

SEC Adopts New Rule Amendments for Money Market Funds and Form PF Reporting Requirements for Large Liquidity Fund Advisers

July 20, 2023

A divided U.S. Securities and Exchange Commission (SEC) on July 12, 2023, stopped short of requiring swing pricing on money market funds but tightened liquidity requirements and imposed mandatory redemption fees on certain institutional funds. The SEC said the new rules were designed to “improve the resilience of money market funds during times of market stress while preserving the benefits that investors have come to expect from these funds.”¹

By a 3–2 vote, the SEC’s final amendments

- require all money market funds to increase their daily liquid asset and weekly liquid asset minimum requirements to 25% and 50%, respectively (an exception to the daily liquid requirement applies to tax-exempt money market funds)
- remove redemption gate provisions from Rule 2a-7 under the Investment Company Act of 1940
- remove the link between liquidity thresholds and liquidity fees
- require institutional prime and institutional tax-exempt money market funds to implement a mandatory liquidity fee when they experience net redemptions that exceed 5% of net assets on a single day; in a major departure from the proposed rules, these funds will not be required to implement swing pricing
- allow any nongovernment money market fund to impose a discretionary liquidity fee if the board determines that a fee is in the best interests of the fund
- allow stable net asset value money market funds the flexibility to cancel shares should they experience negative interest rates; the alternative would be to switch to a floating net asset value
- allow fund boards to delegate to the adviser certain responsibilities, such as deciding to impose a lower threshold for a liquidity fee, subject to oversight and procedures

Our Take. It comes as a relief to many money market funds and their sponsors that the SEC did not require swing pricing. Significantly, the SEC’s approach may be a signal that it will pull back from its proposal to require swing pricing for open-end mutual funds generally. It is also a relief to see the removal of the money market fund gating provisions that have been in place since 2014. Industry participants also will appreciate that the SEC determined to allow money market funds to cancel shares should interest rates turn negative. That said, the new 25%/50% daily and weekly liquid asset minimum requirements are substantial and may pressure yields on some funds.

The mandatory liquidity fee also comes with challenges and complexities, not least because it was adopted with a minimum of public input, as we will describe below.

Although the rule provides for a 12-month transition date for these fee-related provisions, it is not too soon for money market funds and advisers to evaluate how they will do the following:

For institutional prime and institutional tax-exempt money market funds

- identify when the 5% redemption threshold is triggered
- determine whether a smaller trigger would be appropriate
- calculate the redemption fee, which requires a good faith estimate of costs of a sale of a vertical slice of a money market fund's portfolio, during a limited window available

For all nongovernment money market funds

- determine whether it is in the best interests of the money market fund to set a discretionary redemption fee

I. Historical Context

In March 2020, growing concerns about the impact of the Covid-19 pandemic disrupted short-term funding markets and prompted some institutional investors to rotate out of the prime and tax-exempt money market funds that participate in those markets. The SEC believes that data from March 2020 suggest that money market fund managers actively managed their portfolios to avoid weekly liquid assets' falling below the 30% of total assets thresholds that could have triggered their fee and gate provisions (required under the 2014 amendments to the money market fund rules) by, in some cases, selling longer-term portfolio securities to meet redemptions. The SEC further believes that market interventions, including activation by the Federal Reserve of a money market mutual fund liquidity facility, were necessary to slow redemptions. SEC Chair Gary Gensler specifically links that event to the current rulemaking, saying: "I'm voting for fewer bailouts in the future and better investment protection."²

II. Removal of the Tie Between the Weekly Liquid Asset Threshold and Redemption Gates and Liquidity Fees

While fees and gates were intended to provide a "cooling off" period and better allocate the costs of providing liquidity to redeeming investors, the SEC now believes that the possibility of a fee or gate contributed to incentives for investors to redeem and for money market fund managers to maintain weekly liquid asset levels above the threshold rather than use those liquid assets to meet redemptions. In response, these new amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the 1940 Act), remove the regulatory link between liquid asset thresholds and the new fee provisions; they also remove gate provisions from the rule entirely. A money market fund board would continue to be able to suspend redemptions to facilitate an orderly liquidation of the fund under Rule 22e-3 under the 1940 Act. The SEC is not adopting any amendments to Rule 22e-3.

III. Liquidity Fees

A. Mandatory Liquidity Fee Requirement. The SEC abandoned its proposed swing pricing requirement in favor of a mandatory liquidity fee framework for institutional prime and institutional tax-exempt money market funds. The SEC believes that a mandatory liquidity fee would achieve many of the benefits associated with swing pricing while reducing certain operational burdens. The amendments also allow for a discretionary liquidity fee for all nongovernment money market funds, which can be applied regardless of (i.e., with or without) the mandatory fee. Neither the mandatory nor the discretionary liquidity fee are linked by the rules to any fund-specific liquidity testing. The sole required link is that the mandatory liquidity fee, for institutional prime and institutional tax-exempt funds, is tied to net daily redemptions.

Elements of the new liquidity fee requirement include the following:

- Shareholders of institutional prime and institutional tax-exempt money market funds will be subject to a mandatory liquidity fee upon redemption of their shares on days when the fund's total daily net redemptions exceed 5% of the fund's net assets aggregated across all share classes.
- The liquidity fee does not apply to purchases of shares. The liquidity fee does not apply to government and retail money market funds.
- Funds must determine whether they cross the 5% net redemption threshold based on actual flow information available within a reasonable period after the last computation of the fund's net asset value (NAV) on that day.

