SEC Adopts Money Market Fund Reform Rules

Executive Summary

The Securities and Exchange Commission ("SEC" or "Commission") adopted amendments to the rules governing money market mutual funds ("MMFs" or "funds") under Title 17, Part 270 – Rules and Regulations of the *Investment Company Act of 1940* ("Act") on July 23, 2014. The amendments, which are designed to address systemic risks posed by the susceptibility of MMFs to heavy redemptions in times of fund or market stress, consist of two principle reforms to Section 270.2a-7 ("Rule 2a-7") of the Act contained in the Commission's June 2013 MMF reform proposed rule ("June 2013 proposal"), with certain modifications:

- **Floating net asset value** ("NAV"), including removal of the valuation exemption permitting institutional non-government MMFs to maintain a stable NAV. Institutional non-government MMFs, whose investors, the SEC indicates, have historically made the heaviest redemptions during times of fund or market stress, will be required to transact at a floating NAV by selling and redeeming shares based on the current market-based value of the securities in their underlying portfolios, rounded to the fourth decimal place (e.g., $1.0000).
- **Liquidity fees and redemption gates** ("fees and gates"), including provisions providing non-government MMF boards of directors with "new tools" to stem heavy redemptions by (1) allowing them to impose a liquidity fee of no more than 2 percent, if a fund's weekly liquidity level falls below the required regulatory threshold, and (2) giving them discretion to suspend redemptions temporarily under the same circumstances (i.e., to "gate" the funds). Under these amendments, all non-government MMFs will be required to impose a liquidity fee of 1 percent if the fund's weekly liquidity level falls below 10 percent of total assets, unless the fund's board determines that either imposing such a fee is not in the "best interests" of the fund or that a higher fee of up to 2 percent (or a lower fee) is in the fund's best interest.

Additionally, the SEC adopted amendments designed to improve MMFs' resiliency by increasing the diversification of their portfolios, enhancing their stress testing requirements, and improving transparency through additional disclosure requirements to both the SEC and investors. Lastly, the amendments require investment advisers to certain large unregistered liquidity funds to provide additional information to the SEC.

The rules became effective October 14, 2014. The SEC has established compliance dates in 2015 and 2016 that are applicable to specific provisions of the rules that are outlined in more detail below.

Background

MMFs, a type of mutual fund registered under the Act and regulated by the SEC under the Act's Rule 2a-7, are cash management vehicles that are widely used by retail and institutional investors due to their principal stability, liquidity, and payment of short-term yields that are generally higher than interest-bearing bank accounts. MMFs vary by underlying asset type, with some funds investing primarily in government securities, tax-exempt municipal securities, or corporate and financial institution debt securities. Funds investing in corporate debt securities are referred to as "prime MMFs" or "prime funds." In addition, MMFs are structured to meet the demands of different types of investors, with some funds intended for retail investors and marketed to individuals and other funds intended for institutional investors, which typically require higher minimum investments.

MMFs generally pay dividends reflecting prevailing short-term interest rates, are redeemable on demand, and, unlike other investment companies, seek to maintain a stable NAV, typically set at $1.00 per share, by investing in short-term, high-quality debt securities that fluctuate very little in value under normal market conditions. Unlike other mutual funds, which price and transact in their shares using a floating NAV, this stable NAV is facilitated by Rule 2a-7, which permits MMFs to use the amortized cost method of valuation[1] and the penny-rounding method of pricing[2] for their entire portfolios. These valuation and pricing techniques allow an MMF to sell and redeem shares at a stable share price without regard to small variations in the value of the securities in its portfolio.

