

# Oversight of Intermediaries Under Amendments to Rule 2a-7



This document discusses steps money market funds (MMFs) should consider to meet new requirements under Rule 2a-7 under the Investment Company Act of 1940 (Investment Company Act).<sup>1</sup> In particular, the document will focus on actions an MMF may take to ensure that its intermediaries holding shares in omnibus accounts on behalf of underlying shareholders are implementing the fund's policies and procedures in compliance with Rule 2a-7.

## Background

The 2014 reforms to Rule 2a-7 created new categories of MMFs, including retail and government MMFs. Retail funds are MMFs that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. Government funds are MMFs that invest at least 99.5 percent of their total assets in cash, government securities, and/or repurchase agreements collateralized by cash and government securities. Institutional funds, although not specifically defined under amended Rule 2a-7, are MMFs that do not qualify as either retail or government.

Since MMF shares are often held by shareholders through a broker-dealer or other intermediary omnibus account, funds must consider what steps are sufficient to ensure a fund operates in compliance with the new requirements of Rule 2a-7.

## Summary of Requirements

### Calculation of Net Asset Value and Purchase and Sales

Certain MMFs may choose to calculate (or "strike") their net asset value (NAV) multiple times a day. If an MMF strikes a NAV more than once a day and permits transactions (purchases and sales of fund shares) at each strike, an MMF must ensure that intermediaries are complying with the fund's transaction terms and applicable law. Rule 22c-1 under the Investment Company Act requires a fund to transact orders at the NAV next calculated after receipt of the order. An MMF may determine and define what constitutes an order received in good form sufficient to process the order. In response to Item 11 of Form N-1A, a fund must disclose its procedures for the purchase and sale of shares. Accordingly, MMFs that intend to strike a NAV and allow purchase and sale transactions more than once a day must revise any existing Item 11 disclosure in its prospectus. This revision will reflect that transactions will be processed at the NAV next determined after receipt of the order in good form and to define what constitutes "good" form. Orders received after the day's final NAV calculation time will receive the first NAV calculation on the next business day.

<sup>1</sup> On July 23, 2014, the U.S. Securities and Exchange Commission (SEC) adopted final rules governing the structure and operation of money market funds. See *Money Market Fund Reform; Amendments to Form P F*, Investment Company Act Release No. 31166 (July 23, 2014) ("Adopting Release").

## Liquidity Fees and Redemption Gates

Amended Rule 2a-7 requires all nongovernment MMFs (i.e., retail and institutional MMFs) to impose a 1 percent liquidity fee if the fund's weekly liquid assets fall below 10 percent of its total assets, unless the fund's board determines that imposing such a fee is not in the best interests of the fund or determines that a lower or higher (not to exceed 2 percent) fee would be in the best interests of the fund. The new rules also give MMFs the flexibility to impose liquidity fees (up to 2 percent) and/or redemption gates (up to 10 business days in a 90-day period) after the fund's weekly liquid assets have dropped below 30 percent of its total assets, if the fund's board determines that doing so is in the best interests of the fund.

As necessary, intermediaries for these funds must be able to apply or remove (or, in the case of a liquidity fee, revise) a liquidity fee or redemption gate to the underlying beneficial owners of the omnibus account. An MMF will be required to disclose in its prospectus the various circumstances under which an MMF may impose a liquidity fee or a redemption gate.

## Retail Funds

MMFs that choose to operate as retail funds must implement policies and procedures that are reasonably designed to limit beneficial owners to natural persons. The SEC anticipates that retail MMFs would include disclosure in their prospectuses limiting their investors to accounts beneficially owned by natural persons. If a retail MMF fails to have policies and procedures reasonably designed to limit all beneficial owners to natural persons, it may not use amortized cost and/or penny rounding to value the fund's securities and, instead, must price securities using market prices (i.e., "float" the NAV). Accordingly, a retail MMF must adopt policies and procedures that it believes are reasonably designed to prevent investors other than natural persons from investing in the fund either directly or indirectly through intermediaries holding shares in omnibus accounts on behalf of underlying shareholders. An annotated prototype of policies and procedures for retail MMFs is available on ICI's website at [www.ici.org/ops\\_mmf\\_reform](http://www.ici.org/ops_mmf_reform).

## Discussions of Approaches

### SEC Permits a Flexible Approach

In the Adopting Release, the SEC acknowledged that most MMFs do not have the ability to look through omnibus accounts to determine the characteristics of their underlying investors, which poses a challenge to MMFs seeking to comply with the various new provisions of Rule 2a-7.<sup>2</sup> Rather, the SEC determined that it would be appropriate if funds manage their intermediary relationships "in the manner that best suits their circumstances."<sup>3</sup> Accordingly, MMFs have flexibility to choose an approach that—based on their particular facts—will provide a sufficient level of comfort that they are meeting the requirements of the new provisions.

Unlike implementation of Rule 22c-2 in 2005–2006, the SEC specifically did not expressly require that funds amend existing agreements or enter into new agreements with intermediaries with omnibus accounts to have reasonably designed policies and procedures that allow a fund to qualify as a retail MMF or otherwise comply with the new Rule 2a-7 provisions.<sup>4</sup>

<sup>2</sup> See Adopting Release at 232.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 234. The SEC acknowledges in the Adopting Release that a fund's policies and procedures could include among other measures, contractual arrangements or periodic certifications.

