

CLIENT MEMORANDUM

SEC Adopts Changes to Structure and Operation of Money Market Funds

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I. Introduction

The long saga of money market reform commenced a new chapter on July 23, 2014 when the Securities and Exchange Commission, in a 3-2 vote, adopted amendments to Rule 2a-7 (the rule governing money market funds) and other rules under the Investment Company Act of 1940, as well as related reporting and disclosure requirements (the “Amendments”).¹ The Amendments follow lengthy consideration of potential regulatory responses to concerns triggered by the 2007-2008 financial crisis over the susceptibility of money market funds to significant shareholder redemptions and consequent risks to the U.S. financial system, notwithstanding prior amendments to Rule 2a-7 adopted in 2010, and represent significant changes to the way money market funds—particularly institutional prime funds—currently operate.

¹ *Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Release No. 31,166 (July 23, 2014) (“Adopting Release”), available [here](#). References to Rule 2a-7 under the Investment Company Act of 1940 (“1940 Act”) that contemplate the incorporation of the Amendments will be labeled as “Amended Rule 2a-7.”

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The Amendments primarily combine two approaches for restructuring money market fund operations: (1) requiring a floating net asset value (“NAV”) per share for any money market fund other than a government money market fund or retail money market fund; and (2) permitting a money market fund to impose liquidity fees or temporarily suspend redemptions (or “gate” the fund) in certain circumstances, but requiring a money market fund to impose liquidity fees or gates if the fund’s weekly liquid assets fall below 10% of its total assets, unless the fund’s board, including a majority of its independent directors, determines otherwise.

The Treasury Department and the Internal Revenue Service, in an effort to simplify the tax treatment for shareholders in a money market fund with a floating NAV, issued: (1) proposed guidance to permit an aggregate annual method of tax accounting for investor gains and losses; and (2) final guidance providing relief from the “wash sale” rules should a shareholder in a money market fund with a floating NAV choose not to use the proposed aggregate annual method of tax accounting. In addition, the SEC proposed an amendment to Rule 10b-10(a) under the Securities Exchange Act of 1934 to grant exemptive relief from the immediate confirmation delivery requirement, from which stable value funds with no sales load or redemption fee are currently exempt, for all money market funds operating in accordance with Rule 2a-7, subject to certain conditions.

This memorandum highlights key changes and issues related to the future operations of money market funds. In that connection, provided below is a summary of the applicability of the Amendments to the different types of money market funds. Should you be interested in a more detailed discussion of the Amendments, please see [here](#).

II. Overview of the SEC’s Changes to Money Market Funds

	Institutional Prime or Tax-Exempt/Municipal Money Market Fund	Retail Money Market Fund	Government Money Market Fund	Compliance Date
Definitions	Any money market fund not classified as a retail money market fund or government money market fund.	Money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons (e.g., use of social security numbers), which includes individual retirement accounts and 401(k) accounts.	Money market fund that invests 99.5% or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully by cash or government securities.	

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	Institutional Prime or Tax-Exempt/Municipal Money Market Fund	Retail Money Market Fund	Government Money Market Fund	Compliance Date
Net Asset Valuation	<i>Floating NAV</i> – Must price and transact in its shares based on the market value of underlying fund holdings at a NAV rounded to the fourth decimal place (e.g., \$1.0000). Generally may not use amortized cost method of valuation, except for securities that mature in 60 days or less.	<i>Stable NAV</i> – May continue to use the amortized cost method and/or the penny-rounding method to value its portfolio if the board of directors has a good faith belief that it is in the best interests of the fund and its shareholders to do so.		October 14, 2016 This includes any amendments to required disclosure relating to the floating NAV.
Liquidity Fees and Gates	Discretionary – If a money market fund’s weekly liquid assets fall below 30% of its total assets, the fund’s board of directors, including a majority of its independent directors, may impose a liquidity fee up to 2% or suspend redemptions for up to 10 business days in a 90-day period. Required – If a money market fund’s weekly liquid assets fall below 10% of its total assets, the fund must impose a liquidity fee of 1%, unless the fund’s board, including a majority of its independent directors, determines otherwise. The required liquidity fee can be imposed indefinitely.		Not subject to the liquidity fees and gates requirements, but may impose liquidity fees or gates if determined by the board of directors, including a majority of its independent directors, to be in the best interests of the fund.	October 14, 2016 This includes any amendments to required disclosure relating to liquidity fees and gates.

