MMF Reform

Cite
SEC, Notice of Proposed Rulemaking, Money Market Fund Reforms

Recommended Distribution:
Treasury, Asset Management, Policy, Asset/Liability Management, Legal, Government Relations

Website:
https://www.sec.gov/rules/proposed/2021/ic-34441.pdf

Impact Assessment

- Mandatory swing pricing could redefine the extent to which covered institutional funds are deemed cash-equivalent by investors, possibly leading to investor migration to govvies and/or banks. This could adversely affect investor return and sponsor profits, but likely also reduce systemic risk if banks and CP remain liquid under stress.
- New liquidity standards could significantly add to fund cost, promoting an overall migration out of MMFs into other short-term funding products with uncertain competitive and stability implications.
- Swing pricing poses an array of operational, tax, and accounting challenges that, if overcome, would require significant governance and technology investment as well as investor outreach. Sponsors and/or investors might also deem these costs unacceptable, accelerating prime-fund realignment.
- Bank funding costs will vary based on the extent to which an institution depends now on MMFs and/or develops new funding sources based on any MMF migration.
- Preparation for nominally-negative interest rates will require significant investment from sponsors, service providers, and intermediaries, perhaps adversely affecting the extent to which investors view these instruments as cash equivalents and contributing to short-term funding market reconfiguration. However, MMF resilience under negative rates would stabilize markets. Although the SEC's approach will surely be controversial, it rejected still more costly options such as capital buffers or minimum-balance-at-risk requirements.

Overview

In the wake of noncommittal statements from global regulators[1] on ways to address money-market fund systemic risk, the Securities and Exchange Commission

[1] See **MMF18**, *Financial Services Management*, October 18, 2021.

has proposed sweeping changes to the 2014 standards adopted after the 2008 crisis. These were viewed as insufficient at the time by the Fed and Treasury.[2] Based on reconsideration of the U.S. framework after the 2020 crisis by the President's Working Group on Financial Markets,[3] the proposal now would retract the liquidity fee and redemption gates in the current rule. Instead, the Commission would require institutional-prime and institutional tax-exempt funds to adopt swing pricing, sharply hike daily and weekly minimums for liquidity buffers at all MMFs, and institute new reporting and disclosure standards. The SEC is also taking the opportunity of this rulemaking to address a vexing problem in recent years: how MMFs handle nominal negative interest rates. Under the proposal, funds with fixed NAVs would have to float and ensure in advance their ability to do so. Reverse distributions would be banned.

Impact

One of the most significant results of the 2014 rule was a market shift from institutional prime MMFs to government ones (i.e., "govvies"). Many MMF investors use these funds as a means to obtain what they hope will be cash-equivalent liquidity at little to no credit risk but a higher return than possible from cash at a time of ultra-low interest rates. This shift resulted in large part because institutional prime funds were required to move to floating NAVs that diminished cash-equivalence under stress. To minimize them, institutional prime funds invested still more heavily in bank certificates of deposit (CDs) and commercial paper (CP), with CDs concentrated in non-U.S. banks looking for dollar-denominated funding.

Liquidity risk associated with prime MMFs is among the reasons that the U.S. liquidity rules do not treat MMFs as cash-equivalents or core deposits,[4] but other nations do not treat MMFs with like-kind restraint. In 2020, fears about sudden illiquidity at major foreign banks and resulting contagion risk thus led the Fed, with Treasury's consent, to create a massive liquidity backstop for MMFs.[5] Although actual use of this liquidity was relatively small compared to fund outflows ahead of its creation and overall assets in the sector, the FSB and FRB[6] attribute its creation to the equivalent of a "too-big-to fail" backstop that comforted investors who then ceased their run. Proposed changes to institutional prime funds are intended in part to reduce foreign-bank reliance on them and resulting systemic risk, but swing pricing could so alter the extent to which investors view these MMFs as cash equivalent as to bring funding back to banks, thus lowering cost.

The extent to which this reduces systemic risk will depend on the extent to which the overall short-term funding market is stable. The FSB thus calls for reforms to the CD and CP market in concert with those for MMFs, but these have yet to take specific form in global discussions or those in the U.S. Ongoing U.S. efforts to reform the Treasury market also have significant MMF and short-term funding market implications,

[2] See *Client Report* **MMF14**, December 12, 2014.