On September 16, 2008, as a result of its sizeable investment in the commercial paper and medium-term notes issued by a global investment bank[3] that had announced its bankruptcy the day before, one of the oldest and largest mixed retail and institutional MMFs in the United States "broke the buck" (i.e., lowered its NAV from $1.00 per share to $0.97 per share) and temporarily suspended redemptions. Simultaneous turbulence in the broader financial sector securities market resulting from other stresses, including the near failure of a multinational insurance organization whose commercial paper was held by many prime MMFs, further undermined the perceived stability of these funds by their investors. These unusual events triggered a subsequent run on MMFs, with investors withdrawing approximately $300 billion from prime MMFs or 14 percent of assets.[4] Fearing further redemptions, MMF managers retained cash rather than investing in commercial paper, certificates of deposit, or other short-term instruments. Short-term financing markets subsequently froze, impairing corporate and financial institution access to credit. Due to the broad

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[1] Rule 2-7 defines the amortized cost method of valuation as the method of calculating an investment company's NAV whereby portfolio securities are valued at the fund's acquisition cost as adjusted for amortization of premium or accretion of discount, rather than at their value based on current market factors.
[2] Rule 2a-7 defines the penny-rounding method of pricing as the method of computing an investment company's price per share for purposes of distribution, redemption, and repurchase whereby the current NAV per share is rounded to the nearest one percent.
[3] The fund held a $785 million position, or 1.2 percent of the fund's assets, in the global investment bank's commercial paper.
[4] Reported investor redemptions during the financial crisis were heaviest in the institutional share classes of prime MMFs, which tend to hold less liquid, lower credit quality securities than those typically held by government MMFs. Generally, institutional prime MMFs cater to institutional investors and invest in short-term debt obligations issued by corporations and financial institutions, as well as U.S. government securities, repurchase agreements, and asset-backed commercial paper.

economic importance of MMFs to these short-term financing markets and their wide use as vehicles for savings, the U.S. government temporarily intervened to halt the run and stabilize the market.

In response to these events, the SEC adopted a number of amendments to Rule 2a-7 in March 2010 designed to increase MMF resiliency to withstand heavy redemptions by reducing the interest rate, credit, and liquidity risks of fund portfolios. When the Commission adopted the March 2010 amendments, it noted that additional reforms would be forthcoming to assist in addressing potential future situations where either credit losses cause a fund's portfolio to lose value or the short-term financing markets come under stress. The SEC subsequently proposed alternative reforms in June 2013 that included a floating NAV for institutional prime funds and permissible fees and gates.

Description

Definitions and Reform Applicability

For the purposes of identifying the applicability of both the floating NAV reform and the fees and gates reform requirements, the final rules create new categories for retail and government MMFs that are defined as follows:

- A **retail MMF** "means a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons."
    - Notably, this definition differs significantly from the SEC's June 2013 proposal, which would have defined a retail MMF as any MMF that prohibits each shareholder from redeeming more than $1 million from the fund in a single business day.
    - Consistent with the June 2013 proposal, the final rules continue to allow retail MMFs to maintain a stable NAV through the use of amortized cost valuation and/or penny-rounding pricing, but do not provide an exemption from the fees and gates reform requirements.
- A **government MMF** "means a money market fund that invests 99.5 percent or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully."
    - Government MMFs will also continue to be allowed to maintain a stable NAV and are not required to implement the fees and gates reform requirements. A government MMF may, however, voluntarily impose fees and gates, provided they comply with the amended fees and gates requirements and the fund discloses its ability to do so.
    - In a departure from the June 2013 proposal, a government MMF will no longer be permitted to invest up to 20 percent of its total assets in non-government assets, as currently permitted under Rule 2a-7. Rather, these funds will be permitted a 0.5 percent de minimis non-conforming basket in which they may invest in non-government assets and will be required to amend their existing policies and procedures to reflect this new 0.5 percent de minimis amount.

Rule 2a-7 continues to include the following definition of a tax-exempt fund:

- A **tax-exempt fund**, or municipal MMF, "means any money market fund that holds itself out as distributing income exempt from regular federal income tax."

- While both the floating NAV reform and the fees and gates reform will apply to institutional municipal MMFs, a municipal MMF that qualifies as a retail MMF would not be subject to the floating NAV reform.

