

July 28, 2014

Money Market Funds

Securities and Exchange Commission Adopts Money Market Fund Rule Amendments Requiring Institutional Funds to Adopt Floating Net Asset Values and Permitting Boards to Impose Liquidity Fees and Suspend Redemptions

SUMMARY

On July 23, 2014, the Securities and Exchange Commission voted 3-2 to adopt amendments to the rules that govern money market funds under the Investment Company Act of 1940. The amendments include the following:

- ***Floating Net Asset Value Requirement:*** Institutional, non-government money market funds will no longer be permitted to maintain a stable net asset value per share, and instead must sell and redeem shares based on the current market value of the securities in their underlying portfolios, rounded to the nearest 1/100th of one percent (e.g., \$1.0000). Government and retail money market funds would be permitted to continue to maintain a stable net asset value.
- ***Liquidity Fees and Redemption "Gates":*** A money market fund board of directors or trustees may, if the fund's weekly liquidity level falls below 30% of its total assets, (A) impose a liquidity fee of up to 2% on redemptions and/or (B) temporarily suspend redemptions, in each case if the board determines such action is in the best interests of the fund. In addition, money market funds will be required to impose a liquidity fee of 1% if the fund's weekly liquidity level falls below 10% of its total assets, unless the board determines that such fee is not in the best interests of the fund or that a different fee (not to exceed 2%) is in its best interests.
- ***Other Money Market Fund Reforms:*** The rule amendments contain several other reforms that will require increased diversification of money market fund portfolios, enhanced stress testing requirements, and enhanced reporting to the Commission and the public. Enhanced reporting will also apply to unregistered investment advisers of certain large liquidity funds.

Treasury Secretary Lew released statements following the vote describing the rules as "important structural reforms," characterizing the SEC's action as a "significant step forward," and praising the Financial Stability Oversight Council's role in encouraging the Commission to act. The Financial Stability

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Oversight Council subsequently announced that it will meet in closed session on July 31, 2014, to discuss, among other topics, money market fund reform.

The final rules become effective 60 days after their publication in the *Federal Register*, and funds will have two years from publication to comply with the floating net asset value requirement and the rules relating to liquidity fees and redemption gates. Funds will have either nine or 18 months to comply with the other reforms in the final rules.

Also on July 23, the Commission voted unanimously to (1) propose an order that would exempt, subject to certain conditions, money market funds that maintain a floating net asset value from the immediate confirmation delivery requirements of rule 10b-10 of the Securities Exchange Act of 1934 and (2) re-propose amendments to remove references to credit ratings in the money market fund rules and to amend diversification rules to eliminate an existing exclusion for securities subject to a guarantee issued by a non-controlled person. The proposed order for exemptive relief will be subject to a 21-day public comment period after its publication in the *Federal Register*. A 60-day public comment period will apply to the proposed credit rating-related amendments.

BACKGROUND

Publicly offered money market funds (“MMFs”) are required to register under the Investment Company Act of 1940 (“ICA”). Subject to the conditions of ICA rule 2a-7 (“Rule 2a-7”),¹ a MMF, unlike other mutual funds, may maintain a stable net asset value per share (“NAV”) by valuing its portfolio securities at acquisition cost with adjustments for amortization of premium or accretion of discount, or by rounding the MMF’s share price, typically \$1.00 per share, to the nearest penny.

Among other conditions, Rule 2a-7 generally requires a MMF to invest at least 10% of its portfolio in assets that can provide daily liquidity and 30% of its portfolio in assets that can provide weekly liquidity, and to meet certain investment diversification requirements.² Rule 2a-7 also requires MMFs to periodically calculate the market-based, or “shadow,” NAV and compare it to the fund’s stable \$1.00 share price. If the difference between these two values exceeds 0.5%, the MMF’s board must determine whether any action should be taken. One such action includes re-pricing the fund’s securities above or below the fund’s \$1.00 share price, an event referred to as “breaking the buck.”³

Following the financial crisis, the Commission adopted amendments to MMF regulations in 2010 that were designed to reduce the risk profile of MMF portfolios and increase the information MMFs are required to disclose.⁴ At that time, the Commission noted that the 2010 amendments were the first step in addressing MMF reforms, indicating that additional reforms were forthcoming.

On November 19, 2012, pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the Financial Stability Oversight Council (the “FSOC”) published

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for public comment proposed recommendations to the Commission regarding additional enhancements to MMF regulation reform.⁵ Specifically, the FSOC proposed three potential alternatives: requiring all MMFs to adopt a floating NAV, mandatory NAV buffers combined with delayed redemption requirements, and mandatory NAV buffers enhanced by other reforms. The FSOC has not taken any further action on the proposed MMF recommendations. The Commission is required under Dodd-Frank to consider any final recommendation by the FSOC and either implement the recommendation or explain in writing to the FSOC why it chose not to do so.

