SEC Tries to Patch Money Market Rules

Higher minimum liquidity levels for prime funds could compress yields and drive away corporate cash.

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Will the newest round of money market fund reforms from the Securities and Exchange Commission cause corporate treasurers to ditch the vehicles as a parking place for excess cash?

Last December, the SEC proposed its third set of money market reforms in a decade-and-a-half. Like previous changes, the new rules are intended to "enhance the resiliency of this crucial $5 trillion asset class during periods of stress," as SEC Chief Gary Gensler put it.

The rules deal with fund liquidity levels, changing who bears the costs when there's a flood of investor redemptions, and removing some safety mechanisms established a few years ago. The SEC tinkered with money market fund rules since the financial crisis, and most of the rules have made prime money market funds less attractive to institutional investors.

It began in 2008, when the Reserve Primary Fund, tainted from holding Lehman Brothers' commercial paper, "broke the buck" — the net asset value (NAV) of its shares fell below $1. Institutional investors, fearful of principal loss, withdrew their money. But the fund was unable to meet investor redemption requests and was forced to liquidate.

Since then, the SEC has crafted two rounds of new rules (in 2010 and 2014) to prevent investor runs. But when the pandemic hit two years ago, the market experienced a "dash for cash." Tax-exempt money market funds and prime funds — which invest in floating-rate debt, commercial paper, and certificates of deposit (CDs) — experienced large outflows. Many investors moved their assets into cash and short-term government securities.

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“The commercial paper and [CDs] that make up a significant part of the portfolios of prime money market funds tend to be illiquid in times of stress,” said Gensler in his December 21 statement. “There isn’t a lot of trading in commercial paper and CDs in good times. In stressful times, it almost entirely disappears.”

The Federal Reserve stepped in in March 2020 to keep the market functioning, but it doesn’t want to have to want to do it again.

“For a long time the Federal Reserve has treated money market funds [bank-like products that are unregulated] like a bank,” said Tom Hunt, CTP, director of treasury services at the Association for Financial Professionals (AFP). “They don’t want to bail them out. Or create the perception of bailing them out.”

Money market funds once seemed to be the perfect short-term investing vehicle to invest excess corporate cash because they offered stability of principal, diversification, and daily liquidity.

Over the years, though, corporate treasurers have allocated a smaller portion of excess cash to prime funds. On average, companies had about 5% of their short-term cash in prime or diversified money market funds in 2021, according to the AFP’s annual liquidity survey. That compared with 52% in bank deposits and 17% in government or Treasury money market funds.

The new rules would:

- Increase liquidity requirements for money market funds (MMFs). The amendments would raise the daily and weekly liquid asset minimums to 25% and 50%, respectively, up from 10% and 30%.
- Prevent MMFs from imposing limits on redemptions during market stress through redemption fees and “gates” — the ability to stop redemptions. These mechanisms, added in 2016, exacerbated the run in March 2020.
- Require that institutional prime and institutional tax-exempt money market funds have policies and procedures to implement something called “swing pricing.” Swing pricing adjusts a fund’s current NAV such that the transaction price effectively passes on costs stemming from shareholder redemptions to redeeming shareholders. Currently, a funds’ cost of dealing with massive redemptions is borne by the investors remaining in the fund, according to the SEC.

If the rules are approved, the higher liquidity levels in prime funds may compress yields and drive investors into treasury and government MMFs, according to Fitch Ratings. The swing pricing requirement, however, is the real potential thorn in the industry’s side.

That requirement “would likely entail significant operational complexity, which could discourage investors from buying the funds and managers from operating them,” said Fitch in its report, “SEC Money Fund Proposals Credit Positive But May Result in Outflows.”

SEC Commissioner Hester Peirce, who in December called the reform proposals too prescriptive, predicted swing pricing would drive more prime fund money into government funds, “leaving investors, issuers of commercial paper, and markets worse off.”

Said the AFP’s Hunt: “Removing the liquidity fees and redemption gates helps, but it doesn’t offset the fact that a fund’s NAV is going to be even more subject to market environments.” Hunt thinks more investor money is likely to flow back into the banking system “when banks aren’t necessarily wanting [corporates’] money right now.”

Rather than prescriptive rules, Peirce suggested a principles-based approach “so that funds and investors could find a model that works for them.”

In 1 of the 21 submitted comments (as of February 19) on the proposed rules, economist Norbert J. Michel of the Cato Institute said “a highly prescriptive framework has already been proven to produce a fragile system. … The [SEC] should admit that [it] cannot design vibrant capital markets that are always perfectly stable if they also want to allow investors to take the risks that create vibrant capital markets.”

The comment deadline is April 11.