OnPoint

Dechert LLP

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A Legal Update from Dechert LLP

SEC Proposes Sweeping Amendments to Rules Governing Money Market Funds

The U.S. Securities and Exchange Commission (SEC or Commission) on June 5, 2013 proposed for public comment sweeping amendments to Rule 2a-7 under the Investment Company Act of 1940 and other rules relating to money market funds (money funds).[1] The Proposal included two key alternatives – (i) requiring "institutional" prime money funds to operate with a floating net asset value (NAV), rounded to the fourth decimal place (*e.g.*, $1.0000) (Alternative 1) or (ii) requiring money funds (other than government money funds) to impose a 2% liquidity fee during times of stress and allowing them temporarily to suspend redemptions using "redemption gates" during such times (Alternative 2). At the meeting approving the Proposal for public comment, several Commissioners raised the possibility of combining the two Alternatives into a single proposal and the SEC asked for public comment on that approach in the Proposal.

In addition to the Alternatives, the SEC recommended reforms that would be adopted under either Alternative, including more stringent disclosure, diversification and stress testing requirements. The SEC also recommended amendments to Form PF to require investment advisers to private liquidity funds, which generally operate in a manner similar to registered money funds, to disclose the funds' portfolio holdings and certain other information. Finally, the SEC proposed a number of amendments to clarify certain provisions of Rule 2a-7.

The Proposal begins a new phase in the ongoing debate over the regulation of money funds that has loomed over the investment management industry since the 2008 financial crisis. This *DechertOnPoint* provides background on the events leading up to the Proposal and discusses each of the proposed reforms in the Proposal.

BACKGROUND

During the financial crisis, the Reserve Primary Fund, a prime money fund, became the second money fund in history to "break the buck" when its shares dropped from $1.00 to $0.97 in the wake of the Lehman Brothers' bankruptcy. This led to a "flight to quality" as money fund shareholders moved their investments out of prime money funds and into government money funds. The redemptions from prime money funds aggravated a lack of liquidity in the commercial paper market, which some have argued led to further distress in the financial system.

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1 Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (June 5, 2013) (the Proposal) (PDF).

In response to the financial crisis, the SEC adopted amendments to Rule 2a-7 and other rules governing money funds in January 2010 (the 2010 Amendments).[2] These reforms included enhanced liquidity requirements and tighter maturity, diversification and credit quality standards for money fund investments. When the 2010 Amendments were adopted, the Chairman of the SEC at that time, Mary Schapiro, described them as "an important first step in our efforts to strengthen the money market regime."

In 2012, the SEC staff prepared for Commission consideration a proposal that would have required money funds to either: (i) convert to a floating NAV; or (ii) maintain a stable NAV while maintaining a capital buffer and imposing certain restrictions on redemptions (the Staff Proposals). However, Chairman Schapiro was not able to reach a consensus with other SEC Commissioners on the Staff Proposals and announced in late August 2012 that the SEC would not be moving forward with the Staff Proposals.[3]

Prompted by the SEC's failure to act on the Staff Proposals, on November 13, 2012, the U.S. Financial Stability Oversight Council (FSOC) issued proposed recommendations to the SEC (the FSOC Recommendations).[4] The FSOC Recommendations included the following three alternatives: (i) a floating NAV (along with money funds pricing their shares at $100.00 as opposed to $1.00 per share); (ii) a stable NAV subject to a buffer of up to 1% of a money fund's assets and the imposition of a holdback requirement, or minimum balance at risk, applicable to certain redemptions for investors with account balances in excess of $100,000; and (iii) a stable NAV subject to a buffer of 3%, which amount possibly could be reduced if the money fund were to implement a combination of other measures. At the FSOC meeting at which the vote took place, several members of the FSOC stated their belief that the SEC should adopt its own set of reforms for money funds before the FSOC considered further action. The FSOC received over 125 comments on the FSOC Recommendations, many of which raised concerns over the potential conversion to a floating NAV and offered alternative approaches to the reformation of money fund regulation.

On June 5, 2013, nearly seven months after the FSOC Recommendations were issued, the SEC issued the Proposal. Although some aspects of the Proposal are similar to those offered in the Staff Proposals and FSOC Recommendations, the SEC indicated that it considered all available options, including comments from the money fund industry as well as possible reforms suggested by the President's Working Group on Financial Markets, which published a report on money market fund reform options in 2010 (the PWG Report).[5] At the meeting at which the Proposal was approved, recently appointed SEC Chairman Mary Jo White stated that the Proposal "advances the public debate that will shape the final rules to address one of the most prominent events arising from the financial crisis."[6]

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2 Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010). For further information regarding the 2010 Amendments, please refer to *DechertOnPoint* "Amendments to the Regulatory Structure Governing Money Market Funds."

