CLIENT ALERT

SEC Adopts Amendments to Money Market Fund Rules

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On July 12, 2023, in a 3-2 vote, the Securities and Exchange Commission (the "SEC" or "Commission") adopted amendments to rules and forms relating to money market funds ("MMFs"), including Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act"), the primary rule governing the operation of MMFs (collectively, the "Final Amendments").[1] Amendments to rules and forms relating to MMFs were proposed in December 2021.[2] The Final Amendments comprise the third installment of the SEC's endeavors since 2008 to reform MMFs, stemming from concerns about prime and tax-exempt MMFs that were highlighted by market events that occurred in March 2020 at the beginning of the COVID-19 pandemic.[3] Notably, in a change from the proposal, the SEC is not requiring that institutional prime and institutional tax-exempt MMFs employ swing pricing.

Specifically, the Final Amendments, among other things:

- Remove the ability for a MMF board to temporarily suspend redemptions (i.e., impose a "gate") and remove the tie between liquidity thresholds and the potential imposition of liquidity fees;

1 *See* Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A, 1940 Act Release No. 34959 (July 12, 2023), available here (the "Adopting Release").

2 *See* Money Market Fund Reforms, 1940 Act Release No. 34441 (Dec. 15, 2021), available here (the "Proposing Release").

3 *See* Adopting Release at 14; *see also* SEC Press Release, SEC Proposes Amendments to Money Market Fund Rules (Dec. 15, 2021), available here.

- Require institutional prime and institutional tax-exempt MMFs to impose a mandatory liquidity fee if total daily net redemptions exceed 5% of net assets, subject to a *de minimis* exception;

- Permit other MMFs to impose a discretionary liquidity fee if the board determines a fee is in the best interests of the fund;

- Increase the daily liquid asset and weekly liquid asset minimum requirements from 10% and 30% of total assets, respectively, to 25% and 50% of total assets, respectively;

- Specify how MMFs must calculate weighted average maturity and weighted average life;

- Amend existing stress test requirements such that they reflect the amended liquidity fee framework and the increase in the daily and weekly liquid asset minimums;

- Address how MMFs with stable net asset values may handle a negative interest rate environment, which includes permitting these MMFs to a “reverse distribution mechanism”; and

- Amend certain reporting requirements on Form N-MFP, Form N-CR, Form N-1A and Form PF.

Removal of Redemption Gates and Tie Between the Weekly Liquid Asset Threshold and Liquidity Fees

Rule 2a-7 under the 1940 Act currently provides that a MMF may institute a liquidity fee of up to 2% or temporarily suspend redemptions (i.e., impose a “gate”) for up to 10 business days in a 90-day period if the MMF’s weekly liquid assets fall below 30% of its total assets and the MMF’s board of directors determines that imposing a fee or gate is in the MMF’s best interests. Further, a non-government MMF currently is required to impose a liquidity fee of 1% on all redemptions if its weekly liquid assets fall below 10% of its total assets unless the board of directors of the MMF determines that imposing the fee would not be in the best interests of the MMF.

As proposed, the Final Amendments remove the redemption gate provisions from Rule 2a-7. The Final Amendments also remove the link between weekly liquid assets and liquidity fees, and instead include a modified liquidity fee framework that provides for both mandatory and discretionary liquidity fees for certain MMFs under various circumstances.

The Commission stated that it believes the removal of the gate provisions will reduce the risk of large scale investor requests for redemptions from MMFs during periods of market stress and noted that MMFs will continue to be able to impose permanent gates to facilitate orderly liquidation of a MMF pursuant to Rule 22e-3 under the 1940 Act, as the Final Amendments do not address that rule.[4]

[4] *See* Adopting Release at 23.

New Liquidity Fee Framework

Mandatory Liquidity Fee For Institutional Funds. The Final Amendments provide a mandatory liquidity fee framework for institutional prime and tax-exempt MMFs instead of the proposed swing pricing requirement. Specifically, these funds will be subject to a mandatory liquidity fee when net redemptions exceed 5% of net assets, or such smaller amount of net redemptions as the board (or its delegate) determines. In determining whether it has crossed the 5% threshold, a MMF may not distinguish between flows for different pricing periods during the day, and instead must apply a fee to all investors who redeemed on that day if the threshold is crossed. MMFs must use net flow information for the day that is available within a reasonable period after the last computation of the MMF's net asset value on that day. The mandatory liquidity fee applies to all redemptions on each business day on which a MMF crosses the net redemption threshold.

