Phase Two of Money Market Fund Reform: Important Changes to Diversification, Stress Testing, Disclosure and Reporting

By Stephen A. Keen

It has been mistakenly asserted that money market funds are canaries in the financial coalmines—in that distress in money market funds signals problems in the capital markets at large. The history of money market funds generally belies this claim, insofar as idiosyncratic defaults represent the most frequent threat to money market funds.\(^1\) Money market funds are regulatory canaries, however, insofar as significant reforms to money market fund regulations often presage reforms for investment companies generally. For example, the SEC proposed and adopted money market fund reforms in response to the financial crisis months before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “DFA”).\(^2\)

Thus, it may not be a coincidence that three massive reform proposals, regarding derivatives, liquidity and reporting,\(^3\) followed the most significant amendments to Rule 2a-7 since 1991. The reporting proposal was largely based on the SEC’s experience with Form NMFP, which money market funds began to file at the end of 2010. The liquidity proposal was influenced by quantitative liquidity requirements that were added to 2a-7 earlier that same year.

While these broader reform proposals are pending, money market fund managers continue to work on compliance with the amendments to Rule 2a-7 and related regulations and forms adopted in 2014 (the “2014 Reforms”).\(^4\) These changes were so significant that the SEC allowed the funds two years after the effective date of the amendments (October 14, 2014) before they must fully comply with the amendments. The SEC established two intervening compliance dates, however, for certain aspects of the reforms. The first compliance date (for Form N-CR) passed this summer; the next compliance date is April 14, 2016. This article explains the reforms with which money market funds must comply on this second compliance date (the “Phase Two Reforms”). Many of the Phase Two Reforms will require substantial changes to existing procedures and operations, so

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they should not be overlooked in anticipation of the more far-reaching reforms that will take effect on the final compliance date of October 14, 2016.

The Path to Reform

Many of the Phase Two Reforms respond directly to circumstances that threatened money market funds during the financial crisis in 2007 and 2008. A summary of these circumstances therefore provides important context for interpreting the Phase Two Reforms and the 2014 Reforms in general.

The Financial Crisis

Structured Investment Vehicles. The outset of the financial crisis in the summer of 2007 affected prime money market funds which held commercial paper (“CP”) issued by structured investment vehicles (“SIVs”). Banks developed SIVs in the 1980s to finance portfolios off their balance sheets. A SIV would issue CP secured by a portfolio of short and medium-term, high-grade bank and corporate instruments. Unlike other types of asset-backed CP, which have back-up liquidity facilities sufficient to repay the full amount of outstanding CP, a SIV’s back-up liquidity facility covered only part of its outstanding CP. If a SIV could not “roll” its CP (i.e., fund the payment of maturing CP by selling new CP), it would draw on the liquidity facility to cover the shortfall. The SIV would then start selling its portfolio to restore the liquidity facility and pay down subsequent maturities of its CP.

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The success of SIVs began to attract hedge fund managers, who pushed the boundaries of the portfolios that nationally recognized statistical rating organizations (“NRSROs”) would permit to obtain A-1+/Prime 1 ratings for their CP. To provide additional time to unwind their portfolios, these SIVs began to issue “extendable” CP. Extendable CP gave the SIV the option of repaying CP later than the scheduled maturity, provided the SIV paid a premium interest rate after the extension. The required increase in the interest rate provided money market funds with a basis for treating the extendible CP as a “variable rate security” under Rule 2a-7. So long as the SIV could not extend the maturity date beyond 397 days after the original trade date, Rule 2a-7 permitted a money market fund to treat the CP as maturing on the date of the next interest rate adjustment (the scheduled maturity date), rather than the potentially extended maturity date.

Many entrants into the SIV market (both banks and non-banks) began to invest in highly rated tranches of non-agency residential and commercial mortgage-backed securities (“MBS”). As the default rates on mortgages soared during the summer of 2007, the MBS became illiquid and volatile. By August 2007, SIVs holding MBS portfolios could not roll their CP and were forced to extend their maturities. Money market funds holding the extended CP reassessed their credit risks and concluded the CP no longer presented minimal credit risks. Consequently, Rule 2a-7 would not permit the funds to continue to hold the CP without approval from their boards of directors (the “Fund Boards”). To obtain this approval, money market fund managers entered into capital support agreements to hold their funds harmless from losses on the extended CP.

The extension of SIV CP led to a general loss of confidence in the SIV structure, so that, by the autumn of 2007, SIVs could no longer roll their CP regardless of whether they held MBS in their portfolios. Given the general illiquidity of the bond market at this time, none of the SIVs could dispose of sufficient portfolio securities to cover their maturing CP. To avoid default, many bank sponsors stepped in to purchase CP as it matured or to buy out the SIV’s portfolio.