Additional Reforms		Compliance Date
Enhanced Disclosure	<i>Advertisement and Prospectus Disclosure</i> – A money market fund will be required to include a specific mandated disclosure statement, the exact language of which depends on whether the money market fund has a floating or stable NAV, in advertisements and other sales materials and in the summary section of the prospectus. A money market fund will also need to provide in its prospectus and statement of additional information (“SAI”) disclosure regarding the potential imposition of a liquidity fee and/or gate in response to a reduction in the fund’s liquidity, the addition of a liquidity fee and/or gate and also the historical occasions in which a fund has considered or imposed a liquidity fee and/or gate.	Disclosure related to floating NAV or liquidity fees and gates by October 14, 2016.

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Additional Reforms	Compliance Date
<p><i>Website Disclosure</i> – A money market fund will be required to disclose on its website (for the previous six months, as applicable), on a daily basis: its levels of daily and weekly liquid assets, as of the end of each business day; historical information in tabular or graphic form regarding liquid net assets; net shareholder inflows or outflows; market-based NAVs per share in tabular or graphic form (regardless of whether the fund has a floating or stable NAV); imposition of fees and gates; and any use of affiliate/sponsor support.</p> <p><i>New Form N-CR</i> – A money market fund will be required to disclose promptly certain events on a new Form N-CR, including: portfolio security defaults; provision of financial support by an affiliate to the fund, along with the amount of support and a brief description of the reason for support; a ¼ of 1% decline in the fund’s market-based price; and imposition and removal of liquidity fees or redemption gates, along with the primary considerations or factors taken into account by the board of directors in its decision related to fees and gates.</p>	<p>April 14, 2016, but website disclosure related to Form N-CR is required by July 14, 2015.</p> <p>July 14, 2015</p>
<p>Enhanced Disclosure</p> <p><i>Disclosure of Sponsor Support</i> – A money market fund will be required to provide in its SAI disclosure regarding any occasion during the last 10 years (but not for occasions that occurred before April 14, 2016) in which the money market fund received support from specified affiliates. In addition, the fund must disclose the nature of the support, a brief description of the relationship between the person providing the support and the fund, the date and amount of support, and the value of the security supported on the date support was initiated (if applicable). This disclosure would be in addition to a more detailed discussion of current-event disclosures required on new Form N-CR.</p>	<p>April 14, 2016</p>
<p><i>Form N-MFP</i> – Updated to clarify existing requirements and require reporting of additional information relevant to assessing money market fund risk. In addition, the Amendments will eliminate the current 60-day delay on public availability of the information filed on the form and make it publicly available immediately upon filing.</p>	<p>April 14, 2016</p>
<p><i>Form PF</i> – Updated to require a large liquidity fund adviser to report substantially the same portfolio information on Form PF as registered money market funds are required to report on Form N-MFP.</p>	<p>April 14, 2016</p>

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III. Floating Net Asset Value

The Amendments require a money market fund (other than a government money market fund or retail money market fund) to “float” its NAV to the fourth decimal place instead of using a stable \$1.00 per share price. Institutional prime and tax-exempt or municipal money market funds, as a result, will no longer be able to rely on the valuation exemption that previously permitted those types of funds to maintain a stable price through amortized cost valuation and penny-rounding portfolio pricing. A money market fund with a floating NAV may still use amortized cost valuation, however, on securities with remaining maturities of 60 days or less, as long as the fund’s board of directors, or its delegate, can reasonably conclude, *each time* it makes a valuation determination, that the amortized cost value of the security is *approximately* the same as the fair value of the security. The SEC explained that existing credit, liquidity, interest rate conditions and issuer-specific circumstances should be taken into account during each valuation determination.