On June 5, 2013, the Commission voted unanimously to propose amendments to the MMF rules. Following a period for public comment, the amendments were adopted on July 23, 2014 (the “Final Rules”).⁶ The Final Rules are directionally consistent with the reforms proposed on June 5, 2013, except for a few significant changes, some of which are noted in this memorandum. The Commission also voted to propose changes to other rules and issued a proposed order for exemptive relief applicable to MMFs, which are discussed below.

THE FINAL RULES

Most significantly, the Final Rules remove the valuation exemption that currently permits institutional, non-government MMFs to maintain a stable NAV. In addition, the Final Rules give MMF boards the discretion (and in some cases require MMFs) to impose liquidity fees unless the board determines otherwise, and permit boards to temporarily suspend redemptions. These principal reforms, and several others related to enhanced disclosure requirements, portfolio diversification and stress testing, are described in more detail below.

Key Definitions⁷

- **Daily liquid assets:** Assets consisting of (i) cash, (ii) direct obligations of the U.S. government, (iii) securities that will mature, as determined without reference to the exceptions regarding interest rate readjustments, or are subject to a demand feature that is exercisable and payable, within one business day, or (iv) amounts receivable and due unconditionally within one business day on pending sales of portfolio securities.⁸
- **Government MMF:** A MMF that invests at least 99.5% of its total assets in cash, government securities and/or repurchase agreements that are collateralized by cash or government securities. A “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.
- **Retail MMF:** A MMF that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.⁹ The adopting release for the Final Rules (the “Adopting Release”) notes that the Commission believes that most funds will use Social Security numbers as part of their compliance process to limit beneficial ownership in retail MMFs to natural persons. The Adopting Release provides that a fund may involuntarily redeem investors who no longer meet the eligibility requirements in a fund’s retail and/or institutional MMF, provided that the fund notify the investor at least 60 days before the redemption occurs.¹⁰ Moreover, a fund may reorganize a class of a fund into a new fund so that the fund qualifies as a retail MMF.

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- **Tax-exempt MMF:** A MMF that holds itself out as distributing income exempt from regular federal income tax.
- **Weekly liquid assets:** Assets consisting of (i) cash, (ii) direct obligations of the U.S. government, (iii) government securities that are issued by a person controlled by or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by Congress that (A) are issued at a discount to the principal amount to be repaid at maturity without provision for the payment of interest, and (B) have a remaining maturity date of 60 days or less, (iv) securities that will mature, as determined without reference to the exceptions regarding interest rate readjustments, or are subject to a demand feature that is exercisable and payable, within five business days, or (v) amounts receivable and due unconditionally within five business days on pending sales of portfolio securities.

Floating NAV

Under the Final Rules, institutional prime and municipal MMFs, which are funds that are neither a government MMF nor a retail MMF, no longer may rely on the exemption in Rule 2a-7 to maintain a stable NAV. As a result, these institutional funds must value their portfolio securities using market-based factors and transact at a floating NAV; provided that such funds may continue to use amortized cost to value debt securities with remaining maturities of 60 days or less if the board determines in good faith that the fair value of those securities is their amortized cost. In order to make share prices more transparent with respect to small fluctuations in the value of an institutional fund's portfolio, the floating NAV must be rounded to the nearest 1/100th of one percent, so that a fund's share price rounds to \$1.0000. Despite the fact that they must sell and redeem at a floating NAV, institutional MMFs may still hold themselves out as MMFs and must continue to comply with other conditions imposed on MMFs in Rule 2a-7.

The Commission and commenters previously identified issues that the adoption of floating NAV rules could create under current tax rules. In particular, the transaction reporting obligations¹¹ and wash sale rules¹² under existing Internal Revenue Code regulations could create significant practical challenges in tracking and reporting transactions where the NAV is no longer stable and therefore may give rise to losses.

On the same day the Final Rules were adopted, the United States Treasury Department ("Treasury") and Internal Revenue Service ("IRS") proposed new regulations¹³ to simplify the method of accounting for gains and losses in floating NAV MMFs and exempt floating NAV MMFs from the transaction reporting requirements. Regardless of the effective date of the final regulations, MMF shareholders may rely on the proposed exemption for taxable years ending on or after the date on which the proposed regulations are published in the *Federal Register*. If a shareholder adopts the simplified accounting method, the wash sale rules will no longer apply. Even if a shareholder does not adopt the simplified accounting method, Revenue Procedure 2014-45,¹⁴ also released on July 23, 2014, generally exempts dispositions of shares in a floating NAV MMF from the wash sale rules. This exemption will be available beginning on the effective date of the Final Rules.

