MEMO# 33971

December 21, 2021

SEC Proposes Money Market Fund Reforms

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TO: ICI Members
Investment Company Directors
ICI Global Members
Money Market Funds Advisory Committee SUBJECTS: Money Market Funds RE: SEC Proposes Money Market Fund Reforms

On December 15, 2021, the Securities and Exchange Commission, in a 3-2 party-line vote, proposed amendments to Rule 2a-7 and other rules that govern money market funds under the Investment Company Act of 1940. According to the SEC's proposing release (Release), the amendments are "designed to improve the resiliency and transparency of money market funds" following the liquidity stresses experienced in March 2020 in connection with the COVID-19 pandemic and the associated stresses in the short-term funding markets. Comments on the proposed amendments are due 60 days after publication in the Federal Register. Among other things, the proposed amendments would:

- Remove the required and permissive liquidity fee and redemption gate provisions;
- Require swing pricing for institutional prime and institutional tax-exempt money funds;
- Increase the daily and weekly liquid asset requirements;
- Amend liquidity metrics in stress testing;
- Address potential negative interest rates for government and retail prime money market funds and prohibit money market funds from operating a reverse distribution mechanism, routine reverse stock split, or other device that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price;
- Specify the calculations of "dollar-weighted average portfolio maturity" ("WAM") and "dollar-weighted average life maturity" ("WAL"); and
- Enhance certain reporting requirements.

Each of these proposals and their proposed compliance dates are described below.

Amendments to Remove Liquidity Fee and Redemption Gate Provisions

Rule 2a-7 currently provides that a money market fund may impose a liquidity fee of up to

2 percent, or temporarily suspend redemptions (i.e., impose a "gate"), if the fund's weekly liquid assets fall below 30 percent of its total assets and the fund's board of directors determines that imposing a fee or gate is in the fund's best interests. The rule also includes a default liquidity fee if a fund's weekly liquid assets fall below 10 percent, unless the board determines that a fee would not be in the best interests of the fund.

The Release acknowledges that in March 2020, even though no money market fund imposed a fee or gate, the possibility of their imposition appears to have contributed to investors' incentives to redeem from prime money market funds and for fund managers to maintain weekly liquid asset levels above the threshold, rather than use those assets to meet redemptions. The Release states that these tools therefore appear to have potentially increased the risks of investor runs without providing benefits to money market funds as intended. The SEC's analysis and external research are consistent with commenters' views (including ICI) on investor behavior and found that prime and tax-exempt money market funds whose weekly liquid assets approached the 30 percent threshold had, on average, larger outflows in percentage terms than other prime and tax-exempt money market funds. As a result, the SEC is proposing to remove the tie between liquidity thresholds and fee and gate provisions, and moreover, to remove fee and gate provisions from Rule 2a-7 entirely.

Under the proposal, a money market fund would continue to be able to suspend redemptions to facilitate an orderly liquidation of the fund under Rule 22e-3 (consistent with ICI's recommendation). The Release notes that although it is removing fees from Rule 2a-7, the SEC continues to believe that it is important for institutional prime and institutional tax-exempt money market funds to have a tool to cause redeeming investors to bear the costs of liquidity if they redeem during a period of stress. As a result, and as discussed below, it is proposing to require these money market funds to implement swing pricing.

In contrast, because retail prime and retail tax-exempt funds historically have experienced lower, more gradual levels of redemptions in stress periods than institutional funds, the SEC believes retail funds do not need special provisions allowing them to impose liquidity fees or other analogous tools under Rule 2a-7 given the expected effect of the additional liquidity requirements, as discussed below.

The Release also notes that although the proposal would remove the liquidity fee provision in Rule 2a-7, a money market fund's board may nonetheless approve the fund's use of redemption fees (up to 2 percent) under Rule 22c-2.