The final rules do not provide for an explicit definition of an **institutional prime MMF**. Rather, the final rules infer that an institutional prime MMF falls under the category of "any money market fund that is not a government money market fund or a retail money market fund," as described by the above terms.

Floating Net Asset Value Reform

In order to address specific risks associated with institutional prime MMFs, the SEC has amended Rule 2a-7 to rescind certain exemptions that previously permitted these funds to maintain a stable price by using an amortized cost valuation and/or penny-rounding pricing method. As a result, institutional prime MMFs must value their portfolio securities using market-based factors as well as sell and redeem their shares based on a floating NAV.

Consistent with the SEC's proposal, the final rules change the rounding convention from penny rounding to a more precise "basis point" rounding to the nearest 1/100th of one percent. As a result, institutional prime funds will be required to round and transact their share prices to four decimal places, in the case of a fund with a $1.00 target share price (i.e., $1.0000), or an equivalent or more precise level of accuracy for MMFs with a different share price (e.g., an MMF with a $10 target share price could price its shares at $10.000). These funds will (1) be subject to the risk-limiting conditions of Rule 2a-7, (2) continue to be limited to investing in short-term, high-quality, dollar-denominated instruments, and (3) be subject to certain other reforms adopted by the Commission.

Liquidity Fees and Redemption Gates Reform

To stem heavy redemptions and avoid the type of contagion that occurred during the financial crisis, the SEC has also amended Rule 2a-7 to authorize new tools for MMFs to use in times of fund or market stress. These amendments provide MMFs with the ability to impose fees and gates under certain circumstances:

- **Mandatory liquidity fees:** An MMF will be required to impose a liquidity fee of 1 percent on all redemptions if its weekly liquid assets fall below 10 percent of its total assets, unless the fund's board of directors, including a majority of its directors who are not interested persons of the fund, determines that imposing the fee would not be in the fund's best interest.
- **Discretionary liquidity fees and temporary suspensions of redemptions:** An MMF will be allowed to impose a liquidity fee of up to 2 percent on all redemptions, or temporarily suspend redemptions for up to ten business days in a ninety-day period, if the fund's weekly liquid assets[5] fall below 30 percent of its total assets and the fund's board of directors (including a majority of its independent directors) determines that imposing a fee or gate is in the fund's best interest.

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[5] Under Rule 2a-7, weekly liquid assets generally include cash, direct obligations of the U.S. government such as U.S. Treasury securities, certain other government agency securities with remaining maturities of sixty days or less, and securities that convert into cash within one week.

The final fees and gates reform differs from the SEC's June 2013 proposal, which would have required funds to impose a 2 percent liquidity fee on all redemptions and permitted the imposition of redemption gates for up to thirty days in a ninety-day period, if a fund's weekly liquid assets fall below 15 percent of its total assets.

Enhanced Portfolio Diversification Requirements

The final rules include the following changes to the diversification requirements for the portfolios of MMFs:

- **Aggregation of affiliates:** An MMF must treat certain entities that are affiliated with each other as single issuers for the purposes of determining whether they are complying with the MMF's 5 percent issuer diversification limit under Rule 2a-7. Under this limitation, a fund generally could not invest more than 5 percent of its assets in any one issuer or group of affiliated issuers.
- **Removal of the 25 percent guarantor basket for non-tax-exempt MMFs:** The final rules require that all of a non-tax-exempt MMF's assets meet Rule 2a-7's 10 percent diversification limit for guarantors and demand feature providers, thereby removing the "25 percent basket" that permitted up to 25 percent of the value of the securities held in an MMF's portfolio to be subject to guarantees or demand features from a single institution.
- **Reduction of the 25 percent guarantor basket for tax-exempt MMFs:** Under the final rules, the 25 percent basket will 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 will be subject to guarantees or demand features from a single institution.
- **Treatment of asset-backed securities sponsors as guarantors:** MMFs will be required to treat the sponsors of asset-backed securities as guarantors subject to the 10 percent diversification limit of Rule 2a-7 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. The MMF's board will also be required to maintain a record of this determination.