The amount of the mandatory liquidity fee will be determined by the MMF's making a good faith estimate, supported by data, of the costs the MMF would incur if it were to sell a pro rata amount of each security in its portfolio (i.e., a "vertical slice") to satisfy the amount of net redemptions. These costs include transaction and market impact costs. There is no upper limit on the amount of the liquidity fee.

Transaction costs include spread costs, such that the MMF is valuing each security at its bid price, and any other charges, fees and taxes associated with portfolio security sales. To calculate market impact costs, MMFs must establish a market impact factor for each security, which is a good faith estimate of the percentage change in the value of the security if it were sold, per dollar of the amount of the security that would be sold, if the MMF sold a pro rata amount of each security in its portfolio to satisfy the amount of net redemptions, under current market conditions. The MMF would then multiply the market impact factor by the dollar amount of the security that would be sold. MMFs may assume a market impact of zero for daily and weekly liquid assets.

A MMF can estimate transaction costs and market impacts for each type of security with the same or substantially similar characteristics and apply those estimates to all securities of that type in the MMF's portfolio, rather than separately analyze each security.

If the MMF cannot estimate the costs of selling a vertical slice of its portfolio in good faith and supported by data, the MMF must apply a default liquidity fee of 1% of the value of shares redeemed (on days that the 5% threshold has been crossed). In addition, a mandatory liquidity fee will not be required if a MMF makes a good faith estimate that liquidity costs are less than one basis point, which the SEC expects to be the case under normal market conditions.

Discretionary Liquidity Fee For Other Funds. Under the Final Amendments, all prime and tax-exempt MMFs may apply a discretionary liquidity fee of up to 2% of the value of shares redeemed if the board, including a majority of directors who are not interested persons of the MMF, determines that the liquidity fee is in the best interests of the MMF. Similar to current Rule 2a-7, the discretionary liquidity fee provision will not apply to government MMFs, though such MMFs may elect to be subject to such provision. The discretionary fee applies irrespective of liquidity or redemption levels and is charged to redeeming investors. The discretionary fee must be applied to all shares redeemed and remain in effect until the MMF's board, including a majority of directors who are not interested persons of the MMF, determines that imposing the fee is no longer in the best interests of the MMF.

Institutional funds that are subject to mandatory liquidity fee requirements may elect to impose a discretionary liquidity fee on days where a mandatory liquidity fee is not required to be imposed.

Board Responsibilities. A MMF's board is responsible for administering both the mandatory and discretionary liquidity fees; however, it may delegate this responsibility to the MMF's investment adviser or officers, subject to board guidelines and oversight. Under this approach, a MMF will need to adopt and periodically review board-approved written guidelines (including guidelines for determining the application and size of liquidity fees) and procedures under which a delegate makes such determinations. The written guidelines generally should specify the manner in which the delegate is to act with respect to any discretionary aspect of the liquidity fee mechanism. The board will also need to periodically review the delegate's liquidity fee determinations.

Recordkeeping. The Final Amendments also implement certain recordkeeping requirements for MMFs to retain records that document how the MMF determines the amount of any liquidity fee.

Increase to the Minimum Daily and Weekly Liquidity Requirements

As proposed, the Final Amendments require that a MMF, immediately after acquisition of an asset, hold at least 25% of its total assets in daily liquid assets and at least 50% of its total assets in weekly liquid assets.[5] Under current Rule 2a-7, the daily liquid assets and weekly liquid assets thresholds are 10% and 30%, respectively.

