regulations providing a simplified, aggregate annual method of tax accounting for these gains and losses that simplifies the tax treatment. While the regulations are proposed rather than final in order to provide for a period of public

comment, Treasury assured shareholders using floating NAV money market funds that they can now rely on the proposal to begin using the simplified method.

The Treasury Department and the IRS also informed the SEC that persons subject to transaction reporting may rely on the proposed exemption for all calendar years prior to the final regulations' formal date of applicability. Therefore, the Treasury Department and IRS relief is available immediately.

Thus, even in the unlikely event that some shareholders' bases in their shares change due to non-dividend distributions, neither fund groups nor their intermediaries will need to track the tax bases of money market fund shares. On the other hand, if there are any non-dividend distributions by money market funds, the affected shareholders will need to report in their annual tax filings any resulting gains or reduced losses upon the sale of affected money market fund shares.

Redemptions subject to a liquidity fee would almost always result in losses, but gains are possible in the unlikely event that a shareholder received a return of capital distribution with respect to some shares. Because a later redemption of the shares by the shareholder would be for \$1.00 each, there would be small gains with respect to those redemptions. If the money market fund making such a non-dividend distribution is a floating NAV money market fund and if a shareholder uses the simplified aggregate method then the shareholder would be able to report the gain or loss without having to track the basis of individual shares.

The SEC was unable to quantify with any specificity the tax and operational costs because the Commission is unable to predict how often liquidity fees will be imposed by money market funds and how often redemptions subject to liquidity fees would cause the funds to make returns of capital distributions to the remaining shareholders, although the SEC believes that such returns of capital distributions are unlikely.

Specifically, the Treasury and IRS proposed *regulations* that would allow shareholders to measure net gain or net loss without transaction-by-transaction calculations, simplifying tax compliance for shareholders. As a result, shareholders can determine their net gain or loss using information that the funds routinely provide to them for non-tax purposes. In particular, the net gain (or loss) is generally determined as the increase (or decrease) in the value of the investor's shares during a period (such as the tax year), minus the net investment in those holdings (purchases minus sales) during the period. The proposed regulations extend to floating-NAV money market funds the same waiver of gross-proceeds reporting, basis

reporting, and holding-period reporting rules that now apply to stable-value money market funds.

In addition, concurrent with the proposed regulations, Treasury and the IRS issued final guidance in the form of *Rev. Proc. 2014-45* addressing wash sales under which shareholders choosing not to use the simplified method can get relief from the wash sale rules for any losses on shares of a floating NAV money market fund. The wash sale rules do not affect shareholders who elect to use the simplified method. A wash sale occurs when a shareholder sells a security at a loss and within 30 days before or after the sale acquires a substantially identical stock or security.

Cash equivalents and US GAAP

Classifying money market fund investments as cash equivalents is important because, among other things, investors may have debt covenants that mandate certain levels of cash and cash equivalents. In addition, some corporate investors may perceive cash and cash equivalents on a company's balance sheet as a measure of financial strength.

Current U.S. GAAP defines cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. U.S. GAAP includes an investment in a money market fund as an example of a cash equivalent. The Commission's position continues to be that, under normal circumstances, an investment in a money market fund that has the ability to impose a fee or gate under Rule 2a-7(c)(2) qualifies as a cash equivalent for purposes of U.S. GAAP.

However, events may occur that give rise to credit and liquidity issues for money market funds. If such events occurred, including the imposition of a fee or gate by a money market fund under Rule 2a-7(c)(2), shareholders would need to reassess whether their investments in that money market fund continue to meet the definition of a cash equivalent.

Although requested by some commenters, noted the SEC, a more formal pronouncement to confirm this position is not required because the federal securities laws provide the Commission with plenary authority to set accounting standards.

If events occur that cause shareholders to determine that their money market fund shares are not cash equivalents, the shares would need to be classified as investments, and shareholders would have to treat them either as trading securities or available-for-sale securities.

For example, during the financial crisis, certain money market funds experienced unexpected declines in the fair value of their investments due to deterioration in the creditworthiness of their assets and, as a result, portfolios of money market funds became less liquid. Investors in these money market funds would have needed to determine whether their investments continued to meet the definition of a cash equivalent.

Industry Reaction

The reaction of the financial industry to the new money market fund regulations was generally favorable. For example, SIFMA commended Chair White's leadership in navigating the change to completion and acknowledged the balanced, inclusive and transparent approach taken by the SEC in developing the regulations. The final rules will provide the marketplace with a degree of certainty regarding the future of these funds, noted SIFMA.

Further, SIFMA was encouraged that the SEC limited the new floating NAV requirement to institutional prime funds. It was proper to carve out retail and government money market funds from a floating NAV requirement, as these funds have not shown susceptibility to destabilizing runs. Importantly, SIFMA also believes that the SEC has appropriately reframed the determination of retail funds by looking at fund policies and procedures designed to limit investors in these funds to natural persons as opposed to redemption limits as originally proposed, since the nature of investors is a better indicator of a true retail fund.

The Investment Company Institute said that the SEC thoughtfully crafted a robust and meaningful final rule that will impose significant structural changes across the industry, particularly on money market funds used by institutional investors. The ICI believes that the SEC has the long regulatory experience and deep technical expertise required to strike the proper balance, making money market funds more resilient in times of financial stress while preserving the utility and value of these funds for investors. The Institute pledged to work with the Commission and with its members to ensure a smooth transition to these new rules as they are implemented over the next two years.

The Mutual Fund Directors Forum noted that the new regulations also allow the money market fund board to impose liquidity fees of up to 2 percent and redemption gates for a period of up to 10 business

days in a 90-day period where the fund's weekly liquid assets fall below 30 percent of its total assets. Where liquid assets fall below 10 percent, the board would be required to impose a 1 percent fee, unless it makes a determination that the fee is not in the fund's best interest. Government money market funds are excluded from this requirement, but may nevertheless impose a gate or fee, subject to the amendment's provisions, if the fund has previously disclosed its ability to employ such measures in the prospectus. When weekly liquid assets again rise above the 30 percent mark, the fund would need to remove any liquidity fee or redemption gate. Citing the Forum's comment letter, the adopting release stated that the SEC determined to adopt a best interests of the fund standard for board action.

BlackRock, the world's largest asset manager, *supports* the SEC's efforts to improve the resiliency of U.S. money market funds during times of stress and appreciates the thoughtful, deliberate and consultative process the Commission undertook to achieve this result. In light of these changes, the firm believes that money market funds will continue to prove a valuable cash investment strategy. BlackRock said that it looks forward to engaging closely with its clients over the coming months to discuss the wide array of cash solutions available to successfully adapt to the new reforms.

About the Author

James Hamilton is a Principal Analyst at *Wolters Kluwer Law & Business*, a leading provider of corporate and securities information and a prolific blogger (*Jim Hamilton's World of Securities Regulation*, at <http://jimhamiltonblog.blogspot.com>). Hamilton has been tracking, analyzing and explaining securities law and regulation for over 30 years as an analyst for Wolters Kluwer Law & Business. He has written and spoken extensively on federal securities law and is cited as an authority in the Senate Banking Committee Report (S. 111-176) of the Dodd-Frank Act. His analysis of that legislation, the *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis*, is widely read. His earlier analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law* and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to *Securities Regulation Daily* and the industry-standard publication, the *Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

If you would like to post this special report on your firm's intranet site, please contact Randy Kaplan at randy.kaplan@wolterskluwer.com or call 212-771-0866.

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