Proposed Swing Pricing Requirement

The SEC is proposing a swing pricing requirement specifically for institutional prime and institutional tax-exempt money market funds that would apply when the fund experiences net redemptions (not net subscriptions). The Release states that this requirement is designed to "ensure that the costs stemming from net redemptions are fairly allocated and do not give rise to a first-mover advantage or dilution under either normal or stressed market conditions" and would complement the SEC's proposal to require funds to hold additional liquidity by requiring redeeming investors to pay the cost of depleting a fund's liquidity. The SEC believes that past experience with the existing liquidity fee regime supports a mandatory approach to dilution mitigation for institutional funds.

Under the proposal, an institutional fund would be required to adjust its current NAV per share by a swing factor[1] reflecting spread and transaction costs, as applicable, if the fund has net redemptions for the pricing period.[2] If the institutional fund has net redemptions for a pricing period that exceed the market impact threshold,[3] the swing factor also would include market impacts.

Specifically, if the fund has net redemptions that do not exceed the market impact threshold, the swing factor reflects the spread costs and other transaction costs (i.e., brokerage commissions, custody fees, and any other charges, fees, and taxes associated with portfolio security sales) from selling a vertical slice of the portfolio to meet those net redemptions. Including the spread costs in the swing factor calculation effectively requires a fund to value a security in its portfolio at the bid price when the fund has net redemptions.

If net redemptions exceed the market impact threshold, a fund's swing factor also would be required to include good faith estimates of the market impact of selling a vertical slice of a fund's portfolio to satisfy the amount of net redemptions for the pricing period. The fund would estimate market impacts for each security in its portfolio by first estimating the market impact factor. This factor is the percentage decline in the value of the security if it were sold, per dollar of the amount of the security that would be sold, under current market conditions. Then, the fund would multiply the market impact factor by the dollar amount of the security that would be sold if the fund sold a pro rata amount of each security in its portfolio to meet the net redemptions for the pricing period.

Notable points:

- Recognizing that it may be difficult to produce timely, good faith estimates of the market impact of selling a pro rata portion of each instrument the fund holds, the proposal would permit a fund to estimate costs and the market impact factor for each type of security with the same or substantially similar characteristics and apply those estimates to all securities of that type in the fund's portfolio, rather than analyze each security separately.
- The Release notes that it would be reasonable to apply a market impact factor of zero to the fund's daily and weekly liquid assets.
- A fund may estimate shareholder flow information to determine whether the fund has net redemptions for a pricing period and to determine the amount of net redemptions provided the swing pricing administrator[4] receives sufficient investor flow information to make a reasonable estimate.
- An institutional fund with multiple share classes must determine whether it experienced net redemption activity across all share classes in the aggregate, rather than determining net redemption activity on a class by class basis.
- To establish the amount of net redemptions that should trigger application of the market impact factor, the SEC reviewed historical flow information for institutional money market funds over a nearly five year period (December 2016 to October 2021) and found that institutional funds had daily outflows greater than 4 percent on approximately 5 percent of trading days.
- Despite comments to the contrary, the SEC does not agree that a swing pricing requirement would encourage investors to preemptively redeem and seek a first-mover advantage. According to the Release, investors do not necessarily know whether the fund's flows during any given period will trigger swing pricing or, if so, the size of the swing factor for that period. (Discussion of PWG comment letters begins on page 57.)
- The SEC does not believe that a swing pricing requirement would impose significant additional price volatility under normal market conditions because it is their

understanding that many institutional funds already use bid prices when valuing their portfolio investments and, thus, would not need to make additional price adjustments to reflect spread costs.
- The SEC believes that with swing pricing, a fund can pass liquidity costs on to redeeming investors without any reliance on intermediaries to achieve fair and equal application of costs. Nevertheless, the SEC requests comment on whether a liquidity fee alternative may have fewer operational or other burdens than the proposed swing pricing requirement while still achieving the same overall goals.

Board requirements. The proposal also includes non-delegable requirements to facilitate board oversight of swing pricing. A fund's board, including a majority of directors who are not interested persons of the fund, would be required to (1) approve the fund's swing pricing policies and procedures; (2) designate the swing pricing administrator; and (3) review, no less frequently than annually, a written report prepared by the swing pricing administrator describing the adequacy and effectiveness of the program.