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Fees and Gates

- **Discretionary Liquidity Fees.** The Final Rules permit all MMF boards to impose a liquidity fee of up to 2% on redemptions if the fund's weekly liquid assets fall below 30% of its total assets and the board (including a majority of its independent directors) determines that imposing such a fee is in the fund's best interests.
- **Mandatory Liquidity Fees.** A non-government MMF must (and a government MMF may) impose a liquidity fee of 1% on all redemptions if its weekly liquid assets fall below 10% of its total assets, unless the board (including a majority of its independent directors) determines that imposing such a fee would not be in the best interests of the fund. Alternatively, the board may determine that a higher or lower fee would be in the best interests of the fund; provided that the fee may not exceed 2%.
- **Redemption Gates.** If a fund's weekly liquid assets fall below 30% of its total assets, the board may temporarily suspend redemptions for up to ten business days in a 90-day period, if the board (including a majority of its independent directors) determines that suspending redemptions is in the fund's best interests. The Final Rules permit, but do not require, a government MMF to rely on the ability to impose these redemption gates.
- **Redemption Suspension and Liquidation.** Amendments to rule 22e-3 of the ICA¹⁵ permit (but not require) any fund to permanently suspend redemptions and liquidate if the fund's level of weekly liquid assets falls below 10% of its total assets or, in the case of a stable-NAV MMF, if it breaks the buck or if the board (including a majority of its independent directors) determines that breaking the buck is likely.

A board may impose a liquidity fee or redemption gate at any point in a day after the fund's weekly liquid assets drop below 30%, and may remove such restrictions at any time if the board determines to impose a different restriction or that the restriction is no longer in the best interests of the fund. If, at the end of a business day, the fund has invested 30% or more of its total assets in weekly liquid assets, the fund may no longer charge the liquidity fee or impose a redemption gate effective as of the beginning of the next business day.

The Adopting Release states that a board should consider any factors it deems appropriate when determining whether fees or gates are, or are not, in the best interests of the fund, and notes certain "guideposts" that a board may want to consider in making its determination, including: relevant indicators of liquidity stress in the markets and why the fund's weekly liquid assets have fallen; the liquidity profile of the fund and expectations as to how that profile might change in the immediate future; for retail and government MMFs, whether the fall in weekly liquid assets has been accompanied by a decline in the fund's shadow price; the makeup of the fund's shareholder base and previous shareholder redemption patterns; and the fund's experience with the imposition of restrictions in the past (if any).

Diversification

Current Rule 2a-7 generally requires MMFs to limit their investments in:

- Securities of any one issuer of a first tier security, other than government securities and securities subject to a guarantee issued by a non-controlled person, to no more than 5% of fund assets; and
- Securities subject to a demand feature or guarantee to no more than 10% of fund assets from any one provider.

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A guarantee issued by a non-controlled person is a guarantee issued by: (1) a person that, directly or indirectly, does not control, and is not controlled by or under common control with, the issuer of the security subject to the guarantee, or (2) a sponsor of a special purpose entity with respect to an asset-backed security, with “control” defined to mean the power to exercise a controlling interest over the management or policies of a company, unless such power is solely the result of an official position with the company.¹⁶ Under the current 25% basket rule, a MMF may invest up to 25% of its total assets in the first tier securities of a single issuer for up to three business days and up to 25% of its total assets may be subject to guarantees or demand features from a single institution.

The Final Rules generally require MMFs to treat affiliated entities as single issuers when applying the 5% issuer diversification limit. Entities are “affiliated” if one controls or is controlled by or under common control with the other, with “control” defined to mean ownership of more than 50% of an entity’s voting securities. An exclusion to this rule provides that MMFs are not required to aggregate certain asset-backed commercial paper special purpose entities and their equity owners for purposes of the 5% test.¹⁷

Moreover, MMFs must treat the sponsors of asset-backed securities as a single guarantor subject to the 10% limit on demand features and guarantees, unless the board 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.¹⁸

Finally, the Final Rules provide that MMFs other than tax-exempt MMFs may no longer rely on the 25% basket for guarantees or demand features. Up to 15% of a tax-exempt MMF’s total assets may be subject to guarantees or demand features from a single institution; provided that any demand feature or guarantee acquisition in excess of 10% of the fund’s total assets must be a demand feature or guarantee issued by a non-controlled person.¹⁹

Stress Testing

Modifications to existing stress testing provisions in Rule 2a-7 require all funds periodically to test their ability to maintain weekly liquid assets of at least 10% of total assets and to limit principal volatility²⁰ when faced with certain hypothetical events. The events include:

- Increases in the general levels of short-term interest rates;
- A downgrade or default of various portfolio security positions, each representing varying portions of the fund’s portfolio and based on varying assumptions about the amount of loss on a security as a result of a downgrade or default; and
- A widening of yield spreads compared to the indexes to which portfolio securities are tied in various logically related subsets, or “sectors,” of securities in a fund portfolio;
- In each case coupled with various levels of increases in shareholder redemptions.

