

## SEC Releases Long-Awaited Money Market Fund Reform Proposal

*If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.*

**Thomas A. DeCapo**

Boston  
617.573.4814  
thomas.decapo@skadden.com

**Kenneth E. Burdon**

Boston  
617.573.4836  
kenneth.burdon@skadden.com

\* \* \*

*This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.*

On June 5, 2013, the U.S. Securities and Exchange Commission (the SEC) released for public comment its proposal to further reform the regulatory structure governing money market funds and address the perceived systemic risks money market funds present. The SEC's proposed reform package includes two alternative approaches to reform that could be adopted by the SEC either alone or in combination:

1. a requirement that institutional prime money market funds (institutional prime funds) transact at a floating net asset value (NAV) per share, as opposed to a stable NAV per share of \$1.00, while permitting retail prime money market funds (retail prime funds) and government money market funds (government funds) to continue to transact at a stable NAV per share (the Floating NAV Alternative);<sup>1</sup> or
2. a requirement that all money market funds — other than government funds — whose weekly liquid assets fall below 15 percent of its total assets impose a liquidity fee of 2 percent on all redemptions. A fund's board of directors may determine not to impose the liquidity fee if the board (including a majority of the independent directors) determines that imposing the liquidity fee is not in the best interest of the fund, or may determine to impose a smaller fee. Additionally, once a fund's weekly liquid assets fall below 15 percent of a fund's total assets, the fund's board of directors would have the ability to temporarily suspend redemptions (or "gate" the fund) if the board (including a majority of the independent directors) determines that doing so is in the fund's best interest (the Liquidity Fee/Gate Alternative).

If the Floating NAV Alternative and the Liquidity Fee/Gate Alternative were combined, institutional prime funds would be required to transact at a floating NAV and all nongovernment funds would be able to impose liquidity fees or gates in certain circumstances. Together with these reform alternatives, the SEC also proposed a variety of disclosure enhancements and additional tightening of Rule 2a-7 diversification and stress testing requirements for money market funds. Moreover, in an apparent effort to monitor whether assets migrate to private unregistered money market fund alternatives (liquidity funds)<sup>2</sup> in response to any reforms enacted with respect to money market funds, the SEC also proposed amendments to Form PF, which private fund advisers use to report information about certain private funds they advise.

The SEC's release describing these proposed changes to the money market fund regulatory regime (the Release) represents the most comprehensive proposed re-

1 A "prime" money market fund typically holds a variety of taxable short-term obligations issued by corporations and banks, as well as repurchase agreements and asset-backed commercial paper; whereas a "government" money market fund principally holds obligations of the U.S. government, including obligations of the U.S. Treasury and federal agencies and instrumentalities, as well as repurchase agreements collateralized by government securities. For purposes of this reform proposal, the SEC has divided money market funds into "prime" and "government" funds, and then has further divided prime funds into "institutional" prime funds and "retail" prime funds.

2 Form PF defines a "liquidity fund" as any private fund that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors. See Glossary of Terms to Form PF.

One Beacon Street  
Boston, Massachusetts 02108  
Telephone: 617.573.4800

Four Times Square, New York, NY 10036  
Telephone: 212.735.3000

[WWW.SKADDEN.COM](http://WWW.SKADDEN.COM)

write of money market fund regulation since the adoption of Rule 2a-7 in 1983<sup>3</sup> and could have far-reaching implications for the money market fund industry, for issuers of short-term debt instruments, investors in money market funds and for money management industry participants. The Release runs 698 pages and contains 1,249 footnotes and more than 500 requests for comment on dozens of topics. In addition to the principal topics the Release covers, which are summarized in this memorandum, the Release proposes, or requests comment with respect to, a variety of clarifying and conforming amendments to the regulatory structure governing money market funds and attempts to address the tax and accounting related implications of the SEC's proposals.

In order to help industry participants organize and evaluate the requests for comment contained in the Release and consider whether they wish to participate in the comment process, we have created a separate document — “SEC Requests for Comment on Money Market Fund Reform Proposal” — that organizes these requests for comment and identifies particular requests that may be of interest to non-money market fund commenters.

Comments are due 90 days from the Release's publication in the Federal Register. As of the close of business on June 13, 2013, the Release had not yet been published in the Federal Register.