Swing pricing administrator's report. The swing pricing administrator's report to the board would be required to describe (1) the administrator's review of the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation; (2) any material changes to the fund's swing pricing policies and procedures since the date of the last report; and (3) the administrator's review and assessment of the fund's swing factors and market impact threshold, including the information and data supporting the determination of the swing factors and the swing pricing administrator's determination to use a smaller market impact threshold, if applicable.

Operational considerations. The SEC acknowledges that swing pricing will introduce new operational complexity to institutional money market funds. A fund must determine whether it has net redemptions, and the size of those net redemptions, for the pricing period prior to striking its NAV, and this determination would need to be completed multiple times per day for funds that strike their NAVs multiple times per day. In contrast to other mutual funds, the SEC believes that because money market funds often impose order cut-off times that ensure that they receive flow data prior to striking their NAV, they would have the necessary flow information to determine if there are net redemptions and the amount of those net redemptions.

The Release also states that a T+1 settlement is not a likely result of the proposed swing pricing requirement because the SEC believes funds could take steps to maintain their ability to offer same-day settlement if they believe this type of settlement is important to institutional investors (e.g., moving the last NAV strike to an earlier point in the day, reducing the number of NAV strikes per day).

Tax and accounting implications: According to the Release, the SEC staff will continue discussions with the staff of the Treasury Department and IRS regarding the tax consequences of the proposed swing pricing requirement, including any implications for an investor's use of the NAV method of accounting for gain or loss on shares in a floating NAV money market fund or the exemption from the wash sale rules for redemptions of shares in these funds. The SEC recognizes that if the proposed swing pricing requirement modifies the method of accounting for gains or losses in relevant money market shares, or has other tax implications, the tax reporting effects of the proposed swing pricing requirement could increase burdens for investors.

The Release notes that the adoption of swing pricing would not preclude shareholders from classifying their investments in money market funds as cash equivalents for purposes of US GAAP. Under normal circumstances, the SEC anticipates that fluctuations in the amount of cash received upon redemption from a fund that applies swing pricing would likely be small and would be consistent with the concept of a "known" amount of cash. As already exists today and, as noted by the SEC in 2014 when it adopted floating NAVs for institutional money market funds, events may occur that give rise to credit and liquidity issues for money market funds. If such events occur, shareholders would need to reassess if their investments in that money market fund continue to meet the definition of a cash equivalent. This is already the case absent swing pricing, but the SEC recognizes that swing pricing may result in larger fluctuations in a fund's share price during such periods of stress.

Consistent with the approach the SEC established for mutual fund swing pricing in 2016, the proposed swing pricing requirement for institutional money market funds would affect certain aspects of financial reporting, as these funds would need to distinguish between the GAAP NAV per share and the transactional price adjustment to the NAV per share resulting from swing pricing (page 81). Swing pricing also affects disclosure of capital share transactions included in a fund's statement of changes in net assets and a money market fund using swing pricing would be required to disclose certain items in a footnote to its financial statements (page 82).

Disclosure. Money market funds subject to a swing pricing requirement under the SEC's proposal also would be required to respond to the existing swing pricing-related items on Form N-1A that were not historically applicable to these funds.

To help the SEC monitor the size of the adjustments funds are making during normal and stressed market conditions, as well as the frequency at which funds apply swing factor adjustments, the proposal would amend Form N-MFP to require institutional money market funds to use their adjusted NAV, as applicable, for purposes of reporting the series-and class-level NAV per share, and to report the number of times the fund applied a swing factor over the course of the reporting period, and each swing factor applied.

Under current Rule 2a-7, money market funds are required to provide on their websites the money market fund's NAV per share as of the end of each business day during the preceding six months. The proposed amendments also would amend this provision to require institutional money market funds to depict their adjusted NAV, taking into account the application of a swing factor.

Amendments to Portfolio Liquidity Requirements

The Release notes that the largest weekly outflow in March 2020 was around 55 percent, and the largest daily outflow was about 26 percent (both well above the respective weekly liquid asset and daily liquid asset thresholds of 30 percent and 10 percent). Further, since the fee and gate provisions incentivized funds to maintain weekly liquid assets above the current threshold, the SEC believes the proposed removal of the fee and gate provisions from Rule 2a-7 could have the effect of reducing fund liquidity levels by eliminating such incentives.