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Stable NAV funds continue to be required to test their ability to maintain a stable NAV. In addition, the Final Rules require a fund to test for any additional combinations of events that its adviser deems relevant.

The Final Rules do not identify the specific assumptions that must be used in conducting the enhanced stress tests, but require that fund advisers provide to the board a summary of significant assumptions used in the tests, as well as a report that includes the dates on which testing was performed and an assessment of the fund's ability to maintain at least 10% in weekly liquid assets and to minimize principal volatility (and ability to maintain a stable NAV if applicable), and any other information as may be reasonably necessary for the board to evaluate the stress testing. The adviser's report also must include an assessment of the fund's ability to withstand events reasonably likely to occur within the following year.

Disclosure Requirements

The Final Rules amend various disclosure requirements in an effort to improve transparency with respect to MMFs' operations, risk profile and use of affiliate financial support, and require enhanced disclosures on a fund's website.

Amendments to Disclosure of Risks and Current and Periodic Reporting Requirements

- **Disclosure Statements.** MMFs are currently required to include in sales materials and in the summary section of prospectuses disclosures regarding the risks of investing in the funds. The Final Rules require that these disclosures include a specific statement tailored to reflect whether the fund maintains a stable or floating NAV.²¹ In a change from the proposed rules, the Final Rules do not mandate a particular format for this disclosure. In order to meet existing disclosure requirements, the Adopting Release notes that the Commission expects MMFs to update existing disclosures as necessary to reflect the transition to a floating NAV and the addition of liquidity fees and redemption gates.
- **Form N-CR Current Reporting.** A MMF must file a current report on Form N-CR with the Commission if certain portfolio securities default, an affiliate provides financial support to the fund, the fund experiences a significant decline in its shadow price or when liquidity fees or redemption gates are imposed and lifted. A summary report must be filed within one business day, and a more detailed report within four business days, of the occurrence of the triggering event.
- **Disclosure of Liquidity Fees and Redemption Gates.** The Final Rules require a MMF other than a government MMF to disclose in its statement of additional information ("SAI") any occasion during the last ten years on which (1) the fund's weekly liquid assets fell below 10%, and whether the board determined to impose a liquidity fee or redemption gate, or (2) the fund's weekly liquid assets fell below 30% (but not below 10%) and the board determined to impose a liquidity fee or redemption gate. Disclosure with respect to each such occasion must include (A) the length of time that the weekly liquid assets remained below 10% or 30%, (B) the dates and lengths of time that the fee or gate was imposed and (C) the size of any liquidity fee. The fund must note in its SAI that additional information with respect to the event is reported on a Form N-CR filed with the Commission.
- **Disclosure of Affiliate Financial Support.** Amendments to Form N-1A require a MMF to disclose in its SAI any instances during the last ten years where an affiliated person, promoter or principal underwriter of the fund, or any affiliate of such persons, provided any form of financial support²² to the fund or a predecessor fund, except where the person or entity that previously provided financial support to a predecessor fund is no longer an affiliated person, promoter or

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principal underwriter of the disclosing fund. The fund must note in its SAI that additional information with respect to such financial support is reported on a Form N-CR filed with the Commission.

- **Form N-MFP Periodic Reporting.** Form N-MFP is the form on which MMFs report on a monthly basis their portfolio holdings and other key information. Form N-MFP was amended to make certain changes to reflect the changes to Rule 2a-7. These amendments require reporting the fund's NAV per share and shadow price, daily and weekly liquid assets and shareholder flows on a weekly basis for the month covered by the form. In addition, MMFs must report, among other things, (1) additional identifying information regarding its portfolio securities, (2) whether any security is categorized as a level 3 measurement in the fair value hierarchy under U.S. GAAP, (3) whether the fund's adviser or a third party paid for or waived any operating expenses or management fees during the relevant reporting period and (4) investment categories as revised by the Final Rules.²³

Amendments to Website Disclosure

A MMF must disclose prominently on its website: (1) the percentage of its total assets that are invested in daily and weekly liquid assets and (2) its daily net inflows and outflows, in each case as of the end of the previous business day during the preceding six months. A MMF also must disclose its current NAV rounded to the fourth decimal place in the case of funds with a \$1.0000 share price or an equivalent level of accuracy for funds with a different share price, calculated as of the end of each business day during the preceding six months.

