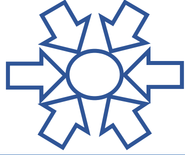

MMF Redemption Fees, Liquidity-Risk Mitigation

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Website
https://www.sec.gov/rules/final/2023/33-11211.pdf

Impact Assessment

- New redemption fees may reduce institutional prime and tax-exempt MMF first-mover advantages, slowing runs and giving advisers more time to liquidate assets and restore confidence in a troubled fund or the sector more generally.
- FRB backstops for covered MMFs may be less likely although the extent to which investors are willing to incur fees or will still run to save remaining principal is unknown.
- Higher liquidity requirements may reduce contagion risk in short-term funding markets if redemptions exceed fund expectations and MMFs are nonetheless able to remain in the market.
- Costs associated with these requirements may reduce fund yield, adversely affect short-term funding market demand (e.g., for commercial paper), and/or persuade investors to move to bank deposits without redemption fees in market- or fund-stress scenarios.
- MMF-liquidity requirements may increase ONRRP use.
- The SEC's decision not to impose swing pricing may lead it similarly to decide against doing so in final open-end fund rules.

Overview

The SEC has significantly revised its proposed MMF-reform standards,[1] eliminating a controversial swing-pricing approach to reduce first-mover advantage in favor of new redemption fees at institutional prime and tax-exempt funds. These and most other funds now also come under stiff new liquidity requirements, which may combine to impose new and costly disciplines that may enhance the relevant appeal of bank deposits without early-redemption risk. Changes in MMF liquidity requirements may also alter demand for commercial paper, municipal obligations, bank debt, and other assets widely held by these funds, perhaps increasing funding cost in certain short-term funding markets as

[1] See **MMF19**, *Financial Services Management*, January 3, 2022.

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demand from MMF drops. MMF use of the Fed's overnight reverse-repo facility could also grow to facilitate liquidity compliance, creating new risks for the Federal Reserve and its longstanding goal of reducing its role as a dominant market maker.

Impact

The new rule repeals many of the reforms adopted by the Commission in 2014 after the 2008 great financial crisis exposed risks in the MMF arena.[2] The FSOC at the time pressed the Commission to address these via tough capital, liquidity, or other standards. The Commission balked at going as far as the FSOC – which was strongly seconded by the Fed – but it did impose new gates suspending redemptions if MMF assets fall below certain thresholds. During the 2020 crisis, these gates were blamed for accelerating MMF runs by investors desperate for cash, heightening runs that forced trillions in promised FRB emergency liquidity.[3]

The SEC generally believes that its new approach sharply constrains MMF externalities related to risk transferred from first-mover investors to those who remain in a fund and to the Federal Reserve because the need for backstops is significantly reduced. That said, the final rule remains controversial in part because the SEC's economic analysis follows the pattern often found in banking-agency rules, listing market-integrity and financial-stability benefits without directly evaluating costs to affected entities and/or investors. As a result, the final rule's objectives may not be met if, for example, institutional prime and/or tax-exempt investors – whom the SEC readily acknowledges to be sophisticated – do not behave as the Commission expects, fleeing funds in stressed markets to avoid redemption fees even though the gates the SEC imposed in 2014 no longer apply.[4]

The SEC also does not consider market-stability or policy issues if investors prefer bank deposit products regardless of FDIC coverage due to the absence of redemption fees for sudden withdrawals and the expectation of Fed backstops at banks not expressly authorized for MMFs. The Fed could of course renew the MMF emergency-liquidity facilities authorized in 2020,[5] but this would defeat one of the SEC's principal goals in the final rule.

In addition to gates, the latest proposal focused on swing pricing, believing it a flexible way to alter fund returns on an ongoing basis to anticipate redemptions and appropriately discourage them. In practice, swing pricing not only has uncertain impact on sophisticated investors, but also poses numerous operational challenges especially towards the end of each trading day. In the final rule, the Commission recognized these problems and reflected them by eliminating swing pricing along with redemption gates in favor of new fees.

2 See **MMF10**, *Financial Services Management*, November 26, 2012.

3 See *Client Report* **NBFI**, November 17, 2020.

4 See *Client Report* **MMF14**, December 12, 2014.

5 See **RESCUE72**, *Financial Services Management*, March 30, 2020.

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Whether these will work as the Commission hopes remains to be seen. As noted, it is possible that investors will fear fees even more than temporary barriers to redemption such as gates. However, the Commission believes that investors fear gates more than fees because of the adverse impact of lack of access to funds in contrast to a fee for obtaining it.

As discussed below, the new approach to redemption fees differentiates mandatory from voluntary fees, with mandatory ones applicable to institutional prime and tax-exempt funds under what the SEC believes would likely be stress scenarios in order to serve as a deterrent to first-mover advantages most likely when sophisticated investors are involved. However, redemption fees are also required for all other non-governmental funds when these are determined to be in the best interests of the investors, with the Commission believing that the new discretionary fees are mandatory to reduce run risk along with eliminating the current stigma applied to situations where funds now can impose fees only when there are significant redemptions.

