FORsights

Sweeping Changes for Money Market Funds

On July 12, 2023, the SEC voted three to two along party lines to approve a final rule making significant updates to requirements for money market funds (MMFs) and large liquidity advisers. Highlights include:

- **Increase minimum daily and weekly liquidity requirements to 25% and 50%**
- **Remove provisions on redemption gates and decouple the imposition of liquidity fees from a fund's liquidity level**
- **In the most significant change from the proposal, the SEC backed away from swing pricing and instead will require institutional prime and tax-exempt MMFs to impose redemption fees. Non-government MMFs could impose a discretionary liquidity fee with board approval**
- **Additional reporting requirements for large liquidity fund advisers**
- **Specific guidance for a negative interest rate environment**

Effective Date
60 days after Federal Reserve publication

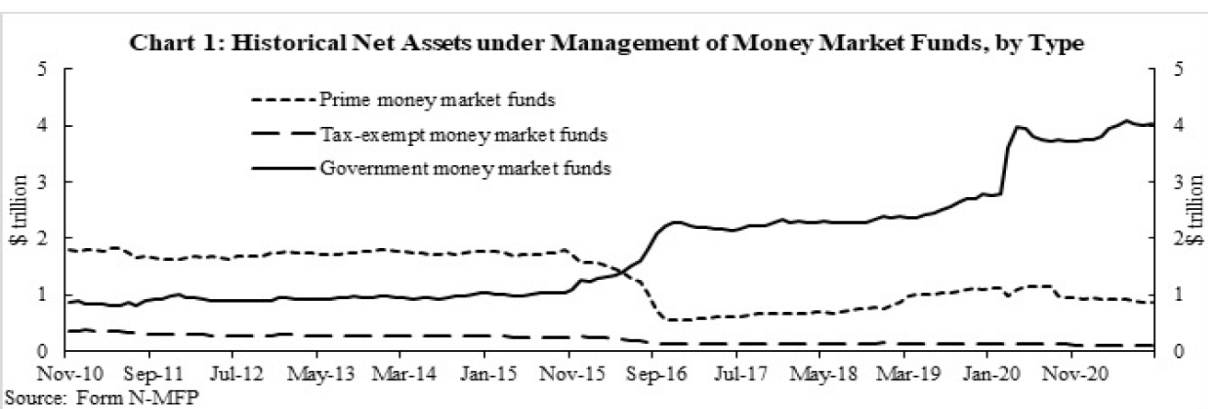
Portfolio & Discretionary Liquidity Fees
6 months after the effective date

Form N-CR, N-MFP, & PF Changes
June 11, 2024

Mandatory Liquidity Fees
1 year after effective date

Background

MMFs provide principal stability by investing in high-quality, short-term debt securities, *e.g.*, Treasury bills, repurchase agreements, or commercial paper, whose value does not fluctuate significantly in normal market conditions. Per the SEC's data, there are 294 SEC registered MMFs with more than $5.7 trillion in assets. Most of the assets are held by government MMFs, $4.4 trillion; followed by prime MMFs, $1 trillion; and tax-exempt MMFs, $119 billion.



Source: Form N-MFP Data, period ending March 2023, sec.gov

These updates are a result of the March 2020 market jolts from the economic uncertainty about the impact of the COVID-19 pandemic. MMF safeguards put in place after the 2008 mortgage crisis did not work as intended and may have even escalated a downward price spiral for certain financial instruments. The 2020 market movements highlighted the continuing susceptibility to heavy redemptions in times of stress. To stem market outflows, the Federal Reserve created the Money Market Mutual Fund Liquidity Facility that provided almost $50 billion in loans to financial institutions.

Minimum Liquidity Levels

After the 2008 mortgage crisis, the SEC updated Rule 2a-7 to establish liquidity requirements—a taxable MMF must hold at least 10% of its total assets in daily liquid assets (cash, U.S. Treasury securities, or securities that mature into cash within one day) and all MMFs must have at least 30% of their assets in weekly liquid assets (cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week). These requirements would allow MMFs to meet redemptions even in market conditions in which MMFs cannot rely on a secondary or dealer market to provide liquidity.

