Institutional Prime Money Market Funds, Reformed and Ready for Prime Time?

As the SEC's MMF rule amendments come into effect in October 2023, investors looking to return to institutional prime funds may want to be aware of the pros and cons of these changes.

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Introduction

Three years after a Covid-induced market panic that caused runs on prime money market funds ("MMFs"), the Securities and Exchange Commission (SEC) has adopted amendments to Rule 2a-7, the principal rule governing the structure and operation of MMFs. The final rule both removed the mandatory redemption requirement (gates) thought by many to be the trigger for the March 2020 MMF runs and severed the tie between the revised "dynamic liquidity fee" requirement and a preset portfolio liquidity threshold. Other changes include higher minimum liquidity requirements and enhanced portfolio disclosures.

As the new rule is slated to be effective on October 2, 2023, institutional cash investors should determine how these changes will impact their use of MMFs as cash management vehicles. Those contemplating a return to institutional prime funds may want to be aware of the complex liquidity fee requirements that retain some of the characteristics of the abandoned "swing pricing" mechanism in the SEC's original 2021 proposal.

The rule change came at a pivotal time for liquidity managers. A decade of MMF reforms and last spring's deposit flight from regional banks both offer good reasons for investors to reflect on how to better incorporate overnight cash vehicles in overall liquidity strategies. We also think that complex and unknown aspects of dynamic liquidity fees may challenge prime fund investors and sponsors in future market stresses in unanticipated ways. As a precaution, we will remain on the sideline for institutional prime funds until the liquidity mechanism is battle-tested in an actual stressed situation that involves redemptions above 5%.

A Brief History of Recent MMF Reforms

The new rule is the SEC's third version of MMF reform, originally enacted in the aftermath of the 2007-2008 financial crisis. The failure of Lehman Brothers in 2008 led to one prime fund "breaking the buck" (net asset value ("NAV") falling below $1) and started a run on other prime funds which eventually compelled the U.S. Treasury to establish a temporary MMF guarantee to stabilize outflows. Two rounds of reforms adopted in 2010 and 2014 were meant to improve prime funds' ability to withstand market stresses, but the second version had the opposite effect. In addition to requiring institutional prime and tax-exempt funds to float their NAVs, the SEC introduced a system of redemption "fees and gates" linked to prime funds' WLA levels. When the Covid-19 pandemic led to stresses in the broader short-term funding markets in March 2020, concerns of being trapped by redemption gates led to runs on some prime funds. With the U.S. Treasury's assistance, the Federal Reserve introduced another MMF liquidity facility to stop the outflows. This new rule is expected to be the final mile in the MMF regulatory journey.

A Recap of Rule Changes

Here is a high-level overview of the amendments that will take effect in October 2023.

***Redemption gates and linkage of liquidity fees to thresholds are removed*:** Institutional prime and tax-exempt funds will no longer be subject to mandatory or voluntary redemption gates. The 30% weekly liquid assets threshold to impose a fee will also be removed. This revision removes the incentive to cash out before an arbitrary threshold is breached and "fees and gates" are imposed.

***Minimum daily and weekly liquidity levels are increased*:** Funds must increase their daily liquid assets (DLA) from 10% of the portfolio to 25%, and weekly liquid assets (WLA) from 30% to 50%. The increases provide a more substantial liquidity buffer against sudden market stresses.

A dynamic liquidity fee is introduced: Institutional prime and tax-exempt funds will impose mandatory liquidity fees when net redemptions exceed 5% of assets unless the associated liquidity costs are *de minimis*. Any non-government fund may charge a discretionary liquidity fee if its board deems it beneficial. This dynamic liquidity charge, similar to the proposed but abandoned "swing factor," is meant to let departing shareholders bear the cost of liquidity conversion in a stressed market and compensate those that stay.

***Flexibility with negative interest rate handling*:** In a negative rate environment, a government fund may elect to maintain its $1 stable NAV by either paying a negative dividend through share cancellations or converting to variable NAV calculations. This stipulation is a reversal from the SEC's earlier requirement forcing government funds to abandon stable NAVs. The probability of negative yields seems low in the current interest rate cycle.

Standardized calculations and amended reporting: Funds will calculate weighted average maturity and weighted average life based on the market values of securities. Enhanced reporting standards provide some shareholder concentration information, selling activity and the administration of liquidity fees.

Compliance Dates: The new rule was published in the Federal Registry on August 3, 2023, and is slated to be effective on October 2, 2023. The implementation period for mandatory fees is 12 months from the effective date, while the period for discretionary fees is six months. New reporting requirements will take effect on day one.

