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INVESTMENT COMPANY INSTITUTE

ICI VIEWPOINTS

February 5, 2025

Sold Under False Pretenses: The SEC's Money Market Fund Reform is Causing Damage

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In response to pandemic-induced stress in money markets three years earlier, the Securities and Exchange Commission (SEC) adopted rule amendments in July 2023 that required significant changes to prime money market funds (MMFs).1 While strengthening the resiliency of MMFs was a worthy objective, the Commission adopted these amendments without seeking public input on specific elements of the amendments' most consequential change: the imposition of a first-ever mandatory liquidity fee on prime institutional funds.2

MMFs serve as an attractive cash management option and have surged in popularity as investors have taken advantage of higher yields in recent years. But the prime institutional segment of the MMF market has experienced significant consolidation and reduced competition as a direct consequence of the SEC's flawed rule amendments.

Then SEC Chair Gary Gensler presented the 2023 reform as one that would "enhance these funds' resiliency and ability to protect against dilution." But Commissioner Hester Peirce took quite a different view in her dissenting statement, pointedly asking if one of the goals of the reform was to "kill prime funds" – something that Chair Gensler denied. Commissioner Peirce and Commissioner Mark Uyeda, as well as ICI and other commentators, expressed deep concern that, rather than helping MMFs, the rule changes would jeopardize the viability of this important type of MMF.

Now that the final implementation deadline has passed, we can begin assessing whether the SEC's MMF reforms worked as the previous SEC leadership said they would. **The bottom line is that many of the concerns with the 2023 reforms have come to fruition, leaving the MMF market facing greater uncertainty.**

Flaws with the Final Rule

The mandatory liquidity fee requirement surprised MMF sponsors because it was not discussed in any detail in the SEC's original proposal.3 Not only is the fee difficult to calculate and for investors to understand; it does not reflect how prime institutional money market funds typically use their portfolios to manage redemptions.

- The SEC's 5% net redemption threshold standard for determining whether a fee

should be imposed is an arbitrary standard unsupported by data.
- The 1 basis point threshold for implementing the fee is completely at odds with securities law standards for materiality.
- The SEC disregarded standard portfolio management liquidity and trading practices by requiring determination of a redemption's impact using a hypothetical vertical slice of the portfolio as a proxy for the impact on remaining shareholders—even after requiring a significant increase in liquidity.

The final rule epitomizes an exercise in academic regulation, uninformed by relevant data, analysis, or feedback on crucial elements from the impacted parties.

A Surprising Change with Unsurprising Consequences

At the end of June 2023, shortly before the SEC's reforms were adopted, there were 25 publicly available prime institutional MMFs. After the effective date of the reforms, that number plummeted to nine as sponsors liquidated, merged, or converted their funds to avoid the complexities of the mandatory liquidity fee. Net assets and the total number of sponsors have suffered a similar fate, as the table below demonstrates.

By the Numbers: Before and After SEC Reforms

		Before New Rule (June 30, 2023)	**After New Rule (October 2, 2024)**	**Change**
Number of Funds	Nonpublic	10	5	-50%
	Public	25	9	-64%
	Total	35	14	-60%
Net Assets	Nonpublic	$356 billion	$102 billion	-71%
	Public	$275 billion	$220 billion	-20%
	Total	$631 billion	$322 billion	-49%
Institutional Prime MMF Sponsors	Nonpublic	9	4	-56%
	Public	15	7	-53%

Note: Data are estimated based on a combination of survey data and public announcements.
Sources: ICI Survey, publicly available SEC Form N-MFP data, Crane data

ICI earlier cautioned the SEC about creating a regulatory environment that dampens competition and accelerates industry consolidation. Indeed, the final rule amendments were so complex and costly that only a handful of the very largest sponsors were willing to dedicate the effort and resources necessary to comply. Even some of the most sophisticated sponsors determined that the challenges of maintaining the products were too great after evaluating the new requirements.

Where Did That Money Go?

For the public funds, $44 billion went to government or prime retail money market strategies, $16 billion liquidated or converted to non-money market strategies, and $220 billion remained in prime institutional MMFs. For the nonpublic funds, $236 billion went to government strategies, $15 billion liquidated or converted to non-money market strategies, and $102 billion of the original $356 billion remained in prime institutional MMFs. All told, the SEC's reforms drove $309 billion out of prime institutional money market funds. **The full impact probably won't be known until the remaining funds and shareholders experience the imposition of a mandatory fee.**

Burdens on Funds and Their Shareholders

Many sponsors of prime institutional MMFs expressed concern that the SEC did not fully appreciate the magnitude of the operational changes. For instance, ongoing data analysis is necessary to validate the methodology underlying each sponsor's good faith estimate of market impact costs as one requirement for implementing the mandatory liquidity fee framework. The process for calculating and verifying whether a mandatory fee should be imposed is complex, burdensome, serves no legitimate regulatory purpose, and is a new daily operational process that all sponsors of institutional prime funds must support. Not only that, but current or historical transactional data on the liquidity market is limited, and requiring inclusion of “market impact” in this fee is highly speculative.