The SEC concluded these threshold levels did not have the desired effect in March 2020. The final rule increases daily and weekly liquid asset requirements to 25% and 50% from 10% and 30%. These increased thresholds are based on the level of liquid assets needed to meet redemptions, based on March 2020 redemptions. The final rule carries over the existing provision that a MMF must comply with the daily and weekly thresholds at the time each security is acquired. A fund that falls below 25% daily liquid assets or 50% weekly liquid assets may not acquire any assets other than daily liquid assets or weekly liquid assets, respectively, until it meets the minimum thresholds.

Tax-exempt MMFs will continue to be exempt from the daily liquid asset requirements.

The final rule requires a fund to notify its board of directors within one day if the fund 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). The fund also must provide the board a brief description of the facts and circumstances that led to the liquidity event within four business days.

Removal of Redemption Gates

Rule 2a-7 previously allowed a MMF to impose a liquidity fee of up to 2% or temporarily suspend redemptions, *i.e.*, gate, if the fund's weekly liquid assets fall below 30% of its total assets and the fund's board of directors determines that these actions were in the fund's best interests. The legacy rule also included a 1% default liquidity fee if a nongovernment fund's weekly liquid assets fall below 10%, unless the board determines that a fee would not be in the fund's best interest. Fees and gates were intended to provide a cooling-off period to offset short-term investor panic and preserve liquidity levels in times of market stress. These provisions did not achieve these objectives during March 2020. In March 2020, even though no MMF imposed a fee or gate, the possibility of their imposition contributed to investors' incentives to redeem and for fund managers to maintain weekly liquid asset levels above the threshold, rather than use those assets to meet redemptions.

The final rule removes a MMF's ability to impose temporary redemption gates. The amendments also remove the regulatory tie that permits MMFs to impose liquidity fees if their weekly liquid assets fall below a certain threshold.

Disclosures – Form N-CR

New public disclosure includes:

If daily or weekly liquid assets declined by more than 50% below the regulatory minimums, *i.e.*, if a 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. Details include:

- The initial date on which the fund fell below either the 25% weekly liquid assets or the 12.5% daily liquid assets threshold
- The percentage of the fund's total assets invested in both weekly liquid assets and daily liquid assets on the initial date of a liquidity threshold event
- A brief description of the facts and circumstances leading to the liquidity threshold event
- The amount of both its weekly liquid assets and its daily liquid assets, regardless of whether it has dropped below one or both thresholds

Mandatory Liquidity Fee Requirements – Institutional MMFs

Comment letter feedback strongly opposed a requirement for institutional prime and tax-exempt MMFs to adopt swing pricing policies and procedures to adjust a fund's current net asset value (NAV) per share by a swing factor when the fund has net redemptions.

The final rule will instead require institutional prime and tax-exempt MMFs to impose mandatory liquidity fees when a fund experiences daily net redemptions that exceed 5% of net assets. If this threshold is crossed, the fund must apply a liquidity fee to all shares that are redeemed at a price computed on that day. A fund that offers multiple NAV strikes will need to develop a method for applying the fee to shares redeemed in an earlier pricing period on that day. Several possible approaches are included in the final rule.

The final rule contains a de minimis exception—if a fund's liquidity costs are less than one basis point, no mandatory liquidity fee is required.

Non-government MMFs would be allowed to impose a discretionary liquidity fee if the fund's board (or its delegate) determines that a fee is in the fund's best interest.

Under the final rule, an institutional fund's board will be responsible for administering both the mandatory and discretionary liquidity fees, but the board can delegate this responsibility to the fund's investment adviser or officers, subject to written guidelines established and reviewed by the board and ongoing board oversight. 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. These written guidelines should specify the manner in which the delegate is to act with respect to any discretionary aspect of the liquidity fee mechanism. The board also will need to periodically review the delegate's liquidity fee determinations.

See **Appendix** for additional details—Table 1 for mandatory fees updates and Table 2 for discretionary fee updates.

Due to differences in investor behavior and liquidity costs, retail and government MMFs are not required to implement mandatory liquidity fee policies.

