July 20, 2023

SEC Adopts Amendments to Rules Governing Money Market Funds

Final Rule Abandons Proposed Swing Pricing but Imposes Other Requirements Targeting the Resilience and Transparency of Money Market Funds

SUMMARY

On July 12, 2023, the Securities and Exchange Commission (the "SEC") voted 3 to 2 (Commissioners Peirce and Uyeda dissenting) to adopt certain amendments to rules and forms under the Investment Company Act of 1940 (the "Investment Company Act") intended to improve the resilience and transparency of money market funds ("MMFs"). The SEC's actions are a response to the outflows experienced by certain types of MMFs in March 2020 during the economic shock related to the COVID-19 pandemic which resulted in intervention by the Board of Governors of the Federal Reserve System (the "Federal Reserve").[1]

As proposed, the SEC amended rule 2a-7 under the Investment Company Act to remove (i) the temporary redemption gate provisions and (ii) the tie between liquidity fees and weekly liquid asset thresholds. Also as proposed, the SEC increased the minimum liquidity requirements applicable to MMFs to 25% daily liquid assets (up from 10% under the current rule) and 50% weekly liquid assets (up from 30% under the current rule). In response to comments from industry and market participants on the significant operational complexity and lack of feasibility of the proposed swing pricing requirement for institutional prime and institutional tax-exempt MMFs, the SEC instead adopted a mandatory liquidity fee for these MMFs in an attempt to "better allocate liquidity costs associated with redemptions to the redeeming investors."[2] The SEC did not include the mandatory liquidity fee in its proposal and, without re-proposing this aspect of the rule before adopting it, has not provided commenters (including the MMF industry) with a meaningful opportunity to provide input on whether the mandatory liquidity fee raises many of the same potential negative consequences for MMFs and their shareholders as the proposed swing pricing framework.[3]

In addition, the SEC amendments permit stable net asset value ("NAV") MMFs (retail and government MMFs) to handle potential negative interest rates through, among other things, the use of share cancellations or a reverse distribution mechanism. The SEC also modified certain reporting forms to reflect the revised regulatory framework. Finally, the SEC adopted amendments to Form PF, the confidential reporting form for certain SEC-registered private fund advisers, to collect additional information on the liquidity of funds they advise, and other related form and rule amendments.

BACKGROUND

MMFs are a critical component of the short-term funding markets and provide short-term financing for a variety of businesses, banks and governments. MMFs are managed with the goal of providing principal stability and access to liquidity by investing in high-quality, short-term debt securities (such as Treasury bills, repurchase agreements and commercial paper) whose value does not fluctuate significantly in normal market conditions. MMFs, however, hold instruments that may increase or decrease in value in connection with broader market developments, and investors in MMFs generally understand that transactions in MMFs carry some investment risk. The combination of limited principal volatility, diversification of portfolio securities, payment of short-term yields and access to overnight repurchase facilities and liquidity has made MMFs popular cash management vehicles for both retail and institutional investors.

Since rule 2a-7 was initially adopted in 1983, the SEC has amended the rule several times in response to market events highlighting MMF vulnerabilities, including the 2008 financial crisis, which resulted in two significant rounds of amendments in 2010 and in 2014 to, among other things, reduce the interest rate, credit and liquidity risks of MMFs, provide for fees and gates to stem heavy redemptions, and require floating NAVs for institutional MMFs to address runs.[4] With the notable exception of fees and gates, which had the risk of a cliff-edge effect, the prior reforms resulted in MMFs having significant liquidity and more resilient portfolios coming into March 2020.

In the Adopting Release, the SEC noted that growing economic concerns surrounding the COVID-19 pandemic in March 2020 led investors to reallocate their assets into cash and short-term government securities, though the SEC cited few examples of MMFs that approached or breached the 30% liquid assets threshold during this period.[5] As discussed in a report (the "PWG Report") issued in December 2020 by the President's Working Group on Financial Markets, prime and tax-exempt MMFs, particularly institutional MMFs, experienced large outflows as investors sought to preserve liquidity, which may have contributed to stress on short-term funding markets.[6] In order to slow and stabilize outflows, the Federal Reserve intervened to establish the Money Market Mutual Fund Liquidity Facility and other programs to support short-term funding markets. We note, however, that the daily and weekly liquid asset requirements are not capital buffers; MMFs are not prohibited from using these assets to meet redemption requests, and MMFs generally had a high level of daily and weekly liquid assets in March 2020.[7] Both the SEC[8] and the PWG

Report[9] noted that investors' concerns about the potential imposition of fees or gates likely contributed to the heavy volume of redemptions.