### Floating NAV Alternative

Under the Floating NAV Alternative, institutional prime funds would be required to transact at a floating NAV per share, as opposed to a stable NAV per share of \$1.00, while retail prime funds and government funds would be permitted to transact at a stable NAV per share. “Retail” prime funds would be defined as those funds that restrict a shareholder of record from redeeming more than \$1 million in any one business day, and “government” funds would be defined as those funds that maintain at least 80 percent of their total assets in cash, “government securities”<sup>4</sup> or repurchase agreements that are collateralized with government securities.

*Floating NAV for Institutional Prime Funds.* Money market funds seek to maintain a stable share price by relying on exemptions provided in Rule 2a-7 under the Investment Company Act of 1940 (the 1940 Act) that permit them to value their portfolio securities using the “amortized cost” method of valuation and to use the “penny rounding” method of pricing. Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount, rather than at their value based on current market factors.<sup>5</sup> The penny rounding method of pricing permits a money market fund when pricing its shares to round the fund's net asset value to the nearest 1 percent (*i.e.*, the nearest penny).<sup>6</sup> Money market funds use a combination of these two methods so that, under normal circumstances, they can use the penny rounding method to maintain a price of \$1.00 per share without pricing to the third decimal point like other mutual funds, and the amortized cost method so that they need not strike a daily market-based NAV.

<sup>3</sup> See Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), 1940 Act Rel. No. 13380 (Jul. 11, 1983).

<sup>4</sup> “Government security” means any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing. 1940 Act § 2(a)(16). This definition excludes securities issued by state and municipal governments.

<sup>5</sup> See Rule 2a-7(a)(2).

<sup>6</sup> See Rule 2a-7(a)(20).

The Floating NAV Alternative would operate by no longer permitting institutional prime funds to value their portfolios using the amortized cost method<sup>7</sup> or price their shares using the penny rounding method of pricing. Instead of using the penny rounding method of pricing, institutional prime funds would be required to price their shares using “basis point” rounding. Under this method of pricing, institutional prime funds would be required to price their shares to the nearest 1/100<sup>th</sup> of 1 percent. Thus, for an institutional prime fund priced at \$1.00, it would be required to price its shares to four decimal places — *i.e.*, \$1.0000.<sup>8</sup> According to the Release, this additional level of precision would better reflect small fluctuations in a fund’s NAV per share and calibrate investor expectations to tolerate fluctuations in the fund’s value. Institutional prime funds would remain subject to the “risk limiting” provisions of Rule 2a-7 — thus, funds holding themselves out as money market funds would continue to be limited to investing in short-term, high-quality, dollar-denominated instruments.

*Exemption for Retail Prime Funds.* Retail prime funds would be permitted to continue to use the penny rounding method to price their shares and thus be exempt from the floating NAV requirement proposed for institutional prime funds. As is the case today, a retail prime fund’s NAV would need to decrease by 50 basis points — or half a penny — in order for the fund to “break the buck.”

The Release asserts that penny rounding alone is sufficient to support a stable NAV per share and that the principal benefit of using amortized cost valuation in addition to penny rounding is that it alleviates the burden of the fund having to value portfolio securities at market value each day. As discussed in further detail under “Enhanced Disclosure and Reporting Requirements,” the Release also proposes to require that all money market funds disclose on a daily basis their share price with their portfolios valued at market value and applying basis point rounding. As a result, money market funds, including those exempt from a floating NAV requirement, would have to value their portfolio assets using market factors instead of amortized cost each day. Thus, the Release proposes to eliminate the ability of all money market funds to use the amortized cost method to value their portfolios, except to the extent other mutual funds are permitted to do so.<sup>9</sup>

The SEC believes that the \$1 million-per-record shareholder daily redemption limit for retail prime funds will cause institutional investors to self-select into institutional prime funds on the assumption that institutional investors would not be able to tolerate such a redemption limit.<sup>10</sup> The principal issues surrounding the \$1 million daily redemption limit for retail prime funds are a mechanism (if any) to accommodate “one-off” redemption requests in excess of \$1 million in a single day; the amount of the redemption limit; various methods by which investors could “game” retail prime funds (through, for example, having an account in one’s own name and an account through an intermediary); the appropriate time frame for the limitation (*i.e.*, daily, weekly, etc.), how to treat redemption requests in excess of the redemption limit and issues surrounding the treatment of omnibus accounts.<sup>11</sup> With respect to omnibus accounts, a fund would not be required to impose redemption limits on an omnibus account holder (which is the shareholder of record) if the fund has in place policies and procedures reasonably designed to “allow” the conclusion that the omnibus account holder does not permit any

