SEC Approves New Rules to Address Run Risks in Money Market Funds

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Introduction

- Money market funds ("MMFs") were created in the early 1970s to offer the opportunity to capture yields significantly higher than the rates banks were legally allowed to pay under Federal Reserve Regulation Q, which placed a ceiling on bank deposit rates.
- MMFs are investment products.
  - MMFs are not guaranteed or insured by any agency of the government or the fund sponsor. Investors can lose money in a MMF, although they rarely do.
- In their 40-year history, only two MMFs have not returned the full $1.00 per share.
  - 1994 –Community Banker's U.S. Government Money Market Fund. Fund was holding a substantial amount of adjustable rate securities in a rising rate environment. The fund ultimately returned 96 cents on the dollar to shareholders.
  - 2008 -- Reserve Primary Fund. $62.5 billion MMF holding 1.2% of its assets in Lehman Brothers debt in September 2008. Shareholders received 99 cents on the dollar.
- Today MMFs hold approximately $3 trillion in assets.
- Considered part of the "Shadow Banking System" by bank regulators (whether correctly or not)

Post 2008 Regulatory History

- 2010
  - SEC adopted a number of amendments to rule 2a-7 designed to make MMFs more resilient by requiring higher credit quality of holdings, reduced maturities, greater liquidity, stress testing, new disclosure on Form N-MFP and shadow pricing
  - Dodd-Frank Wall Street Reform and Consumer Protection Act creates the Financial Stability Oversight Council
  - President's Working Group of Financial Markets recommends several policy options to further reform Money Market Funds to prevent destabilizing runs and further contagion on the broader economy
- 2011
  - SEC Round Table on Money Market Funds and Systemic Risk
  - SEC staff proposes additional reform including floating NAV or capital buffers but SEC unable to get votes to approve

Post 2008 Regulatory History (cont'd)

- 2012
  - FSOC releases for public comment its own recommended proposals, to which the SEC was required to respond
- 2013
  - SEC issues rule proposed 2a-7 rule amendments
- 2014
  - After 1,400 comments received on the proposal, the SEC adopts amendments to Rule 2a-7 providing for:
    - Floating NAV
    - Fees and Gates
    - Portfolio Diversification, Disclosure and Stress Testing
    - Treasury and IRS issue companion tax guidance
      - Simplified tax accounting for tracking gains and losses in Floating NAV MMF
      - Relief from "wash sale" rules for any losses on shares of a Floating NAV MMF

Classifying Money Market Funds

The Amendments have the effect of creating two types of MMFs:

- ***Floating NAV MMF***
  - Institutional Prime MMFs
  - Institutional Tax-Exempt MMFs

Classifying Money Market Funds (cont'd)

- ***Stable Value MMF***
  - Retail MMFs - A "retail money market fund" is defined as a MMF that has policies and procedures reasonably designed to limit all beneficial owners of the fund to "natural persons"
  - Government MMFs - A ***"government money market fund"*** is defined as any MMF 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.

Classifying Money Market Funds (cont'd)

- For ease of discussion, we use the terms, ***"institutional prime MMF,"*** which are non-government/non-retail money market funds and "***institutional tax-exempt MMF,"*** which are non-retail tax-exempt or municipal money market funds."

Floating Nav

Overview

- Institutional prime and tax-exempt MMFs required to transact at a floating NAV, instead of at a $1.00 stable share price.
- Government and retail MMFs permitted to continue using the amortized cost method and penny-rounding method of pricing to seek to maintain a stable share price.
- Designed to
  - reduce the first mover advantage
  - reduce the chance of unfair investor dilution and
  - make it more transparent to investors that they, and not the fund sponsors or the Federal government, bear the risk of loss.