1. Exemption for Government Money Market Funds

Under the Amendments, a government money market fund will be able to continue to provide a stable NAV using the penny-rounding method of pricing and/or the amortized cost method of valuation. A government money market fund is defined as a money market fund that invests 99.5% or more of its total assets in cash, government securities (as defined in the 1940 Act), and/or repurchase agreements that are fully collateralized by cash or government securities. Securities issued by state or local municipal governments do not fall under the definition of a government security, and therefore a tax-exempt or municipal money market fund is not eligible for this exemption from the floating NAV requirement (though a municipal or tax-exempt fund could be covered by the retail money market fund exemption).

2. Exemption for Retail Money Market Funds

A retail money market fund also may continue to provide a stable NAV, using the penny-rounding method of pricing and/or the amortized cost method of valuation for securities. A retail money market fund is defined as a fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. The SEC explained in the Adopting Release that many tax-advantaged saving accounts (e.g., individual retirement accounts or participant-directed defined contribution plans) and ordinary trusts would likely qualify under the natural person test because those types of accounts are beneficially owned by natural persons.

3. Operational Challenges

A money market fund currently serving retail and institutional investors will need to reorganize in order to rely on the retail exemption, offering separate money market funds to retail and institutional investors. Accordingly, the SEC exercised its authority under Section 6(c) of the 1940 Act to provide exemptions from certain provisions of the 1940 Act to permit, in the context of a one-time reorganization, a money market fund to (1) reorganize a class of a fund into a new fund in order to qualify as a retail money market fund, provided that the fund’s board of directors, including a majority of its independent directors, determines that the reorganization results in a fair and approximately pro rata allocation of the fund’s assets

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between the class being reorganized and the class remaining in the fund, and (2) make involuntary redemptions of certain shareholders who become ineligible to invest in a particular fund so long as the fund provides at least 60 days' written notice before the redemption occurs.

The SEC acknowledged that applying the natural person test is complicated where money market fund shareholders hold shares through an omnibus account or other financial intermediary. Since an omnibus accountholder is the shareholder of record (and not the beneficial owner), retail money market funds must establish reasonable procedures to determine that the underlying beneficial owners of the omnibus account are natural persons.² The SEC did not mandate specific procedures that retail money market funds should follow to comply with the natural person test, nor did the SEC establish a safe harbor. Accordingly, retail money market funds, in consultation with their counsel, must establish policies and procedures reasonably designed to limit beneficial owners to natural persons. The SEC believes that many funds will rely on social security numbers or other government-issued identification to verify beneficial ownership by natural persons, along with information provided by financial intermediaries relating to beneficial ownership of client accounts.

IV. Liquidity Fees and Redemption Gates

The SEC also adopted amendments to: (1) require money market funds to institute a liquidity fee in certain circumstances and (2) provide money market funds with the ability to impose a liquidity fee or temporary gate for a limited period of time.

1. Liquidity Fees

Discretionary Fees. Under the Amendments, if, at any time, a money market fund has less than 30% of its total assets invested in weekly liquid assets,³ the fund may institute a liquidity fee of up to 2% of the value of the shares redeemed, if the fund's board of directors, including a majority of its independent directors, determines that imposing a fee is in the fund's best interests. The fee must be applied to all shares redeemed and must remain in effect until the fund's board of directors, including a majority of its independent directors, determines the fee is no longer in the best interests of the fund. Unlike the redemption gates, there is no limit on the duration of a liquidity fee.

² Although it is the money market fund's obligation to satisfy the retail fund definition, an intermediary may still be held liable for violations of other federal securities laws, including the antifraud provisions, where institutional investors are improperly permitted to invest in retail funds. Adopting Release at 233, n.715.

³ "Weekly liquid assets" is defined as (1) cash, (2) direct obligations of the U.S. government, (3) government securities, as defined in Section 2(a)(16) of the 1940 Act, that are issued by a person controlled or supervised by and acting as an instrumentality of the U.S. government issued at a discount to the principal amount to be repaid at maturity without the provision for the payment of interest and have remaining maturities of 60 days or less (e.g., certain agency discount notes), (4) securities that will mature or are subject to a demand feature that is exercisable and payable within five business days, (5) and amounts receivable and due unconditionally within five business days on pending sales of portfolio securities. See Amended Rule 2a-7(a)(34).