3 *See* Statement on Money Market Fund Reform by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission (Aug. 22, 2012). For further information regarding the Staff Proposals and the debate surrounding them, please refer to *DechertOnPoint* "SEC Will Not Vote on Money Market Fund Reform."

4 *See* Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012). For additional information on the FSOC Recommendations, please refer to *DechertOnPoint* "U.S. Financial Stability Oversight Council Proposes Recommendations for Money Market Fund Reform."

5 *See* Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options (Oct. 2010).

6 Opening Statement at the SEC Open Meeting by Chairman Mary Jo White, U.S. Securities and Exchange Commission (June 5, 2013).

THE PROPOSAL

Alternative 1 – Floating NAV

Overview

Under Alternative 1, money funds (other than government and retail money funds)[7] would be required to convert to a floating NAV, calculating their market-based NAV per share to the nearest basis point. Government money funds and retail money funds, as discussed below, would be exempt from the requirement to convert to a floating NAV and could continue to use the penny rounding method[8] to price their shares. However, under Alternative 1, *all* money funds would no longer be permitted to use the amortized cost method of valuation, except with respect to valuing securities that mature in 60 days or less.[9]

Alternative 1 is intended to increase the transparency of institutional prime money funds' pricing and reduce the incentive for fund shareholders to redeem their shares during times of financial stress. By removing the ability of investors to redeem their shares at a $1.00 per share price when the actual market-based NAV is below $1.00, Alternative 1 seeks to remove the perceived "first mover advantage," which some have credited with contributing to the heavy redemptions from institutional prime money funds during the financial crisis. The Proposal concedes that the floating NAV requirement does not address other justifications for redemptions during periods of financial stress, including the flight to higher quality assets, such as government or Treasury money funds and securities.

Under Alternative 1, an institutional prime money fund would have to calculate its NAV based on the current market values of its portfolio holdings as opposed to using the amortized cost method of valuation, except with respect to securities that mature in 60 days or less, as noted above. In addition, an institutional prime money fund would be required to calculate its share price to the fourth decimal place if it prices its shares at one dollar per share (*e.g.*, $1.0000). This level of precision, which the Proposal refers to as "basis point rounding," is ten times greater than that required for other mutual funds.[10] Moreover, basis point rounding is 100 times more precise than the penny rounding method currently utilized by money funds.

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7 For the purposes of this *DechertOnPoint*, such money funds are referred to as "institutional prime money funds," although they could also include institutional municipal (or tax-exempt) money funds (municipal money funds) that do not qualify as "retail money funds" under Alternative 1. As noted in the Proposal, the SEC did not specifically exempt municipal money funds from the floating NAV requirement, explaining that the tax advantages of municipal money funds are generally applicable only to individuals and, therefore, such funds should be able to qualify under the retail money fund exemption discussed below.

8 Under penny rounding pricing, a money fund's market-based NAV per share is calculated and rounded to the nearest cent on a share price of one dollar. Currently, there are very few money funds that rely solely on the penny rounding method to price their shares.

9 Under the amortized cost method of valuation, portfolio securities are valued by reference to their acquisition cost, as adjusted for amortization of premium or accretion of discount, rather than at their value based on current market factors. Under the Proposal, a money fund would still be permitted to use amortized cost valuation to the same extent that other mutual funds are able to do so – where the fund's board determines, in good faith, that the fair value of debt securities with remaining maturities of 60 days or less is their amortized cost — unless particular circumstances, such as the impairment of the creditworthiness of an issuer or other factors, warrant otherwise. *See* Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Investment Company Act Release No. 9786 (May 31, 1977).

10 Under valuation guidance from the SEC, many mutual funds that are not money funds price their shares at an initial NAV of $10 and round their NAV to the nearest penny. *See Id*. The Proposal expressed concerns that using that level of pricing precision could lead managers of floating NAV money funds to manage such funds more conservatively to avoid any price changes, thereby defeating a primary purpose of the variable NAV, which is to sensitize investors to market fluctuations in the value of money fund assets.

Government Money Fund Exemption

Alternative 1 would exempt government money funds from the requirement to convert to a floating NAV. Under the Proposal, government money funds would be defined as money funds that maintain at least 80% of their total assets in cash, U.S. government securities (as defined in Section 2(a)(16) of the 1940 Act)[11] or repurchase agreements that are "collateralized fully" (as defined in Rule 2a-7).[12] The Proposal noted that during the financial crisis, government money funds did not experience the same magnitude of redemption pressures as prime money funds. Although government money would be able to use the penny rounding method to price their shares under Alternative 1, they would be required to use market-based valuation as opposed to the amortized cost method of valuation, except as discussed above.