If a MMF falls below one of these liquidity minimums, the MMF may not acquire any assets other than daily liquid assets or weekly liquid assets, respectively, until it meets these minimum thresholds. As proposed, the MMF must notify its board when its liquidity falls to less than half of the required levels, meaning that the MMF has invested less than 12.5% of its total assets in daily liquid assets or less than 25% of its total assets in weekly liquid assets (a "liquidity threshold event"). The MMF must notify its board within one business day of the liquidity threshold event and must provide the board with a brief description of facts and circumstances that led to the liquidity threshold event within four business days after its occurrence.

Amendments Related to Liquidity Stress Testing Requirements

The Final Amendments also provide for amendments to the liquidity metrics in Rule 2a-7's stress testing requirements to reflect the liquidity fee framework and increase of regulatory liquidity minimums. The Final Amendments remove the current

[5] Assets that make up daily liquid assets and weekly liquid assets are cash or securities that can readily be converted to cash within one business day or five business days, respectively.

requirement under Rule 2a-7 that a MMF test its ability to have at least 10% of its total net assets invested in weekly liquid assets and instead require a MMF to determine the minimum level of liquidity it seeks to maintain during stress periods, identify that liquidity level in its written stress testing procedures, periodically test its ability to maintain such liquidity, and provide the MMF’s board with a report of the results on testing.

Amendments Related to Negative Interest Rate Environments

The Commission noted that, if negative interest rates occur in the future, the gross yield of a MMF’s portfolio may turn negative. Under those circumstances, it would be challenging for a government or retail MMF (or “stable NAV fund”) to maintain its stable share price under current Rule 2a-7, as the MMF would begin to lose money. The Final Amendments provide for a stable NAV fund to either convert to a floating NAV (an option it has under current Rule 2a-7) or to use a “reverse distribution mechanism” (i.e., reduce the number of its shares), subject to certain conditions and required disclosures. If a stable NAV fund converts to a floating NAV under these circumstances, the MMF’s losses will be reflected through a declining share price. If a stable NAV fund uses a reverse distribution mechanism (also referred to as “share cancellation”), the MMF will maintain a stable share price, despite losing value, by reducing the number of its outstanding shares. Investors in such a MMF would observe a stable share price but a declining number of shares for their investment.

The Final Amendments allow for a stable NAV fund to use a reverse distribution mechanism only if the MMF has negative gross yield as a result of negative interest rates, and then only if the MMF’s board of directors determines that reducing the number of its shares outstanding is in the best interests of the MMF and its shareholders.[6] The board generally should review its determination that share cancellation is in the best interests of the MMF and its shareholders if circumstances change, including if a negative interest rate event appears to be reasonably likely to occur in the near future. The board may not delegate to the MMF’s investment adviser or officers the responsibility to make such determination.[7]

Calculation of Weighted Average Maturity and Weighted Average Life

The Commission adopted, as proposed, an amendment to Rule 2a-7 to specify the calculations of “dollar-weighted average portfolio maturity” (“WAM”) and “dollar-weighted average life maturity” (“WAL”). Under the amended definitions of WAM and WAL, a MMF will be required to calculate WAM and WAL based on the percentage of each security’s market value in its

6 The board should consider the capabilities of the MMF’s service providers and intermediaries to support the equitable application of share cancellation across the MMF’s shareholders, as well as any state law limitations on share cancellation. *See* Adopting Release at 117.

7 The MMF must provide to investors timely, concise, and plain-English disclosure about the MMF’s share cancellation practices and their effects on investors both before and during a negative interest rate event. This disclosure should include a clear and prominent statement that an investor is losing money when the MMF cancels the investor’s shares. The MMF generally should also clearly and concisely describe tax effects for shareholders. *See* Adopting Release at 119-23.

portfolio. The Commission noted that these amendments are intended to enhance the consistency of calculations for MMFs, while allowing the Commission to better monitor and respond to indicators of potential risk and stress in the market.[8]

Amendments to Reporting Requirements

Form N-CR. The Final Amendments remove the current reporting requirements on Form N-CR about the imposition of liquidity fees, as that information will now be required to be reported on Form N-MFP.