Although many industry commenters strongly opposed swing pricing, opinions in favor of the final, fee-based approach are mixed. The goal of fees is, as noted, to reduce or even end the advantage early redeemers have because later redeemers may experience losses as funds rebalance or otherwise adjust to address dilution caused by early redemptions. Commenters argued that liquidity requirements – especially the new, higher ones – are effective dilution deterrents, but the Commission was unpersuaded based in part on the 2020 crisis. In the wake of the proposal, at least one group also argued that the new approach related to fees so diverges from the proposal that it warrants a separate proposal prior to finalization; the SEC obliquely rebuts this by pointing to the proposal's discussion of redemption fees.

The MMF framework outlined by the global Financial Stability Board after the March 2020 crisis gave national regulators considerable discretion on issues such as swing pricing and new MMF capital standards even as it concluded that MMF reform alone might not suffice without underlying changes to critical short-term funding markets such as those for commercial paper.[6] The final rule acknowledges the need for reform to underlying short-term funding markets but concludes that MMFs need reform regardless of these risks. As a result, it is possible that MMFs will be resilient under stress, but sudden drops in demand for key financial instruments could be severely disruptive. There is, however, no clear path to federal regulation of these funding markets due to the significant role of nonbank and non-financial issuers.

Another key provision in the final rule raises mandatory MMF liquidity for most funds. The SEC believes the new levels are approximately those MMFs actually hold but have been afraid to touch in order to prevent gates under the current rule. The SEC fears that eliminating gates could lead MMFs to reduce liquidity, making them more vulnerable and increasing the odds of investor runs in stress scenarios. Indeed, even if most MMFs remain resilient, fragility at just

[6] See **MMF17**, *Financial Services Management*, July 7, 2021.

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one fund that reduced liquidity and might thus "break the buck" and could, the SEC fears, throw the entire sector into disarray as in fact occurred in 2008. The Commission disputes that these new standards – which will fall most heavily on prime MMFs – will adversely affect yields or short-term funding markets because most prime MMFs in fact hold this much liquidity.

Another major shift in the final rule addresses what MMFs are to do in the event of negative interest rates, which seemed more than possible at various times before the Federal Reserve began rapidly to increase rates as inflation took off. The proposal would have barred MMFs from cancelling shares to offset the cost of negative rates, instead mandating immediate conversion from fixed to floating NAVs. The final rule allows this in light of the operational burden to MMFs and potentially adverse investor consequences. Had this not been approved, many funds associated with brokerage sweep accounts and/or tied to bank services such as check-writing would have been jeopardized because none of these programs is functional with floating NAVs.

The MMF rule may also have precedent-setting impact on proposed SEC standards for open-end funds (OEFs). However, new fees could be particularly challenging because many of these funds are held by retail investors who are less likely to be first movers, an issue the SEC may decide to address via tough liquidity requirements rather than express redemption barriers.

What's Next

The SEC finalized this rule on July 12. It will be effective sixty days after *Federal Register* publication, with compliance generally mandated by June 11, 2024 where not otherwise specified. The new fee requirements will go into effect one year after the rule's effective date – i.e., later than June 11, 2024 given the delays usually affecting *Federal Register* publication of a rule as lengthy as the SEC's final MMF standards. A six-month schedule following publication governs discretionary liquidity fees and certain other technical revisions. The minimum liquidity requirements are also effective six months after *Federal Register* publication. These compliance deadlines are considerably quicker than those recommended in most industry comments.

Analysis

A. Redemption Fees

Redemption fees are now required of all institutional prime and tax-exempt funds if daily redemptions exceed five percent of net assets unless liquidity costs are less than one basis point (i.e., under normal market conditions). Funds may set the fee trigger at lower redemption rates if deemed in investors' best interest. The rule does not govern what the fee should be but does stipulate how this fee is to be set based on good-faith estimates of liquidity costs and market-impact estimates, also stipulating that it may be based on either net or total daily redemptions regardless of the size of any redemption and may be charged the morning after redemptions occurred. In the event it proves impossible to set a good-faith fee (e.g., when markets are frozen), a one percent fee default requirement applies. Board-approved guidelines must govern all these decisions and procedures.

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All other non-government funds now also must impose redemption fees when the board or an objective adviser believes these are in the fund's best interest. The fees are discretionary in that the rule does not define when this is the case, but they are mandatory in situations identified as problematic under applicable fund standards.

Numerous new disclosures apply to these redemption-fee requirements.

B. Liquidity Requirement

Under the final rule, all MMFs except tax-exempt MMFs must hold liquid asset minimums of twenty-five percent of daily liquid assets and fifty percent in relation to weekly assets. As with current liquidity requirements, MMFs may acquire no new illiquid assets when they fall below the daily or weekly thresholds. Boards are to be notified within one business day if a fund falls below half of its daily or weekly liquidity requirement.

C. Liquidity Metrics and Stress Testing

The final rule eliminates the current test threshold of ten percent daily weekly assets in favor of mandating that funds maintain sufficient minimum liquidity under various stress scenarios, setting their own scenarios and reporting to fund boards when thresholds are breached. Stress-test results need not be made public.

D. Negative Rates

The proposal would have required fixed-NAV funds to convert to floating structures when nominal interest rates turn negative. This remains an option under the final rule, but fixed-NAV funds could also "reverse distribute" shares – that is, reduce investor holdings to reflect actual NAVs. Additional board determination that this is in the fund's best interest as detailed in the rule and investor disclosures that are also prescribed are required if an MMF selects this option. Such funds would also need to ensure that their intermediaries can handle a reverse distribution.

E. Disclosures and Reports

The final rule also includes many new reporting requirements to investors and the SEC.

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