Floating Nav (cont'd)

Floating the NAV

- Institutional MMFs will be required to use market prices to calculate its NAV
  - Adopting release makes clear that Institutional MMFs may continue to use the amortized cost method to value securities with remaining maturities of 60 days or less, if the board, in good faith, determines that doing so represents fair value for those securities, unless particular circumstances warrant otherwise.
- Daily share prices would fluctuate along with changes in the market-based value of their portfolio securities.
- No more penny rounding -- institutional MMFs will be required to round their share price to the nearest 1/100th of one percent (the fourth decimal place in the case of a fund with a $1.0000 share price).

Liquidity Fees And Redemption Gates

Intended to provide MMF Boards the ability to address a “run” on a MMF by charging liquidity fees or temporarily suspending redemptions.

- *Requirements are pegged to a MMF’s “Weekly liquid assets,”* which 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.
- *Prompt Public Disclosure* – MMF will 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 MMFs* – Government MMFs not be subject to the new fees and gates provisions. However, under the proposed rules, these funds could voluntarily opt into them, if previously disclosed to investors.

Liquidity Fees

Discretionary Liquidity Fee

- if "weekly liquid assets" fall below 30 percent of its total assets (the regulatory minimum), the MMF's board is allowed to impose a liquidity fee of up to two percent on all redemptions.
- imposed only if the MMF's board of directors determines that such a fee is in the best interests of the fund.

Default Liquidity Fee

- If weekly liquid assets fall below 10 percent, the MMF required to impose a liquidity fee of one percent on all redemptions, **<u>unless</u>**, fund's board of directors determines that such a fee is not in the best interests of the fund or that a lower or higher (up to two percent) liquidity fee is in the best interests of the fund.

Redemption Gates

If weekly liquid assets falls below 30 percent, a Retail or Institutional MMF's board could temporarily suspend redemptions (gate).

- To impose a gate, the board of directors is required to find that imposing a gate is in the MMF's best interests.
- A MMF that imposes a gate is required to lift that gate within 10 business days, although the board of directors could determine to lift the gate earlier.
- MMFs are not able to impose a gate for more than 10 business days in any 90-day period.

Liquidity Fees And Redemption Gates: Board Considerations

- Imposition of fees and gates require that the board determine them to be in the fund's "best interest."
- Adopting release provided a non-exhaustive list of board considerations in determining whether to use liquidity fees or gates:
  - Relevant indicators of liquidity stress in the markets and why the fund's weekly liquid assets have fallen.
    - 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?

Liquidity Fees And Redemption Gates: Board Considerations (cont’d)

- The liquidity profile of the fund and expectations as to how the profile might 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.
  - 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 make-up of the fund’s shareholder base and previous shareholder redemption patterns; and
- the fund’s experience, if any, with the imposition of fees and/or gates in the past.

Government And Retail Money Market Funds

Government Money Market Funds:

- Not subject to Floating NAV
- Board may determine to use liquidity fees and redemption gates
- Must invest 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.
  - Government MMFs may need to amend its investment limitations to reflect change

Government And Retail Money Market Funds (cont'd)

Retail Money Market Funds:

- Not subject to Floating NAV;
- Board may determine to use liquidity fees and redemption gates
- Must adopt policies and procedures to reasonably limit all beneficial owners of the fund to natural persons
  - Identify shareholders through social security numbers or other means
  - Special procedures may need to be adopted with respect to shares held through an omnibus

Government And Retail Money Market Funds (cont'd)

- Relief to Reorganize Existing MMFs into Retail Funds
  - Convert a Multi-Class MMF into separate funds: Institutional Fund and Retail Fund
    - No separate exemptive relief required so long as independent directors determine that the reorganization results in a fair and approximately pro rata allocation of the assets
    - Retail MMF may involuntarily redeem investors who are no longer eligible to invest in a Retail MMF provided they are given 60 days prior written notice.

Valuation Guidance

Use Amortized Cost Method of Valuation

- Government and retail MMF may continue to maintain a stable NAV by using amortized cost valuation and/or the penny rounding method of pricing. In addition, all other registered investment companies, including Institutional MMFs and business development companies may continue to use amortized cost to value debt securities with remaining maturities of 60 days or less if fund directors, in good faith, determine that the fair value of the debt securities is their amortized cost value, unless the particular circumstances warrant otherwise.

