New Regulations: The Devil is in the Details (a U.S. Perspective)

Crane Data’s European Money Fund Symposium 2016

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About Sullivan & Worcester LLP

Sullivan & Worcester is a law firm with approximately 170 lawyers practicing from offices in Boston, New York, Washington, D.C. and London. We also have long-standing strategic alliances with law firms in Ireland and Israel, as well as throughout Europe, Asia and the Middle East.

Our investment management practice covers registered U.S. mutual funds and their independent directors, registered offshore funds, including UCITS funds, unregistered U.S. and offshore hedge funds, commodity pools, private equity and venture capital funds, as well as real estate investment trusts (REITS) and private real estate funds.
Agenda

- Summary of Rule 2a-7 and the 2014 /2015 amendments
- How U.S. registered money market funds (MMFs) have addressed the 2014/2015 amendments
- Questions going forward
- **Bonus (if there is time):**
  - A summary comparison of U.S. and E.U. money fund regulation
  - How U.S. managers select the jurisdiction of their offshore funds
Summary of Rule 2a-7

• Rule 2a-7 is an interpretative rule on how to value individual securities in a MMF portfolio

• Rule 2a-7 establishes conditions on any registered investment company that wants to operate as a MMF
  › Risk-limiting conditions on individual portfolio holdings (quality, maturity) and over the entire portfolio (diversification, liquidity)
  › Valuing individual securities (e.g., amortized costs, market prices) and the MMF as a whole (e.g., “penny rounding”)
  › Periodic reporting to the SEC and investors
  › MMF-specific policies and procedures (including stress testing)
  › Special duties of MMF directors
Summary of the 2014/2015 Amendments

- 2014 Amendments
  - Floating share price - required of funds that are not Government funds (i.e., funds that invest principally in U.S. government securities) or retail funds (i.e., beneficial owner of shares must be a natural person)
    - Intended primarily to apply to institutional prime MMFs
    - Limits the use of Amortized Cost in favor of market pricing
    - Requires MMF share prices calculated to 4 decimals
  - If the MMFs holdings of weekly liquid assets falls below certain levels
    - Redemption fees - Directors may impose, and in certain cases must impose unless they determine otherwise
    - Temporary redemption gates – Directors may impose
    - Does not apply to Government MMFs (but Government MMFs may adopt)
  - Changes to Stress Testing Requirements – MMFs must now test to determine whether they may maintain at least 10 percent weekly liquid assets under stressed conditions
Summary of the 2014/2015 Amendments (cont.)

- 2014 Amendments (cont.)
  - **Government funds** - must have at least 99.5 percent of assets invested in U.S. government securities (before minimum 80 percent)
  - **Disclosure** - new prospectus and SAI disclosure requirements, as well as new website requirements
  - New **SEC reporting** - Form N-CR (reporting sponsor support, actions with respect to application of fees and gates); amendments to Form N-MFP (reporting portfolio holdings)
Summary of 2014/2015 Amendments (cont.)

- 2015 Amendments
  - **Removal of credit ratings** from Rule 2a-7
    - MMFs still must report on Form N-MFP any credit ratings they considered in determining whether a security is an eligible security
  - Eliminated an exclusion from the diversification requirement for securities subject to a **guarantee issued by a non-controlled person**

*Both the 2014 and 2015 Amendments require compliance by October 14, 2016*
How U.S. MMFs Have Addressed the 2014/2015 Amendments

- Examining their product lines
  - Segregating retail and institutional investors into different MMFs
  - Replacing (or will replace) prime MMFs with
    - U.S. government funds
    - High-quality, short-term bond funds or government MMFs

- Operationally
  - Calculating share prices with four decimals instead of two decimals
  - Complying with new reporting requirements
  - Complying with new disclosure requirements
  - Amending compliance procedures
  - Incorporating rule changes into portfolio construction methodology
    - Bringing government MMFs into compliance with 99.5% requirement

- Communicating to investors – how these changes will affect their investment selections
Questions Going Forward

- Where will institutional investors invest their cash if they cannot invest in stable share price prime MMFs?
  - Separately managed accounts
  - Collectively managed individual accounts
  - Private funds, which are not subject to Rule 2a-7
    - Some private funds will follow most Rule 2a-7 conditions, but are not required to follow any
    - Possible to have stable share prices and portfolio of corporates without following Rule 2a-7
  - New products

- How will redemption fees and temporary redemption gates work in real time?
  - Conditions under which Directors will determine whether to impose fees/gates
  - Conditions under which Directors will determine not to impose redemption fees if they are otherwise required
Questions Going Forward (cont.)

- Will the SEC look to impose additional regulations?
  - Further pressure from the Federal Reserve, U.S. Treasury
    - Industry concentration may create even more risk in the market
  - Extension of Rule 2a-7 conditions to non-registered investment products
    - SEC already has amended Rule 12d1-1 (registered fund investments in unregistered funds) to require certain unregistered funds to comply with Rule 2a-7, including floating share prices and liquidity fees and gates
  - New data received by the SEC may show additional risks in the market
Questions Going Forward (cont.)

- Will the SEC adopt current proposed regulations?
  - Business Continuity
    - Would formalize by rule certain informal advice regarding fund business continuity plans
  - Modernization of Data Gathering
    - Would update reporting regimes for funds through new monthly N-PORT and annual N-CEN reporting forms; information would be presented in new structured format
    - Purpose is to allow SEC to better assess information
  - Liquidity Risk Management
    - Intended to improve firms’ risk management of funds’ liquidity to ensure that there is sufficient cash when investors redeem their shares
    - Would apply to high-quality, short-term bond funds
Questions Going Forward (cont.)