[3] See *Client Report* **MMF16**, December 23, 2020.

[4] See **LIQUIDITY32**, *Financial Services Management*, October 27, 2020.

[5] See *Client Report* **COVID8**, March 26, 2020.

[6] See **SYSTEMIC92**, *Financial Services Management*, November 9, 2021.

although the preliminary state of work in this area makes unclear the final shape of these effects.[7]

As discussed below, the SEC has decided to reverse much of the fees-and-gates provisions in its 2014 rule, backing this proposal with a detailed analysis showing that prime institutional and tax-exempt funds had significant outflows under 2020's stress likely caused not only by illiquidity (see below), but also by institutional-investor first movers who were sensitive to the potential for redemption gates that could undermine their own liquidity or expose them to loss. Retail investors were less sensitive to this risk, leading the proposal to retain this option for these MMFs.

Instead of relying on gates or fees to reduce first-mover advantage, the SEC is instead turning to swing pricing for institutional prime or tax-exempt funds. It notes that swing pricing must be mandatory to prevent collective-action problems and ensure covered funds take rapid action under stress, now setting out a calculation methodology with no upper limit accompanied by governance standards.

The industry generally opposes this idea, in part because investors may not know as they place or sell orders if swing pricing actually applies, thus offsetting its deterrent effect. The SEC rejects this on grounds that swing pricing is fair to all investors and is likely to slow runs. The SEC does recognize the many operational concerns industry comments have highlighted that are also of concern to the FSB, but it concludes that floating NAVs are now well managed and intra-day or similar concerns can thus be addressed without undue burden or complexity.

Still, the many questions posed on this issue suggest at least some flexibility, with change in the final rule possible not only due to these and other concerns, but also those expressed during the SEC meeting by Chairman Gensler's two Democratic colleagues. Tax and accounting issues are also discussed, with the Commission again noting concerns and seeking views on them. Global regulators also suggested that swing pricing might reduce investor interest in MMFs, a result they thought might have offsetting benefits by encouraging direct investment in government funds, CDs, and/or CP that is more likely to be truly cash-equivalent under stress.

Fearing that swing pricing may not suffice to ensure liquidity, the SEC also proposes sharp increases in daily and weekly liquidity requirements governing all MMFs other than tax-exempt funds. Although only one prime fund fell below the weekly threshold that might have prompted the fees or gates now set for elimination, the SEC believes that this occurred largely because funds liquidated other assets under fire-sale conditions that exacerbated systemic risk. Had MMFs held more liquid assets, the SEC reasons that this then might not have occurred. The agency also fears that removing fees and gates might encourage MMFs to hold smaller buffers above their minimum requirements.

As noted, the SEC is also using the opportunity of this proposal to address a problem that has twice loomed large in recent years: interest rates so close to zero that nominal rates in the U.S. could join nominally-negative ones in many other nations.

[7] See *Client Report* **TMARKET2**, November 10, 2021.

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Were this to occur, MMFs fear that they might have to undertake reverse distributions – that is, by reducing the number of an investor's shares reflecting negative returns in a fashion akin to how bank-deposit balances fall in similar circumstances. These scenarios are particularly acute risks for govvies, which must invest the majority of assets in Treasury obligations where rates may go negative in the marketplace even if fed-funds rates stay above zero, but prime funds also face significant risk.

The Commission thus proposes to require government and retail prime funds, their service providers (e.g., transfer agents), and intermediaries (e.g., brokers) to determine that they can readily convert to floating NAVs under negative-rate scenarios. Reverse distributions would be expressly barred because the Commission has concluded it could confuse or even inadvertently deceive fixed-NAV investors.

What's Next

The SEC adopted this proposal on December 15 by a 3-2 vote. Comments are due sixty days after publication in the Federal Register. The agency is also working on liquidity buffers for open-end funds; action on them would affect the extent to which MMF investors migrate to open-end funds and resulting market risk.