Retail Money Fund Exemption

Under Alternative 1, retail money funds also would be exempt from the requirement to convert to a floating NAV. The Proposal would define a retail money fund as a money fund that "does not permit any shareholder of record to redeem more than $1,000,000 of redeemable securities on any one business day." The Proposal noted that retail investors historically have been less likely to redeem money fund shares during times of financial stress. Retail money funds could continue to use the penny rounding method to price their shares, but they would not be allowed to use the amortized cost method of valuation, except to value their assets having a maturity less than 60 days.

In the Proposal, the SEC indicated its belief that the $1 million limit on redemptions should be relatively simple to implement, since it would only require a retail money fund to establish a one-time, across-the-board redemption policy.[13] If an investor in a retail money fund sought to redeem more than $1 million in a business day, the fund could either reject the request as not in "good order" or could treat the request as an order to redeem $1 million and reject the remainder of the order or treat it as if it were received on the next business day. The Proposal stated that a retail money fund would need to disclose how it handles such excessive redemption requests in its statutory prospectus.[14]

Issues Associated with Omnibus Accounts

One of the most difficult challenges to qualifying a money fund for the retail money fund exception would be to determine how to treat omnibus accounts. The Proposal noted that many investors hold shares of money

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[11] Pursuant to Section 2(a)(16) of the 1940 Act, a "government security" is 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 U.S. Congress, and any certificate of deposit for such securities.

[12] Rule 2a-7 defines "collateralized fully" by reference only to a portion of the definition of that term in Rule 5b-3(c)(1) under the 1940 Act, with the result that, under Rule 2a-7, a repurchase agreement is collateralized fully only if the collateral consists entirely of cash items or government securities.

[13] Of course, implementing such a limit on redemptions could raise issues under a money fund's organizational documents, which may provide that the fund's shareholders have an absolute right to redeem their shares, in any amount.

[14] The Proposal also described other possible criteria the SEC considered to distinguish institutional funds from retail funds. These criteria included a maximum account balance; a limit on shareholder concentration (*e.g.*, the top 20 shareholders of a fund could not own more than 15% of its assets); and other shareholder characteristics (*e.g.*, whether a shareholder had a social security number or a taxpayer identification number). Ultimately, the SEC determined that a $1 million redemption limit was the appropriate approach, but the SEC requested comment on other approaches.

funds through omnibus accounts and that most money funds are not able to look through such accounts to determine underlying investors' redemptions. Under Alternative 1, retail money funds would not be required to impose the $1 million daily redemption limit on shareholders of record that are omnibus account holders, provided that the fund has put into place policies and procedures reasonably designed to allow the conclusion to be drawn that the omnibus account holder does not permit any beneficial owner to "directly or indirectly" redeem more than $1,000,000 in a single day. The restriction on "direct or indirect" redemptions relates to the possible chains of intermediaries that may exist before reaching the beneficial shareholder.[15] If a retail money fund cannot be reasonably certain that such a redemption limit would be enforced by an intermediary, it would be required to limit redemptions by that intermediary's omnibus account to $1,000,000 per day. The Proposal does not require that retail money funds enter into agreements or contracts with, or request certifications from, omnibus account holders, but would instead allow a fund to manage these relationships in whatever manner supports the ability of the fund to conclude that an omnibus account holder is applying the redemption limit to underlying beneficial owner redemptions.

Other Potential Issues Raised by Alternative 1

The SEC recognized several other potential issues that could be raised by the $1 million redemption limit in the retail money fund exception. For example, the SEC noted that, through using multiple accounts, institutional investors possibly could "game" the daily redemption limitation by opening multiple accounts through different intermediaries, or across different fund complexes. Another challenge is that prime money funds that currently have both institutional and retail share classes (or both institutional and retail shareholders in a single class of shares) may have to reorganize into separate funds for retail and institutional investors in order to rely on the retail money fund exception, which could lead to increased costs and reorganization expenses.[16]

With respect to the floating NAV requirement for institutional prime money funds, the SEC identified several potential issues. First, the Proposal noted that institutional prime money funds with floating NAVs would result in taxable investors experiencing gains and losses.[17] Institutional prime money funds would become subject to information reporting requirements to the Internal Revenue Service (IRS) and fund shareholders. The Proposal explained that, under wash sale rules, the losses realized in certain redemptions would be disallowed in whole or in part, but noted that the Treasury Department and the IRS are actively considering administrative relief under which redemptions of floating NAV institutional prime money fund shares that generate losses below a *de minimus* threshold would not be subject to wash sale rules.

The Proposal also discussed the accounting implications of converting to a floating NAV. The Proposal stated the SEC's belief that floating NAV institutional prime money funds would still meet the definition of

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[15] With respect to registered separate accounts funding variable insurance contracts, the SEC exempted such separate accounts and the sponsoring insurance companies of such accounts from the requirements of Section 27(i)(2)(A) of the 1940 Act, to the extent necessary to permit those entities to apply the limitations on redemptions to contract owners who allocate all or a portion of their contract value to a subaccount of the separate account that is either a money fund or that invests all of its assets in shares of a money fund. However, there is a question as to whether the insurance contracts would need to be amended to impose such a redemption limit on contract owners.