---

7 The amortized cost method of valuation could be used only to the same extent as other mutual funds are currently able to do so — *i.e.*, where the fund’s board of directors determines, in good faith, that the fair value of debt securities with remaining maturities of 60 days or less is their amortized cost.

8 An equivalent level of accuracy would be required for funds with a different share price (*e.g.*, \$10.000 or \$100.00).

9 See *supra*, n. 7.

10 The SEC also considered maximum account balance and shareholder concentration as alternative methods to distinguish between “retail” prime funds and “institutional” prime funds and requests comment on these alternative approaches.

11 Omnibus accounts may consist of holdings of thousands of investors and typically aggregate all customer orders, net purchases and redemptions, and often present a single buy and a single sell order to the fund.

beneficial owner from “directly or indirectly” redeeming more than \$1 million in a single day.<sup>12</sup> This requirement in particular may result in significant new ongoing compliance obligations and commenters may wish to consider encouraging the SEC to clearly define any such compliance obligations in any final rule it may adopt.

*Exemption for Government Funds.* Government funds, like retail prime funds, would be permitted to continue to use the penny rounding method to price their shares and thus be exempt from the floating NAV requirement proposed for institutional prime funds. As discussed above, the Release proposes to eliminate the ability of all money market funds to use the amortized cost method to value their portfolios, except to the extent other mutual funds are permitted to do so, and this would likewise apply to government funds.

Notably, tax-exempt municipal bonds would not satisfy the 80 percent “government securities” requirement for purposes of this exemption.<sup>13</sup> Thus, money market funds principally investing in tax-exempt municipal bonds would not qualify for the government fund exemption. Rather, in order to continue to maintain a stable NAV per share, such funds could only qualify under the retail prime fund exemption discussed above.<sup>14</sup> Most money market funds are required to invest at least 10 percent of their portfolios in assets that can provide daily liquidity; however, this requirement does not apply to tax-exempt funds.<sup>15</sup> The Release requests comment on whether the SEC should require tax-exempt funds that wish to take advantage of the proposed retail prime fund exemption to also meet the 10 percent daily liquid asset requirement.

*Amendment to Rule 22e-3.* Rule 22e-3 exempts money market funds from Section 22(e) of the 1940 Act to permit them to suspend redemptions and postpone payment of redemption proceeds to facilitate an orderly liquidation of the fund. Rule 22e-3 currently requires that a fund’s board of directors, including a majority of independent directors, determine that the deviation between the fund’s amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results before it suspends redemptions. Under the Floating NAV Alternative, institutional prime funds would be permitted to suspend redemptions pursuant to Rule 22e-3 to facilitate an orderly liquidation, when, among other requirements, the fund, at the end of a business day, has less than 15 percent of its total assets in weekly liquid assets.<sup>16</sup> Funds maintaining a stable NAV per share under the Floating NAV Alternative — retail prime funds and government funds — would have the same flexibility and would further be permitted to suspend redemptions to facilitate an orderly liquidation when the fund’s price per share is no longer equal to its stable share price at the end of a business day or the fund’s board (including a majority of independent directors) determines that such a change is likely to occur.

---

12 The Release explains that the restriction on “direct or indirect” redemptions is designed to manage issues related to “chains of intermediaries,” such as when an investor purchases fund shares through one intermediary, for example, an introducing broker or retirement plan, which then purchases the fund shares through a second intermediary, such as a clearing broker. The proposed exemption would require that a retail prime fund’s policies and procedures be reasonably designed to “allow” the conclusion that the fund’s redemption limit is applied to beneficial owners all the way down any chain of intermediaries. If a fund cannot reasonably conclude that such policies are enforced by intermediaries at each step of the chain, then the fund must apply its redemption limit at the aggregate omnibus account holder level (or rely on a cooperating intermediary to apply the fund’s redemption limits to any uncooperative intermediaries further down the chain). See Release at pp.89-90.

