MONTHLY CASH REVIEW – AUGUST 2023 (USD)

Money Market Fund Reform 2023

The Securities Exchange Commission (SEC) recently proposed some changes to Rule 2a-7, the standard that governs money market mutual funds (MMFs). We consider some of the challenges of the new rule and what it could mean for the industry, fund providers and investors.

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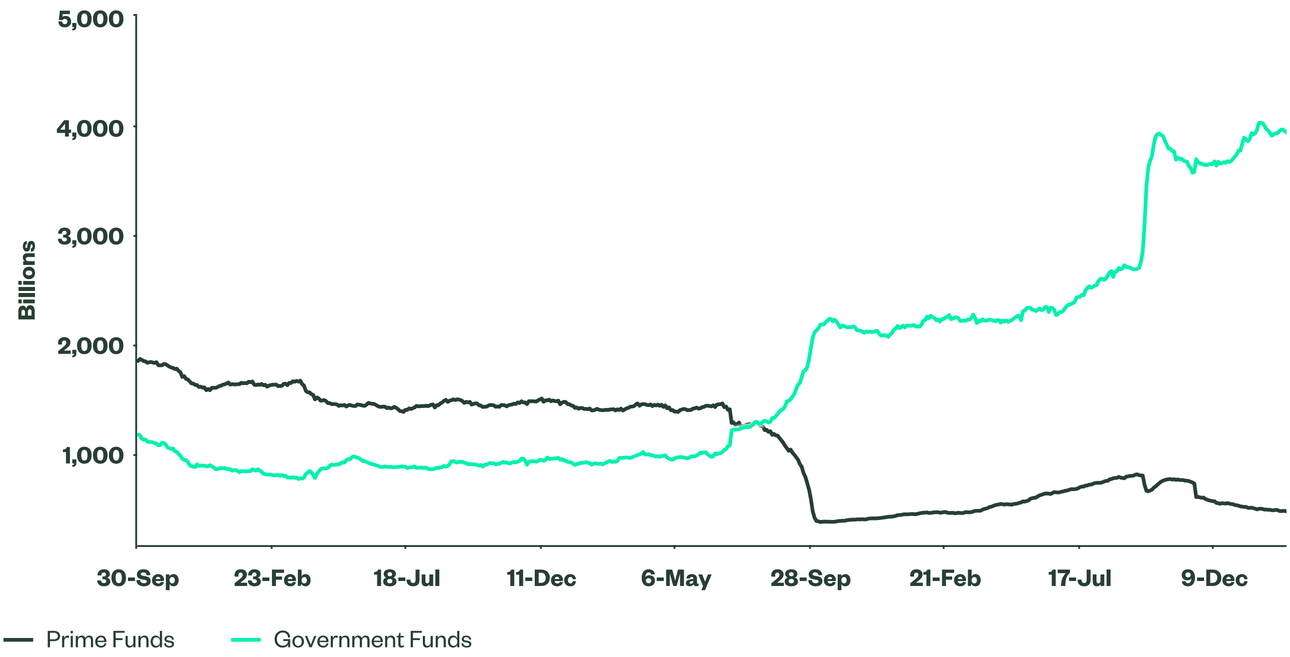
A Brief History

Moving cash back and forth between banks and non-bank entities, such as investment managers and brokerages, had become cumbersome, and sparked the invention of money market mutual funds in 1971. These new funds used amortized cost accounting, allowing them to report a steady USD 1.00 as net asset value (NAV), and, in theory, resembled a bank deposit. There were challenges in the early days, similar to what the cryptocurrency space is experiencing today. It took the SEC more than a decade to create Rule 2a-7, in 1983, which would specifically govern MMFs, making them separate and distinct from other (stock and bond) mutual funds. The rule was revised in the early 1990s and again after the Global Financial Crisis (GFC), in 2010 and 2014, to create a more robust, commingled vehicle.

The 2014 rule change that took effect in 2016 spurred the most significant shift in MMF strategies and led to over USD 1 trillion in assets moving from prime funds to government funds.

Figure 1: Investment Company Institute (ICI) Money Market Fund Assets Under Management (AuM)



Source: ICI, as of 31 August 2023

But some of the 2014 rule changes created unintended consequences, such as the first-mover advantage, thus necessitating further changes to the rule in 2023. The 2023 rule changes continue to focus on investor behavior during market disruptions and how to protect shareholders.

