How SEC Money Market Fund Reform Diverges From Proposal

By **Jon-Luc Dupuy, Michael Davalla and Maxwell Black** (August 7, 2023)

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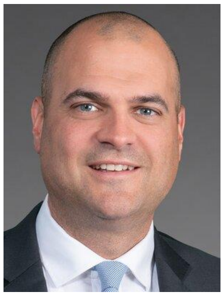

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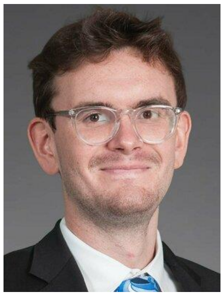

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The U.S. Securities and Exchange Commission on July 12 adopted amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended, which governs the structure and operation of money market funds, or MMFs.

The amendments, which were first proposed by the SEC in a December 2021 release as a proposed rule, reflect the SEC's concern over market stresses experienced in response to the COVID-19 pandemic in March 2020 and are intended to improve the resiliency and transparency of MMFs.

The final rule includes several differences from the proposed rule, namely the elimination of swing pricing, the imposition of a new liquidity fee framework featuring both mandatory and discretionary fees, the availability of a broader array of options for MMFs when facing a negative interest rate environment, and certain regulatory reporting requirements.

Elimination of Swing Pricing

The most significant difference between the proposed rule and the final rule is the elimination of swing pricing. The proposed rule would have required institutional prime and institutional tax-exempt MMFs to adopt swing pricing, which the SEC believed would shift to redeeming shareholders the liquidity costs of their redemptions rather than diluting the interests of remaining shareholders by having the fund bear such liquidity costs.

The SEC ultimately decided not to adopt swing pricing as part of the final rule, citing industry concerns that it would be too complex and difficult to implement, and instead, it adopted mandatory and discretionary liquidity fees as an anti-dilution measure.

Under the proposed rule, institutional prime and institutional tax-exempt MMFs would have been required to impose a so-called swing factor reflecting spread costs and other transaction costs of selling a vertical slice of the portfolio during any pricing period in which there were net redemptions.

If redemptions were to exceed 4% of the fund's net asset value, or NAV, divided by the number of pricing periods in a given day, that swing factor would have additionally needed to take into account market impact factors — which would have reflected the potential decline in value of a security if sold under current market conditions.

Industry responses to the swing pricing requirement in the proposed rule were overwhelmingly opposed to it.

Some commenters claimed that swing pricing would inhibit a fund's ability to offer features such as same-day settlement and multiple NAV strikes per day, as swing pricing would delay a fund's ability to determine its NAV, making it difficult for a MMF to offer these features.

Other commenters were concerned that swing pricing could have imposed liquidity fees based on estimated liquidity costs greater than those funds would actually incur to meet redemptions.

They pointed out that MMFs generally satisfy redemptions through maturing assets or cash on hand, rather than secondary market selling activity.

As a result, they argued that swing pricing would impose unnecessary costs on funds and investors.

Finally, some commenters expressed concern that swing pricing would discourage investors from using MMFs as cash management vehicles, as swing pricing could have made funds less attractive as a place to hold short-term cash, and could have led investors to switch to other types of investments.

Imposition of Mandatory Liquidity Fees

In lieu of swing pricing, the final rule requires institutional prime and institutional tax-exempt MMFs to impose mandatory liquidity fees when a fund experiences daily net redemptions that exceed 5% of net assets — unless liquidity costs are de minimis.

This liquidity fee framework is in response to industry comments that a liquidity fee would be less confusing and more transparent with respect to the liquidity costs redeeming shareholders incur because investors are more familiar with the concept of liquidity fees, which exist in the current rule.

As with the proposed swing pricing requirements, the mandatory liquidity fee will be calculated based on a net redemption threshold. However, the liquidity fee must be applied when the fund has net redemptions on a business day in excess of 5% of the fund's NAV based on flow information available after the last computation of the fund's NAV on that day.

A fund's board may determine to use a net redemption threshold below 5% for the purpose of applying mandatory fees, if the board determines that this is in the best interest of the fund.

The size of the fee generally is determined by making a good faith estimate of the spread and other transaction and market impact costs the fund would incur if it were to sell a pro rata amount of each security in its portfolio to satisfy the amount of net redemptions.

This contrasts with the proposed threshold, which would have required a swing factor to be imposed during any pricing period where there were net redemptions and would have also included market impact factors if net redemptions exceeded 4% of net assets divided by the number of pricing periods during the day.

In addition to the difference in the percentage threshold, the final rule also differs from the proposed rule in that the threshold for mandatory liquidity fees will be based on daily net redemptions, whereas the threshold for the imposition of swing pricing market impact factors would have been divided by the number of pricing periods in a day, which would have lowered the practical threshold for any individual pricing period.