Accordingly, the SEC is proposing to increase daily and weekly liquid asset requirements to 25 percent and 50 percent, respectively. The Release notes that the proposed increase in funds' required daily and weekly liquid assets would be paired with the proposed removal of liquidity fees and redemption gates from Rule 2a-7. The SEC explains that these two proposed changes, together, should reduce incentives for managers to avoid using liquidity buffers and therefore allow them to use the increased amounts of required daily and weekly liquid assets to meet redemptions without the concern that using the assets could lead to runs to avoid a fee or gate. The Release also notes that the proposed liquidity buffers are generally consistent with the average liquidity levels prime money market funds have maintained over the past several years. With the exception of tax-exempt money market funds, which will continue to be exempt from the daily liquid asset requirements, the SEC's proposal does not establish different liquidity thresholds by type of fund.

Currently, Rule 2a-7 requires that a money market fund comply with the daily liquid asset and weekly liquid asset standards at the time each security is acquired. A money market fund's portfolio that does not meet the minimum liquidity standards has not failed to satisfy the daily liquid asset and weekly liquid asset conditions of rule 2a-7; the fund simply may not acquire any assets other than daily liquid assets or weekly liquid assets, respectively, until it meets these minimum thresholds. The SEC's proposal maintains this approach with respect to the increased minimum liquidity thresholds.

Board notification. The proposed rule would require a fund to notify its board of directors when the fund has invested less than 25 percent of its total assets in weekly liquid assets or less than 12.5 percent of its total assets in daily liquid assets (a "liquidity threshold event"). The proposal would require a fund to notify the board within one business day of the liquidity threshold event and provide a brief description of the facts and circumstances that led to the liquidity threshold event within four business days after its occurrence.

Proposed Amendments to Liquidity Metrics in Stress Testing

Each money market fund is currently required to engage in periodic stress testing under Rule 2a-7 and report the results of such testing to its board. Currently, one aspect of periodic stress testing involves the fund's ability to have invested at least 10 percent of its total net assets in weekly liquid assets under specified hypothetical events described in Rule 2a-7. Because the SEC's proposal would no longer provide for default liquidity fees if a fund has weekly liquid assets below 10 percent, and the proposal would increase the weekly liquid asset minimum from 30 percent to 50 percent, the SEC no longer believes that the rule should require funds to test their ability to maintain 10 percent weekly liquid assets under the specified hypothetical events described in Rule 2a-7.

Instead, the SEC is proposing to require funds to test whether they are able to maintain sufficient minimum liquidity under such specified hypothetical events. As a result, each fund would be required to determine the minimum level of liquidity it seeks to maintain during stress periods, identify that liquidity level in its written stress testing procedures, periodically test its ability to maintain such liquidity, and provide the fund's board with a report on the results of the testing.

Amendments Related to Potential Negative Interest Rates

The Release notes that twice during the past 15 years, the Federal Reserve established the lower bound of the target range for the federal funds rate at 0 percent. Government and retail money market funds can still maintain a non-negative stable share price while investing in instruments that yield a low but positive interest rate; however, if interest rates turn negative and the gross yield of a fund's portfolio turns negative, it would be challenging or impossible for the fund to maintain a non-negative stable share price.

Rule 2a-7, in its current form, does not explicitly address how money market funds must operate when interest rates are negative. Rather, Rule 2a-7 states that government and retail money market funds may seek to maintain a stable share price by using amortized cost and/or penny-rounding accounting methods. A fund may only take this approach so long as the fund's board of directors believes that the stable share price fairly reflects the fund's market-based NAV per share. Accordingly, if negative interest rates turn a stable NAV fund's gross yield negative, the board may reasonably believe the stable share price does not fairly reflect the market-based price per share, as the fund would be unable to generate sufficient income to support a stable share price. Under these circumstances, the fund would not be permitted to use amortized cost and/or penny-rounding accounting methods to seek to maintain a stable share price. Instead, the Release states that a fund would need to convert to a floating share price.