Disclosures – Mandatory & Discretionary Liquidity Fees

Form N-MFP is amended to require that MMFs report whether they 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. Funds will be required to identify whether a fee was a mandatory fee or a discretionary fee. For a mandatory liquidity fee, a fund will be required to identify whether the amount of the fee was based on good faith estimates of the fund's liquidity costs or was a default fee. Funds should report the total dollar value of the fee applied to redemptions and the amount of the fee as a percentage of the value of shares redeemed.

Form N-1A is amended to require MMFs to provide narrative risk disclosure related to both mandatory and discretionary liquidity fees in their prospectuses.

Form N-MFP Changes

New Items

- **Shareholder concentration.** The final rule requires MMFs to report the type of beneficial or record owner who owns 5% or more of the shares outstanding in the relevant class.
- **Shareholder composition.** Funds other than government or retail MMFs must identify the percentage of investors within certain categories.
- **Prime MMF selling activity.** The gross market value of portfolio securities a prime MMF sold or disposed of during the reporting period for each investment category (CD, time deposit, U.S. Treasury debt, etc.). Portfolio securities held by a fund until maturity are excluded from this disclosure.
- **Share cancellation.** A fund must report if it used share cancellation during the reporting period and, if so, the dollar value of shares canceled, the number of shares canceled, and the dates on which it used share cancellation.

Other Updates

The final rule removes the current requirement to provide a name related to fee/expense waivers and streamlines several reporting categories. The final rule makes updates to the disclosures related to repurchase arrangements. The final rule did not carry forward the proposal's requirement for lot-level details, which received strong negative comment letter feedback. New required details include:

- The name of the counterparty in a repurchase agreement
- Whether a repurchase agreement is centrally cleared and the name of the central clearing counterparty, if applicable
- If a repurchase agreement was settled on a triparty platform
- The CUSIP of the securities involved in the repurchase agreement

Form N-MFP will now require a MMF to include in the monthly filing daily details on the percentage of total assets invested in daily liquid assets and in weekly liquid assets, NAV per share (including for each class of shares), and shareholder flow data. This data is currently reported on a weekly basis. Currently, funds must report seven-day gross yields (at the series level) and seven-day net yields (at the share class level) as of the end of the reporting period. Form N-MFP now requires funds to report this information for each business day.

Form PF – Large Liquidity Fund Advisers

Liquidity funds follow similar investment strategies as MMFs, but investment advisers are not required to register liquidity funds as investment companies under the 1940 Act. Like MMFs, liquidity funds are managed to maintain a stable NAV or minimize principal volatility. However, liquidity funds are not required to comply with the risk-limiting conditions of Rule 2a-7, such as the restrictions on the maturity, diversification, credit quality, and liquidity of investments.

The Form PF amendments would apply only to large liquidity fund advisers, which generally are SEC-registered investment advisers that advise at least one liquidity fund and manage—collectively with their related persons—at least $1 billion in combined liquidity fund and money market fund assets. Large liquidity fund advisers today are required to file information on Form PF quarterly, including certain information about each liquidity fund they manage. Under the final amendments, new details in section 3 include:

- **Operational Information.** Currently, advisers must report whether the liquidity fund uses certain NAV calculation methodologies to determine how a fund might try to maintain a stable NAV. The final rule replaces current questions with a requirement for advisers to report the information more directly, by requiring advisers to report whether the liquidity fund seeks to maintain a stable price per share and, if so, to provide the price it seeks to maintain.
- **Assets and portfolio information.** The final rule requires advisers to report cash separately from other categories when reporting assets and portfolio information concerning repo collateral. (Currently, there is not a distinct category for cash for reporting fund assets). The rule also updates the definition of "weekly liquid assets" to specify that the term includes "daily liquid assets."
- **Additional repo reporting.** Advisers will be required to provide clearing information for repos about liquidity fund activity in various market segments. Form PF will continue to permit the advisers to aggregate certain information if multiple securities of an issuer are subject to a repo. This aligns with comparable reporting requirements under amended Form N-MFP highlighted above.
- **Subscriptions/Redemptions.** Advisers must report the total gross subscriptions (including dividend reinvestments) and total gross redemptions for each month of the reporting period.
- **Financing information.** Advisers must report financing information to indicate whether a creditor is based in the U.S. and whether it is a "U.S. depository institution," rather than a "U.S. financial institution," as section 3 currently provides. Advisers also must indicate if a creditor is based outside the U.S. but will not have to indicate whether that non-U.S. creditor is a depository institution. These changes better align with Federal Reserve reporting.
- **Investor information.** Advisers must provide the following information for each investor that beneficially owns 5% or more of the reporting fund's equity: (1) the type of investor; and (2) the percent of the reporting fund's equity owned by the investor.
- **Disposition of portfolio securities.** New Item F advisers will report information about the portfolio securities the liquidity fund sold or disposed of during the reporting period (not including portfolio securities that the fund held until maturity). Advisers will report the gross market value sold or disposed of for each investment category.
- **WAM and WAL.** Consistent with the WAL and WAM definition updates notes below, WAM and WAL must be calculated with the dollar-weighted average based on the percentage of each security's market value in the portfolio.