As the industry digests and begins to react to the final rule, there remains a concern that a liquidity fee could be triggered even though a fund did not incur corresponding transaction or market impact costs to meet such redemptions.

This concern is elevated for funds that typically satisfy such redemption requests either with cash or maturing liquid assets on hand, rather than selling a pro rata vertical slice of their entire portfolios.

Accordingly, the new mandatory liquidity fees could still impose greater liquidity costs than funds actually incur in order to meet redemptions, and the concerns raised in this area with respect to swing pricing would still be prevalent under a mandatory liquidity fee regime.

In addition, in order to determine the amount of a liquidity fee and to fairly allocate costs across all redemptions, funds will need to obtain gross redemption information from each intermediary on a daily basis.

In the adopting release, the SEC acknowledged that certain intermediaries may only provide such information on a net basis and that funds may therefore need to update arrangements and agreements with such intermediaries in order to obtain gross redemption information.

In the adopting release for the final rule, the SEC noted that it believes that the mandatory liquidity fee is a fair and reasonable way to ensure that redeeming investors bear the costs of their redemptions and would be sufficient to deter a first-mover advantage and mitigate dilution.

However, as liquidity fees were not part of the proposed rule, the industry arguably has not had an opportunity to comment on a liquidity fee proposal resembling the fee as adopted in the final rule.

Availability of Discretionary Liquidity Fees

The final rule retains the requirement under the current rule for all nongovernment MMFs to have policies reasonably designed to impose discretionary liquidity fees.

However, the SEC has removed weekly liquid asset thresholds as the trigger to the imposition of these discretionary liquidity fees.

Under the current rule, funds can impose a liquidity fee if weekly liquid assets were to dip below 30%. The SEC has acknowledged that this had certain unintended consequences, including the shifting of assets from institutional prime and institutional tax-exempt MMFs to government MMFs that have no such requirements.

The proposed rule would have removed liquidity fees entirely and would have instead relied on swing pricing in an attempt to deter first-mover advantage and mitigate potential dilution caused by large shareholder redemptions.

The final rule permits nongovernment MMFs to impose a discretionary liquidity fee if the fund's board — or its delegate — determines that a fee is in the best interest of the fund.

Government MMFs may, but are not required to, adopt policies reasonably designed to impose discretionary liquidity fees.

The SEC retained discretionary liquidity fees in response to commenter feedback that the discretionary liquidity fee provision was a valuable tool for MMFs to manage their liquidity during times of stress.

As in the proposed rule, the SEC also removed the tie between discretionary liquidity fees and a liquidity threshold in order to reduce any incentive for preemptive redemptions.

Options in a Negative Interest Rate Environment

Under the proposed rule, the SEC would have required stable NAV MMFs to convert to a floating share price if market conditions resulted in negative fund yields, and it also would have expressly prohibited MMFs from the use of certain mechanisms — including a reverse distribution mechanism — that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price.

In contrast to the proposed rule, the final rule allows MMFs to either convert to a floating share price or implement a reverse distribution mechanism in a negative yield environment, provided that a fund's board determines that such a device is in the best interest of the fund and its shareholders and that the fund appropriately disclose the use of such a device to investors.

In contrast with the proposed rule, the final rule also eliminates the record-keeping requirements for stable NAV MMFs to identify the intermediaries able to process orders at a floating NAV, and stable NAV MMFs are no longer required to transact only with such intermediaries.

However, in making such a determination, the SEC notes the board should consider the capabilities of the fund's service providers and intermediaries to support the equitable application of such a mechanism, any applicable state law limitations on share cancellations, and the tax consequences to the fund and its shareholders of such a share reduction.

Reporting Requirements

In large part, the differences between the reporting requirements under the proposed rule and the final rule align with changes in the other requirements. There are, however, certain additional changes to Form N-MFP and Form PF under the final rule as compared to the proposed rule.

Form N-MFP

With respect to Form N-MFP, the SEC originally proposed that MMFs disclose the name and percent of ownership of each person who owns of record or is known by the fund to own beneficially or of record 5% or more of the shares outstanding in the relevant class.

However, after considering comments raising privacy and related concerns, the SEC decided not to require this disclosure as part of the final rule.

Instead, the final rule requires MMFs to report only the type of beneficial or record owner who owns 5% or more of the shares outstanding in the relevant class. This means that funds will need to disclose whether the 5% shareholder is an individual, a government entity, a financial institution, or another type of entity.

Form PF

Notably, the final rule imposes new reporting requirements on Form PF, a confidential reporting form for certain SEC-registered investment advisers to private funds.

The final amendments will update reporting requirements in Section 3 of Form PF, which will require large liquidity fund advisers to provide more detailed information about their liquidity fund portfolios, including the types of assets held, the maturities of those assets, and the liquidity of those assets.

The amendments will also require large liquidity fund advisers to provide more information about their liquidity risk management practices, including their stress-testing procedures and their contingency plans for dealing with liquidity events.

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