For instance, the SEC made several observations regarding the COVID-19-induced investor panic in March 2020. One of them was that institutional investors fled a week before retail investors. During the first two weeks of market turmoil (11–24 March), publicly offered institutional prime funds experienced a 30% redemption rate (about USD 100 billion). Some institutional prime MMFs experienced redemptions greater than 50% of their AuM. Alternatively, privately offered institutional prime funds had redemptions of just ~6% of their assets. Retail prime funds lost approximately 11% of their assets (about USD 48 billion), while tax-exempt funds, mostly retail, lost 8% (about USD 12 billion). The SEC's current reform is mainly aimed at rebalancing risks and eliminating the first-mover advantage for institutional prime funds.

So What Is New?

Amendments and Clarifications to Reporting Requirements

There were several clarifications to the reporting and calculation of certain MMF attributes. The calculation of a fund's weighted average maturity (WAM) and weighted average life (WAL) will now use market value and not amortized cost accounting. The implications of this change are de minimis, and will ultimately benefit the shareholders.

There will be amendments to Form N-CR, which would require reporting of liquidity threshold events and liquidity level declines of more than 50% below regulatory minimums, along with the clean-up of other reporting (fund identifiers, etc.) requirements.

There will also be amendments to Form N-MFP. Now MMFs will be required to report beneficial ownership of greater than 5%, the shareholder composition by SEC type and the market value of sales during the reporting period, new liquidity fees, and share cancelation on stable NAV funds (negative rates). There will also be enhanced reporting on repurchase agreements. All of these changes are seen as reasonable and achievable.

Negative Interest Rates

Thankfully, the SEC had the good sense to allow for stable NAV funds (retail prime, retail municipal, government, and Treasury funds) to be able to apply a reverse distribution mechanism (RDM), also known as share cancelation, if a fund's yield turns negative. Originally, the SEC proposed that all funds would have to float their NAV and would not be able to use RDM. This would have posed enormous challenges to accounting systems that could not process a variable NAV (phew, potential crisis averted).

Daily and Weekly Liquidity Requirements

The SEC has increased the liquidity requirements of prime funds. Reminder: Liquidity is considered ready cash or securities that can be easily converted to ready cash, like US Treasury securities. The daily (1-business-day) liquidity requirement will increase to 25% of AuM, when previously it was 10%. The weekly (5-business-day) liquidity requirement will increase to 50% of AuM, when previously it was 30%. This increase could be worth 1–3 bp of yield depending on the interest rate environment. Most funds have already been running their liquidity levels at or close to these new requirements; therefore, this rule change is not a game-changer.

Mandatory Liquidity Fee

One of the unintended consequences of the 2014 rule changes was the potential for a fund's board to apply a redemption gate or a liquidity fee on a fund if the fund's weekly liquidity level dropped below 30%. The SEC notes that form N-MFP data suggests publicly offered institutional prime funds increased their sales of long-term securities in March 2020 to 15% of total assets vs. a 4% monthly average between October 2016 and February 2020. Bid offer spreads by the SEC's estimation were 25–55 bp wider during the period in March 2020, thus providing evidence that funds were incurring significant liquidity costs when selling assets.

The SEC concluded two things. First, the potential for a redemption gate caused more fear than a liquidity fee (not getting any money was worse than getting less money). And second, maintaining the liquidity level in a fund caused forced selling in times of stress. So, the SEC has removed the tie between a fund's liquidity levels and a fee or a gate, and focused on the cost of that liquidity.

The SEC had proposed a swing price mechanism. This mechanism is common in Europe and in other non-SEC-regulated comingled vehicles in the US. The regulator had proposed that if a fund loses 4% of its AuM, the fund would have to calculate a swing price. This means the fund would calculate the cost of selling a pro rata amount of each security in the portfolio and apply that cost to the NAV.

Most, if not all, fund managers said this would not work. Simply, there was not enough time between the fund closing and determining the amount of the redemptions, and then implementing a swing price. The SEC listened, modified, and adopted a different rule. The new rule will require a fund that loses 5% or more of its AuM to apply a determined fee to the NAV for those who are redeeming. The amount of the fee will be calculated using ***a good faith estimate*** on market liquidity and the cost of liquidating those bonds in the portfolio.

The SEC has made it clear that there is no discretion in applying the fee. The fee will be determined anytime there are redemptions of 5% or more of AuM and it will be applied at the start of the redemptions, not at the end. The current rule would allow the fee to be applied after the fund had seen redemptions, essentially after everyone had "run."