Analysis

A. Redemption Fees and Gates

As noted, the ability of an institutional prime or tax-exempt fund's board to impose these liquidity buffers would be eliminated. Retail funds could continue to impose a two percent liquidity fee under certain circumstances, but gates would still be barred. This is based on the Commission's conclusion that these provisions encourage first-mover behavior that destabilizes covered funds. The analysis suggests that gates may be most problematic, but the NPR concludes that its new construct is preferable to retaining fees even if liquidity triggers are altered, board discretion is removed, or other changes are made. Comment is sought on:

- whether there are circumstances in which fees or gates may be warranted;
- giving boards more discretion;
- liquidity thresholds at which gates may be warranted;
- whether gates should be allowed for other MMFs;
- whether the circumstances in which liquidity fees are allowed should be revised;
- if boards can act quickly enough to use fees effectively;
- if the SEC should set default-fee amounts;
- which MMFs might be allowed to use fees; and
- if gates and/or fees remain, if other proposals are unnecessary or warrant significant revision.

B. Swing Pricing

1. Pricing Metrics

As noted, swing pricing would apply only to institutional prime and tax-exempt funds when they are experiencing net redemptions. Under this approach, covered funds would have to adjust NAVs to reflect spread and transaction costs, with a market-cost factor added to the swing-pricing calculation when net redemptions exceed defined thresholds. Net redemptions are judged across all asset classes and sales also must be made using a "vertical slice" approach to prevent funds from selecting assets for sale based on relative liquidity, even though the Commission recognizes that executing these calculations and redemptions is a technical challenge. A board-designated "swing-pricing administrator" must be properly segregated from portfolio management and other business considerations. The proposal also sets an array of board-oversight requirements.

Views are sought on:

- using liquidity fees instead of swing pricing;
- making swing pricing discretionary;
- alternate calculation methods;
- operational issues, with these described in detail and on which many specific questions are posed;
- if swing pricing should cover govvies or retail funds or, conversely, if some covered funds should be excluded;
- tax and accounting considerations;
- the extent of likely investor migration; and
- if the new liquidity requirements provide sufficient protection against dilution for remaining shareholders.

2. Disclosures

The SEC also proposes that all institutional MMFs subject to swing pricing would be required to conform to amended versions of the swing-pricing disclosures now required of open-end funds. Comment is sought on:

- in addition to upper limits, should any others applicable to open-end funds be eliminated for covered funds;
- the nature, form, and timing of these disclosures;
- the need for disclosures of swing-pricing policies and procedures; and
- if daily disclosures inform investors or permit them to game market prices or lead to preemptive runs.

C. Portfolio Liquidity Requirements

The SEC also proposes to increase the daily and weekly liquidity requirements that now dictate that MMFs hold at least ten percent of assets in daily-liquid form (e.g., cash) and do the same for thirty percent of assets with regard to weekly liquidity (i.e., assets that are liquid in five days even under acute stress). Under the proposal, these limits would rise to 25 percent and 50 percent respectively and new governance procedures would ensure that boards know of any shortfalls and take action to remedy it. Comment is sought on questions such as:

- the benefits of a range of liquid-asset requirements;
- the implications for prime-fund yields;
- the impact on incentives that now lead funds to hold above-minimum liquidity;

- the risk of longer maturities that compensate for increased liquidity;
- the need to differentiate liquidity requirements by fund type;
- if liquidity requirements could be counter-cyclical;
- the impact of liquidity disclosures;
- revisions to the daily liquid-asset definition; and
- the consequences for falling below liquidity minimums.

D. Liquidity Metrics and Stress Testing

Current stress-testing standards and default fees would be eliminated in favor of stress tests to ensure compliance with the new liquidity standards under severe stress. There would be no supervisory bright line determining adequate liquidity. Numerous questions are also posed on these changes.

E. Negative Interest Rates

As noted, MMFs with fixed rates would need to ensure that they and third parties handling investor transactions are able to convert from fixed to floating NAVs under nominal negative rates. Reverse distributions in an array of possible structures would be barred. Comments are invited on matters such as:

- the need for specific disclosures;
- allowing reverse distributions under various methods;
- the need for advance investor consent;
- the need to require all stable-NAV funds to handle negative rates the same way;
- investor impact;
- whether sponsors are likely to continue to offer MMFs when negative rates are persistent; and
- intermediary implications and related procedures, including the need for advance testing of NAV-conversion capacity along with the need for reporting test results to the SEC and/or disclosing them to the public.