A fund also must disclose prominently on its website, on the same business day that it files an initial report with the Commission on Form N-CR, certain information regarding the provision of financial support to the fund, imposition of liquidity fees, temporary suspension of fund redemptions and/or removal of liquidity fees and/or redemption gates. This disclosure must be maintained on the fund's website for at least one year following the date on which the Form N-CR was filed. The fund also must note in its website disclosure that additional information is reported on a Form N-CR filed with the Commission. In addition, certain information reported monthly to the Commission on Form N-MFP now must be reported on the fund's website at the same time that the information becomes public on Form N-MFP.

Investment Adviser Disclosure on Form PF

Form PF requires certain investment advisers to report, on a quarterly basis, certain information regarding the private funds that they advise. The Final Rules require large liquidity fund advisers (advisers with \$1 billion or more in combined MMF and liquidity fund assets) to file information on Form PF substantially similar to the information MMFs are required to file on Form N-MFP. For purposes of Form PF, a "liquidity fund" is any private fund that seeks to generate income by investing in a portfolio of short term obligations in order to maintain a stable NAV per unit or minimize principal volatility for investors.

Compliance Dates

The Final Rules will become effective 60 days after their publication in the *Federal Register*, although the compliance dates vary. The compliance date for the Final Rules (1) with respect to the floating NAV requirement, liquidity fees and gates, and related disclosure requirements, is two years after the effective

date, (2) with respect to the diversification, stress testing, Form PF, Form N-MFP and disclosure not specifically related to the floating NAV, liquidity fees or gates, is 18 months after the effective date and (3) with respect to Form N-CR and related website disclosure is nine months after the effective date.

INITIAL REACTIONS TO THE FINAL RULES

In the Open Meeting at which the Commission adopted the Final Rules, Chair White praised the amendments as “a significant step toward promoting financial stability and protecting the interests of investors,” but noted that they constitute “multi-faceted reform that warrants close monitoring as we proceed with implementation.”²⁴ Also voting in favor of the Final Rules were Commissioners Aguilar and Gallagher.

Commissioners Piowar and Stein voted against adopting the Final Rules. Commissioner Stein argued that, while redemption gates may stop a run in one fund, they “could be very damaging to the financial system as a whole” because “investors in other funds likely will fear that they also will impose gates.” Commissioner Stein also argued that the Final Rules do little to address the moral hazard created by sponsor support.²⁵ Commissioner Piowar did not support the Final Rules’ combination of floating NAV and fees and gates, arguing that the “combination impedes one of the Commission’s stated goals of this reform effort – ‘preserving, as much as possible, the benefits of money market funds.’” Commissioner Piowar advocated for an “investor choice” approach as a preferable alternative, under which investors, after receiving adequate disclosure, would choose whether to invest in a floating NAV fund or a fund with fees and gates.²⁶

Following the Commission’s meeting, Treasury issued a statement on behalf of the FSOC, describing the Final Rules as being “significant structural reforms” and noting that the FSOC “looks forward to more fully examining the SEC’s rule and its potential impact on MMFs and financial stability.”²⁷ Following the Open Meeting, Treasury Secretary Lew, who chairs the FSOC, echoed Chair White’s statements: “While the SEC’s reforms will require careful consideration and continued monitoring of their effectiveness in addressing risks to financial stability, the SEC’s final rule is a significant step forward.”²⁸ He praised the FSOC’s role, saying “the FSOC process has been used in an effective way. The FSOC came together, identified an unaddressed risk to financial stability, and encouraged the relevant regulator to take action.”²⁹

Later the same day, the FSOC announced that it will hold a closed meeting on July 31, 2014, to discuss MMF reform, among other matters.³⁰

THE PROPOSED RULES

Proposed Exemptive Relief from Immediate Confirmation Delivery Rules

Also on July 23, 2014, the Commission voted unanimously to propose exemptive relief for floating NAV MMFs under the immediate confirmation delivery requirements of rule 10b-10³¹ under the Securities

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Exchange Act of 1934 (“Exchange Act”).³² That rule generally requires broker-dealers to provide customers with information relating to their investment decisions at or before the completion of a securities transaction, but exempts from the general requirement MMFs that attempt to maintain a stable NAV where no sales load or redemption fee is charged. The exemption to the general rule under rule 10b-10 permits the investment information to be provided to MMF shareholders on a monthly basis, subject to certain conditions.