13 See *supra*, note 4.

14 See Release at p.69.

15 See Rule 2a-7(c)(5).

16 “Weekly liquidity 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. Money market funds are generally subject to a requirement to maintain 30 percent of their portfolios in assets that can provide weekly liquidity. See Rule 2a-7(c)(5).

### Liquidity Fee/Gate Alternative

Under the Liquidity Fee/Gate Alternative, all money market funds (subject to special rules for government funds) would continue to transact at a stable NAV per share using the penny rounding pricing method.<sup>17</sup> However, the Liquidity Fee/Gate Proposal would:

- require a money market fund whose weekly liquid assets fall below 15 percent of its total assets (*i.e.*, half the amount required to be maintained by a money market fund under Rule 2a-7) (the liquidity threshold) to institute a liquidity fee of 2 percent on all redemptions;
  - unless** the fund's board of directors (including a majority of the independent directors) determine that the liquidity fee is **not** in the best interests of the fund or that a **lower** fee is in the best interests of the fund; and
- permit a money market fund whose weekly liquid assets fall below the liquidity threshold to impose a gate for a limited period of time;
  - provided that** the fund's board (including a majority of the independent directors) determines that doing so is in the fund's best interests.

Government funds<sup>18</sup> would be exempt from the liquidity fee *requirement*, but would be *permitted* to impose such a liquidity fee or a gate consistent with the provisions of the Liquidity Fee/Gate Alternative if such ability were disclosed in the fund's prospectus.

Under this proposal, the liquidity fee is structured as an immediate default position, with an optional ability for a fund's board to eliminate or lower the fee, replace the fee with a gates or impose a gate immediately — so long as the board determines that doing so is in the best interests of the fund. The Liquidity Fee/Gate Alternative imposes significant additional duties on a fund's board as it relates to determinations of whether, when and in what amount (with respect to liquidity fees) to enact a liquidity fee or gate, and the Release contains various suggestions with respect to factors a board may wish to consider in this regard.<sup>19</sup>

With respect to the terms of liquidity fees, in addition to the board's discretion to eliminate or reduce the fee at any time upon a finding that doing so is in the best interests of the fund, any liquidity fee would be automatically lifted once the money market fund's level of weekly liquid assets had risen to or above 30 percent of its total assets (*i.e.*, the amount required under Rule 2a-7). Likewise, any gate imposed would be automatically lifted once the money market fund's level of weekly liquid assets had risen to or above 30 percent of its total assets. Additionally, irrespective of a money market fund's level of weekly liquid assets, any money market fund imposing a gate would need to lift that gate within 30 days and a money market fund could not impose a gate for more than 30 days in any 90-day period.

17 As discussed above, the Release proposes to eliminate the ability of all money market funds to use the amortized cost method to value their portfolios, except to the extent other mutual funds are permitted to do so, and this would likewise apply to all money market funds if the SEC enacts the Liquidity Fee/Gate Alternative.

18 "Government" funds would be defined as those funds that maintain at least 80 percent of their total assets in cash, government securities or repurchase agreements that are collateralized with government securities. This is the same definition used under the Floating NAV Alternative.

19 See Release at pp.179, 185, 222. As an example, for imposing a smaller liquidity fee these suggested factors include the fund's shadow price, relevant market indicators of liquidity stress in the markets, changes in spreads for portfolio securities (whether based on actual sales, dealer quotes, pricing vendor mark-to-model or matrix pricing, or otherwise), changes in the liquidity profile of the fund in response to redemptions and expectations regarding that profile in the immediate future, and whether the money market fund and its intermediaries are capable of rapidly putting in place a fee of a different amount. See Release at p.185. For imposing a gate, the Release suggests similar factors, though adds factors such as the fund's ability to apply any collected liquidity fees quickly to rebuild fund liquidity and the predicted time for portfolio securities to mature and provide internal liquidity to the fund, and for potentially distressed portfolio securities to mature or recover. See Release at p.222.