Negative Interest Rates

Twice in the past 15 years, the Federal Reserve set the lower bound of the target range for the federal funds rate at 0% to spur borrowing and other economic activity. If negative interest rates occur in the future, the gross yield of a MMF's portfolio may turn negative, which would make it challenging or impossible for a government or retail MMF to maintain its stable share price, as the fund would begin to lose money.

Currently, Rule 2a-7 does not explicitly address how MMFs must operate in a negative interest rate environment. Government and retail MMFs can maintain a stable share price by using amortized cost and/or penny-rounding accounting methods if the fund's board of directors believes the stable share price fairly reflects the fund's market-based NAV per share. 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. In this circumstance, a fund would not be allowed to use amortized cost and/or penny-rounding to maintain a stable share price, but rather would need to convert to a floating share price.

In Europe, some MMFs used a reverse distribution mechanism for periods of negative interest rates before the practice was prohibited by regulators. Under a reverse distribution mechanism, investors would see a stable share price but with a reduction in their number of shares for a fund that is generating a negative gross yield.

The proposal would have explicitly prohibited MMFs from operating a reverse distribution mechanism, routine reverse stock split, or other device that periodically reduces a fund's outstanding shares to maintain a stable share price. After considering comment letter feedback, the SEC modified the final rule to allow more flexibility. Under the final rule, retail and government MMFs may manage a negative interest rate environment either by converting from a stable share price to a floating share price or by reducing the shares outstanding to maintain a stable NAV per share.

Should a negative interest rate environment occur in the future, the final rule contains additional board and tax considerations if a share cancellation approach is appropriate. Disclosure would be required before and during a negative interest rate event about the fund's share cancellation practices and the impact to investors.

Weighted Average Maturity & Weighted Average Life

The 2010 rule updates shortened the permitted weighted average portfolio maturity (WAM) and introduced a separate weighted average life (WAL) to limit the portion of a fund's portfolio held in longer-term adjustable rate securities. These calculations help measure a portfolio's risk—a longer WAM and WAL may increase a fund's exposure to interest rate risks. Currently, funds use different approaches when calculating WAM and WAL. A majority of MMFs calculate WAM and WAL based on the percentage of each security's market value in the portfolio, while others base calculations on the amortized cost of each portfolio security. The final rule specifies that WAM and WAL calculations should use market value.

Effective Dates

- The final rule is effective 60 days after **Federal Register** publication and compliance dates are staggered:
- Amendments to Rule 2a-7, Rule 31a-2, and Form N-1A are effective 60 days after **Federal Register** publication.
- Amendments to Forms N-MFP, N-CR, and PF have a compliance date of June 11, 2024.
- The minimum portfolio liquidity requirements and the discretionary liquidity fee provision will be effective six months after **Federal Register** publication.
- Funds have 12 months after the effective date to comply with the mandatory liquidity fee framework.

Conclusion

Forvis Mazars will continue to follow this project. Visit our **Asset Management site** to learn more. If you have questions about these changes, reach out to one of our professionals today.