In addition to the pricing provision described above, Rule 2a-7 also includes certain procedural standards for stable NAV funds that require that the fund periodically calculate the market-based value of the portfolio ("shadow price") and compare it to the fund's stable share price. If the deviation between these two values exceeds ½ of 1 percent (50 basis points), the fund's board of directors must consider what action, if any, should be taken by the board, including whether to re-price the fund's securities above or below the fund's $1.00 share price (i.e., "break the buck"). Regardless of the extent of the deviation, Rule 2a-7 imposes on the board of a money market fund a duty to consider appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. The SEC believes that, if interest rates turn negative, the board of a stable NAV fund could reasonably require the fund to convert to a floating share price to prevent material dilution or other unfair results to investors or current shareholders.

Rule 2a-7 also requires stable NAV money market funds and their transfer agents to have the capacity to redeem and sell securities at prices that do not correspond to a stable price per share. While the SEC is not proposing changes to the Rule 2a-7 pricing provisions in relation to negative interest rates, it is proposing to expand government and retail money market funds' obligations to confirm that they can fulfill shareholder transactions if they convert to a floating share price.

Financial intermediaries. Specifically, the SEC proposes to require a government or retail money market fund (or the fund's principal underwriter or transfer agent on its behalf) to determine that financial intermediaries that submit orders—including through an agent—to purchase or redeem the fund's shares have the capacity to redeem and sell the fund's shares at prices that do not correspond to a stable price per share or, if this determination cannot be made, to prohibit the relevant financial intermediaries from purchasing the fund's shares in nominee name. Funds would have the flexibility in how they make this determination for each financial intermediary but would be required to maintain records identifying the intermediaries the fund has determined have the capacity to transact at non-stable share prices and the intermediaries for which the fund was unable to make this determination.

Reverse distribution mechanism. Due to concerns regarding the potential misleading or confusing nature of a reverse distribution mechanism, the SEC is proposing to amend Rule 2a-7 to prohibit money market funds from operating a reverse distribution mechanism, routine reverse stock split, or other device that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price.

Amendments to Specify the Calculation of WAM and WAL

The SEC is proposing to amend Rule 2a-7 to specify the calculation of WAM and WAL. The SEC has found that funds use different approaches when calculating WAM and WAL under the current definitions in the rule. For instance, the SEC understands that a majority of money market funds calculate WAM and WAL based on the percentage of each security's market value in the portfolio, while other money market funds base calculations on the amortized cost of each portfolio security. This discrepancy can create inconsistency of WAM and WAL calculations across funds, including in data reported to the SEC and provided on fund websites. Accordingly, the SEC is proposing to require that money market funds calculate WAM and WAL based on the percentage of each security's market value in the portfolio because all types of money market funds already determine the market values of their portfolio holdings for other purposes, while only certain money market funds use amortized cost. Thus, the SEC believes all money market funds can use this calculation approach with information they already obtain. The Release notes that these amendments will enhance the consistency of calculations for funds, while allowing the SEC to better monitor and respond to indicators of potential risk and stress in the market.

Amendments to Reporting Requirements

Form N-CR

- The SEC is proposing to add a new requirement for a money market fund to file a report on Form N-CR when a liquidity threshold event occurs (i.e., the fund has invested less than 25 percent of its total assets in weekly liquid assets or less than 12.5 percent of its assets in daily liquid assets). Currently, money market funds are required to provide information about the size of their weekly liquid assets and daily liquid assets on a daily basis on their websites. The SEC believes this new requirement would help investors, the SEC and its staff monitor significant declines in liquidity, without having to monitor each money market fund's website.
- The SEC proposes to require funds to file Form N-CR reports in a custom eXtensible Markup Language ("XML")-based structured data language created specifically for reports on Form N-CR. Further, it is proposing other amendments to improve the utility of reported information and to remove reporting requirements related to the imposition of liquidity fees and redemption gates under Rule 2a-7.