In addition to the ability to impose the liquidity fees and gates described above, under the Liquidity Fee/Gate Alternative money market funds would have the same flexibility under Rule 22e-3 to suspend redemptions to facilitate an orderly liquidation of the fund as described with respect to the Floating NAV Alternative. Because all money market funds would be stable NAV funds under the Liquidity Fee/Gate Alternative, all money market funds would have the ability to suspend redemptions to facilitate an orderly liquidation of the fund if, at the end of a business day, either (a) the fund has less than 15 percent of its total assets in weekly liquid assets or (b) the fund's price per share is no longer equal to its stable share price or the fund's board (including a majority of independent directors) determines that such a change is likely to occur.

### Combination of the Floating NAV Alternative and the Liquidity Fee/Gate Alternative

The Release also proposes an alternative of combining the Floating NAV Alternative and the Liquidity Fee/Gate Alternative (the Combined Approach). According to the Release, the SEC would seek to preserve the exemptions applicable to the Floating NAV Alternative and the Liquidity Fee/Gate Alternative in any Combined Approach — *i.e.*, any Combined Approach would likely provide an exemption to the floating NAV **and** to fees and gates for government funds, but would provide only an exemption to the floating NAV for retail prime funds, and **not** an exemption to fees and gates.<sup>20</sup>

A Combined Approach also raises a number of issues with respect to how the contours of the Floating NAV Alternative and the Liquidity Fee/Gate Alternative might be modified and/or combined in a Combined Approach:

- the appropriate default size of the liquidity fee, the appropriate thresholds for triggering the imposition of a liquidity fee and the thresholds for removing it;
- whether to combine a floating NAV with a liquidity fee alone, or with a gate alone; and
- whether to permit nongovernment funds to choose either to transact at a floating NAV or to be able to impose liquidity fees and gates in times of stress.

Several SEC commissioners have indicated interest in a Combined Approach and have encouraged commenters to address a Combined Approach.<sup>21</sup>

### Enhanced Disclosure and Reporting Requirements

The Release also proposes a variety of disclosure enhancements designed to provide greater transparency.

*Prospectuses, Statements of Additional Information and Advertisements.* Each of the reform proposals discussed above also contains proposed mandatory disclosure to be included in funds' prospectuses, statements of additional information and sales materials.

*Financial Support Provided to Money Market Funds.* A money market fund would be required to disclose in its Statement of Additional Information any occasion during the last 10 years on which an affiliated person, promoter or principal underwriter of the fund, or an affiliated person of such person, provided any form of financial support to the fund. Additionally, a money market fund would have to post prominently on its website certain information regarding any occasion on which it receives financial support from a sponsor or an affiliate within one business day, and maintain that

<sup>20</sup> See Release at p.247.

<sup>21</sup> See Statement of Chairman Mary Jo White (Jun. 5, 2013) ("We specifically solicit and I am interested in commenters' views on this combined approach."); Statement of Commissioner Elisse B. Walter (Jun. 5, 2013) ("My preliminary preference would be to combine these two options, and I welcome comment on how they might work together."); Statement of Commissioner Daniel M. Gallagher (Jun. 5, 2013) ("For me, the combination of floating NAV and gating, which is one of the regulatory options we are proposing today, is the most robust plan for strengthening these important investment products.").

information on its website for at least a year. “Financial support” would include, but not be limited to, any capital contribution, purchase of a security from the fund in reliance on Rule 17a-9, purchase of any defaulted or devalued security at par, purchase of fund shares, execution of a letter of credit or letter of indemnity, capital support agreement (whether or not the fund ultimately received support), or performance guarantee, or any other similar action to increase the value of the fund’s portfolio or otherwise support the fund during times of stress.

The Release does not propose to repeal or otherwise modify Rule 17a-9 under the 1940 Act, which permits money market fund sponsors to support money market funds through portfolio purchases in some circumstances. The Release does, however, request comment as to whether the retention of Rule 17a-9 is consistent with achieving the goals of reform proposals contained in the Release.