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Appendix

Table 1 – Summary of Changes to Default & Mandatory Liquidity Fee		
	Superseded Guidance **Default Liquidity Fee**	**Final Rule** **Mandatory Liquidity Fee**
Description	A default fee is charged to redeeming investors when the fund's weekly liquid assets decline below 10%, subject to certain board discretion.	A mandatory fee is charged to redeeming investors when the fund has net redemptions above 5% of net assets.
Scope – Funds	Prime and tax-exempt MMFs.	Institutional prime and institutional tax-exempt MMFs.
Scope – Investors	Redeeming investors are charged a liquidity fee. The liquidity fee does not affect subscribing investors.	
Threshold	If weekly liquid assets fall below 10%, then a default fee would apply to redeeming investors, unless the board determines a fee is not in the fund's best interest.	Fees are triggered when the fund has total daily net redemptions that exceed 5% of net assets based on flow information available within a reasonable period after the last computation of the fund's NAV on that day, or such smaller amount of net redemptions as the board determines.
Duration and application of the charge	The liquidity fee begins to apply on the business day after the fund crosses the 10% weekly liquid asset threshold. Once imposed, the fee must be applied to all shares redeemed and remains in effect until the fund's board determines that imposing a fee is not in the best interests of the fund. If the fund has invested 30% or more of its total assets in weekly liquid assets as of the end of a business day, the fund must cease charging a fee effective the beginning of the next business day.	The fund must apply a liquidity fee to all shares that are redeemed at a price computed on the day the fund has total daily net redemptions that exceed 5% of net assets.
Size of the charge	The default fee is 1%, unless the fund's board of directors determines that a higher or lower fee level is in the best interests of the fund.	The fee generally 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 to satisfy net redemptions.

Table 1 – Summary of Changes to Default & Mandatory Liquidity Fee		
	Superseded Guidance **Default Liquidity Fee**	**Final Rule** **Mandatory Liquidity Fee**
		MMFs can estimate costs and market impacts for each security type 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. If the estimated liquidity costs are less than 0.01% of the value of the shares redeemed, a fund is not required to apply a fee. If a fund cannot estimate the selling costs of each portfolio security in good faith and supported by data, a default liquidity fee of 1% of the value of shares redeemed applies.
Maximum charge	The fee cannot exceed 2% of the value of the shares redeemed.	The fee has no upper limit.
Administration	The board is responsible for administering the liquidity fee requirement. The board may not delegate liquidity fee determinations.	The board is responsible for administering the liquidity fee requirement, but the board can delegate this responsibility to the fund's investment adviser or officers, subject to written guidelines established and reviewed by the board and ongoing board oversight.

Table 2 – Summary of Changes to Discretionary Liquidity Fee		
	Superseded Guidance Discretionary Liquidity Fee	**Final Rule Discretionary Liquidity Fee**
Description	A discretionary fee may be charged to redeeming investors when the fund's weekly liquid assets decline below 30% and the board determines that a fee is in the best interests of the fund.	Irrespective of liquidity or redemption levels, a discretionary fee is charged to redeeming investors when the board determines that the fee is in the best interests of the fund.
Scope – Funds	Prime and tax-exempt MMFs. Government MMFs may opt in.	
Scope – Investors	Redeeming investors are charged a liquidity fee. The liquidity fee does not affect subscribing investors.	
Threshold	If weekly liquid assets fall below 30%, then a fund may institute a fee if the board determines that the fee is in the best interests of the fund.	If the board determines that doing so is in the best interests of the fund, the board must impose a liquidity fee.
Duration and application of the charge	Once imposed, the discretionary fee must be applied to all shares redeemed and remain in effect until the fund's board determines that imposing a fee is not in the best interests of the fund. If the fund has invested 30% or more of its total assets in weekly liquid assets as of the end of a business day, the fund must cease charging a fee effective the beginning of the next business day.	Once imposed, the discretionary fee must be applied to all shares redeemed and remain in effect until the fund's board determines that imposing a fee is not in the best interests of the fund.
Size of the charge	The rule does not prescribe the manner or amount of the fee calculation. The fee, however, must be in the best interests of the fund.	
Maximum charge	The fee cannot exceed 2% of the value of the shares redeemed.	
Administration	The board is responsible for administering the liquidity fee requirement. The board may not delegate liquidity fee determinations.	The board is responsible for administering the liquidity fee requirement, but the board can delegate this responsibility to the fund's investment adviser or officers, subject to written guidelines established and reviewed by the board and ongoing board oversight.