The failure of MBS and SIVs also led to a general loss of confidence in structured products, so that some money market investors stopped investing in any type of asset-backed CP. This led several asset-backed conduits to draw down on their liquidity facilities when they could no longer roll their CP. The asset-backed CP market stabilized by the beginning of 2008, although only $800 billion was outstanding as compared to the market’s peak of $1.2 trillion in mid-2007.
Monoline Insurers. The next event during the financial crisis to affect money market funds was the deterioration of “monoline” insurance companies. “A monoline insurance company generally is an insurance company that only provides guarantees to issuers of securities.” MBIA (originally the Municipal Bond Insurance Association), AMBAC (originally the American Municipal Bond Assurance Corporation) and FGIC (the Financial Guaranty Insurance Co.) were among the best known monoline insurers.

“In 2007, around half of all new municipal bonds carried insurance.” The composition of tax exempt fund portfolios reflected the dominance of monoline insurers in the municipal market, so that “[i]n 2008, as much as 30% of the municipal securities held by tax-exempt money market funds were supported by bond insurance issued by monoline insurance companies.” Many of these securities were variable rate obligations with “conditional demand features” (VRDOs). Under Rule 2a-7, a demand feature is a right to require the provider of the demand feature to purchase the underlying security at approximately its amortized cost value. A demand feature is conditional when the right to demand payment may terminate upon the occurrence of certain events.

In the case of insured bonds, the conditions for terminating the demand feature typically included a downgrade of the monoline insurer’s long-term credit rating below investment grade or the insolvency of the monoline insurer. In fact, Rule 2a-7 prohibited a money market fund from acquiring a conditional demand feature unless the monoline insurer’s rating was at least AA/Aa. Prior to 2008, all of the major monoline insurers had AAA/Aaa ratings from the NRSROs, which gave the fund plenty of time to exercise the demand feature before it might terminate due to NRSRO downgrades.

The monoline insurers also underwrote the credit risks of MBS and MBS collateralize debt obligations, so the increase in mortgage defaults undermined their financial condition. In January 2008, Fitch downgraded AMBAC to AA. Although AA is still a high quality, investment grade rating, and Moody’s and S&P maintained AMBAC’s AAA ratings, the market viewed AMBAC’s insurance as “toxic.” The resulting lack of confidence in the bond insurers was a primary contributor to the market “freeze” that occurred in [VRDOs] in 2008 when money market funds and other investors reduced their purchases of these securities or sold them to the financial institutions that had provided demand features for the securities. The freeze in turn strained the providers of the demand feature and also increased the interest the issuers of the securities were required to pay. A lack of confidence in the creditworthiness of the bond insurers also caused dislocations in the market for tender option bonds, which use short-term borrowings from money market funds and others to finance longer-term municipal bonds.

Many issuers of insured bonds and tender option bonds responded by modifying the conditions of their demand features to require the downgrading or insolvency of both the monoline insurer and the bond’s issuer to terminate the demand feature. Other issuers obtained an additional guarantee from a highly rated company that was not a monoline insurer. This eventually stabilized the VRDO market, so no tax exempt funds ever required capital support from their sponsors even though, “[b]y 2010, Ambac and FGIC had filed for bankruptcy” and MBIA had a junk rating.

The Lehman Bankruptcy. The culminating events of the financial crisis for money market funds were Lehman Brothers Holdings, Inc. (“Lehman”) filing for relief under Chapter 11 early on Monday, September 14, 2008 and the Federal Reserve’s bailout of American International Group, Inc. (“AIG”) the following day. With one critical exception, managers of prime money market fund holding obligations of Lehman or AIG immediately purchased these obligations or added them to the capital support arrangements already established for SIV CP.

The exception was The Reserve Primary Fund (the “Primary Fund”), “the world’s first money market mutual fund.” At the opening of the day on September 14, the Primary Fund had assets of approximately $62.4 billion, $785 million (1.2%) of which was invested in Lehman obligations. Reserve Management Company, Inc. (“RMCI”), the Primary Fund’s investment adviser, did not have the resources to cover the potential losses on these obligations. RMCI called a meeting of the Primary Fund’s Board of Trustees at 8:00 a.m. that Monday morning. At this first meeting, the Board decided to stop valuing Lehman’s obligations at their amortized cost and asked RMCI to recommend an alternative fair value. The Board reconvened at 9:30 a.m., at which time they were advised “that there was ‘no valid marker’ for Lehman paper, with bids ‘being thrown out there anywhere from 45 to 80 [cents on the dollar].” The Board then fairly valued the Lehman
obligations at 80% of their amortized cost. The 20% reduction in the value of a 1.2% position had a negative impact of 24 basis points on the share price, almost halfway to where the fund would have to penny round below a dollar a share, assuming the Primary Fund’s total assets remained stable.

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This was not the case, however, as the fund was losing assets rapidly. By the time the Board revalued the Lehman holdings, shareholders had redeemed approximately $10 billion. At 10:10 a.m. that Monday morning, the Primary Fund’s custodian suspended its overdraft privileges. This had the effect of “gating” the fund, insofar as, even though redemption orders continued to mount, the fund did not have the liquidity to make redemptions.