In part to address concerns about prime and tax-exempt MMFs highlighted by these events, on December 15, 2021, the SEC voted 3 to 2 (Commissioners Peirce and Roisman dissenting) to propose certain amendments (the "Proposed Amendments") to rules and forms under the Investment Company Act.[10] The proposal drew significant attention from market participants, and the SEC received 108 unique comment letters primarily centered on key elements of the Proposed Amendments, including the swing pricing requirement. We summarized and discussed the Proposed Amendments in our publication, dated December 21, 2021. With the notable exception of the replacement of the swing pricing requirement with a mandatory liquidity fee framework, the SEC adopted many of the Proposed Amendments substantially as proposed.

SUMMARY OF THE AMENDMENTS

Below, we summarize the SEC's amendments to rule 2a-7 and related amendments to reporting forms.

Amendments to Remove Liquidity Fee and Redemption Gate Provisions

Under current rule 2a-7, an MMF must impose temporary liquidity fees or redemption gates ("fees and gates") after crossing specified liquidity thresholds. Fees and gates were intended to serve as a "cooling off" period to temper the effects of short-term investor panic and to preserve liquidity levels in times of market stress, as well as to allocate the costs of providing liquidity to redeeming investors.[11] However, the SEC acknowledged, during the period of market stress in March 2020, investor fear of the possibility of fees and, in particular, gates being imposed—although no MMF actually imposed a fee or gate—likely contributed to incentives for investors to redeem and for MMF managers to sell more illiquid assets at a potentially disadvantageous price in order to maintain weekly liquid asset levels above the specified thresholds.[12]

As proposed, the SEC removed from rule 2a-7 the ability of MMFs to impose redemption gates altogether and amended the liquidity fee structure to remove weekly liquid asset-linked thresholds, instead implementing a mandatory liquidity fee (as discussed below).[13] The SEC accepted, after the March 2020 market turmoil, that redemption gates, adopted by the SEC after the 2008 financial crisis, "may not be an effective tool for money market funds to stem heavy redemptions in times of stress."[14] An MMF would continue to be able to suspend redemptions to facilitate an orderly liquidation of the MMF pursuant to rule 22e-3.[15]

Mandatory Liquidity Fee Framework to Replace Swing Pricing Proposal

The Proposed Amendments would have imposed swing pricing for institutional prime and institutional tax-exempt MMFs when such MMFs experience daily net redemptions.[16] A large number of commenters strongly objected to this aspect of the proposal.[17] Many commenters expressed broad concerns with the

operational workability and effectiveness of swing pricing as an anti-dilution tool for institutional MMFs and investors.[18] Several commenters stated that alternative solutions such as liquidity fees would be more operationally feasible and would promote the SEC's anti-dilution goals more effectively than swing pricing.[19]

Acknowledging these comments, the SEC abandoned the proposed swing pricing requirement, but, without re-proposing, adopted a mandatory liquidity fee to address potential shareholder dilution and the potential for a first-mover advantage for institutional MMFs.[20] Specifically, all redeeming investors in institutional prime and institutional tax-exempt MMFs will be charged a mandatory liquidity fee when daily net redemptions exceed 5% of net assets.[21] MMFs will not be required to impose a liquidity fee, however, when liquidity costs are less than one basis point, which the SEC anticipates will "often be the case under normal market conditions."[22] To determine the size of the fee, given that MMFs generally use daily liquid assets to meet redemptions, the manager would make "a good faith estimate," supported by data, of the costs the MMF would incur ***if*** it had sold a vertical slice of portfolio securities to satisfy redemptions.[23] The manager would include the hypothetical costs associated with that sale, such as spreads and other transaction costs, as well as market impact.[24] If the MMF cannot make a "good faith estimate" of such costs, a default liquidity fee of 1% of the value of shares redeemed applies.[25] Relatedly, the SEC also amended rule 31a-2 to require MMFs to preserve records regarding their liquidity fee computations.[26]