Form N-MFP

- The proposed amendments would require all money market funds provide the name and percent of ownership of each person who owns of record or is known by the fund to own beneficially 5 percent or more of the shares outstanding in the relevant class. The proposal would require information about beneficial owners known by the fund in recognition that funds may not have information about the amount each beneficial owner holds in an omnibus account. The proposed item would distinguish between record owners and beneficial owners to facilitate a more nuanced understanding of potential concentration levels.
- The proposal would require institutional money market funds provide information about the composition of its shareholders by type.
- New Part D would require a prime money market fund to disclose the aggregate amount it sold or disposed of for each category of investment (which would mirror the categories of investments that funds already use on Form N-MFP for identifying month-end holdings).
- As noted above, the proposal would require institutional money market funds to report the number of times the fund applied a swing factor over the course of the reporting

period, and each swing factor applied.
- The proposal would include several changes to improve the accuracy and consistency of currently reported information (pages 133-137).
- To provide industry-wide daily data in a central depository as a resource for the SEC, investors, and others, the proposal would require more frequent data points, including daily liquidity, NAV, and flow data in monthly reports (rather than the current weekly requirement).
- The proposal would increase the frequency with which funds report certain yield information. Currently, funds must report 7-day gross yields and 7-day net yields as of the end of the reporting period. The proposal would require funds to report this information each business day.
- Similar to Forms N-CEN and N-PORT, the proposal would require funds to identify the name and LEI for both the fund registrant and the series on Form N-MFP.

Compliance Dates

If adopted as proposed, removal of the liquidity fee and redemption gate provisions and related disclosure requirements would be effective when the final rule is effective. For the other amendments, the SEC proposes the following compliance dates following the effective date:

- 12 months

  - Swing pricing. The SEC proposes a 12-month compliance period for funds to comply with the proposed swing pricing requirements and related disclosures to Forms N-MFP and N-1A.
  - Amendments related to potential negative interest rates. The SEC proposes a 12-month compliance period for government and retail funds to determine that financial intermediaries have the capacity to redeem and sell at a price based on the current NAV per share or prohibit the financial intermediary from purchasing in nominee name on behalf of other persons, securities issued by the fund.

- 6 months

  - The SEC proposes a six-month compliance period for all other aspects of the proposal, including increased daily and weekly liquid assets and amendments to Forms N-CR and Form N-MFP.

Jane G. Heinrichs
Associate General Counsel

endnotes

[1] Swing factor is defined as the amount, expressed as a percentage of the fund's NAV and determined pursuant to the fund's swing pricing policies and procedures, by which a fund adjusts its NAV per share. Unlike the mutual fund swing pricing rule (Rule 22c-1(a)(3)), the definition does not include an upper limit.

[2] Pricing period is defined as the period of time an order to purchase or sell securities issued by the fund must be received to otherwise be priced at a given current NAV under

Rule 22c-1. This is designed to address money market funds that compute their NAVs multiple times per day.

[3] Market impact threshold is defined as an amount of net redemptions for a pricing period that equals the value of 4 percent of the fund's NAV divided by the number of pricing periods the fund has in a business day, or such smaller amount of net redemptions as the swing pricing administrator determines. This definition would require a fund to divide 4 percent of the fund's NAV by the number of pricing periods to arrive at the amount of net redemptions that would trigger the threshold. Because the number of pricing periods may vary among funds, this aspect of the definition is designed to provide a threshold that would apply more consistently to funds with different numbers of pricing periods, as opposed to a static figure applicable to all funds. For example, if a fund computes a NAV three times a day, it would divide 4 percent by 3 (which equals 1.33 percent). Therefore, if net redemptions in any of the three daily periods exceeds 1.33 percent, the swing factor for that particular period must include market impact.

[4] Swing pricing administrator is defined as the fund's investment adviser, officer, or officers responsible for administering the swing pricing policies and procedures. The swing pricing administrator may consist of a group of persons. The administration of the swing pricing program must be reasonably segregated from portfolio management of the fund and may not include portfolio managers.