The next day, September 16, 2008, it became apparent that the Primary Fund could not staunch the flow of redemption orders, raise the liquidity need to pay redemptions or obtain the capital support required to maintain a $1 share price. Consequently, “RMCI issued a press release announcing that the ‘value of the debt securities issued by [Lehman] … and held by the Primary Fund has been valued at zero effective 4:00PM …. As a result, the NAV of the Primary Fund, effective as of 4:00PM, is $0.97 per share.”

The announcement of the Primary Fund “breaking a dollar” prompted a “run” on prime money market funds. “During the week of September 15, 2008 (the week that Lehman Brothers announced it was filing for bankruptcy), investors withdrew approximately $300 billion from prime money market funds or 14% of the assets in those funds.” One fund suffered redemptions of 64% without breaking a dollar. These redemptions were overwhelmingly concentrated in funds that labeled themselves as “institutional” prime funds.

The run on institutional prime funds contributed to a general “freeze” in the short-term financing markets. In response: On September 19, 2008, the U.S. Department of the Treasury announced a temporary guarantee program, which would use the $50 billion Exchange Stabilization Fund to support more than $3 trillion in shares of money market funds, and the Board of Governors of the Federal Reserve System authorized the temporary extension of credit to banks to finance their purchase of high-quality asset-backed commercial paper from money market funds. These programs successfully slowed redemptions in prime money market funds and provided additional liquidity to money market funds.

In October, money started flowing back into prime money market funds, which reached a high-water mark of $1.9 trillion of assets by May 2009. Meanwhile, the Primary Fund received an order from the SEC permitting it to suspend redemptions while it completed its plan of complete liquidation.

2010 Reforms

In response to the financial crisis, the Investment Company Institute convened a task force to develop and propose regulatory reforms for money market funds. The task force issued its report in March 2009. The SEC incorporated most of these recommendations into reforms proposed in June 2009 and adopted in February 2010 (the “2010 Reforms”). Among the most significant reforms were:

- Requirements to maintain sufficient liquidity for anticipated redemptions and to hold 10% of a fund’s total assets in daily liquid assets and 30% in weekly liquid assets;
- Requiring periodic stress tests of a fund’s ability to maintain a stable share price;
- Creation of Form N-MFP to provide detailed monthly reporting to the SEC and a requirement to disclose monthly portfolio information on the fund’s website;
- Reduction in the dollar-weighted average maturity (“WAM”) to 60 days and a new limit on the dollar-weighted average life (“WAL”) of a portfolio to 120 days; and
- Adoption of new Rule 22e-3, permitting a money market fund to suspend redemptions after adopting a plan of liquidation.
President’s Working Group and Financial Stability Oversight Council

The SEC no sooner adopted the 2010 reforms than its Chairman began pressing for more far-reaching reforms. The President’s Working Group on Financial Markets’ Report on Money Market Fund Reforms provided the first slate of reform proposals. The SEC staff spent much of 2012 drafting a reform proposal based on the comments to this report, but the Chairman failed to garner sufficient support from the other commissioners to adopt the proposal. The Chairman then sought support from the Financial Stability Oversight Council (“FSOC”) created by the DFA.

FSOC responded by threatening to exercise its powers under Section 120 of the DFA to recommend reform measures. FSOC sought comments on three possible reforms:

- Requiring money market funds to “float” their share prices by prohibiting use of the amortized cost method and requiring funds to round their share price to the nearest basis point (one one-hundredth of a percent);
- Requiring money market funds or their sponsors to hold capital to absorb portfolio losses; or
- Requiring shareholders to maintain a minimum balance at risk for a specified period, together with a smaller capital requirement.

2013 Proposal and 2014 Adoption

Chairman Schapiro left the SEC without proposing additional reforms. Her successor, Chair White, continued to press for further reforms, and, in June 2013, the SEC unanimously adopted a proposal for additional money market fund reforms. A floating share price was the only FSOC reform included in the proposal, and this was limited to non-government institutional funds. Ultimately, in July 2014, a bare majority of the SEC commissioners adopted the 2014 Reforms.

Three Phases of the 2014 Reforms

Although the 2014 Reforms became effective on October 14, 2014, the compliance dates were staggered to facilitate an orderly transition. The first compliance date was July 14, 2015. Starting on that date, money market funds were required to file Form N-CR within one business day following:

- a default or event of insolvency affecting portfolio securities accounting for at least 0.5% of the fund’s total assets;
- the provision of any form of financial support to the fund by an affiliated person, promoter, or principal underwriter of the fund, or an affiliated person of such person; and
- a deviation in the fund’s Shadow NAV of more than 0.25% below its intended stable price per share.

Form N-CR provides summary information regarding any reported event. Funds should have already adopted procedures for filing Form N-CR. The first N-CR filing occurred on October 30, 2015.