The size of the mandatory liquidity fee is determined by making a good faith estimate of the spread, 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 (vertical slice) to satisfy the amount of net redemptions. This pro rata methodology is not consistent with money market trading practices, and the limited availability of data and speculative nature of the fee calculations are intractable complications.

Furthermore, it’s uncertain whether the mandated liquidity fee methodology accurately reflects actual liquidity costs, as opposed to the hypothetical cost of liquidating a vertical slice of the portfolio on the given day, which could result in inflated fees that punish redeeming investors.

This complex, expensive process to collect fees on floating NAV funds that could be quite small not only serves no regulatory purpose but has further created an anti-competitive market, causing significant participants to leave the space and presenting a barrier for new entrants to the market.

These costs are ultimately borne by the shareholders of the funds in the form of expense and product selection. In addition, this unjustified calculation and verification process can result in delays in the delivery of shareholder redemptions, including on days where a fee is not applied.

A Reckless Approach to Rulemaking

The Commission’s reforms raise questions about conformance to the Administrative Procedure Act, which requires the SEC and other agencies to provide interested persons with a meaningful opportunity to comment on proposed rules. The SEC’s original proposal merely suggested mandatory liquidity fees as one of 15 *rejected* alternatives. MMF sponsors, service providers, and investors were not provided a meaningful opportunity to comment on critical elements of the rule amendments that were ultimately adopted.

As Commissioner Peirce noted in her dissenting statement, “The proposing release discussed the use of liquidity fees as an alternative to fight dilution costs in the proposal, but it also *rejected* that option….” Commissioner Uyeda’s dissent observed that the “mandatory liquidity fee … was not described in detail to the public and, thus … the Commission does not have the benefit of extensive public comment.” It is no surprise that a poor rulemaking process would have serious consequences—in this case, decreased competition and significant industry concentration.

The full impact of the SEC’s MMF reforms may not yet have been realized, as a prime institutional MMF could find itself in a situation where it is forced to institute a mandatory liquidity fee. Recall that this most recent set of MMF reforms undid prior amendments that linked liquidity fee and gate provisions to an artificial floor of weekly liquid assets. In reversing itself, the SEC acknowledged that there were “unintended effects” from its actions and that the requirements “did not achieve” the SEC’s objectives.

There, the SEC admitted that the “possibility of the[ ] imposition” of liquidity fees …

appears to have contributed to investors' incentives to redeem from prime money market funds." What can the SEC expect in the case of an actual imposition of such fees? This regulatory guillotine only serves to amplify—not mitigate—market uncertainty and has the potential, like the last round of reforms, to cause unintended effects when applied.

The SEC Should Heed These Lessons and Avoid Similar Outcomes in the Future

The aftermath of the SEC's MMF reform demonstrates that in addition to imposing compliance costs borne by fund investors, bad regulation can damage funds' overall utility. Had the Commission undertaken a thoughtful and transparent rulemaking process by engaging with MMF sponsors, service providers, and investors, it might have been able to achieve its policy goals without causing such unnecessary damage. Thus, there are two key conclusions:

- Responsibility for potential vulnerabilities in the MMF market caused by the mandatory liquidity fee sits with the SEC and the central bank community that urged the SEC to take these steps, and not with the MMF providers.
- The existence of the mandatory liquidity fee in the MMF regulatory framework should not be used by policymakers to justify extending the practice to other types of funds.

Using the same regulatory playbook in other areas of the market could have devastating consequences. Take for example the SEC's heavily criticized 2022 mandatory swing pricing proposal for mutual funds, the SEC proposal most similar to the MMF amendments. It's chilling to consider the potential impact of similarly misguided rulemaking on more than 6,700 long-term mutual funds, with their combined $21.7 trillion in assets. The stakes are too high for these recent substantive and procedural policy mistakes to be repeated.

Notes

1 Notably, the redemptions in 2020 were exacerbated by a fatal flaw in the 2014 amendments which linked weekly liquid asset levels to board consideration of liquidity fees and redemption gates. Many comments on the SEC's reform proposals observed that the only reform necessary was to de-link this consideration which paradoxically prevented MMFs from using their most liquid assets to meet redemption in March 2020 for fear of triggering a run.

2 The SEC also imposed a mandatory liquidity fee on institutional tax-exempt MMFs and increased the minimum liquidity requirements for all MMFs, among other changes.

3 The fee requires a prime institutional fund experiencing at least 5% or greater net redemptions on any business day to calculate a hypothetical cost of liquidity of selling a pro rata share of a vertical slice of its portfolio to meet the redemption amount. If the hypothetical cost of liquidity exceeds 1 basis point, it must be converted into a fee and allocated pro rata to every redeeming investor.