Valuation Guidance (cont'd)

- A fund may only use the amortized cost method to value a portfolio security with a remaining maturity of 60 days or less when it can reasonably conclude, at *each time* it makes a valuation determination, that the amortized cost value of the portfolio security is *approximately the same* as the fair value of the security as determined without the use of amortized cost valuation.
  - Existing credit, liquidity, or interest rate conditions in the relevant markets and issuer specific circumstances at each such time should be taken into account in making such an evaluation.
  - Because each MMF is required to "shadow price" its portfolio holdings on a daily basis using market-based factors and disclose the fund's share price using basis point rounding, SEC believes that each MMF should have readily available market-based data to assist it in monitoring any potential deviation between a security's amortized cost and fair value determined using market-based factors.

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Valuation Guidance (cont'd)

- The SEC believes in certain circumstances a fund may rely on the last obtained market-based data to assist it when valuing its portfolio securities using amortized cost.
- SEC suggests that Fund's policies and procedures could be amended to have the fund's adviser actively monitoring both market and issuer-specific developments that may indicate that the market-based fair value of a portfolio security has changed during the day indicating the use of amortized cost valuation for that security may no longer be appropriate.

Enhanced Disclosure Requirements

Website Disclosure

- Daily disclosure the following information as of the preceding business day
  - 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.

Enhanced Disclosure Requirements (cont'd)

New Form N-CR

- *Disclosure of Material Events*
  - 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.

Enhanced Disclosure Requirements (cont'd)

Form N-1A Amendments -- SAI Disclosure of Sponsor Support

- any occasion during the last 10 years (but not for occasions that occurred before the compliance date) in which the MMF received sponsor or fund affiliate support.
- In addition to the current-event disclosures required on Form N-CR.

Form N-MFP Amendments – Immediate Reporting of Fund Portfolio Holdings

- Form N-MFP information will be publicly available upon filing. The 60-day delay on public availability of the information filed on Form MFP has been removed.
- Additional information required for assessing MMF risk.

Enhanced Disclosure Requirements (cont'd)

Form PF Amendments

- Form PF is amended in order to monitor whether substantial assets migrate to private "liquidity funds" in response to MMF reforms
- "Large liquidity fund adviser" (a liquidity fund adviser managing at least $1 billion in combined MMF and liquidity fund assets) must report substantially the same portfolio information on Form PF as a MMF is required to report on Form N-MFP.

Modified Diversification Requirements

Aggregation of Affiliates

- MMFs are required to treat portfolio holdings of certain issuers that are affiliated with each other as single issuers for purposes of determining whether they are complying with MMFs' five percent issuer diversification limit.
- Under this limitation, a fund generally could not invest more than five percent of its assets in any one issuer, or group of affiliated issuers.

Removal of the 25 Percent Basket

- For MMFs other than tax-exempt MMFs the final rules would require that all of a MMF's assets meet the 10 percent diversification limit for guarantors and demand feature providers.
- For tax-exempt MMFs (also referred to as municipal MMFs), the 25 percent guarantor basket would be reduced to 15 percent so that no more than 15 percent of the value of securities held in a tax-exempt MMF's portfolio could be subject to guarantees or demand features from a single institution.

Asset-Backed Securities

MMFs would be 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 MMF's board of directors (or its delegate) 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

- Under the amendment, MMFs are 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.
- Current reporting requirements to boards of directors regarding stress testing aimed at improving the quality of reports the boards receive.