The Final Amendments add a new requirement for a MMF to report on Form N-CR the occurrence of a liquidity threshold event (i.e., the MMF has invested less than 12.5% of its total assets in daily liquid assets or less than 25% of its total assets in weekly liquid assets) within one business day of the event. However, the MMF may file an amended report providing the required brief description of the facts and circumstances leading to the liquidity threshold event up to four business days after such event. Specifically, the MMF must report (1) the initial date on which the MMF fell below the applicable liquidity threshold; (2) the percentage of the MMF's total assets invested in both weekly liquid assets and daily liquid assets on the initial date of a liquidity threshold event; and (3) a brief description of the facts and circumstances leading to the liquidity threshold event.

The Final Amendments also require MMFs to (1) file reports on Form N-CR in a custom eXtensible Markup Language ("XML")-based structured data language created specifically for reports on Form N-CR; (2) include the registrant name, series name, and legal entity identifiers ("LEIs") for the registrant and the series; (3) add definitions of LEIs, registrant, and series to Form N-CR for clarity and consistency with the same defined terms on Form N-MFP; (4) remove the reporting events that relate to liquidity fees and redemption gates; and (5) amend Part C of Form N-CR, which relates to the provision of financial support to the MMF.

Form N-MFP. The Final Amendments include revisions to Form N-MFP to include certain information related to any application of a liquidity fee. Specifically, MMFs will now be required to report whether they applied a liquidity fee during the reporting period and, if so, information about each liquidity fee applied, including the date, the type of fee, and the amount. If the fee was mandatory, the MMF must disclose whether the fee was based on good faith estimates of the MMF's liquidity costs or was a default fee.

Further, the Final Amendments require MMFs to report additional information about the composition and concentration of MMF shareholders and about prime MMFs' sales of non-maturing investments.

The Commission also adopted, as proposed, amendments to Form N-MFP which require that filers identify (1) the name of the counterparty in a repurchase agreement; (2) whether a repurchase agreement is centrally cleared and the name of the

8 *See* Adopting Release at 126.

central clearing counterparty, if applicable; (3) if a repurchase agreement was settled on a triparty platform; and (4) the CUSIP number of the securities involved in the repurchase agreement.

Form N-1A. The Final Amendments also amend the narrative risk disclosure requirement in Form N-1A to reflect the amended liquidity fee framework. Additionally, MMFs must make certain disclosures in the Statement of Additional Information related to the new liquidity fee mechanism.

Form PF. The Final Amendments include amendments to Form PF, the confidential reporting form for certain SEC-registered investment advisers to private funds, which were proposed in January 2022.[9] The amendments require large liquidity fund advisers to provide additional information regarding the liquidity funds they advise, given the similarity between liquidity funds and MMFs.

Technical Amendments to Form N-CSR and Form N-1A

Finally, the Commission also adopted technical amendments to Form N-CSR and Form N-1A to correct certain errors from prior rulemakings. The Commission adopted an amendment to Form N-CSR to retain an exception addressing MMFs' financial statements that was inadvertently omitted as a result of amendments adopted in the Tailored Shareholder Reports Adopting Release. The Commission also adopted amendments to Item 27A(i) of Form N-1A and the corresponding instructions to correct an error resulting from the Commission's 2022 rulemaking on enhanced reporting of proxy votes by registered management investment companies.

Effective and Compliance Dates

All of the Final Amendments have a simultaneous effective and compliance date of October 2, 2023, except as set out below.

<table>
<tr><th>Amendment</th><th>Effective Date</th><th>Compliance Date</th></tr>
<tr><td>Increase to the Minimum Daily and Weekly Liquidity Requirements</td><td rowspan="4">October 2, 2023</td><td rowspan="3">April 2, 2024</td></tr>
<tr><td>Calculation of Weighted Average Maturity and Weighted Average Life</td></tr>
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<tr><td>Mandatory Liquidity Fee Requirement</td><td>October 2, 2024</td></tr>
<tr><td>Amendments to Forms N-MFP, N-CR, and PF</td><td colspan="2">June 11, 2024</td></tr>
</table>

9 *See* Form PF; Reporting Requirements for All Filers and Large Hedge Fund Advisers, Advisers Act Release No. 6083 (Aug. 10, 2022), available here.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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