All MMFs Continue to Have Discretion to Impose a Redemption Fee of Up to 2%

Amended rule 2a-7 largely retains the discretionary liquidity fee provisions of current rule 2a-7, allowing any MMF to impose a fee of not more than 2% of the value of the shares redeemed if the MMF's board of directors determines that a liquidity fee is in the best interest of the MMF.[27] Unlike the current rule, the fee is not tied to a weekly liquid asset threshold. The requirement under amended rule 31a-2 for MMFs to preserve records also applies to records regarding discretionary liquidity fee calculations.[28]

Liquidity Fee Role of MMF Boards

MMF boards are responsible for administering the liquidity fee requirement, but they can delegate this responsibility to the MMF's investment adviser or officers, subject to written guidelines established and reviewed by the board and ongoing board oversight.[29] Specifically, MMF boards will need to "adopt and periodically review written guidelines (including guidelines for determining the application and size of liquidity fees) and procedures under which a delegate makes liquidity fee determinations" and also periodically review the delegate's liquidity fee determinations.[30] This aspect of amended rule 2a-7 would seem to impose further obligations of a management, rather than oversight, nature on MMF boards.[31]

Amendments to Portfolio Liquidity Requirements

Currently, an MMF is required to hold at least 10% of its total assets in daily liquid assets and at least 30% of its total assets in weekly liquid assets.[32] The SEC adopted these requirements after the 2008 financial crisis to support MMFs' ability to meet redemptions from cash or securities convertible to cash even in

market conditions in which MMFs cannot rely on a secondary or dealer market to provide liquidity.[33] This heightened level of liquidity allowed MMFs to meet the increased redemption activity in March 2020.

Nonetheless, the SEC proposed and adopted increases to the daily and weekly liquid asset requirements from 10% and 30% to 25% and 50%, respectively.[34] While commenters generally supported a higher level of daily and weekly liquid asset requirements, particularly to support the removal of gates, many commenters asserted that the proposed levels were too high and would negatively impact portfolio construction.[35] The amendments do not alter the current approach with respect to consequences of falling below the minimum daily and weekly liquidity requirements, which prohibits an MMF from acquiring any assets other than daily liquid assets or weekly liquid assets until the minimum thresholds are met.[36] However, as proposed, an MMF will be required to notify its board of directors within one business day when the MMF's liquidity falls to less than half of the required levels, i.e., when the MMF has invested less than 25% of its total assets in weekly liquid assets or less than 12.5% of its total assets in daily liquid assets (a "liquidity threshold event").[37]

As proposed, the SEC also amended the existing periodic stress testing requirements, which require MMFs to test their ability to have invested at least 10% of their total net assets in weekly liquid assets under specified hypothetical events.[38] Departing from the 10% threshold, the SEC will now require each MMF 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 at such intervals as the board determines appropriate and reasonable in light of current market conditions and provide the MMF's board with a report on the results of the testing.[39]

Other Amendments

The SEC also adopted the following additional amendments:

- ***Amendments Related to Potential Negative Interest Rates.*** The amendments include various changes designed to address the challenges stable NAV MMFs may face in negative interest rate environments. Under the amendments, government and retail MMFs seeking to maintain stable NAVs must either convert to a floating share price or engage in share cancellation if future market conditions result in negative fund yields.[40] In addition, in a change from the proposal, the amendments will permit the use of share cancellations or a reverse distribution mechanism by MMFs (retail and government) if the fund has negative gross yield as a result of negative interest rates.[41]
- ***Amendments to Specify the Calculation of Weighted Average Maturity and Weighted Average Life.*** To rectify inconsistencies among calculations of weighted average maturity ("WAM") and weighted average life ("WAL") across MMFs, the SEC amended rule 2a-7, as proposed, to require that MMFs calculate WAM and WAL based on the percentage of each security's market value in the portfolio.[42]
- ***Amendments to Reporting Requirements.*** Under the amendments, as proposed, a requirement will be added for all MMFs to file a report on Form N-CR upon the occurrence of a liquidity threshold event (as defined above).[43] MMFs will also be required to file Form N-CR reports in a structured data language.[44] With respect to Form N-MFP, the amendments will require MMFs to report whether the MMF applied a liquidity fee during the reporting period and, if so, information about

each liquidity fee applied, including the date, the type of fee and the amount.[45] The final amendments also provide for certain conforming changes to Form N-1A to reflect other changes to the regulatory framework.