[16] The Proposal did not address the SEC staff's position that the reorganization of a class of shares into a stand-alone fund is inconsistent with Sections 18(f)(1) and 18(i) of the 1940 Act and is not permitted by Rule 18f-3. *See* Investment Management Staff Issues of Interest, Rule 18f-3 under the Investment Company Act — Removal of a Class (Sep. 2, 2010). The Proposal also did not address certain potential tax-related issues relating to such reorganizations.

[17] The Proposal also noted that, since the SEC anticipates little fluctuation in the NAV of institutional prime funds' shares, the SEC anticipates that any changes in tax burdens would be minimal.

"cash equivalents" under U.S. generally accepted accounting principles (GAAP), because any fluctuations "would likely be insignificant and would be consistent with the concept of a 'known' amount of cash." However, the Proposal noted that severe market events could result in floating NAV institutional prime money funds being treated as investments instead of cash equivalents.

Finally, the Proposal noted that in order for certain states and municipal entities to invest in floating NAV institutional prime money funds, states and municipal entities may have to amend their laws and policies, which may currently permit only investments in money funds that maintain a stable share price.

The Proposal observed that, while all money funds are currently required to have the capacity to process transactions at floating NAVs, institutional prime money funds and their service providers may not currently be in a position to actually process sales and redemptions of shares at a floating NAV on a daily basis.

Alternative 2 – Liquidity Fees and Redemption Gates

Overview

Under Alternative 2, money funds would be given certain tools to better manage redemption requests during times of market illiquidity. When a money fund's "weekly liquid assets" [18] (required by Rule 2a-7 to constitute at least 30% of a money fund's assets) fall below 15% of total assets, the fund would be *required* to impose a 2% liquidity fee on all redemptions, *unless* the fund's board determines that imposing such a fee would not be in the fund's best interests. Moreover, under such circumstances, a money fund's board also would be *permitted* to temporarily suspend redemptions for a limited period of time. The Proposal stated the Commission's belief that, had these tools been available, money funds "would have been able to better manage the heavy redemptions that occurred [during the financial crisis] and to limit the spread of contagion."

Under Alternative 2, all money funds would continue to be permitted to maintain a stable price per share through using the penny rounding method of pricing. However, all money funds would no longer be permitted to use amortized cost to value their holdings, except for securities with maturities of 60 days or less, as discussed above. Furthermore, under Alternative 2, government money funds (as defined above) would be permitted – but not required – to impose liquidity fees and redemption gates when their weekly liquid assets fall below the 15% threshold. The Proposal noted that government money funds have historically experienced *inflows* of assets during times of stress due to flights to quality.

Liquidity Fees

Under certain stressful market conditions, a money fund may be forced to deplete its most liquid assets or sell its holdings at a loss to satisfy redemption requests. According to the Proposal, shareholder redemptions during such periods can impose expected future liquidity costs on the money fund and its non-redeeming shareholders that are not reflected in a $1.00 share price based on current amortized cost valuation. Liquidity fees would cause redeeming shareholders to bear these costs – that is, liquidity fees would help offset these costs – and provide a disincentive to redeem under these conditions. Moreover, to the extent that liquidity fees exceed the costs of redemptions, liquidity fees could be accretive and could actually increase the money fund's NAV, making the fund less likely to break its dollar share price.

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[18] "Weekly liquid assets" are defined to 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.

If a money fund's weekly liquid assets were below 15% of its total assets as of the end of a business day, the fund would be required to impose, on the next business day, a 2% liquidity fee on each shareholder redemption, unless the fund's board [19] determines that imposing a liquidity fee would not be in the fund's best interests or determines that imposing a lower liquidity fee would be in the fund's best interests. Liquidity fees would be suspended once a money fund's weekly liquid assets rise to or above 30% of its total assets, or sooner, if determined by the fund's board. [20]

The Proposal described certain factors that a fund board may consider in determining whether to impose or lift liquidity fees, including: (i) the reasons for the decline in weekly liquid assets (for example, did the decrease stem from financial stress or from unexpected shareholder redemptions?); (ii) the expected duration of the decline in weekly liquid assets (for example, will "staggered" maturities cause weekly liquid assets to increase in the short term?); and (iii) any corresponding changes in the money fund's market-based NAV (for example, does the money fund have the capacity to absorb losses without breaking the buck?). [21]

According to the Proposal, the Commission believes that a 2% liquidity fee would be "high enough that it may impose sufficient costs on redeeming shareholders to deter redemptions in a crisis, but is low enough to permit investors who wish to redeem despite the cost to receive their proceeds without bearing unwarranted costs." The Commission also considered a "market-sized" liquidity fee (*i.e.,* "a liquidity fee with an amount explicitly tied to market indicators of changes in liquidity costs for money market funds"). However, the Proposal noted that there would be operational issues in assessing such a fee and a lack of transparency in determining such a fee, which "may hinder shareholders' ability to make well-informed decisions."