The compliance date for the Phase Two Reforms will be April 14, 2016. Starting on this date, money market funds will need to comply with what might be regarded as routine reforms, insofar as they modify existing provisions of Rule 2a-7. As discussed in detail below, these Phase Two Reforms include changes in:

- Diversification;
- Disclosure;
- Stress testing and other procedures; and
- Maturity.

The amendments to Rule 2a-7 also codified some staff guidance given after the 2010 Reforms. Although these amendments technically take effect on April 14, 2016, funds should already comply with these changes.

The final compliance date is October 14, 2016. On this date:

- All prime and municipal money market funds become subject to potential liquidity fees and “gates” (suspension of redemptions for up to ten business days);
- Government funds must invest at least 99.5% of their total assets in cash, government securities and fully collateralized repurchase agreements;
- Retail money market funds must restrict the beneficial owners of their shares to natural persons; and
- All other funds (i.e., non-government institutional funds) must calculate a floating NAV rounded to the nearest basis point (e.g., $1.0000).

Parts of Form N-CR requiring funds to report the imposition and termination of liquidity fees and gates will also come into effect on this date.
Phase Two Reforms

Diversification

The Phase Two Reforms include the first significant changes to Rule 2a-7’s diversification requirements since 1996. Some changes responded directly to problems created by SIVs and monoline insurers during the financial crisis. Another change codified a long-standing diversification practice of many money market fund managers.

Asset-Backed Securities. A new clause has been added to the definition of guarantee requiring the “sponsor” of an asset-backed security (an “ABS”) to be treated as having provided a guarantee of the security. This reflects the propensities of banks to provide financial support to their ABS programs, as illustrated during the collapse of the SIVs, and of some money market fund managers to rely on this implicit support when assessing the credit of ABS.

Rule 2a-7 treats a sponsor as a guarantor of its ABS for three purposes. First, a fund must include the full amount of the ABS against the diversification limit on securities issued by or subject to demand features or guarantees provided by the sponsor. Second, a fund may exclude an asset-backed security from the issuer diversification limitations if it treats the security as guaranteed by its sponsor. Finally, a fund must dispose of ABS following an event of insolvency by the sponsor, unless the Fund Board determines that this would not be in the fund’s best interest.

Rule 2a7 does not define who is a “sponsor” of an ABS. According to the Adopting Release, “For [asset-backed] CP, we [the SEC] believe that the sponsor will typically be the financial institution that provides explicit liquidity and/or credit support and also provides administrative services to the [asset-backed] CP conduit.” In this context, “liquidity support” probably refers to a liquidity facility that serves to bridge cash flows from the qualifying assets to payment obligations on the ABS. It appears that more than just explicit liquidity support is required for sponsorship; a potential sponsor must administer the conduit to some extent.

From a compliance perspective, it may be better to start with who the fund does not have to treat as a guarantor of the ABS. A fund does not have to treat a sponsor as a guarantor if the Fund Board (or its designee) “has determined 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 quality or liquidity of the asset-backed security, and maintains a record of this determination.” The minimal credit risk determination for ABS should identify every entity on whose financial strength the fund will rely; the illiquid security determination should identify to whom the fund might sell the ABS in seven days. A fund may exclude any entity not so identified from further consideration as a potential guarantor of the ABS.

With respect to the entities identified in the minimal credit risk and illiquid security processes, the next question is whether Rule 2a-7 already treats them as the provider of a demand feature or guarantee. If so, the ABS is already subject to the demand feature and guarantee diversification limits for these entities, and compliance with these limits will assure compliance with the limitations on the sponsor of the ABS.

This should be true even if the entity guarantees only a fraction of the qualifying assets underlying the ABS. In the context of ABS, a fractional guarantee results when a credit support provider takes the “first loss exposure” on the qualifying assets, up to a fixed dollar amount or percentage. For example, a special purpose entity with $100 million of qualifying assets might arrange for an entity to guarantee the first $5 million of losses on the qualifying assets. This would protect the ABS from defaults on the qualifying assets unless the aggregate losses exceed the $5 million limit.

Rule 2a-7 permits a fund to use this “fraction” to calculate the amount of the ABS subject to a guarantee for purposes of diversification. In the example, a fund would treat only 5% of the ABS as subject to the fractional guarantee. Hence, if a money market fund held $20 million of the ABS, it would treat only $1 million as exposure to the provider of the fractional guarantee and would treat the other $19 million as exposure to the special purpose entity issuing the securities.

According to the Adopting Release:

in cases where a security is subject to a fractional demand feature or guarantee by the sponsor, as defined in rule 2a–7, a money market fund may count the fractional demand feature or guarantee in place of deeming the sponsor as a guarantor of the entire principal amount of the ABS.