Compliance Dates

The SEC adopted a tiered compliance approach. MMFs must be in compliance with these amendments as of the applicable compliance date.

- The effective date for the final amendments to rule 2a-7, rule 31a-2 and Form N-1A and technical amendments to Form N-CSR and Form N-1A is 60 days after publication in the Federal Register (the "Effective Date").[46] Except as set forth below, there will be no separate compliance dates for the amendments to rule 2a-7, rule 31a-2 and Form N-1A, including the removal of redemption gates, removal of the tie between liquidity fees and liquidity thresholds and the new provision allowing share cancellation under certain circumstances.[47]
- The compliance date for the mandatory liquidity fee framework will be 12 months after the Effective Date.[48]
- The increased portfolio liquidity requirements, the changes to the discretionary liquidity fee provision and amendments to the calculation of WAM and WAL will have compliance dates that are six months after the Effective Date.[49]
- For the final amendments to Form N-MFP, Form N-CR and Form PF, the SEC adopted a delayed effective and compliance date of June 11, 2024.[50]

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ENDNOTES

1 Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A, SEC Release Nos. 33-11211; 34-97876; IA-6344; IC-34959 (Jul. 12, 2023), *available at*: https://www.sec.gov/rules/final/2023/33-11211.pdf (the "Adopting Release"), at 6.

2 *Id.* at 9.

3 Although the proposing release included a few questions about the potential use of a mandatory liquidity fee, and some comments on the proposed rule discussed liquidity fees generally as a possible alternative to swing pricing (*see id.* at 32-34), the SEC did not put forward a specific proposal. Market participants and both Commissioners Peirce and Uyeda questioned the SEC's adoption of a mandatory liquidity fee without an opportunity for more targeted and detailed comments specific to the mandatory liquidity fee framework. *See, e.g.*, the statements of Commissioners Peirce and Uyeda on the final rule, Commissioner Hester M. Peirce, Air Dancers and Flies: Statement on Adoption of the Latest Round of Money Market Fund Reforms (Jul. 12, 2023), *available at*: https://www.sec.gov/news/statement/peirce-statement-air-dancers-flies-adoption-latest-money-market-fund-reforms (stating that the SEC "should go back out for comment to get the wisdom of commenters" with questions regarding the mechanics of liquidity fees and the appropriateness of the specific values set for liquidity fees and redemption triggers); Commissioner Mark T. Uyeda, Statement on Final Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A (Jul. 12, 2023), *available at*: https://www.sec.gov/news/statement/uyeda-final-money-market-fund-reforms-07-12-2023 (noting that the mandatory liquidity fee "was not described in detail to the public and, thus, unlike in 2014, the Commission does not have the benefit of extensive public comment").

4 For additional information on the 2010 amendment and 2014 amendment, *see* Adopting Release at 12-14. The SEC also adopted amendments to rule 2a-7 in 2015 pursuant to section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act to replace references to credit ratings in the rule with alternative standards. *See* Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, SEC Release No. IC-31828 (Sept. 16, 2015), *available at*: https://www.sec.gov/rules/final/2015/ic-31828.pdf.

5 Money Market Fund Reforms, SEC Release No. IC-34441 (Dec. 15, 2021), *available at*: https://www.sec.gov/rules/proposed/2021/ic-34441.pdf (the "Proposing Release"), at 168 (citing ICI Report, Experiences of US Money Market Funds During the Covid-19 Crisis (Nov. 2020), *available at*: https://www.ici.org/doc-server/pdf%3A20_rpt_covid3.pdf). The Proposing Release noted that, "[d]uring peak volatility in March 2020, some funds experienced a reduction in their daily and weekly liquid asset values as they drew down on their liquid assets to meet large redemptions. Specifically, a high of 6 institutional prime funds on March 18 had weekly liquid assets below 35%, and one of the institutional prime money market funds had weekly liquid assets below 30%." *Id.*

6 *See* Report of the President's Working Group on Financial Markets, Overview of Recent Events and Potential Reform Options for Money Market Funds (Dec. 2020), *available at*: https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf (the "PWG Report").