Similar to Alternative 1, omnibus accounts may pose certain challenges to money funds under Alternative 2. However, the SEC expects that money funds would implement liquidity fees, if any, in a manner similar to the manner in which redemption fees are imposed to deter market timing of non-money fund shares. The SEC noted that certain money fund sponsors may seek certifications or other assurances from intermediaries and service providers to determine whether liquidity fees are appropriately applied at the beneficial owner level. However, the Proposal requested comment on the application of liquidity fees to omnibus accounts.

Redemption Gates

Under Alternative 2, a money fund's board would be empowered, but not required, to impose a temporary suspension of shareholder redemptions (*i.e.,* "gating" or a "redemption gate") when the fund's weekly liquid assets fall below 15% of its total assets. To impose a redemption gate, a fund's board must determine that

[19] Board findings relating to both liquidity fees and redemption gates under Alternative 2 would have to be approved by the board as a whole, as well as a majority of the fund's disinterested board members.

[20] In discussing other possible approaches to liquidity fees, the Proposal noted that an *optional* liquidity fee (*e.g.*, one that does not trigger automatically) might not be utilized by a fund's board because, among other reasons, the imposition of such a fee may signal trouble for the fund complex, resulting in a reduction of business or reputational harm. Further, the Proposal noted that an *automatic* liquidity fee which the board could not reduce or remove would not be flexible enough to be a proper instrument in all circumstances. Nonetheless, the Proposal requested comment on these other approaches.

[21] According to the Proposal, the SEC staff considered imposing a liquidity fee based on a reduction in a money fund's market-based NAV. However, the Proposal noted that, by the time the market-based NAV drops below a certain level, it may be too late to mitigate the impact of heavy redemptions and to protect shareholders.

the redemption gate is in the best interests of the fund.[22] Redemption gates could be imposed for no more than 30 days at a time and for no more than 30 days within any 90-day period. Moreover, redemption gates must be suspended once a money fund's weekly liquid assets rise to or above 30% of its total assets or sooner, if determined by the fund's board. However, the Proposal noted that a fund's board would likely need to meet throughout any period when redemption gates are imposed to monitor and determine whether gating continues to be appropriate.

According to the Proposal, a money fund could use the time afforded by a redemption gate to assess the viability of the fund, to create a "circuit breaker" giving time for a market panic to subside, or to create "breathing room" to permit more fund assets to mature and provide internal liquidity to the fund. The Proposal also requested comment on partial redemption gates that permit, for example, shareholders to redeem: (i) a certain percentage of their holdings; (ii) a certain percentage of the fund's outstanding shares; or (iii) a certain dollar amount per day, in each case during periods in which a redemption gate is imposed.

Preemptive Redemptions

Although liquidity fees and redemption gates are generally supported by the investment management industry, the Proposal expressed the concern that these tools may trigger preemptive redemptions by shareholders that seek to avoid paying the liquidity fee or being subject to a redemption gate. The FSOC Recommendations expressed similar concerns. However, the Proposal noted that, even if shareholders had an incentive to redeem, these "redemptions eventually will cause a fee or gate to come down and halt the run." The Proposal further noted that liquidity fees and redemption gates "could provide fund managers with a powerful incentive to carefully monitor shareholder concentration and shareholder flow to lessen the chance that the fund would have to impose liquidity fees or gates in times of market stress (because larger redemptions are more likely to cause the fund to breach the threshold)."

Potential Combination of Alternatives 1 and 2

The SEC also noted the possibility that any final rule may combine the primary features of Alternatives 1 and 2 by requiring institutional prime money funds to convert to a floating NAV and requiring *all* money funds to impose liquidity fees (as well as permitting them to impose redemption gates), or permitting a money fund to choose to either transact with a floating NAV or be able to impose liquidity fees and redemption gates in times of stress. Several SEC Commissioners raised this possibility when voting on releasing the Proposal for public comment. The Proposal noted that combining the two Alternatives into one reform package would address certain limitations of each Alternative, but could also raise the costs of implementing the changes and reduce the attractiveness of investing in money funds. The Proposal requested comment on how such a combination should work and whether the potential benefits would outweigh the costs.