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Related Rule Proposals

Re-proposed Ratings Removal

- The re-proposed amendments would implement section 939A of the Dodd-Frank Act, which requires the SEC to remove any reference to or requirement of reliance on credit ratings in its regulations and to establish appropriate standards of creditworthiness in place of certain references to credit ratings in SEC rules.
  - Rule 2a-7 currently requires that MMFs invest only in securities that have received one of the two highest short-term ratings (that is, are rated either “first tier” or “second tier”) or if they are not rated, are of comparable quality to ensure that these funds are invested in high quality short-term securities.
  - It also currently requires that a MMF invest at least 97 percent of its assets in first tier securities. In addition, rule 2a-7 requires that a fund’s board of directors, or a delegate (typically the adviser), determine that the security presents minimal credit risks.
  - This determination must be based on factors pertaining to credit quality in addition to any rating assigned to the security.

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Related Rule Proposals (cont'd)

- *Credit Quality Determinations for Money Market Fund Portfolio Securities* –Proposal to eliminate the credit ratings requirements for MMFs. Instead, a MMF could invest in a security only if the fund's board of directors (or its delegate) determines that it presents minimal credit risks, and that determination would require the board of directors to find that the security's issuer has an exceptionally strong capacity to meet its short-term obligations.

- *Amendments to Form N-MFP* – Currently MMFs report their portfolio holdings and other information to the Commission each month on Form N-MFP, including certain credit ratings assigned to each portfolio security. The re-proposed amendments to Form N-MFP would require that a MMF disclose any credit rating that the fund's board considered in determining that a portfolio security presents minimal credit risk.

Proposed Issuer Diversification Exclusion

- The proposed amendment to rule 2a-7 would eliminate an exclusion from the issuer diversification provisions for securities with certain guarantees.

Related Rule Proposals (cont'd)

Notice of Proposed Rule 10b-10 Exemptive Relief

- Rule 10b-10 under the Securities Exchange Act of 1934 requires delivery of confirmations after each trade in mutual fund shares, except that broker-dealers are permitted to provide transaction information in MMFs on a monthly, rather than a per-transaction, basis.
- Because institutional prime money funds will no longer have stable NAVs, broker-dealers will not be able to continue to rely on this exception.
- To address, SEC proposed exemptive relief from Rule 10b-10 to exempt broker-dealers from the written notification requirement under Rule 10b-10(a) of the Securities Exchange Act of 1934 for transactions effected in shares of Floating NAV MMFs.

U.S. Treasury and IRS Issue Guidance on Accounting for Gains and Losses in Floating NAV MMFs and Wash Sales Rules

Accounting for Gains and Losses in Floating NAV MMFs -- In order to alleviate some of the complexity created by Floating NAV MMFs, the U.S. Treasury issued proposed guidance providing a simplified, aggregate annual method of tax accounting for these gains and losses, simplifying the tax treatment and promoting compliance. Shareholders in Floating NAV MMFs are able to rely on these proposed regulations to begin to use the simplified method. Specifically, the guidance:

Related Rule Proposals (cont'd)

- Allows 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 periods.
- Extends to Floating NAV MMFs the same waiver of gross-proceeds reporting, basis reporting, and holding-period reporting rules that now applies to Stable Value MMFs.

Proposed Regulation Regarding Wash Sale Rules -- Treasury and the IRS issued final guidance addressing the wash sale rules. If shareholders choose not to use the simplified method described above, this guidance provides relief from the "wash sale" rules for any losses on shares of a Floating NAV MMF. The wash sale rules don't affect shareholders who 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.

Compliance Dates

Compliance Dates	Rule/Amendment/Disclosure Requirement
May 14, 2015 ***(9 months after Effective Date)***	New Rule 30b1-8 New Form N-CR and related website disclosure (other than Parts E-G)
February 14, 2016 ***(18 months after Effective Date)***	Diversification Requirements Stress Testing Advertising Form N-1A (Amendments) Form N-MFP (Amendments) Website Disclosures (other than those required by Form N-CR) Amended Rule 30b1-7
August 14, 2016 ***(Two years after Effective Date)***	Floating NAV Liquidity Fees/Redemption Gates Form N-CR-Parts E-G and related website disclosure

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- Partner and practice leader for hedge funds of Pepper's Funds Services Practice Group
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