Since the Final Rules require institutional MMFs to maintain a floating NAV, these MMFs will no longer meet the requirements of the existing MMF exemption to rule 10b-10. Accordingly, the Commission proposes to exempt a floating NAV MMF from the immediate confirmation delivery requirements where (1) no sales load is deducted on the purchase or redemption of shares in the MMF, (2) the broker-dealer complies with the existing requirements set forth in rule 10b-10(b)(2) with respect to periodic reporting requirements and (3) the broker-dealer has notified the customer of its ability to request delivery of an immediate confirmation. So long as the MMF meets these requirements, and does not receive a request from the customer for immediate confirmation, it would be permitted to rely on the exemption from immediate confirmation delivery.

The Commission requests public comment on the proposed exemptive order, including with respect to whether the Commission should consider any alternatives other than the proposed exemption, such as requiring the provision of confirmations to shareholders at a different time interval. The public comment period will run for 21 days after the proposal’s publication in the *Federal Register*.

RE-PROPOSED AMENDMENTS TO REMOVE CREDIT RATING REFERENCES AND AMEND DIVERSIFICATION EXCLUSIONS

Credit Rating Amendment Re-Proposals

The Commission re-proposed amendments initially proposed in March 2011 to remove references to credit ratings in Rule 2a-7 and Form N-MFP as required under Dodd-Frank.³³ Section 939A of Dodd-Frank requires, among other things, that each federal agency review any regulation that requires the assessment of the creditworthiness of a security or money market instrument and remove any requirement of reliance on credit ratings.³⁴ Accordingly, the Commission proposes to remove the provisions in Rule 2a-7 that limit a MMF’s portfolio investments to eligible securities that the board determines present minimal credit risks. Eligible securities are currently defined to be securities that have received credit ratings from the requisite nationally recognized statistical rating organization (“NRSRO”) in one of the two highest rating categories or comparable unrated securities.

The proposal would instead define an eligible security as a security with a remaining maturity of 397 calendar days or less that the board or its delegate determines presents minimal credit risks, which determination would be required to include a finding that the security’s issuer has an exceptionally strong capacity to meet its short-term obligations. In addition, boards would no longer be required to designate

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NRSROs³⁵ and funds would not be prohibited from investing more than 3% of their portfolios in second tier securities. Under the proposed standards, only second tier securities of the highest quality would qualify as eligible securities, and third tier securities likely would be ineligible. The proposal would also replace credit rating references in other sections of the MMF rules, including the rules governing conditional demand features, the monitoring of credit risks, and stress testing.

The proposal notes that a fund adviser may take into account credit quality determinations prepared by outside sources that it determines are reliable in making the proposed determinations. In addition, an assessment of the strength of any issuer's or guarantor's ability to satisfy its short-term obligations should include an assessment of the following factors, among others, as appropriate: (1) the issuer's or guarantor's financial condition, (ii) the issuer's or guarantor's liquidity, (iii) the issuer's or guarantor's ability to react to future events and repay debt in a highly adverse situation and (iv) the strength of the issuer or guarantor's industry within the economy and competitive position within its industry. Moreover, the fund should consider whether the price and/or yield of the security is similar to that of other securities in the fund's portfolio.³⁶

Form N-MFP would be amended to replace the requirement that funds disclose for each portfolio security the name of each designated NRSRO and the rating assigned to the security with a requirement that the fund disclose each rating assigned by an NRSRO to which the fund subscribes and any other NRSRO rating that the board considered in making its minimal credit risk determination.³⁷

Diversification Proposal

As discussed above with respect to the Final Rules, MMF rules generally limit a fund's investments in securities of any one issuer of a first tier security to no more than 5% of fund assets and in securities subject to a guarantee to no more than 10% of fund assets from any one provider. The proposal would remove the exception to the 5% issuer diversification rule that provides that funds are not required to meet such diversification requirements with respect to issuers of securities that are subject to a guarantee by a non-controlled person. Therefore, MMFs that invest in securities subject to a guarantee, regardless of whether the guarantor is a non-control person, now would be required to comply with both the 5% issuer diversification requirement as well as the 10% guarantor diversification requirement unless another exclusion applies (e.g., the exclusion for government securities).

Comment and Compliance Periods

The Commission will solicit public comment on the proposal for 60 days after its publication in the *Federal Register*. The proposed compliance date for the re-proposed amendments to Rule 2a-7 and Form N-MFP and the proposed amendments to the issuer diversification requirements is 18 months after the effective date of the Final Rules.