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Required Fees. If, at the end of a business day, a money market fund has less than 10% of its total assets invested in weekly liquid assets, the fund must institute a liquidity fee in the amount of 1% of the value of the shares redeemed, effective as of the beginning of the next business day, unless the fund's board of directors, including a majority of its independent directors, determines that imposing the liquidity fee is not in the best interests of the fund. The fund's board of directors may also vary the level of the liquidity fee if it determines that a lower or higher fee (up to a maximum of 2%) is in the best interests of the fund. Once imposed, the liquidity fee will remain in effect until the money market fund's board of directors, including a majority of its independent directors, determines that imposing the fee is not in the best interests of the fund. If, however, the money market fund has 30% or more of its total assets invested in weekly liquid assets, the fund must cease charging the liquidity fee, effective as of the beginning of the next business day.

For beneficial owners holding money market fund shares through omnibus accounts, liquidity fees will be applied in accordance with contractual arrangements between the fund or its transfer agent and the financial intermediary. The SEC expects that some money market fund sponsors will review their contractual arrangements to determine whether contractual modifications are necessary or advisable to ensure that liquidity fees are appropriately applied to the beneficial owners of money market fund shares.

Government money market funds are not required to impose a liquidity fee under any circumstances, including where less than 10% of a fund's total assets are invested in weekly liquid assets. Nonetheless, a government money market fund may impose a liquidity fee provided that the ability to do so is disclosed in the fund's prospectus and the fund complies with the liquidity fee requirements of Amended Rule 2a-7.

2. Redemption Gates

Under the Amendments, if, at any time, a money market fund has less than 30% of its total assets in weekly liquid assets, the fund's board of directors, including a majority of its independent directors, may determine to suspend the right of redemption temporarily. The suspension must apply to all shares (*i.e.*, a fund board could not allow a shareholder to redeem a specific dollar amount of the shareholder's investment in the fund) and remain in effect until the earlier of: (1) the beginning of the first business day following a business day at the end of which 30% or more of the money market fund's total assets were in weekly liquid assets; or (2) the first business day following ten business days after suspending redemptions. The money market fund may not suspend the right of redemption for more than 10 days in any rolling 90 calendar day period. Unlike the liquidity fee, the imposition of the gate is imposed purely at the discretion of the fund's board.

3. Board Determinations

To determine whether a liquidity fee or gate is appropriate should a money market fund's weekly liquid assets drop below the required minimum, the SEC explained that the fund's board, in consultation with the fund's adviser, should follow the

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“best interests” standard. Nevertheless, the SEC provided the following non-exhaustive list of factors a board of directors may want to consider in making the determination as to whether to impose a liquidity fee or suspend redemptions:

- relevant indicators of liquidity stress in the markets and reasons why the fund’s weekly liquid assets have fallen;
- the liquidity profile of the money market fund and expectations as to how that profile might change in the immediate future, including 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;
- for retail money market funds and government money market funds, whether the decrease in weekly liquid assets has been accompanied by a decline in the fund’s shadow price;
- the composition of the money market fund’s shareholder base and previous shareholder redemption patterns for the fund; and/or
- the fund’s experience, if any, with the imposition of liquidity fees and/or gates in the past.⁴

If you have any questions regarding this memorandum, please contact Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), Margery K. Neale (212-728-8297, mneale@willkie.com), Joseph A. Riley (212-728-8715, jriley@willkie.com), Christopher S. Petito (202-303-1117, cpetito@willkie.com), Anne C. Choe (202-303-1285, achoe@willkie.com), James W. Hahn (202-303-1228, jhahn@willkie.com) or the Willkie attorney with whom you regularly work.

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⁴ Adopting Release at 90-91. The SEC declined to affirm that the board’s deliberations would be protected by the business judgment rule, stating that it would not “be appropriate for us to address the application of the business judgment rule because the business judgment rule is a construct of state law and not the federal securities laws.” Adopting Release at 91.