In other words, the money market fund must rely on something more than the fractional guarantee before it must treat the provider of the fractional guarantee as having guaranteed the entire amount of the ABS.
Any remaining entities identified in the minimal credit risk and illiquid security processes would require further analysis to determine whether one of them should be treated as the sponsor of the ABS. Based on the Adopting Release, this should require, at a minimum, an explicit undertaking by the entity to provide some credit or liquidity support for the ABS. This might be the case if the entity provides a liquidity facility that does not rise to the level of a demand feature, or makes a market in the ABS.

This limited guidance of ABS “sponsorship” raises an interesting question in the context of the failed SIVs. Non-bank sponsors of SIVs typically did not provide any explicit credit or liquidity support for their CP, so they would not appear to satisfy the criteria for a sponsor of asset-backed CP. They performed many of the functions of a tender option bond sponsor (see, supra note 47), however, and were generally referred to as “sponsors.” In hindsight, a fund would have been well advised not to treat these sponsors as guarantors, insofar as none of them provided support for their SIV’s CP.

Elimination of the “25% Basket” for Demand Feature and Guarantees. When originally adopted in 1983, Rule 2a-7 did not have any diversification requirements. Reforms adopted in 1986 added the first limitations, limiting securities subject to unconditional demand features from a single provider to 10% of total assets, and securities subject to conditional demand features to 5% of total assets. The limitations, however, applied only “75 percent of the total value of [a fund’s] assets.”50 This created a so-called “25% basket,” in which a money market fund could hold securities subject to demand features provided by the same company in excess of the 10% or 5% limits.

The diversification limits for demand features and guarantees were simplified in the 1996 reforms, with a 10% limit on all securities issued or subject to guarantees or demand features (whether conditional or unconditional) issued by the same company, subject to a 25% basket available to all types of money market funds.51 Because the rule separated issuer diversification requirements from limitations on demand features and guarantee, the limit technically applied only to when a fund acquired a security subject to a demand feature or guarantee. This led some (not including the author) to conclude that a fund could invest up to 25% of its total assets in securities subject to guarantees and demand features provided by a single issuer, and then (once the 25% basket was filled) invest another 5% of its total assets in the issuer’s direct obligations.

The Phase Two Reforms tighten these diversification requirements. First, the reforms require 100% diversification for all money market funds other than tax exempt funds.52 Non-tax exempt funds must limit investments in securities issued by or subject to demand features and guarantees provided by the same issuer to 10% of their total assets. This reflects the SEC staff’s conclusion that only tax exempt funds regularly relied on the 25% basket.53 Second, the reforms reduced the basket for tax exempt funds from 25% to 15%. The reduction has the effect of limiting the basket to only one issuer, insofar as two issuers over the 10% limit would represent more than 20% of the tax exempt fund’s total assets. This reduction in the basket was a response to the downgrading of the monoline insurers during the financial crisis, which highlighted the possibility that up to 25% of a fund’s total assets might be exposed to a single insurer.

Finally, the reforms eliminate any ambiguity about whether the demand feature and guarantee diversification limits apply to the acquisition of direct obligations. Paragraph (d)(3)(i) now explicitly applies to all acquisitions. To make doubly sure this was the case, the diversification requirements for demand features and guarantees are repeated in Paragraph (d)(3)(i) (although still captioned “Issuer Diversification”). Unfortunately, the 15% basket for tax exempt funds was not included in (d)(3)(i), so it would seem to impose a 10% limitation without exception. The staff addressed this inconsistency in Question 52 of the 2014 Reform FAQs:

The Adopting Release amendments provided that as much as 15 percent of the value of securities held in a tax-exempt money market fund’s portfolio may be subject to guarantees or demand features from a single institution. Therefore, a tax-exempt fund (other than a single state fund, which is addressed below) is required to comply with rule 2a-7(d)(3)(i)(A)(2) (Issuer diversification — Taxable and national funds) with respect to only 85 percent of its total assets.54

Consolidation of Issuers. The Phase Two Reforms codify a common practice of money market funds to apply diversification limits to the companies included in consolidated financial statements as a group. Specifically, Rule 2a7(d)(ii)(F) requires money market funds to “treat as a single issuer two or more issuers of securities owned by the money market
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fund if one issuer controls the other, is controlled by the other issuer, or is under common control with the other issuer ....” “Control”\(^{55}\) is defined as ownership of a majority of the voting securities (securities entitled to vote for a company's board of directors) of a company.

Compliance with this requirement will require funds to group a "parent" company with all of its controlled subsidiaries. For this purpose, a "parent" is a natural person or company that controls subsidiaries, but is not itself controlled by another person or company. The fund must then aggregate all obligations of the parent and its controlled subsidiaries held in the portfolio (the "Consolidated Obligations"). The amount of Consolidated Obligations would be the same for the parent and every one of its controlled subsidiaries. The fund must use these Consolidated Obligations to determine the diversification limits on the acquisition of any additional obligations issued by the parent or any of its controlled subsidiaries.