*Additional Enhanced Website Disclosures.* The Release contains proposals for all money market funds to expand the scope of information available on their websites, including to:

- disclose prominently the percentage of the fund’s total assets that are invested in daily and weekly liquid assets, as well as the fund’s net inflows and outflows, as of the end of the previous business day, and maintain a schedule, chart, graph or other depiction showing six months’ worth of historical information about the same, updated each business day; and
- disclose prominently on a daily basis the fund’s “current NAV” — meaning its basis point rounded (*i.e.*, \$1.0000) NAV per share after valuing its portfolio based on current market factors (in other words, the fund’s “shadow NAV” if transacting at a stable NAV) — and maintain a schedule, chart, graph or other depiction showing six months’ worth of historical information about the same, updated each business day.<sup>22</sup>

*New Form N-CR.* The Release proposes a new rule that would require money market funds, under either the Floating NAV Alternative or the Liquidity Fee/Gate Alternative, to file new Form N-CR with the SEC upon the occurrence of portfolio security defaults, sponsor “financial support” of funds (as described above) and other similar events. Funds maintaining a stable NAV (retail prime funds and government funds under the Floating NAV Alternative, or all funds under the Liquidity Fee/Gate Alternative) would be required to report a fall in the fund’s market-based NAV per share below \$0.9975 (*i.e.*, ¼ of 1 percent below the intended stable price).

Additionally, if the Liquidity Fee/Gate Alternative is enacted, a fund would need to file a report on Form N-CR (1) upon reaching the threshold triggering board consideration of a liquidity fee or redemption gate and (2) upon lifting the fee or resuming redemptions. The Form N-CR filing would need to disclose various details regarding the reportable event, the most notable being a short discussion of the board’s analysis supporting its decision regarding the imposition of a liquidity fee and/or gate.

Form N-CR would be filed with the SEC on EDGAR, publicly available upon filing and due one business day following the reportable event. Certain items regarding the imposition of a liquidity fee and/or gate, including the discussion of the board’s analysis, would be due the fourth business day following the reportable event.

*Amendments to Form N-MFP Reporting Requirements.* The Release proposes various amendments to the Form N-MFP reporting regime. Other than amendments designed to address changes to Rule 2a-7 arising out of the adoption of the Floating NAV Alternative or the Liquidity Fee/Gate Alternative, the Release indicates that the SEC may adopt the proposed changes to the Form N-MFP reporting

---

22 A related proposed amendment to Rule 2a-7 would clarify that stable NAV funds must calculate their current NAV per share based on current market factors at least once each business day, rather than at times determined in the discretion of the fund’s board. *Cf.* Rule 2a-7(c)(8)(ii).

regime even without enacting broader money market fund reform.<sup>23</sup> The proposed changes to the Form N-MFP reporting regime include adding several new items to Form N-MFP designed to address perceived gaps in information that have become apparent to the SEC,<sup>24</sup> making certain technical clarifying amendments and eliminating the 60-day delay on the public availability of the information contained in Form N-MFP and making it public immediately upon filing. The elimination of the 60-day delay on the public availability of the information contained in Form N-MFP largely operates to make funds' "shadow NAVs" immediately available, consistent with the general approach to transparency favored by the Release.

The Release likewise proposes to harmonize the portfolio holdings information required to be disclosed on a fund's website under Rule 2a-7 with the corresponding portfolio holdings information proposed to be reported on Form N-MFP (including market-based valuations of portfolio securities) and requests comment on whether to require more frequent disclosure of money market funds' portfolio holdings on the fund's website (currently, this information must be disclosed monthly).

*Broker Confirmations.* Rule 10b-10 under the Securities Exchange Act of 1934 (the Confirmation Rule) addresses broker-dealers' obligations to confirm their customers' securities transactions. The rule provides an exception for transactions in money market funds that attempt to maintain a stable net asset value and where no sales load or redemption fee is charged.<sup>25</sup> The rule permits a broker-dealer to provide transaction information to money market fund shareholders on a monthly basis in lieu of individual, immediate confirmations for all purchases and redemptions of shares of money market funds. The Release requests comment on whether, if the SEC adopts the Floating NAV Alternative, it should leave the Confirmation Rule unchanged, which would have the effect of requiring broker-dealers to provide investors in floating NAV money market funds (*i.e.*, institutional prime funds) immediate confirmations of their transactions.

### Diversification and Stress Testing

The Release also includes several proposals designed to strengthen the diversification of money market fund assets and enhance the stress testing requirements the SEC adopted as part of its 2010 money market fund reform package.