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[22] The Commission is also proposing amendments to Rule 22e-3 under the 1940 Act to permit, but not require, the board of a fund to permanently suspend the right of redemption if the money fund's level of weekly liquid assets falls below 15% of total assets. Rule 22e-3 currently permits money funds to suspend redemptions and postpone payment of redemption proceeds in order to facilitate an orderly liquidation of the fund only in the event that the extent of the deviation between the fund's amortized cost price per share and its market-based NAV per share may result in material dilution or other unfair results to investors. These proposed amendments, which would apply under either Alternative, would permit a board to suspend redemptions and liquidate a fund to avoid harm to investors without waiting for the fund to actually break the dollar share price.

Enhanced Disclosure Requirements

In addition to the Alternatives discussed above, the SEC proposed enhanced disclosure requirements in order to provide greater transparency regarding money funds. Following is a discussion of the key changes to the disclosure requirements.

New Rule 30b1-8 and Adoption of Form N-CR

The SEC proposed the adoption of Rule 30b1-8, a new rule that would require information regarding certain material events to be reported to the SEC on newly created Form N-CR. Under either Alternative, a money fund would be required to disclose on Form N-CR: (i) any instances of default (other than an immaterial default unrelated to the financial condition of the issuer) or an event of insolvency of a portfolio security that, immediately before the default or event of insolvency, accounts for ½ of 1% of the fund's total assets; (ii) any "financial support" [23] by a sponsor of the fund; and (iii) any instance in which the fund's market-based NAV per share falls below $0.9975. [24] The SEC also proposed the inclusion of certain other information on Form N-CR if Alternative 2 is adopted. [25] In each case, money funds would be required to file a Form N-CR within one business day following the triggering material event. [26] The SEC would use the information provided on Form N-CR in its regulatory, disclosure review, inspection and policymaking roles. The information also would be publicly available on the SEC's EDGAR website immediately upon filing.

Fund Website Disclosure Requirements

Currently, Rule 2a-7 requires money funds to disclose on their websites the funds' schedule of investments, the dollar-weighted average portfolio maturity (WAM) and dollar-weighted average life to maturity (WAL). Under the Proposal, Rule 2a-7 would also be amended to require a money fund to disclose on its website substantially the same information regarding financial support of the fund that would be required to be reported on Form N-CR. [27] In addition, the following new disclosure items would be required to be posted on a money fund's website: (i) the percentage of the fund's total assets that are invested in daily and weekly liquid assets as of the end of the previous business day; (ii) the fund's net inflows and outflows as of the end of the previous day; and (iii) the fund's daily market-based NAV per share, rounded to the fourth decimal place in the case of a fund with a $1.00 share price, as of the end of the previous business day (current

[23] Under the Proposal, "financial support" to a money fund would include, but not be limited to: (i) any capital contribution; (ii) the purchase of a security from the fund in reliance on Rule 17a-9; (iii) the purchase of any defaulted or devalued security at par; (iv) purchase of fund shares; (v) the execution of a letter of credit or letter of indemnity; (vi) a capital support agreement (whether or not the fund ultimately received support); (vii) performance guarantees; or (viii) any other similar action to increase the value of the fund's portfolio or otherwise support the fund during times of stress.

[24] Reporting of a money fund's market-based price falling below $0.9975 per share would not apply to an institutional prime money fund under Alternative 1.

[25] For example, under Alternative 2, reporting on Form N-CR would be required when a money fund's weekly liquid assets fall below 15% of total assets and when the fund has imposed or removed a liquidity fee and/or redemption gate.

[26] With respect to the reporting requirement relating to when a money fund's weekly liquid assets fall below 15% of total assets or when the fund has imposed or removed a liquidity fee and/or redemption gate, the money fund also would be required to file an amendment to the Form N-CR by the fourth business day following the event in order to provide additional detailed information about the event.

[27] The money fund would be required to post instances of financial support on its website on the same day as it files Form N-CR with the SEC and the information would be required to remain posted for a period of not less than one year.

NAV). The Proposal also would require a money fund to display and maintain a schedule, chart, graph or other depiction on its website showing the historical information about its investments in daily and weekly liquid assets, the fund's net inflows or outflows and daily current NAV for the previous six months, and would require the fund to update this historical information each business day as of the end of the preceding business day. The SEC also proposed additional information regarding the posting of: (i) the categories of a money fund's portfolio securities; (ii) maturity date information for each of the fund's portfolio securities; and (iii) market-based values of the fund's portfolio securities at the same time as this information becomes publicly available on Form N-MFP. Finally, the SEC would require that money funds post prominent risk disclosure, as discussed in more detail below.