Regulatory Goals vs. Industry Interests

Before delving into the new rule's pros and cons for MMF investors, we should acknowledge that what regulators intend to achieve does not always align with what investors or the fund sponsors want. For example, Federal Reserve officials often consider MMFs as shadow banks with systemic risk outside their regulatory reach[1]. In introducing the final amendments, SEC Chair Gensler noted that changes "will make money market funds more resilient, liquid and transparent, including in times of stress." Left unsaid are the potential costs of these purported benefits to all parties involved. How the amendments influence the behaviors of other inhabitants in the liquidity market ecosystem, such as both domestic and foreign banks, corporate borrowers, various other groups of investors and third-party intermediaries, will have significant ramifications on the future viability of prime funds as effective institutional cash management tools.

[1] Melanie L. Fein, "Shooting the Messenger: The Fed and Money Market Funds", page 5, March 9, 2012. https://www.sec.gov/comments/4-619/4619-157.pdf

Variable NAVs Are a Bridge Too Far for Many

The last round of reforms stripped institutional prime funds of their ability to price NAVs at a fixed $1. The combined effect of switching to variable NAVs and imposing redemption gates resulted in institutional prime share assets plunging 87% from $926 billion to $123 billion in 2016. Correspondingly, institutional government share assets gained 82% from $888 billion to $1.6 trillion in the same year.[2] Although variable NAV funds continue to qualify as cash instruments in accounting conventions and receive simplified income tax treatment, cash investors prefer the simplicity offered by constant NAV government funds. Some institutions amended their investment policies to exclude prime funds as eligible cash instruments. Whether the removal of redemption gates will enable these investors to reconsider prime funds has no clear answers, as some investors are wary of any credit risk in their overnight liquidity vehicles and others dislike daily market value fluctuations. To these investors, variable NAVs remain the main impediment returning to prime funds. Even those who see the benefit of prime fund investments may consider it a low priority to advocate for investment policy amendments before their boards of directors in the recent low yield environment.

Tougher Liquidity Requirements Lead to Lower Yield Potential

Yield spreads over comparable government MMFs and bank deposits are a main reason to consider prime funds, as credit investments typically pay higher rates than government securities. After nearly two years of essentially zero return during the Covid-19 pandemic, institutional prime funds returned on average 0.15% more than government funds in 2022, and 0.14% this year through July, according to Crane Data. Tougher liquidity requirements in the SEC amendments may squeeze this advantage and make the prime option less attractive.

As noted earlier, all funds must increase their DLAs from 10% of the portfolio to 25%, and WLAs from 30% to 50%, to build a more substantial liquidity buffer against sudden market stresses. Funds typically create liquidity either by holding securities of shorter maturities, such as repurchase agreements, or buying Treasury and government securities, which qualify as liquid assets by the SEC's definition. In a normal interest rate environment, the shorter the maturity, the lower its yield. In a normal credit environment, a government security yields less than a credit instrument of comparable maturity. Either of the liquidity raising methods will likely result in lower yield potential.

As an added precaution, MMFs typically have DLA and WLA levels significantly above the SEC-mandated minimums to reduce the chance of breaching them inadvertently. If this practice continues, one should expect substantially more than 50% of fund assets either in very short paper or in eligible government securities, further reducing yield potential. If the average spread of 0.15% over government funds is not enough to lure investors back to prime, the incentive may be even less after the amendments are in place in a year's time.

Mandatory Dynamic Liquidity Fees May Be the New Monkey Wrench

Cash investors barely had time to celebrate the SEC's retraction of the proposed "swing pricing" mechanism before discovering that the revised dynamic liquidity fees retain some of the functional features of swing pricing that gave them pause to jump back into prime funds. With a purpose resembling swing pricing, the new dynamic liquidity fee requirement deters "first movers" by forcing them to pay for the cost of leaving a fund when their actions will cause a liquidity shortfall. The mechanism is reasonable in theory, except that MMFs, as same day liquidity vehicles, need to figure out an accurate NAV and allow people to redeem shares in a very short

[2] iMoneNet.com Domestic Market Share data as of December 31, 2015 and December 31, 2016.

time frame. Extensive analysis is needed to determine the components of the fees, such as the bid-ask spread, other transaction costs, and market impact costs of selling a slice of the entire portfolio in a stressed market.

Unlike the current requirements that allow funds to assess liquidity fees on the day after they cross a liquidity threshold, the amendment will require them to apply the fees on the same day when a threshold is breached. This requirement is especially challenging and logic-defying for funds with intra-day activity and multiple NAV strikes, when the fee is calculated only once but applied to investors who redeemed at different NAVs on that day.