*Aggregation of Affiliates for Purposes of the 5 percent Issuer Diversification Requirement.* Generally, money market funds must limit their investments in the securities of any one issuer to no more than 5 percent of fund assets.<sup>26</sup> Rule 2a-7, however, does not require a money market fund to aggregate its exposures to entities that are affiliated with each other when measuring its exposure for purposes of these requirements.<sup>27</sup> The Release proposes to require money market funds to aggregate their exposures to certain entities that are affiliated with each other by control when applying Rule 2a-7's 5

23 See Release at n.753.

24 These include security identifiers, fair value hierarchy characterization of securities under U.S. Generally Accepted Accounting Principles, additional information about portfolio securities, reporting of daily liquid assets and weekly liquid assets, shareholder concentration and information regarding maturities.

25 See Rule 10b-10(b).

26 This requirement applies to "first tier securities" other than government securities. See Rule 2a-7(c)(4)(i)(A)-(B). A "first tier security" is any eligible security that has received a short-term credit rating in the highest short-term category for debt obligations or, if the security is an unrated security, that is of comparable quality, as determined by the money market fund's board of directors. See Rule 2a-7(a)(14). A fund also may invest no more than 0.5 percent of fund assets in any one issuer of a second tier security. See Rule 2a-7(c)(4)(i)(C). A second tier security is an eligible security that is not a first tier security. See Rule 2a-7(a)(24).

27 As explained in the Release, "Under current Rule 2a-7, for example, a money market fund could invest 5 percent of its assets in Bank XYZ, NA, another 5 percent of its assets in Bank XYZ Corp., another 5 percent of its assets in Bank XYZ Securities, LLC, another 5 percent of its assets in Bank XYZ (Grand Cayman), another 5 percent of its assets in Bank XYZ (London), and so on." Release at p.422.

percent issuer diversification limit. Under the proposal, entities would be affiliated if in a control relationship (*i.e.*, controlling, controlled by or under common control with), and “control” for this purpose would be defined to mean ownership of more than 50 percent of an entity’s voting securities.<sup>28</sup>

*Asset-Backed Securities.* Rule 2a-7 does not currently require a money market fund to diversify its exposure to asset-backed security (ABS) sponsors because special purpose entities (SPEs) — rather than the sponsors themselves — issue the ABS, and the support that ABS sponsors provide, implicitly or explicitly, typically does not meet the rule’s definition of a “guarantee” or “demand feature.”<sup>29</sup> Nonetheless, the Release states that the SEC believes money market funds investing in some types of asset-backed commercial paper (ABCP) functionally rely on the ABCP sponsor for liquidity and other support and make investment decisions based, at least in part, on the presumption that the sponsor will take steps to prevent the ABCP from defaulting, including committing capital.<sup>30</sup> The Release proposes to treat the sponsor of an SPE issuing ABS as a guarantor of the ABS subject to Rule 2a-7’s diversification limitations applicable to guarantors and demand feature providers.<sup>31</sup> As a result, a fund could not invest in an ABS if, immediately after the investment, it would have invested more than 10 percent of its total assets in securities issued by or subject to demand features or guarantees (as newly defined) from the ABS sponsor. The Release also proposes to permit a fund’s board of directors (or its delegate) to determine that the fund is not relying on the ABS sponsor’s financial strength or its ability or willingness to provide liquidity, credit or other support to determine the ABS’s quality or liquidity and thereby not treat the ABS sponsor as a guarantor of the ABS.<sup>32</sup>

*Elimination of the “25 percent Basket.”* Rule 2a-7 currently applies a 10 percent diversification limit on guarantees and demand features only to 75 percent of a money market fund’s total assets — this is often referred to as the “25 percent basket” because as much as 25 percent of the value of securities held in a fund’s portfolio may be subject to guarantees or demand features from a single institution.<sup>33</sup> The Release proposes to eliminate the 25 percent basket<sup>34</sup> and apply the 10 percent diversification limit on guarantees and demand features to all of a fund’s assets.<sup>35</sup>

*Issuer Transparency.* Rule 2a-7 permits a money market fund when determining if a security subject to a guarantee meets the rule’s credit quality standards to rely exclusively on the credit quality of the

28 A “voting security” is any security presently entitling the owner or holder thereof to vote for the election of directors of a company (or its equivalent, *e.g.*, general partner, manager of an LLC, etc.). See 1940 Act § 2(a)(42).