Enhanced Portfolio Stress Testing Requirements

The final rules include certain enhancements to the stress testing requirements for MMF portfolios that were adopted as part of the SEC's March 2010 amendments to Rule 2a-7. Specifically, an MMF will be required to periodically test its ability to maintain weekly liquid assets of at least 10 percent, as opposed to the 15 percent threshold in the SEC's June 2013 proposal. An MMF will also be required to minimize principal volatility in response to specified hypothetical events that have been modified from the June 2013 proposal to include:

- An increase in the general level of short-term interest rates, in combination with various levels of increasing shareholder redemptions;
- A downgrade or default of particular portfolio security positions, each representing various exposures in a fund's portfolio, as well as varying assumptions about the resulting loss in the security's value, in combination with various levels of increasing shareholder redemptions;
- A widening of spreads in various sectors to which the fund's portfolio is exposed, in combination with various levels of increasing shareholder redemptions; and
- Any additional combination of events that the fund adviser deems relevant.

The fund adviser will also be required to establish written procedures and report the stress testing results to the MMF's board.

The proposed enhancements would have included requirements for funds to consider factors such as correlations among securities returns and various combinations of certain events in their stress tests, an assessment of how a fund would meet increasing shareholder redemptions (taking into consideration assumptions regarding the liquidity and price of the portfolio's securities), and both parallel and non-parallel shifts in the yield curve.

Disclosure and Reporting Requirements Amendments

The final rules include various additional MMF disclosure and reporting requirements, including, for example:

- **Daily web site disclosures of fund portfolio holdings:** MMFs will be required to post certain information on their web sites that must be updated each business day, such as daily and weekly liquid asset levels, net shareholder inflows and outflows, the fund's market-based NAV per share, the imposition of fees and gates, and any use of affiliate sponsor support.
- **New reporting Form N-CR:** Under the final rules, the SEC has adopted a new Form N-CR that MMFs must file with the Commission within one business day after certain significant events occur, including instances, for example, when a portfolio security defaults, an affiliate provides financial support to the fund, the fund experiences a significant decline in the market-based value of its portfolio, or liquidity fees or redemption gates are either imposed or lifted.
- **New material event disclosure:** MMFs will be required to promptly post their response to the occurrence of any event specified in Part C (financial support), Part E (imposition of liquidity fees), Part F (suspension of fund redemptions), or Part G (removal of liquidity fees and/or resumption of fund redemptions) of the SEC's new Form N-CR.
- **Immediate reporting of fund portfolio holdings:** The final rules amend Form N-MFP[6] to clarify certain existing requirements and require reporting of additional information relevant to assessing an MMF's risk. In addition, the final rules eliminate the current sixty-day delay on public availability of the information filed on the form and require that it be made available to the public immediately upon filing.
- **Additional private liquidity fund reporting:** In order to better monitor whether substantial assets migrate to private liquidity funds[7] in response to the Commission's MMF reforms, the final rules amend Form PF[8] to require a large liquidity fund adviser[9] to report substantially the same portfolio information on Form PF as registered MMFs are required to report on Form N-MFP.

Tax and Accounting Guidance

In response to the SEC's adoption of the final rules, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued guidance

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[6] Form N-MFP is used by MMFs to report information about their portfolio holdings to the SEC each month.
[7] A liquidity fund is generally defined as an unregistered MMF.
[8] Form PF is used by private fund advisers to report information about certain private funds they advise.
[9] The SEC defines a large liquidity fund adviser as one that manages at least $1 billion in combined MMF and liquidity fund assets.

proposing new regulations to allow floating NAV MMF investors to use a simplified tax accounting method, referred to as the "NAV method," to track gains and losses. The proposed regulation would eliminate the need to track individual purchase and sale transactions for tax reporting purposes. The Treasury and IRS state that shareholders of floating NAV MMFs may rely on the proposed regulations before the issuance of their final regulations.