If the impact to the NAV from the estimated cost of the redemption is less than 1 bp of the fund's NAV, no fee needs to be applied. The impact will be considered de-minimis. The SEC believes this to be the result the majority of the time. In the event that the estimated cost of liquidity is larger than 1 bp, the size of the fee would be determined by making ***a good faith estimate*** of the liquidity costs the fund would incur if it were to sell a pro rata share of each position in the fund. This gets complicated. If the fund cannot estimate the cost of liquidity, the fee would default to 1.0%. Recall "breaking the buck" is a 0.5% move in NAV. There is no limit on the size of the fee a fund can apply. The previous rule (2014) limited the fee to 2%. The SEC has removed this limit.

The board is responsible for administrating the fee, but it can delegate that authority to the fund's investment advisor. We suspect all boards would delegate. The current rule does not allow the board to delegate. Thus the current rule creates a delay in applying a fee. The new rule will trigger the fee; no decision making is necessary by the board or anyone else. The cost of a vertical slice is intended to compensate the remaining shareholders for staying in the fund, and not penalize them for staying in the fund as the current rule allows. The SEC is trying very hard to remove the first-mover advantage.

A good faith estimate can be difficult because not all securities price easily. Because of this, the SEC has provided guidance for estimating the price of a security. First, grouping securities in certain categories by region, sector, issuance size, credit worthiness, distribution (widely held), etc. Second, daily and weekly liquidity should incur zero cost. Third, a grid could be used to apply different market conditions to the vertical slice: credit stress, liquidity stress, and interest rate stress. This grid would need to be updated from time to time.

Importantly, the fee is only applied to redemptions. Thus, intermediaries that net their flows will need to update their reporting. There will be two prices – one for subscribing and one for redeeming in case a fee is applied.

Some Questions We Are Asking

Will fund managers close/shut down institutional prime funds? –

It is possible that some fund managers will determine the operational mechanics of the new fee structure as more than they want to take on at this time.

If the fee is applied, how will I know what the fee is? –

You will not know the fee until the NAV is struck and you receive proceeds from your redemption. It is unclear if the standard practice will be to disclose the fee or just report the NAV with the fee included.

Will institutional prime funds need to close earlier? –

Continuing to support multiple intraday pricing points could pose challenges. If, at the 3 p.m. close, it is determined that a fee must be applied, those that had redeemed at 8 a.m. or 12 p.m. would need to have some amount of their redemption returned and applied as the fee. This could force funds to only have one pricing point each day.

What impact could this have on the commercial paper or certificate of deposit markets? –

It is possible that Commercial Paper (CP) and Certificates of Deposit (CD) spreads may widen vs. US Treasury debt. This did happen in the lead-up to the deadline for the implementation of the 2014 changes in October 2016. Eventually the markets did rebalance and spreads gravitated back to their historical averages.

Will this impact other cash vehicles?

At the time of this writing, we do not see this impacting other cash credit comingled vehicles, like bank-regulated short-term investment funds.

What is the timing on implementation of these new rules?

Please reach out to your State Street representative with additional questions or to schedule a follow-up call on this topic.

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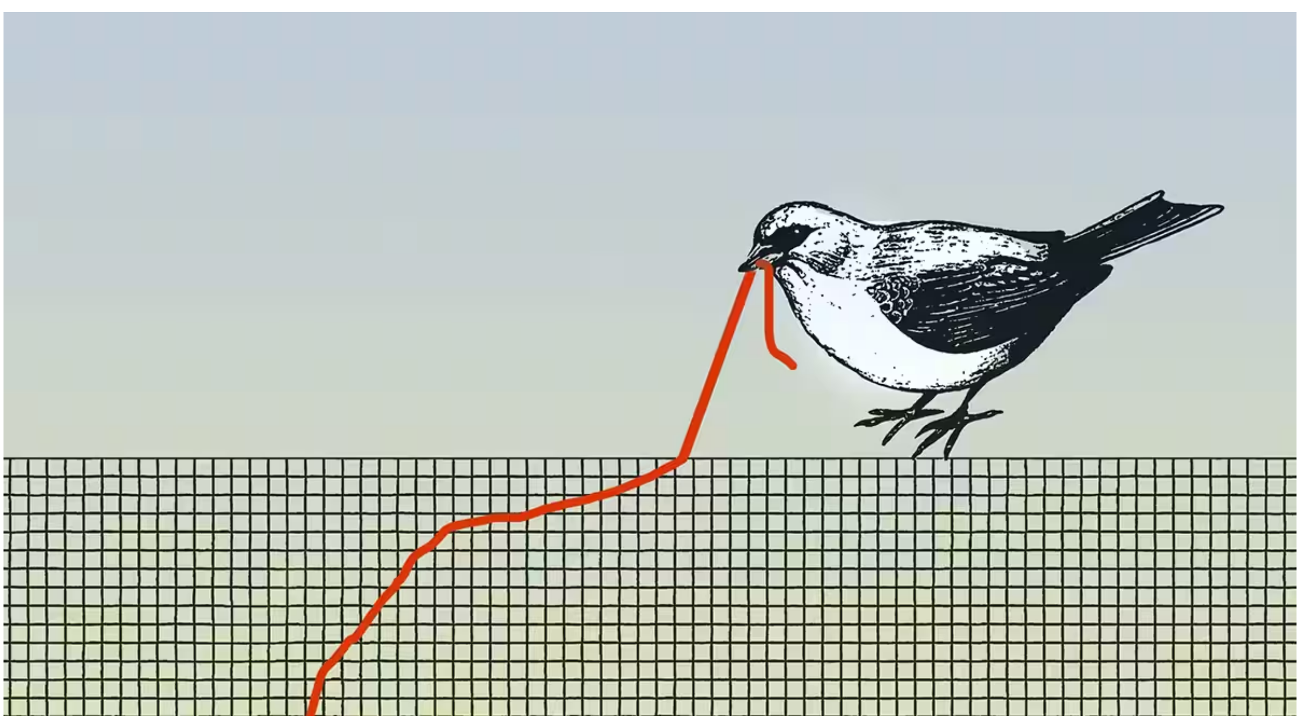