The SEC allows a fund to opt not to impose a fee if the liquidity cost from a 5% redemption is *de minimis*, defined as NAV impact from redemption at less than 0.01% from redeeming shares. This exposes a fund's board to the risk of assessment error, as there is no easy way to determine if the estimated liquidity costs are less than the de minimis level without running through some calculations. Alternatively, a fund may impose a flat fee representing 1% of the portfolio assets if it is unable to estimate the actual cost. Given the difficulty in estimations, this may become the default solution for prime funds as a matter of convenience. Ironically, the sticker shock from this arbitrary allowance may become the impetus for a run when sell orders approach 5% of net assets.

From recent market liquidity events, institutional cash investors developed a healthy helping of skepticism towards anything with newfangled features. The complex and untested nature of dynamic liquidity fees may require a real-life stress event to prove their effectiveness in slowing down rapid share redemptions, stabilizing NAVs, and preventing contagion in the larger liquidity market. Among all the amendments, dynamic fees received the most criticism, in part since it was inserted into the final rule to replace swing pricing in a hurry, bypassing a feasibility study by the SEC and not allowing the customary public comment period.

As an aside, the amended rule allows all non-government funds to impose discretionary liquidity fees of up to 2% if a fund's board, or its delegate, determines that it is in the best interest of the fund. Despite a low probability of its actual usage, the inclusion of discretionary fees in the final rule may be an unnecessary distraction for investors considering prime funds.

Higher Costs May Encourage Sponsors and Intermediaries to Fold Tents

Structural and operational challenges of collecting fund flows and calculating and applying liquidity fees in a short timeframe expose fund sponsors to risks that may lead to the conclusion that institutional prime funds are nonviable business options. The risks are higher for funds offering multiple NAV strikes and those sold through intermediaries.

For fund sponsors, compliance with the new rule means significant technological and human capital investments. Even though 5% redemption events are rare under normal market conditions, all firms offering institutional prime funds must commit their resources and be ready to operate under the new rule by October 2, 2024. Other than a few very large sponsors, fund companies will be hard pressed to justify the added upfront expenses to stay in the business, especially when their relative yield advantage over government funds is diminished by new liquidity requirements.

A large portion of institutional MMF shares are sold through intermediaries such as banks, broker-dealers, financial advisors, and trading portals in a commingled (omnibus) fashion. It is not clear if the intermediaries should inform the funds of daily activity in the omnibus account on a gross or net basis for liquidity fee purposes. It's equally unclear if liquidity fees should be applied to redeeming shareholders when the outflow from the omnibus account does not exceed 5%. If the intermediary channel is deemed unworkable for funds that are subject to liquidity fees, their popularity will likely be further diminished and the business prospects to fund sponsors further dimmed.

In short, the dynamic liquidity fee requirement gives plenty of reasons for fund sponsors and intermediaries to question if offering the product in the future continues to make sense. Funds offering multiple NAV strikes appear to be most at risk. If time constraints require funds to move up their daily cutoff times, their utility as cash management vehicles may be further reduced. The result may be fewer institutional prime funds, lower asset levels, and further consolidation in the industry. The concentration of prime assets at fewer, very large fund families may present additional diversification challenges, which could become yet another reason to turn away from prime funds.

Conclusion – Reduce unnecessary exposure to prime money market funds

The SEC's 2023 MMF rule amendments, particularly the removal of redemption gates, may marginally improve the resilience of institutional prime funds. However, variable NAVs, the biggest impediment for institutional cash investors, will likely remain intact. Higher liquidity requirements may also reduce prime funds' competitive advantage over government funds. Operational complexity and business liability concerns may lead to the loss of multiple NAV strikes, earlier cutoffs, less portal trading and fewer prime funds, which may lead to less functional utility and more concentration risk.

Particularly of concern is the dynamic liquidity fee feature. The implementation of this feature could precipitate a run on a fund in a down market by shareholders unable to determine when the fund will lose more than 5% of its assets to withdrawals. It would be an unfortunate irony if a new mouse trap meant to stop runs, caused a run and suffered the fate of the old mouse trap, needing to be replaced by yet another.

With recent MMF reforms and deposit flights from regional banks, institutional cash investors should reevaluate leaving too much excess cash in overnight vehicles such as MMF shares and deposit balances. While the Federal Reserve's interest rate decisions present some challenges, it may still be prudent to reduce overnight balances and invest conservatively in a portfolio of government and credit instruments with laddered maturities further out on the yield curve. Doing so will help provide sufficient liquidity, improve yield potential, and reduce exposure to potential liquidity fees.

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