SEC Requests Comments on Potential Money Market Fund Reforms

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There is a broad consensus that the money market fund (**MMF**) reforms adopted in the wake of the 2008 crisis have not fully achieved their intended aims. Indeed, a report by the President's Working Group on Financial Markets[1] **released** in December 2020 (the **Report**) concluded that, notwithstanding reforms adopted by the SEC in 2010 and 2014, "more work is needed to reduce the risk that structural vulnerabilities in prime and tax-exempt MMFs will lead to or exacerbate stresses in short-term funding markets."

Last week, the SEC **requested comment** on the Report, including with respect to (1) the effectiveness of previously enacted MMF reforms and (2) the effectiveness of implementing policy measures described in the Report, either in addition to, or a replacement for, previously-enacted reforms. The SEC's request for comment is an important step in the MMF reform process, but – as the SEC itself acknowledges – MMF reform is likely to require coordinated action by several regulatory agencies, and perhaps the private sector.

The President's Working Group Report

The Report begins by noting that in March 2020 economic concerns related to the COVID-19 pandemic resulted in stress in short-term funding markets.[2] Prime and tax-exempt MMFs faced significant outflows and increasingly illiquid markets for the funds' assets. These outflows did not subside, and short-term funding market conditions did not improve, until the Federal Reserve established the Money Market Mutual Fund Liquidity Facility and other facilities to support short-term funding markets generally and MMFs specifically.

The fact that prime and tax-exempt MMFs continued to exhibit structural vulnerabilities that can create or transmit stress in short-term funding markets, despite SEC reforms intended to address those vulnerabilities, led the Report to conclude that U.S. financial regulators must examine closely the role, operation, and regulatory framework for these MMFs, with a view toward potential improvements.

The Report offers several potential policy measures to increase the resilience of prime and tax-exempt MMFs. Policy measures explored in the Report include:

- Removing the tie between MMF liquidity and fee and gate thresholds;[3]

[1] The President's Working Group on Financial Markets is chaired by the Secretary of the Treasury and also includes the Chair of the Board of Governors of the Federal Reserve System (**Federal Reserve**), the Chair of the Securities and Exchange Commission (**SEC**) and the Chair of the Commodity Futures Trading Commission. Therefore, as constituted in 2020, the President's Working Group was comprised of Trump-appointed principals. Given the broad, bipartisan consensus that MMF regulation is in need of further reform, however, we expect that many of the policy measures explored in the Report will be part of the potential Biden Administration's MMF reform agenda.

[2] The Report focuses on short-term funding markets in the United States, but the stresses it describes are generally consistent with a case study of MMFs during the COVID-19 shock across jurisdictions **published** by the Financial Stability Board (**FSB**) in December 2020, included in the FSB's 2020 **Global Monitoring Report on Nonbank Financial Intermediation**.

[3] As described in the Report, under current rules, MMF boards have the discretion to impose gates or fees when weekly liquid assets (**WLAs**) fall below 30 percent of total assets and generally must impose a fee of 1 percent if WLAs fall below 10 percent, (*cont.*)

- Reforming conditions for imposing redemption gates;[4]
- Minimum balance at risk (**MBR**) rules, meaning that a portion of a shareholder's recent balances in an MMF would be available for redemption only on a delayed basis;
- New or modified liquidity management requirements, including new categories of liquidity requirements or additional Weekly Liquid Assets (**WLAs**) thresholds to augment current liquidity buffers;
- Countercyclical WLA requirements, under which minimum WLA requirements could be calibrated such that they would automatically decline in certain circumstances, including when net redemptions are large;
- Floating net asset value (**NAV**) requirements for all prime and tax-exempt MMFs;
- Swing pricing rules, meaning that when a fund's NAV "swings" down, redeeming investors would receive less for their shares, thus imposing costs stemming from redemptions directly on redeeming investors, rather than on other investors in the fund;
- Capital buffer requirements;
- Requiring prime and tax-exempt MMFs to be members of a private liquidity exchange bank;[5] and
- New requirements governing sponsor support that would clarify who bears MMF risks by establishing clear rules for when a sponsor would be required to provide support.

The Report is careful to note that it is not at this time endorsing any given measure listed above. Instead, the Report includes a brief discussion of the potential benefits of each option, as well as the potential drawbacks, limitations and challenges.

The SEC Request for Comment

Last week's formal request for comment from the SEC follows an **informal request** issued by the SEC's then-Director of the Division of Investment Management soon after the release of the Report.

As noted above, the SEC's request for comment asks that commenters discuss (1) the effectiveness of previously enacted MMF reforms and (2) the effectiveness of implementing policy measures described in the Report, either in addition to, or a replacement for, previously enacted reforms. When commenting on the policy measures floated by the Report, the SEC would like commenters to address the effectiveness of the measures in: (1) addressing MMFs' structural vulnerabilities that can contribute to stress in short-term funding markets; (2) improving the resilience and functioning of short-term funding markets; and (3) reducing the likelihood that official sector interventions will be needed to prevent or halt future MMF runs, or to address stresses in short-term funding markets more generally.

(*cont.*)

unless the board determines that such a fee would not be in the best interest of the fund or that a lower or higher (up to 2 percent) liquidity fee is in the best interests of the fund.

[4] Potential reform options include requiring funds to obtain SEC permission or provide notice to the SEC before imposing gates, requiring fund boards to consider liquidity fees before gates, lowering the WLA threshold at which gates could be imposed to, for example, 10 percent, and "soft" or "partial" gates.

[5] The Report describes one proposal under which the liquidity exchange bank, which would be a chartered bank, would be capitalized by MMF members and their sponsors through initial contributions and ongoing commitment fees. During times of market stress, the bank would purchase eligible assets from MMFs that need cash, up to a maximum amount per fund.

Comments are due 60 days after the SEC's request for comment is published in the Federal Register. After receiving comments, the SEC anticipates conducting discussions with various stakeholders, interested persons, and other regulators to discuss the options in the Report and the comments received.

Other Regulatory Action

The SEC's request for comment states that although many of the policy measures discussed in the Report may be implemented by the SEC using its existing statutory authority, other measures "may require coordinated action by multiple agencies or the creation of new private entities."[6] MMF reform efforts may thus be a key early indicator of the powers and limitations of the Financial Stability Oversight Council (**FSOC**) in driving and coordinating regulatory reform.[7]

The prospects for coordinated action with respect to MMFs, and for the FSOC more generally, are currently unclear, and may remain so until additional Biden-appointed regulators are confirmed by the Senate.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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[6] The SEC notes, for example, that requiring prime and tax-exempt MMFs to be members of a private liquidity exchange bank may require rulemaking by the SEC as well as regulatory action from the Federal Reserve or other banking regulators.

[7] There is history of the FSOC and the SEC not always moving in complete lockstep on MMF reform. In November 2012, the FSOC **voted unanimously** to issue for public comment several **MMF reform recommendations**. Certain of these recommendations are consistent with reforms ultimately adopted by the SEC in 2014. The SEC **concluded in 2014**, however, that other FSOC recommendations, many of which are included again in the Report, "would not achieve our regulatory goals as well as the reforms we are adopting today."