New Form N-1A Disclosures

Currently, a money fund must provide general risk disclosure statements in the summary section of the statutory prospectus (and summary prospectus, if used). In addition, all mutual funds, including money funds, must disclose any limitations on redemptions. The SEC proposed that money funds include new bulleted statements relating to the risks associated with a floating NAV under Alternative 1 and/or the liquidity fees and redemption gates under Alternative 2. Additionally, a money fund would be required to state that the fund's sponsor has no legal obligation to provide financial support to the fund and an investor should not expect that the sponsor will provide financial support to the fund at any time. Under Alternative 2, a money fund would be expected to file a prospectus supplement and provide related disclosure on the fund's website promptly after imposing a liquidity fee or redemption gate to inform prospective investors of any fees or gates in place.[28]

In addition, the SEC proposed amendments to Form N-1A that would require money funds to provide disclosure in the Statement of Additional Information (SAI) regarding historical instances in which the fund has received "financial support" (as defined above) from a sponsor.[29] In particular, the SEC proposed that each money fund would be required to disclose in its SAI any occasion during the last ten 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.[30]

Finally, if Alternative 1 is adopted, institutional prime money funds would have to disclose in a post-effective amendment or prospectus supplement under Rule 497 under the Securities Act of 1933 that the fund will be required to transition to a floating NAV.

New Rule 482 Advertisement Disclosures

Rule 482 currently requires that all money funds include certain risk disclosure statements in advertisements. The Proposal would update these statements to reflect the new risks of Alternatives 1 and 2

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28 The Commission requested comment on whether additional steps, such as a press release, should be required to notify individual shareholders about the imposition of redemption gates.

29 Under Alternative 2, money funds also would be required to provide SAI disclosure regarding the historical occasions when the funds' weekly liquid assets have fallen below 15% or the fund has imposed liquidity fees or redemption gates.

30 This SAI disclosure requirement would also apply to any financial support provided to a predecessor money fund (in the case of a merger or other reorganization) within the proposed look-back period, in order to allow investors to understand the full extent of historical support provided to a fund or its predecessor.

similar to those required to be disclosed in the statutory prospectuses (and summary prospectuses, if used), as discussed above.

Rule 30b1-7: Amendments to Form N-MFP

Currently, Rule 30b1-7 under the 1940 Act requires money funds to file electronically a monthly report on Form N-MFP, which is not made public until 60 days after the end of the month for which the filing is made. The Proposal would eliminate the 60-day delay, making information publicly available immediately upon filing. In addition, the SEC has proposed structural, reporting and clarifying changes to Form N-MFP. There are also new reporting requirements, including, but not limited to: (i) weekly reporting of NAV; (ii) new information with respect to each portfolio holding; (iii) disclosure about the amount of cash the money fund holds; (iv) the fund's daily and weekly liquid assets; (v) whether a portfolio security is considered a daily or weekly liquid asset; (vi) whether any person paid for or waived all or part of the fund's operating expenses or management fees; and (vii) the total percentage of shares outstanding held by the 20 largest shareholders of record.

Enhanced Diversification Requirements

Rule 2a-7 currently requires that money fund portfolios be diversified as to the issuers of securities and guarantors and demand feature providers related to those securities. To address the concern that the diversification provisions in Rule 2a-7 may not appropriately limit a money fund's risk exposure, the Proposal would: (i) require the grouping of affiliates in calculating the 5% issuer diversification limitation; (ii) require each money fund to treat the sponsors of asset-backed securities (ABS) as guarantors unless the board of the money fund (or its delegate) makes certain determinations; and (iii) remove the exception that allows 25% of a fund's portfolio to be subject to guarantees or demand features from a single institution. The Proposal also requested comment on additional diversification alternatives considered.

Grouping of Affiliates for 5% Issuer Diversification Limitation

Under Rule 2a-7, a money fund generally may not invest any more than 5% of its assets in a single issuer. The Proposal would require a money fund to aggregate affiliates for purposes of applying the 5% issuer diversification limit, to prevent the fund from assuming a concentrated amount of risk by investing in affiliates that comprise a single economic enterprise. Under the Proposal, entities are "affiliates" for purposes of this aggregation requirement if one is controlled by the other or they are under common control. For this purpose only, "control" would be defined to mean ownership of more than 50% of an entity's voting securities.

Sponsor of ABS as Guarantor

Rule 2a-7 mandates that a money fund limit its investments in securities subject to demand features or guarantees from any one provider to no more than 10% of the fund's assets (the 10% limitation), subject to the 25% basket exception discussed below. The Proposal would require that a money fund include the sponsor of a special purpose entity (SPE) that issues ABS as a guarantor for purposes of calculating the 10% limitation, unless the fund's board or its delegate determines that the fund is not relying on the ABS sponsor's financial strength or ability to provide support when determining the quality or liquidity of the ABS. Absent such a finding, this restriction would limit a money fund to investing no more than 10% of fund assets in ABS issued by SPEs of any one sponsor.