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ENDNOTES

- 1 17 C.F.R. § 270.2a-7.
- 2 See current rule 2a-7(c)(4) and (c)(5).
- 3 See current rule 2a-7(c)(8)(ii).
- 4 For additional information regarding the 2010 MMF reforms, Sullivan & Cromwell's previous publications are available at <http://www.sullcrom.com/publications/detail.aspx?pub=643> and <http://sullcrom.com/publications/detail.aspx?pub=776>.
- 5 For additional information regarding the FSOC's proposed recommendations, Sullivan & Cromwell's previous publication is available at <http://www.sullcrom.com/files/Publication/945c164c-e8b9-4c75-96b8-05ee357df511/Presentation/PublicationAttachment/f8cbfde4-7848-4e10-b971-07ab0bae63a5/Money-Market-Mutual-Funds-11-21-2012.pdf>.
- 6 Money Market Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014), which is available at: <http://www.sec.gov/rules/final/2014/33-9616.pdf>.
- 7 See rule 2a-7(a).
- 8 The Final Rules clarify certain characteristics of instruments that meet the definitions of daily liquid assets and weekly liquid assets. These clarifications (1) limit a fund's ability to use maturity-shortening provisions in Rule 2a-7(d) regarding interest rate readjustments and (2) require that an agency discount note with a remaining maturity of 60 days or less qualify as a weekly liquid asset only if the note is issued without an obligation to pay additional interest on the principal.
- 9 The Commission's proposed rules would have defined a retail fund as a MMF that restricts a shareholder of record from redeeming more than \$1 million in one business day.
- 10 A MMF's governing documents and applicable state laws may also apply to or limit involuntary redemptions.
- 11 See sections 446, 6045, 6045A and 6045B of the Internal Revenue Code. The frequent purchase and redemption of MMFs raises concerns about the ability to track and report gains and losses from shares in floating NAV MMFs for purposes of accounting for and reporting transactions.
- 12 See section 1091 of the Internal Revenue Code, which generally disallows a loss realized by a taxpayer on a sale or other disposition of shares of stock or securities if, within a period beginning 30 days before and ending 30 days after the date of such sale or disposition, the taxpayer acquires by purchase or by an exchange, or enters into a contract or option to acquire, substantially identical stock or securities. Given the potential for losses on redemptions of shares in floating NAV MMFs, and the volume of transactions in MMFs, tracking wash sales of MMF shares could present significant practical challenges.
- 13 See §§ 1.446-7 and 1.6045-1(c)(3)(vi) of the proposed Income Tax Regulations, which is available at: <http://www.treasury.gov/resource-center/tax-policy/Documents/MMF%20Acc%27t%27g%20NPRM.pdf>.
- 14 Revenue Procedure 2014-45 is available at: <http://www.irs.gov/pub/irs-drop/rp-14-45.pdf>.
- 15 17 C.F.R. § 270.22e-3.
- 16 Rule 2a-7(a)(19) and ICA section 2(a)(9) (defining "control" as the "power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more

ENDNOTES (CONTINUED)

than 25 per centum of the voting securities of any company shall be presumed not to control such company. A natural person shall be presumed not to be a controlled person within the meaning of this title. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person. If an application filed hereunder is not granted or denied by the Commission within 60 days after filing thereof, the determination sought by the application shall be deemed to have been temporarily granted pending final determination of the Commission thereon. The Commission, upon its own motion or upon application, may by order revoke or modify any order issued under this paragraph whenever it shall find that the determination embraced in such original order is no longer consistent with the facts.”)

17 See rule 2a-7(d)(3)(ii)(F)(2).

18 See rule 2a-7(a)(18)(ii); Adopting Release page 494.

19 See rule 2a-7(d)(3)(iii)(B).

20 The adopting release notes that the Commission determined not to set specific thresholds against which MMFs would be required to test principal volatility because, for floating NAV funds, there is not a single measure of what level of volatility investors will tolerate. Therefore, boards are directed to use volatility thresholds based on the level of volatility that the boards believe their investors will likely tolerate. See page 550 of the Adopting Release.

21 Government MMFs that have not chosen to rely on the ability to impose fees and gates generally must include the following disclosure:

You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Government MMFs that chose to rely on the ability impose liquidity fees and redemption gates generally must include the following disclosure:

You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it cannot guarantee it will do so. The Fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the Fund’s liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Floating NAV funds generally must include the following disclosure:

You could lose money by investing in the Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the Fund’s liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Form N-1A Item 4(b)(1)(ii)(B).