As such, MMFs may use a variety of methods to ensure intermediary compliance. These include:

- » Amending existing intermediary agreements to account for the new requirements for “retail” and “institutional” MMFs.
- » Requiring certifications from intermediaries regarding compliance with an MMF’s policies and procedures relating to the new Rule 2a-7 provisions.
- » Notifying intermediaries regarding new policies and procedures and obligations to comply with terms of prospectus.
- » Amending prospectus and SAI disclosure (together, “prospectus”) to reflect new MMF policies and procedures relating to new Rule 2a-7 provisions.
- » Reviewing and monitoring an intermediary’s compliance with stated fund policies and procedures.

## Determining an Appropriate Approach

As noted above, the SEC did not mandate any particular approach and therefore an MMF should consider the approach that “best suits [its] circumstances.”<sup>5</sup>

- » **Reviewing Existing Intermediary Agreements.** Although most intermediary agreements with MMFs contain provisions requiring the intermediary to comply with the prospectus terms, funds should review existing intermediary agreements to assess whether formal amendments are necessary to contractually obligate an intermediary to comply with the new Rule 2a-7 provisions. For example, many of the new Rule 2a-7 provisions are not typical prospectus disclosure. MMFs that determine to amend their existing agreements may decide a simple one time addendum agreement is sufficient. A sample form addendum agreement is available on ICI’s website at [www.ici.org/ops\\_mmf\\_reform](http://www.ici.org/ops_mmf_reform). In addition, MMFs whose intermediary agreements include negative consent amending provisions may choose to amend the agreements in this regard.
- » **Certifications from Intermediaries.** MMFs also may consider obtaining one-time or periodic certifications from intermediaries regarding their compliance with a fund’s new Rule 2a-7 policies. Such certifications may be done on a one-time basis for all existing intermediary relationships and then on a going forward basis when a new intermediary relationship has been established or when an MMF has reason to believe that an existing intermediary may not be complying with stated policies.<sup>6</sup> Certifications may be useful for MMFs that historically have had a high level of responsiveness from its intermediary base when requesting certifications or other affirmative responses. If an MMF anticipates a significant non-responsiveness rate, certifications will likely not provide a meaningful method to ensure intermediary compliance. A sample certification of beneficial ownership of retail fund shares is available on ICI’s website at [www.ici.org/ops\\_mmf\\_reform](http://www.ici.org/ops_mmf_reform).

<sup>5</sup> *Id.*

<sup>6</sup> Alternatively, an MMF may decide to obtain certifications only from certain of its intermediaries. For example, funds may have hundreds or more intermediary relationships, but a significant majority of the fund’s shares are held by a limited number of intermediaries. In such cases, a fund may determine that obtaining certifications only from that limited number of intermediaries representing a significant percentage of the fund’s shares, provides comfort for those intermediary relationships.

- » **Disclosure, Notification, and Monitoring.** MMFs that determine existing intermediary agreements do not need to be amended and for which certifications would not provide a reasonable means to ensure compliance by intermediaries may consider a tiered approach as described below.
- *Notification to Intermediaries.* Before an MMF commences operating in compliance with new Rule 2a-7 provisions, it should send notifications to its intermediaries explaining that the fund has new Rule 2a-7 compliant operating policies and procedures. The notification should explain that the intermediary must take steps to ensure that its accounts and the beneficial owners of its accounts are complying with the terms of the fund's prospectus and/or other communications made to the intermediary as permitted under their agreement with the fund. A sample notice to remind an intermediary of its responsibilities with respect to retail MMFs is available on ICI's website at [www.ici.org/ops\\_mmf\\_reform](http://www.ici.org/ops_mmf_reform).
  - *Prospectus Disclosure.* MMFs should review and update prospectus disclosure to ensure that it accurately addresses any applicable policies and procedures that a fund has adopted to comply with the new Rule 2a-7 provisions. For example, a retail MMF should include disclosure in its prospectus that clearly states that the fund is a retail fund and therefore limits beneficial owners of the fund (whether investing direct or through an intermediary) to natural persons.
  - *Due Diligence.* When on-boarding new intermediaries, a fund should obtain a copy of an intermediary's policies and procedures (or written statement or other representation regarding same) as part of its due diligence process to limit investors in retail MMFs to natural persons and to otherwise comply with the new provisions of Rule 2a-7 as disclosed in the prospectus or communicated to the intermediary. In addition, to the extent a fund already conducts due diligence reviews of existing intermediary relationships, the fund may wish to review the intermediaries' policies and procedures for all applicable investor limitations.
  - *Monitoring.* To the extent a fund otherwise monitors compliance with terms of intermediary agreements and/or prospectus requirements, it may wish to include compliance, including investor limitation provisions, as part of any review or monitoring process. An MMF also should consider reviewing and following-up on any known instances of non-compliance by an intermediary and the steps taken by the intermediary to remedy.
  - *Compliance Program Review.* As part of the annual Rule 38a-1 compliance review, an MMF should review its policies and procedures for all new Rule 2-7 compliance policies and procedures, including for its retail MMF qualifications.

## Conclusion

The SEC gave MMFs flexibility to develop policies and procedures and otherwise manage their intermediary relationships to comply with the new Rule 2a-7 provisions. Accordingly, MMFs may consider the approaches outlined above to determine which approach best fits their particular circumstances.