Although new subparagraph (F) appears under the caption “Issuer diversification calculations,” it also applies to the limitations on demand features and guarantees. This is because paragraph (d)(3)(i)(A)(2) reiterates the 10% diversification limit for demand features and guarantees, and subparagraph (F) applies “for purposes of paragraph (d)(3)(i).” Hence, a fund must also include in the Consolidated Obligations all securities subject to demand features or guarantees from the parent and its controlled subsidiaries when calculating diversification limits on demand features and guarantees.

Disclosure

Expanded Website Disclosure. The Phase Two Reforms expand both the frequency and content of required website disclosures. Most significantly, each money market fund must maintain on its website “schedules, charts, graphs, or other depictions” of the fund’s:

- Shadow NAV;
- Percentage of total assets held in daily and in weekly liquid assets; and
- Net flows from fund share transactions (in other words, net purchases or redemptions of fund shares).\(^{56}\)

Funds must update this information daily as of the end of the previous business day. For example, information as of the close of business on Monday must be posted by the close of business on Tuesday. The website must include information for every business day during the preceding six months. Even the first required posting must include six months of information (i.e., information from October 14, 2015 through April 13, 2016).

The Phase Two Reforms expand the information required in a fund’s monthly website postings as well. Money market funds will need to disclose their WAMs and WALs, as well as the maturity of each portfolio security for purposes of calculating WAM and WAL. Funds must also disclose the value of each portfolio security (as used to calculate the Shadow NAV). Finally, the categories of investments have been expanded to include Non-U.S. Sovereign, Sub-Sovereign and Supra-National debt.

Changes to Form N-MFP. Under the Phase Two Reforms, information on Form N-MFP will become publicly available immediately upon filing, rather than after 60 days as is currently the case. Much of the most significant information (such as the Shadow NAV) will already be available on the fund’s website, so the immediate availability of Form N-MFP data will probably not affect shareholders to any significant degree.

Amended Form N-MFP also requires reporting of some interim information in addition to month-end data. Hence, funds must now include their daily and weekly liquid assets (both the total value and the percentage) as of each Friday during the month. The funds must also report their Shadow NAV and weekly net flows (by class and in total) as of each Friday during the month.

Additional fund and class level information that funds must report on Form N-MFP include:

- The number of shares outstanding (both by class and in total);
- Current cash holdings;
- Fee waivers and expense reimbursements.

Additional portfolio level information includes:

- The yield as of the reporting date;
- Whether the security is a daily or weekly liquid asset;
- Whether the security is categorized as a level 3 fair value for purposes of ASC 820 (a fair value based on unobservable inputs);
- Whether a demand feature is conditional;
- The percentage of support provided by each demand feature issuer or other enhancement provider;
- The period until the principal amount may be recovered by exercising a demand feature;
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Many of the Phase Two Reforms respond directly to circumstances that threatened money market funds during the financial crisis in 2007 and 2008. For a floating NAV fund, funds must now test the “ability to minimize principal volatility.” In the case of government and retail money market funds, this still includes “the fund’s ability to maintain [its] stable price per share.”

It is not clear how a fund should test its ability to maintain 10% of total assets in weekly liquid assets. Shareholder redemptions are the only stress directly affecting the amount of weekly liquid assets held by a fund. Other stresses, such as increases in interest rates or spreads, affect only the value, rather than the composition, of a fund’s portfolio.

The relationship of shareholder redemptions to weekly liquid assets depends on the assumptions underlying the test. For example, if the test assumes that a fund will raise liquidity for redemptions by selling its shortest maturities first, then every $1 of redemptions would produce a $1 decrease in weekly liquid assets. On the other hand, if the test assumes the fund will raise liquidity by selling its portfolio on a pro rata basis, then redemptions would not have any effect on the percentage of weekly liquid assets. Unless these assumptions regarding liquidity vary based on other stresses, the tests will always produce the same results in terms of the effect on weekly liquidity.

The SEC, however:

As noted above, combining changes in interest rates or credit spreads with increased redemptions would not alter the results in terms of the percentage of weekly liquid assets held by the fund. Perhaps all that can be said of this change is that stress tests must include assumptions about how a fund will raise liquidity to meet increased redemptions. Although not required, a Fund Board might consider varying the assumptions based on other stresses. For example, the test might assume that markets remain liquid up to a certain increase in interest rates (so that the fund could sell longer-term assets to raise liquidity), but becomes illiquid after that point (so only weekly liquid assets could be used to raise liquidity).
Testing the “ability to minimize principal volatility” should be more clear cut. Current stress tests calculate the impact of particular stresses on the fund’s Shadow NAV and show the point at which the Shadow NAV would fall below $0.995. A floating NAV fund can run the same tests, which will show the impact of stresses on the fund’s actual (rather than Shadow) NAV. The Fund Board would have latitude to pick a different target NAV as a minimal principal volatility, as a $0.9950 NAV would not have any particular significance to a floating NAV fund.