• Will the SEC adopt current proposed regulations? (cont.)
  › Fund’s use of Derivatives
    • Would limit mutual fund exposure to leverage through their use of derivatives by requiring new limits on the amount of assets required to meet their obligations
    • Would require funds to implement risk management programs to manage the risks that related to the use of derivatives
Bonus 1: Summary Comparison of E.U and U.S. MMF Regulations

• Both the E.U. and U.S. MMF regulations have the same general objectives:
  › To make MMFs more resilient to short-term market changes
  › To reduce instability in the money markets caused by MMFs

• E.U. and U.S. regulators generally approach regulation differently
  › U.S. – one national regulator        E.U. – supranational and national regulators

• Defining a Money Market Fund
  › U.S. – standard definition of what is a “money market fund” (i.e., a fund that complies with Rule 2a-7) since 1983; industry eventually evolved to stable share prices using amortized cost and penny rounding
  › E.U. – until recently, very different types of funds could be a “money market fund”; industry practices in some countries are inconsistent with practices in other countries
## Bonus 1: Summary Comparison of E.U. and U.S. MMF Regulations (cont.)

<table>
<thead>
<tr>
<th></th>
<th>Council Compromise (10 June 2016)</th>
<th>U.S. Rule 2a-7 (as of 14 October 2016)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Debt (government) CNAV MMFs</strong></td>
<td>99.5% in public debt</td>
<td>* CNAV permitted</td>
</tr>
<tr>
<td></td>
<td></td>
<td>* 99.5% U.S. government (federal) debt only</td>
</tr>
<tr>
<td><strong>Retail CNAV MMFs</strong></td>
<td>Only offered to charities, non-profits, public authorities, pensions, natural persons</td>
<td>* CNAV permitted</td>
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<tr>
<td></td>
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<td>* Only offered to natural persons or where natural persons are the beneficial owners</td>
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## Bonus 1: Summary Comparison of E.U and U.S. MMF Regulations (cont.)

<table>
<thead>
<tr>
<th>Low Volatility NAV MMF</th>
<th>Council Compromise (10 June 2016)</th>
<th>U.S. Rule 2a-7 (as of 14 October 2016)</th>
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<tr>
<td>* May use a CNAV</td>
<td>* May use amortized cost for securities with remaining maturity &lt; 75 days</td>
<td>* May not use CNAV</td>
</tr>
<tr>
<td>* May use amortized cost for securities with remaining maturity &lt; 75 days</td>
<td>* May calculate NAV to 2 decimals if shadow price less than 20 bp</td>
<td>* May use amortized cost only with securities with remaining maturity &lt; 60 days</td>
</tr>
<tr>
<td>* May calculate NAV to 2 decimals if shadow price less than 20 bp</td>
<td></td>
<td>* Must calculate NAV to 4 decimals</td>
</tr>
<tr>
<td>Max Asset Maturity</td>
<td>* 397 days for all funds other than Std VNAV</td>
<td>397 days remaining maturity</td>
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<td>* 2 yrs for Std VNAV (interest rate reset &lt; 397 days)</td>
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<td><strong>Max WAM</strong></td>
<td>* 60 days all funds other than Std VNAV</td>
<td>60 days all funds</td>
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<td></td>
<td>* 6 months for Std VNAV</td>
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<tr>
<td><strong>Max WAL</strong></td>
<td>* 120 days all funds other than Std VNAV</td>
<td>120 days all funds</td>
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<tr>
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<td>* 12 months for Std VNAV</td>
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<tr>
<td><strong>Minimum Overnight</strong></td>
<td>* 10% for CNAV</td>
<td>* 10% for all funds other than Tax-Exempt MMFs (no limit)</td>
</tr>
<tr>
<td>Liquidity</td>
<td>* 7.5% for VNAV</td>
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| **Minimum Weekly Liquidity** | * 30% for CNAV  
* 15% for VNAV                                            | 30% all funds                           |
| **Amortize Costs**        | * May be used by CNAVs if asset’s amortized cost is with 10 bp of market price  
* May be used by LVNAVs for securities with remaining maturity < 75 days | Only may be used by Gov’t MMFs and Retail MMFs |
Bonus 1: Summary Comparison of E.U and U.S. MMF Regulations (cont.)

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<tr>
<td>Fees and Gates</td>
<td>Applies to all MMFs</td>
<td>Applies to all funds other than Gov’t MMFs (but Gov’t MMFs may apply)</td>
</tr>
<tr>
<td>Sponsor Support</td>
<td>Prohibited</td>
<td>Permitted but must be publicly disclosed</td>
</tr>
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Bonus 2: Selecting a Jurisdiction

- **Choices of Jurisdiction**
  - Dublin, Luxembourg, Cayman Islands, BVI, Bermuda, Channel Islands, others

- **Basic information**
  - Who are the intended investors (e.g., public/retail, institutional, sovereign funds)?
  - In which countries are the intended investors located?
  - What is the type of strategy?
  - Where does the manager already have offshore offices?

- **Other considerations**
  - Does the jurisdiction have well-developed bodies law regarding shareholder rights, director duties, bankruptcy and insolvency?
  - If the fund is supposed to complement funds organized in other jurisdictions (e.g., master-feeder funds), how close are the laws of different jurisdictions?
For Additional Information

If you have any question or comment relating to this presentation, please call or email:

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