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Strategy Insights | Fixed Income

US Money Fund Reform Proposals, A Quick Look

The US Securities and Exchange Commission (SEC), on December 15, 2021, proposed amendments to certain rules that govern US money market funds (MMFs) under the Investment Company Act of 1940 (1940 Act). These proposed changes to SEC Rule 2a-7, if adopted, are designed to improve the resiliency and transparency of US money market funds and will impact the manner in which US money market funds operate.

These proposed reforms are a consequence of market events in March 2020 when growing concerns about the impact of the COVID-19 pandemic led investors to reallocate their assets into cash and short-term government securities. Specifically, heavy outflows from US institutional prime and tax-exempt MMFs placed stress in the short-term funding markets, which became "frozen," making it difficult for these funds to sell investments.

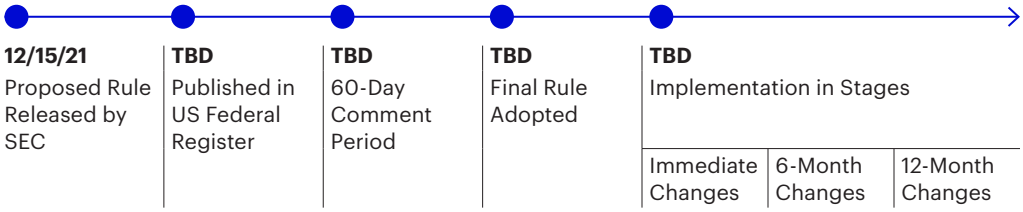
Proposed amendments:

- Remove the liquidity fee and redemption gate provisions from SEC Rule 2a-7.
- Increase the daily liquid asset and weekly liquid asset requirements for all MMFs to 25% and 50%, respectively.
- Implement swing pricing policies and procedures for US institutional prime and institutional tax-exempt MMFs.
- Address how money market funds should handle a negative interest rate environment.
- Specify how funds calculate weighted average maturity (WAM) and weighted average life (WAL).
- Amend certain reporting requirements on Forms N-MFP and N-CR.

There will be a 60-day comment period following publication of the proposed amendments in the US Federal Register. The proposed amendments have not yet been posted in the Federal Register.

When the amendments are finalized/adopted and published in the US Federal Register, the SEC has proposed implementation in stages to include (a) immediate changes, (b) 6-month changes, and (c) 12-month changes. Immediate changes will focus on the removal of liquidity fee and redemption gate provisions including related disclosures. At 6 months, funds must be in compliance with the increased daily liquid asset and weekly liquid asset requirements and all other aspects of proposal. In the final stage at 12 months, funds must be in compliance with swing pricing requirements and the requirements that address how money market funds should handle a negative interest rate environment.

Steps to Rule Adoption and Implementation



Discussion of proposed amendments

Remove the liquidity fee and redemption gate provisions in their entirety from existing rules

The SEC recognized that the current fee and gate provisions did not have their intended effect in March 2020 and appeared to have contributed to some of the stress that some money market funds and the short-term funding markets faced. As a result, they have proposed to remove the tie between liquidity thresholds and fee and gate provisions and, moreover, to remove fee and gate provisions from SEC Rule 2a-7 entirely.

Money market funds would continue to be able to suspend redemptions to facilitate an orderly liquidation of a fund under SEC Rule 22e-3 of the 1940 Act. The SEC believes that SEC Rule 22e-3 will continue to provide a money market fund the ability to suspend redemptions in certain circumstances and help address a significant run risk and potential harm to shareholders.

Increase the daily liquid asset and weekly liquid asset requirements to 25% and 50%, respectively (from 10% and 30%, respectively)

The SEC believes that increasing the minimum liquidity thresholds, paired with removing fees and gates from SEC Rule 2a-7, would be a more efficient manner of enhancing MMFs' access to liquidity and thus their ability to withstand market stress. The SEC believes the proposed increased thresholds will provide a more substantial buffer that would better equip money market funds to manage significant and rapid investor redemptions, while maintaining a MMF's flexibility to invest in diverse assets during normal market conditions.

The proposal would require a MMF to notify its board if daily liquid assets fell below 12.5% or weekly liquid assets fell below 25%, defined as a "liquidity threshold event," basically a decline in liquidity thresholds of 50%. MMFs would also be required to file Form N-CR upon a liquidity threshold event.