The Phase Two Reforms make three principal changes to the stresses funds must include in their testing. First, as previously mentioned, funds must combine “various levels of an increase in shareholder redemptions” with each stress being tested. Prior to the reforms, funds had the option to test redemptions and other stresses on an isolated basis. Even before Rule 2a-7 required stress testing, however, rated money market funds provided NRSROs with stress tests that combined the impact of interest rate increases with increased redemptions, and this approach was widely adopted for Rule 2a-7 stress testing as well. Hence, many money market funds already comply with this reform.

Second, the SEC tried to clarify the currently required stress of a “widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund.” The reforms modified this to require testing of “[a] widening of spreads compared to the indexes to which portfolio securities are tied in various sectors in the fund’s portfolio (in which a sector is a logically related subset of portfolio securities, such as securities of issuers in similar or related industries or geographic region or securities of a similar security type) ….”60 This change is consistent with how many funds interpreted the prior requirement. Essentially, the tests must include stresses affecting the entire portfolio (“increases in the general level of short-term interest rates”), stresses affecting a subset of the portfolio (the revised sector test) and stresses affecting isolated issuers (“a downgrade or default of particular portfolio security positions”).

Finally, the tests must include “[a]ny additional combinations of events that the adviser deems relevant.”61 This means that stress testing procedures should allow for ad hoc tests performed at the direction of the fund’s adviser.

The Phase Two Reforms also require changes to the reporting of stress tests to the Fund Board. First, the reports must include “such information as may reasonably be necessary for the board of directors to evaluate the stress testing conducted by the adviser and the results of the testing.” This could include information on current market conditions, such as expected changes in monetary policy, heightened concerns about a particular sector (such as the Eurozone) or anticipated rating changes. Second, the Fund Board must receive “a summary of the significant assumptions made when performing the stress tests.”62

Other Procedural Changes. The Phase II Reforms include procedural changes that correspond to the substantive changes to Rule 2a-7. For example, insofar as funds must now post a daily shadow price to their website, the Fund Board’s shadow pricing procedures must now require the calculation of a shadow price “at least daily”63 rather than “at such intervals as the board of directors determines.” In the event that a fund determines not to treat an ABS sponsor has providing a guarantee of the ABS, the fund must also adopt procedures to evaluate this determination periodically.64 Funds must maintain written records of these evaluations for a period of not less than three years.

Finally, procedures for filing Form N-CR should replace any existing procedures requiring the fund to contact the SEC following a default or significant deviation in the fund’s Shadow NAV and to file a schedule on Form N-SAR describing the actions taken. Funds may also remove procedures requiring notification to the SEC of any transactions by the fund in reliance on Rule 17a-9.

Changes Relating to Maturity

The definition of demand feature was amended to remove the 30-day limit on the notice period. Previously, a demand feature could not be used to shorten the maturity of an obligation if it required more than 30 days’ notice of exercise. For example, an obligation that permitted the holder to demand repayment at the end of any month by giving notice at the end of the prior month could be used to shorten maturities for months of 30 days or less, but not for months of 31 days.

The new definition of demand feature includes any right to require repayment “at the later of the time of exercise or the settlement of the transaction, paid within 397 calendar days of exercise.”65 The new language is somewhat confusing, insofar as the transaction cannot be settled until the demand feature is exercised. The intent nevertheless seems clear: a
“maturity” based on a demand feature equals the period until the demand feature may next be exercised plus the period from exercise until settlement.

For example, a demand feature that may be exercised only at the end of the month, for settlement at the end of the following month would have a maturity of 31 days on June 30, because the demand feature could be exercised on that day and settlement would occur on July 31. On July 1, however, the demand feature’s maturity would be 61 days, because the holder would have to wait until July 31 to exercise the demand feature and then wait until August 31 for settlement.

This reform permits money market funds to invest in longer-term securities than they might have in the past. For example, a fund might acquire an instrument with a final maturity in excess of 397 days, but with a demand feature that may be exercised at any time for settlement in 90 days and an interest rate that adjusts every 90 days to maintain the security’s par value. Such an instrument would have a maturity of 90 days, for purposes of both WAM and WAL.66

Conclusions

With all of the concerns about the conversion of institutional money market funds to a floating NAV and the potential implementation of fees and gates, there is a risk that some managers may overlook the important changes included in the Phase Two Reforms. It is critical that managers and their compliance staffs complete their work on these reforms in the near term to allow Fund Boards to review and adopt revised procedures in advance of the April 14, 2016 deadline. Fund Boards commonly meet only once a quarter, so they will need to act on these procedures in the first quarter of 2016 in order to meet the compliance deadline.

ENDNOTES

4 With 25 years of experience, Stephen Keen is a nationally recognized authority on money market funds and money market instruments and has written extensively on these topics. He has represented the industry in connection with regulatory proposals and in developing new financial products for the money markets, most notably tender option bonds and variable rate demand preferred stock. He also advises clients on the application of federal and state laws to structured products and derivative contracts and their valuation. A graduate of University of Chicago Law School, Stephen has received repeated recognition from The Best Lawyers in America. Prior to his private practice, Stephen worked for 15 years in the legal department of the investment management company Federated Investors Inc., where he became general counsel.