29 See Release at p.441.

30 See Release at pp.441-442.

31 The ABS sponsor would not be deemed to be a guarantor for purposes of the following aspects of Rule 2a-7 (as proposed to be amended): definition of eligible security, credit substitution, fractional guarantees and guarantees not relied on. See Release at n.875.

32 This exception would be analogous to the current treatment of guarantees and demand features that a fund does not rely upon and that may be disregarded under Rule 2a-7. See Rule 2a-7(c)(6).

33 See Rule 2a-7(c)(4)(iii)(A). The 25 percent basket can only be used to invest in demand features or guarantees that are first tier securities issued by noncontrolled persons (currently defined in Rule 2a-7(a)(10)). See Rule 2a-7(c)(4)(iii)(B)-(C).

34 The Release states that the SEC is not proposing to change the application of Rule 2a-7’s 5 percent issuer limit to single-state funds, which today applies only to 75 percent of a single-state fund’s total assets. A “single-state fund” is a tax exempt fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state and, where applicable, subdivisions thereof. See Rule 2a-7(a)(25).

35 The Release requests comment on whether the SEC should eliminate a similar 25 percent basket contained in Rule 12d3-1 under the 1940 Act, which provides that the acquisition of a demand feature or guarantee as defined in rule 2a-7 will not be deemed to be an acquisition of the securities of a securities-related business provided that “immediately after the acquisition of any Demand Feature or Guarantee, the company will not, with respect to 75 percent of the total value of its assets, have invested more than ten percent of the total value of its assets in securities underlying Demand Features or Guarantees from the same institution.” See Rule 12d3-1(d)(7)(v). Rule 12d3-1 under the 1940 Act generally permits investment companies to purchase certain securities issued by companies engaged in securities-related activities notwithstanding the limitations on these kinds of transactions contained in Section 12(d)(3) of the 1940 Act.

guarantor.<sup>36</sup> The Release requests comment on whether the SEC should require money market funds to obtain financial data on the underlying issuers whose securities are subject to the guarantees.

*Stress Testing.* The Release proposes that money market funds stress test against the fund's level of weekly liquid assets falling below 15 percent of its total assets, in addition to its ability to maintain a stable NAV per share (in the case of a fund that would maintain a stable NAV per share under the reform alternative adopted). In addition, the Release proposes various enhancements designed to strengthen how money market funds stress test their portfolios and report the results of their stress tests to their boards of directors. In particular, the Release proposes to add a requirement that the fund's adviser provide to the fund's board, in addition to its assessment of the results of the stress test, such information as may reasonably be necessary for the board of directors to evaluate the stress testing conducted by the adviser and the results of the testing.

### Treatment of Private Liquidity Funds

The Release proposes to amend Form PF, the form that certain investment advisers registered with the SEC use to report information regarding the private funds they manage, including "liquidity funds," which are private funds that seek to maintain a stable NAV (or minimize fluctuations in their NAVs) and thus can resemble money market funds. This proposal is in response to the SEC's apparent concern that any money market fund reforms could result in a migration of assets to liquidity funds that would, in the SEC's view, reduce transparency of the potential purchasers of short-term debt instruments and potentially increase systemic risk.<sup>37</sup> To address this perceived risk, the Release proposes to require large liquidity fund advisers — defined as registered advisers with \$1 billion or more in combined money market fund and liquidity fund assets — to file in large part the same information with respect to their liquidity funds' portfolio holdings on Form PF as money market funds are required to file on Form N-MFP.

### Proposed Compliance Dates

The compliance date for these proposals would be as follows:

- *Floating NAV Alternative:* **two years** after the effective date of the adoption with respect to any amendments specifically related to the Floating NAV Alternative, including any related amendments to disclosure;
- *Liquidity Fee/Gate Alternative:* **one year** after the effective date of the adoption with respect to any amendments specifically related to the Liquidity Fee/Gate Alternative, including any related amendments to disclosure; and
- *General Compliance Date:* **nine months** after the effective date of the adoption for all other proposed amendments to money market fund regulation not specifically related to either the Floating NAV Alternative or the Liquidity Fee/Gate Alternative.

---

<sup>36</sup> See Rule 2a-7(c)(3)(iii).

<sup>37</sup> See Release at pp.398-399.