Additionally, a MMF would now be required to (i) determine its own minimum level of liquidity it seeks to maintain during times of stress, (ii) identify that level in its written procedures, (iii) periodically stress test such liquidity, and (iv) provide the fund's board with a report on the results.

Implement swing pricing policies and procedures

The SEC is proposing swing pricing as an effective tool to address shareholder dilution and potential institutional investor incentives to redeem quickly in times of liquidity stress to avoid further losses. Swing pricing is designed to ensure that the costs stemming from net redemptions are allocated fairly and do not give rise to a first mover advantage or dilution, under either normal or stressed market conditions.

Swing pricing would apply specifically to institutional prime and institutional tax-exempt MMFs when a fund experiences net redemptions for a pricing period.

Under the proposal, a fund would be required to adjust its NAV per share by a swing factor reflecting (i) spread and (ii) transaction costs, as applicable. Furthermore, if a fund has net redemptions that exceed a "market impact threshold," defined as 4% or more of the fund's net asset value, the swing factor would also include a (iii) market impact factor, or a good faith estimate of the market impact of selling a vertical slice of a fund's portfolio to satisfy the amount of net redemptions. This market impact factor is defined as the percentage decline in the value of each security in the portfolio if sold under current market conditions. The rule would permit a MMF to estimate costs and the market impact factor for each type of security with the same or substantially similar characteristics to all securities of that type in the fund's portfolio.

Additionally, the proposal would require that swing pricing policies and procedures be implemented by a board-designated swing price administrator and the administration of the swing pricing program be reasonably segregated from portfolio management of the fund.

Swing Pricing Process

Step		Result	
1	Did the fund have net redemptions?	**No:**	Do not apply a swing factor
		Yes:	Proceed to next step
2	Did the net redemptions exceed the market impact threshold?	**No:**	Apply swing factor that includes spread costs and other transactions costs of selling a vertical slice of the fund's portfolio.
		Yes:	Apply swing factor that includes spread costs, other transactions costs, **and a market impact factor** of selling a vertical slice of the fund's portfolio.

Address how money market funds should handle a negative interest rate environment

The SEC noted that twice in the past 15 years, the US Federal Reserve established the lower bound for the federal funds rate at 0% and 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.

Under the proposed rule, the SEC believes that, if interest rates turn negative, the board of a stable NAV MMF 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.

SEC Rule 2a-7, in its current form, does not explicitly address how money market funds must operate when interest rates are negative. SEC Rule 2a-7 only states that government and retail MMFs may seek to maintain a stable net asset value by using prescribed amortized cost and/or penny rounding methods. According to the SEC, if negative interest rates turn a stable NAV fund's gross yield negative, the fund would be unable to generate sufficient income to support a stable share price. Under these circumstances, a MMF would not be permitted to use amortized cost and/or penny rounding accounting methods to seek to maintain a stable NAV and would need to convert to a floating share price.

Notably, the proposed amendments would prohibit money market funds from operating a reverse distribution mechanism, routine reverse stock splits, or other device that would periodically reduce the number of the fund's outstanding shares in order to maintain a stable share price. In their rationale, the SEC stated that reverse distribution mechanisms would not be intuitive for retail investors in government and retail money market funds and that investors may be misled by such a mechanism.

The proposal expands government and retail money market funds' obligations to confirm that they can fulfill shareholder transactions if they convert to a floating share price. Specifically, a government or retail money market fund must determine that financial intermediaries that submit orders 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 intermediaries from purchasing the fund's share in nominee name. The SEC believes it is necessary that all parties involved are capable of processing transactions in a fund's shares in the event that the fund converts to a floating net asset value (FNAV).

Specify how funds calculate weighted average maturity (WAM) and weighted average life (WAL)

The SEC is proposing to require all funds to use market value to calculate WAM and WAL, as they believe 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.

Amend certain reporting requirements on Forms N-MFP and N-CR

The SEC is proposing to (i) add new requirements to Form N-CR, (ii) file Form N-CR reports in a structured data language (XML — eXtensible Markup Language), and include other amendments to (iii) improve the utility of information and (iv) remove reporting requirements related to fees and gates.

For Form N-MFP, the form that money market funds use to report monthly portfolio holdings and other key information, the SEC is proposing amendments to improve the SEC's ability to monitor money market funds. The amendments propose certain new information about a fund's shareholders and disposition of non-maturing portfolio investments and enhance the accuracy and consistency of information as well as the frequency of certain data points.

About risk

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations), and investors may not get back the full amount invested.

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