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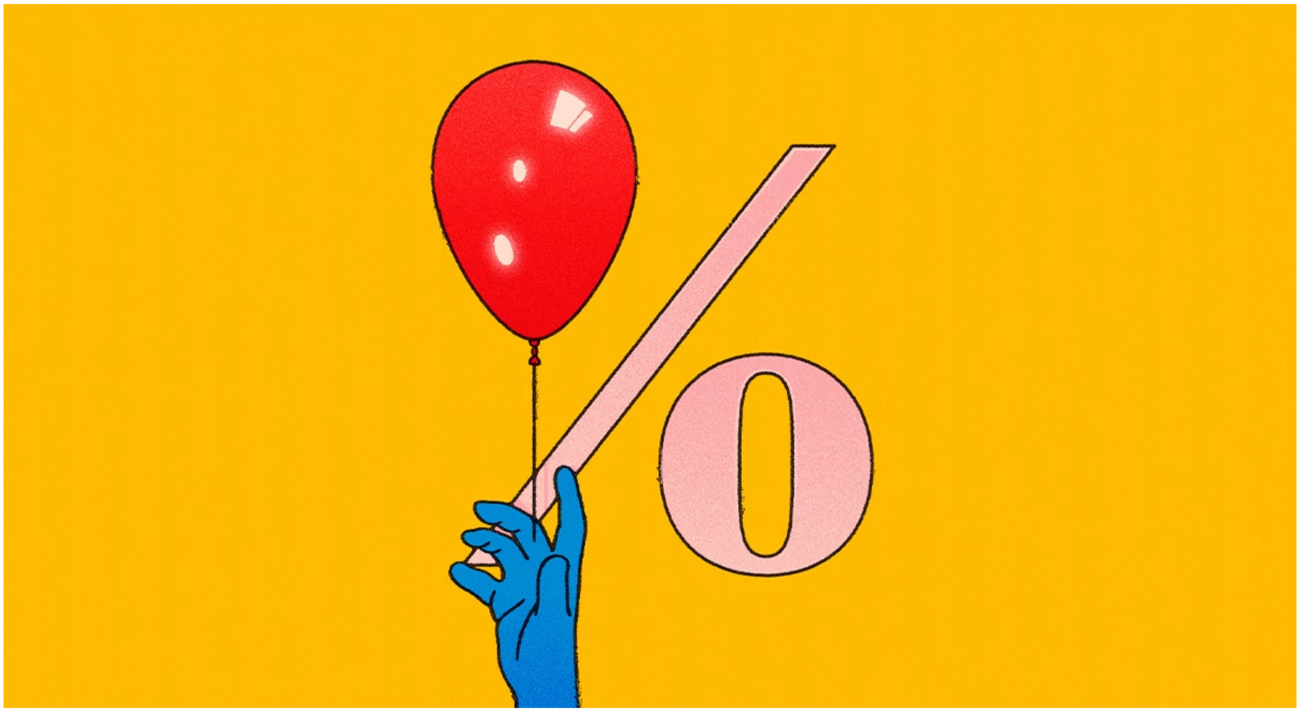
September 6, 2023



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