Removal of the 25% Basket

Currently, Rule 2a-7 provides an exception to the 10% limitation, under which 25% of a fund's assets may be subject to guarantees or demand features from a single institution (the 25% basket). The Proposal would eliminate this 25% basket. The SEC posited that the majority of money funds do not use the 25% basket and that, therefore, the principal effect of this amendment would be to restrain managers from using it in the future.

Other Diversification Alternatives Considered

The SEC requested comment on other potential diversification amendments, including: (i) reducing the current 5% and 10% diversification limits discussed above; (ii) eliminating the distinction between a money fund's exposure to issuers and its exposure to guarantors and demand feature providers; and (iii) imposing industry concentration limits.

Enhanced Stress Testing

The SEC proposed enhancing stress testing requirements, which were first adopted as part of the 2010 Amendments. The SEC noted that, through the SEC staff's examinations of money fund stress testing procedures, it has observed disparities in the quality and comprehensiveness of stress tests and related reporting to the board. Under the Proposal, the SEC specifically would require money funds to consider a multitude of different factors in determining whether a money fund could maintain a stable NAV under heavy redemption pressure. The proposed changes in stress testing would also specifically require money fund managers to consider movements in interest rates and the impact of such movements on money funds and their portfolio holdings.

Changes to Form PF

The Proposal also recommends changes to Form PF, the form SEC-registered investment advisers use to report information regarding the private funds they advise. These private funds include "liquidity funds," which are similar to money funds except that they are not registered as investment companies under the 1940 Act. The Proposal would impose a requirement on "large liquidity fund advisers," which the SEC defines as "registered advisers with $1 billion or more in combined money market fund and liquidity fund assets." Under the Proposal, these advisers would be required to file portfolio holdings information on Form PF similar to the information required to be filed on Form N-MFP for registered money funds. The amendments to Form PF are designed to: (i) ensure that any reallocation of assets to private liquidity funds as a result of money fund reforms will not decrease transparency in the short-term financial markets; (ii) better enable the FSOC to monitor and address any systemic risks; and (iii) better enable the SEC to develop effective regulatory policy responses to any shift in investor assets.

Clarifying Amendments

The SEC, noting questions that have arisen regarding the application of certain provisions of the 2010 Amendments, proposed a number of amendments to clarify these provisions.

Daily and Weekly Liquid Assets

The SEC proposed amendments to clarify certain characteristics of instruments that qualify as daily and weekly liquid assets. In particular, the amendments would: (i) make clear that money funds cannot use the maturity-shortening provisions in Rule 2a-7(d) regarding interest rate readjustments when determining whether a security satisfies the maturity requirements of a daily or weekly liquid asset; (ii) establish that an agency discount note with a remaining maturity of 60 days or less qualifies as a weekly liquid asset only if the note is issued without an obligation to pay additional interest on the principal amount; and (iii) include in the definition of daily and weekly liquid assets amounts receivable that are due unconditionally within one or five business days, respectively, on pending sales of portfolio securities.[31]

Demand Features

The definition of "demand feature" currently requires that a demand feature be exercisable at any time on no more than 30 calendar days' notice. The amended definition would eliminate this 30-day notice requirement and would define a demand feature as a feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise, paid within 397 calendar days of exercise.

Short-Term Floating Rate Securities

The Proposal would provide that, for purposes of determining WAL, a short-term floating rate security that is subject to a demand feature shall be deemed to have a maturity equal to the period remaining until the principal amount can be recovered through demand. This amendment is designed to ensure that money funds apply the maturity-shortening provisions for short-term floating rate securities consistent with the intent of the rule and in a similar manner as short-term variable rate securities.[32]

Second Tier Securities

Rule 2a-7 allows money funds to invest in second tier securities with remaining maturities of 45 days or less. The Proposal would amend Rule 2a-7 to state that the 45-day limit applicable to second tier securities must be determined without reference to the maturity-shortening provisions in Rule 2a-7(d) for interest rate readjustments.

PROPOSED COMPLIANCE DATES

The SEC is proposing a compliance period of two years for Alternative 1, one year for Alternative 2 and nine months for the other proposed amendments that are not specifically related to either Alternative.

CONCLUSION

Overall, the Proposal sets forth sweeping potential changes to money fund regulation. While representing a more balanced and tailored approach to reform than the approaches advocated in the Staff Proposals, FSOC Recommendations and PWG Report, the Proposal nevertheless would have a tremendous impact on the money fund industry and, potentially, on the markets in which money funds invest. Comments on the Proposal are due 90 days after its publication in the Federal Register.

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[31] The SEC stated its expectation that such receivable would only be included in daily or weekly liquid assets if the money fund or its adviser has no reason to believe that the buyer might not perform.

[32] This amendment is consistent with informal guidance that the SEC staff has provided. *See* Investment Company Institute, Request for Interpretation under Rule 2a-7 (Aug. 10, 2010).

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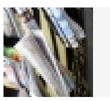

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