7 Proposing Release at 168.

8 Adopting Release at 20 ("evidence suggests that in March 2020, even though no money market fund imposed a liquidity fee or gate, the possibility of their imposition after crossing the publicly disclosed 30% weekly liquid asset threshold appears to have contributed to investors' incentives to redeem from prime money market funds.")

ENDNOTES (CONTINUED)

[9] PWG Report at 15 ("Investor redemptions, which may have been further exacerbated by declining WLAs, can put additional pressure on fund liquidity during times of stress.").

[10] Proposing Release.

[11] Adopting Release at 20.

[12] *Id.* at 20-22.

[13] *Id.* at 23, 27-28.

[14] *Id.* at 23.

[15] *Id.* (citing 17 CFR 270.22e-3).

[16] *Id.* at 28-29.

[17] *Id.* at 29.

[18] *Id.* at 29-32.

[19] *Id.* at 32-34.

[20] *Id.* at 34.

[21] Amended rule 2a-7(c)(2)(ii).

[22] Adopting Release at 35 (citing amended rule 2a-7(c)(2)(iii)(D)).

[23] *Id.* at 67-68 (citing amended rule 2a-7(c)(2)(iii)(A)) (emphasis added).

[24] *Id.* at 69. To calculate market impact costs, an MMF would first establish a market impact factor for each security, which is "a good faith estimate of the percentage change in the value of the security if it were sold, per dollar of the amount of the security that would be sold, if the fund sold a pro rata amount of each security in its portfolio to satisfy the amount of net redemptions, under current market conditions." *Id.* at 70. The MMF would then "multiply the market impact factor by the dollar amount of the security that would be sold." *Id.*

[25] *Id.* at 68 (citing amended rule 2a-7(c)(2)(iii)(C)).

[26] *Id.* at 174 (citing amended rule 31a-2(a)(2)).

[27] *Id.* at 81; 82, n.237.

[28] *Id.* at 174 (citing amended rule 31a-2(a)(2)).

[29] *Id.* at 66 (citing amended rule 2a-7(j)).

[30] *Id.* at 67.

[31] *Cf.* the SEC's approach in adopting board oversight requirements for the use of derivatives by registered investment companies. Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-34084 (Nov. 2, 2020), *available at*: https://www.sec.gov/rules/final/2020/ic-34084.pdf, at 81 ("We agree with commenters that the board's role is distinct from that of the derivatives risk manager and is not one that requires the board to be involved in the day-to-day management of the fund. It is the derivatives risk manager, not the board, that is responsible for having sufficient derivatives experience to administer the derivatives risk management program.")

[32] 17 CFR 270.2a-7(d)(4)(ii) and (iii).

[33] Adopting Release at 94.

[34] *Id.* (citing amended rule 2a-7(d)(4)(ii) and (iii)).

[35] *Id.* at 95-96.

ENDNOTES (CONTINUED)

36 *Id.* at 106 (citing 17 CFR 270.2a-7(d)(4)(ii) and (iii)).

37 Amended rule 2a-7(f)(4)(i).

38 Adopting Release at 109-10 (citing 17 CFR 270.2a-7(g)(8)).

39 *Id.* at 110; amended rule 2a-7(g)(8)(i) and (g)(8)(ii)(A).

40 Adopting Release at 113 (citing amended rule 2a-7(c)(3)).

41 *Id.* at 117 (citing amended rule 2a-7(c)(3)).

42 *Id.* at 126-27 (citing amended rule 2a-7(d)(1)(ii) and (iii)).

43 *Id.* at 128-31 (citing Part E of amended Form N-CR).

44 General Instruction D of amended Form N-CR.

45 Adopting Release at 88 (citing Item A.22 of amended Form N-MFP).

46 *Id.* at 168.

47 *Id.* at 173.

48 *Id.* at 170.

49 *Id.* at 171-72.

50 *Id.* at 169.

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