5 “Variable rate security means a security the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.” Rule 2a-7(a)(27). Although this article will sometimes quote a definition for purposes of analysis, it assumes the reader is already familiar with the terms defined in Rule 2a-7(a).

6 DERA Report, supra note 1, at 6.


8 Asset-backed Commercial Paper Outstanding, https://research.stlouisfed.org/fred2/series/ABCOMP.


11 Proposing Release, supra note 9, at 36961.

12 Rule 2a-7(a)(9) (definition of a “demand feature”) and (a)(6) (definition of a “conditional demand feature”).

13 Rule 2a-7(a)(9) (definition of a “demand feature”).
In the opinion of the author, Rule 2a-7 does not permit a security-by-security application of the amortized cost method. Paragraph (c) (1) of the rule permits "the board of directors of [a] money market fund [to] determine, in good faith, that it is in the best interests of the fund and its shareholders to maintain a stable net asset value per share or stable price per share, by virtue of either the amortized cost method and/or the penny-rounding method. The... money market fund may continue to use such methods only so long as the board of directors believes that they fairly reflect the market-based net asset value per share..." Paragraph (a)(2) defines the "[a]mortized cost method of valuation [as] the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's acquisition cost as adjusted for amortization of pre-mium or accretion of discount rather than at their value based on current market factors." In other words, a money market fund may only use the amortized cost method "to maintain a stable net asset value per share." As long as it does so, all portfolio securities should be fair valued at their amortized cost.

The trustees of the Primary Fund should have revalued the Lehman obligations solely for purposes of "shadow pricing" the Primary Fund; that is, estimating the deviation between the market-based net asset value per share (the "Shadow NAV") and $1. If the Shadow NAV deviated by more than 0.5%, the trustees would have been required to determine what actions, if any, should have been initiated. Rule 2a-7(g)(1)(B). If they determined to stop using the amortized cost method, the entire portfolio (not just the Lehman obligations) should have been fairly valued "based on current market factors."
as the sponsor or conclude that it is not relying on the sponsor to provide financial support or liquidity for the TOB.

48 Rule 2a-7(a)(16)(ii) (cross-references omitted).
49 Adopting Release at 47875.
52 “Tax exempt fund means any money market fund that holds itself out as distributing income exempt from regular federal income tax.” Rule 2a-7(a)(23). Government securities and fully collateralized repurchase agreements are not subject to any diversification limits, so as a practical matter this change will affect only prime funds.
53 Adopting Release at 47881. (“DERA staff found that tax-exempt money market funds in general, and single state money market funds in particular, use the twenty-five percent basket to a higher degree than money market funds as a whole.”)
54 Amended paragraph (d)(3)(iii) also repeats the 5% issuer diversification requirement, but without the 3-day safe harbor and 25% basket for single state funds. Questions 53 and 54 of the 2014 Reforms FAQs clarify that these exceptions still apply.
55 This is arguably the third definition of “control” under the 1940 Act, which defines “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” and creates a presumption of “control” whenever a person “owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company ....” § 2(a)(9). It may have been less confusing if the SEC used the existing definitions of “parent” and “majority-owned subsidiary.” See, 17 C.F.R. § 230.405 (2015).
56 Rule 2a-7(h)(10)(ii)-(iii).
57 Rule 2a-7(g)(8)(i).
58 Adopting Release at 47891.
59 The Adopting Release cited a comment letter from Fidelity in support of including weekly liquid assets in stress testing results. Adopting Release 47891 n 1773, citing comment letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., Fidelity Investments (Sept. 16, 2013), http://www.sec.gov/comments/s7-03-13/s70313-149.pdf. The comment letter included examples of Fidelity’s stress tests (at pp. 47-48), which combined stresses with shareholder redemptions of 25% and 50% and showed the resulting percentage of weekly liquid assets. It is clear from the graphs that Fidelity used the same liquidity assumptions for every combination of stresses and redemptions. Fidelity’s test also assumed a 1% liquidity premium for sales of non-liquid assets. Such an assumption would factor in the potential impact of portfolio liquidation on the fund’s portfolio value, but would not change the percentage of weekly liquid assets.
60 Rule 2a-7(g)(8)(i)(C).
61 Rule 2a-7(g)(8)(i)(D).
62 Rule 2a-7(g)(8)(ii).
63 Rule 2a-7(g)(8)(i)(A)(I).
64 Rule 2a-7(g)(7).
65 Rule 2a-7(a)(9). This change was also made to the reference to an unconditional demand feature in the definition of “guarantee.” Rule 2a-7(a)(16)(i).
66 Rule 2a-7(i)(3) (“a maturity equal to the longer of the period remaining until the next readjustment of the interest rate or the period remaining until the principal amount can be recovered through demand”).

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