In addition, the Treasury and IRS issued a new revenue procedure that provides relief from the "wash sale" rules for any losses on shares of a floating NAV MMF. Under the wash sale rules, a taxpayer is not permitted to realize a loss on a disposition of stock or other securities if, within thirty days before or after the disposition, the taxpayer acquires, or enters into a contract or option to acquire, substantially identical stock or securities.

Additional Related Reform Proposals

Concurrent with its adoption of the amendments to Rule 2a-7, the SEC issued additional MMF reform proposals, including a notice of proposed exemptive order that would grant relief from certain confirmation delivery requirements applicable to broker-dealers for qualified transactions in floating NAV MMFs. The SEC also re-proposed amendments that would implement Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which requires the Commission to remove references to credit ratings in its regulations and establish appropriate standards of creditworthiness in place of certain references to credit ratings in its rules. Lastly, the Commission proposed an amendment to Rule 2a-7 that would eliminate an exclusion from the issuer diversification provisions for securities with certain guarantees.

Compliance Timing

The SEC has established the following compliance requirements for specific provisions of the rules:

Provision	Required compliance date	Modifications from the proposal
Floating NAV reform, including all related disclosure amendments.	October 14, 2016	Adopted as proposed.
Fees and gates reform, including all related disclosure amendments.	October 14, 2016	Adoption of a longer two-year compliance period instead of the proposed one-year period.
Rule 30b1-8,[10] Form N-CR, and related web site disclosure.	July 14, 2015[11]	Adopted as proposed.
Diversification, stress testing, disclosure, Form PF, Form N-MFP, and clarifying amendments not specifically related to either floating NAV or fees and gates.	April 14, 2016	Adoption of a longer eighteen-month compliance period instead of the proposed nine-month period.

[10] The SEC's new Rule 30b1-8 requires MMFs to file the new Form N-CR when certain significant events occur.
[11] The SEC notes that Parts E, F, and G of Form N-CR are disclosure items specifically related to the fees and gates amendments and therefore would also have the two-year compliance period after the effective date of the adoption of Parts E, F, and G of Form N-CR and Rule 2a-7(h)(10)(v) (web site disclosure of certain information required to be reported in Form N-CR).

Commentary

The SEC's adoption of the MMF reforms is an important milestone for the retail and institutional investors who use MMFs as cash management vehicles and the corporations, financial institutions, municipalities, and others that use MMFs as a source of short-term funding.

Many commenters on the SEC's June 2013 proposal expressed concern about the unintended consequences of requiring a floating NAV for certain MMFs, suggesting that it was a significant reform that would remove one of the most desirable features of these funds, while imposing numerous costs and operational burdens. However, other commenters supported the floating NAV reform, noting that, by limiting its applicability to institutional non-government MMFs, the SEC had provided a targeted solution aimed at addressing the risks associated with the types of MMFs most susceptible to destabilizing runs by investors. Most commenters generally supported requiring the imposition of fees and gates in certain circumstances, suggesting that they could potentially prevent investor runs at minimal cost. However, commenters also noted that fees and gates alone would not resolve certain MMF features that can incentivize heavy redemptions.

The SEC has offered some relief to MMFs by extending the compliance dates for certain amendments to allow additional time for these funds, as well as their sponsors and service providers, to incorporate the requisite operational changes to their systems needed to implement these provisions. However, impacted institutional MMFs should consider starting their efforts immediately to address the complexities of these reforms, as the floating NAV and other requirements may involve a major platform transformation. While the full impact of the SEC's reforms on MMFs remains to be seen, it is clear that these measures will likely serve as a catalyst for back office transformation. Additionally, both fund administrators and managers will likely need to contemplate and implement certain operational and reporting capabilities necessary to support the floating NAV requirements. As managers seek to enhance their systems and regulatory reporting capabilities to comply with the final rules and their related enhanced disclosure requirements, administrators should also consider enhancing certain monitoring processes.

This is a publication of KPMG's Financial Services Regulatory Risk Practice and the Americas Financial Services Regulatory Center of Excellence

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