22 The Final Rules define “*financial support*” consistent with the definition used in Form N-CR. See Instruction 1 to Item 16(g) of Form N-1A; Form N-CR Part C (defining financial support as

ENDNOTES (CONTINUED)

- “including any (i) capital contribution, (ii) purchase of a security from the fund in reliance on § 270.17a-9, (iii) purchase of any defaulted or devalued security at par, (iv) execution of letter of credit or letter of indemnity, (v) capital support agreement (whether or not the Fund ultimately received support), (vi) performance guarantee, or (vii) any other similar action reasonably intended to increase or stabilize the value or liquidity of the fund’s portfolio; excluding, however, any (i) routine waiver of fees or reimbursement of fund expenses, (ii) routine inter-fund lending, (iii) routine inter-fund purchases of fund shares, or (iv) any action that would qualify as financial support as defined above, that the board has otherwise determined not to be reasonably intended to increase or stabilize the value or liquidity of the fund’s portfolio.”).
- 23 The Final Rules amend the investment categories to include the following: U.S. Treasury Debt; U.S. Government Agency Debt; Non-U.S. Sovereign, Sub-Sovereign and Supra-National debt; Certificate of Deposit; Non-Negotiable Time Deposit; Variable Rate Demand Note; Other Municipal Security; Asset Backed Commercial Paper; Other Asset Backed Securities; U.S. Treasury Repurchase Agreement, if collateralized only by U.S. Treasuries (including Strips) and cash; U.S. Government Agency Repurchase Agreement, collateralized only by U.S. Government Agency securities, U.S. Treasuries, and cash; Other Repurchase Agreement, if any collateral falls outside Treasury, Government Agency and cash; Insurance Company Funding Agreement; Investment Company; Financial Company Commercial Paper; Non-Financial Company Commercial Paper; or Tender Option Bond. If Other Instrument, include a brief description.
- 24 Opening Statement at the SEC Open Meeting, Chair Mary Jo White, U.S. Securities and Exchange Commission, July 23, 2014, which is available at: <http://www.sec.gov/News/Speech/Detail/Speech/1370542343041>.
- 25 Statement of Commissioner Kara M. Stein, July 23, 2014, which is available at: <http://www.sec.gov/News/Speech/Detail/Speech/1370542347012>.
- 26 Statement at Open Meeting Regarding Money Market Fund Reform, Commissioner Michael S. Piowar, July 23, 2014, which is available at: <http://www.sec.gov/News/Speech/Detail/Speech/1370542346300>.
- 27 Statement on Behalf of the Financial Stability Oversight Council (FSOC) on the Final Money Market Fund Rule by the Securities and Exchange Commission (SEC), available at: <http://www.treasury.gov/press-center/press-releases/Pages/jl2578.aspx>.
- 28 Statement from Secretary Lew on the Final Money Market Mutual Fund Rule by the SEC, U.S. Department of the Treasury, July 23, 2014, which is available at: <http://www.treasury.gov/press-center/press-releases/Pages/jl2583.aspx>.
- 29 *Id.*
- 30 Financial Stability Oversight Council, Council Meetings, available at: <http://www.treasury.gov/initiatives/fsoc/council-meetings/Pages/default.aspx>.
- 31 17 C.F.R. 240.10b-10.
- 32 Notice of Proposed Exemptive Order Granting Permanent Exemptions Under the Securities Exchange Act of 1934 From the Confirmation Requirements of Exchange Act Rule 10b-10 for Certain Money Market Funds, Release No. 34-72658 (July 23, 2014), which is available at: <http://www.sec.gov/rules/exorders/2014/34-72658.pdf>.
- 33 Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, Investment Company Act Release No. 31184 (July 23, 2014) (the “Re-Proposal”), which is available at: <http://www.sec.gov/rules/proposed/2014/ic-31184.pdf>.
- 34 See Pub. L. No. 111-203 § 939A(a)(1)-(2) and (b).

ENDNOTES (CONTINUED)

- ³⁵ But see the staff no-action letter dated August 19, 2010, to Investment Company Institute (stating that the staff of the Securities and Exchange Commission would not recommend that the Commission institute an enforcement action if a MMF did not designate NRSROs or make related disclosure), available at: <http://www.sec.gov/divisions/investment/noaction/2010/ici-nrsro081910.htm>.
- ³⁶ See Re-Proposal pages 21-25 for a non-exhaustive list of other factors to consider in making a credit assessment.
- ³⁷ See proposed Form N-MFP Item C.10.

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CONTACTS

New York

John E. Baumgardner, Jr.	+1-212-558-3866	baumgardnerj@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com

Washington, D.C.

Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Paul J. McElroy	+1-202-956-7550	mcelroy@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