- The adopting release suggests that the fund may use a flexible approach in determining when to calculate net flows, but the approach should be addressed in board-approved guidelines on the application of liquidity fees.
- The adopting release suggests that to the extent a fund does not have net redemptions of more than 5% within a reasonable period after the last pricing period but subsequently receives additional net redemptions that would cause it to cross the threshold, the fund “should consider” imposing a discretionary liquidity fee.
- A fund that offers multiple NAV strikes per day may need to develop a method for applying the fee to shares redeemed in an earlier pricing period on that day. For example, the adopting release suggests that the fund might apply the liquidity fee charge to the remaining balance in an investor’s account if the investor did not redeem the full amount of its shares in the fund or the fund might hold back a portion of the redemption proceeds until the end of the day when the liquidity fee determination is made.
- The fund’s board may approve a threshold lower than 5% of net redemptions if it chooses.
- Mirroring the SEC’s proposed swing pricing terms, the liquidity fee amount must be based on a good-faith estimate, supported by data, of the costs the fund would incur if it sold a pro rata amount of each security in its portfolio (i.e., a vertical slice) to satisfy the amount of net redemptions.
 - This includes transaction costs, such as spread costs and any other charges, fees, and taxes associated with portfolio security sales, as well as market impact costs. As to market impact, for each security, the fund must make a good-faith estimate of the percentage change in the value of the security were it to be sold and multiply this factor by the dollar amount of the security to be sold. A fund may assume a market impact of zero for its daily and weekly liquid assets.
 - A fund may estimate transaction and market impact costs for each type of security with the same or substantially similar characteristics and apply those estimates to all securities of that type. Estimated transaction costs and market impact costs must be fairly allocated across all redemptions, that is, across total gross redemptions, not net redemptions.
 - If a fund cannot estimate the costs of selling a pro rata amount of each portfolio security in good faith and supported by data, the fund must apply a default liquidity fee of 1%.
 - Funds will not be required to impose a liquidity fee when transaction and market impact costs are less than one basis point (0.01%) of the value of shares redeemed (which the SEC anticipates will often be the case under normal market conditions).
 - There is no upper limit on the amount of the mandatory liquidity fee.
- Special rules apply to feeder funds in a master-feeder structure.
- The fund’s board is responsible for administering the mandatory liquidity fee requirement, but, unlike under the current rule, it may 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.

B. Operational Considerations. The SEC recognizes that its liquidity fee rule will introduce new operational complexity to institutional money market funds. For example:

- Unlike under the current rules, where default liquidity fees begin to apply on the *day after* the fund has crossed the 10% weekly liquid assets threshold, under the amended rules, funds and intermediaries may need to update their systems to be able to apply mandatory fees on the *same day* the 5% threshold is crossed.
- To determine the liquidity fee amount under the mandatory framework, funds will need information about gross redemptions from each intermediary for that day. Because some intermediaries may provide only net flow information, funds may need to update their arrangements with intermediaries to obtain gross redemption data in a timely manner.

C. Criticisms of Mandated Fees. The liquidity fee requirement, in part because of its complexity and in part because it was treated only in passing in the original rule proposal as one of a number of alternatives to swing pricing, was criticized immediately. Investment Company Institute president Eric Pan said in a statement that a “significant new measure such as this should have been re-proposed by the SEC, with greater detail and allowing for public comment.”³ Taking the same view, dissenting SEC Commissioner Hester Peirce described liquidity fees as “one of fifteen rejected alternatives sketched out in the proposing release” and advocated “go[ing] back out for

comment to get the wisdom of commenters.” Her dissent goes on to list six different categories of information that she believes was needed before the Commission could appropriately consider mandating a liquidity fee.”⁴

Dissenting Commissioner Mark Uyeda questioned, since any liquidity fee will not be based on actual liquidity costs, whether “redeeming shareholders could be assessed a fee that exceeds any actual costs.”⁵ Both commissioners also expressed concern that the one-year compliance period for the mandatory liquidity fee framework may not be enough time, especially in light of a high volume of other rules being tracked by fund firms and multiple rules already coming into force in 2024. There also were questions as to the agency’s authority to adopt a detailed liquidity fee when the proposing release had focused on swing pricing.

D. Discretionary Liquidity Fees. In a departure from the proposing release, the SEC allows for nongovernment money market funds to continue to impose a discretionary liquidity fee, but those fees are no longer linked to liquid assets thresholds. The fee also does not have to be tied to redemption levels. Important elements of the adopted discretionary liquidity fee provision include the following:

- All nongovernment money market funds must impose a discretionary liquidity fee if the fund’s board, including a majority of the independent directors, or the board’s delegate determines that the fee is in the best interests of the fund.
 - The manner and amount of the fee calculation are not specified in the adopted rules; however, the fee must be in the best interests of the fund.
 - The discretionary liquidity fee may not exceed 2% of the value of the shares redeemed.

E. Delegation. Under the revised delegation provision for both mandatory and discretionary liquidity fees, a board may delegate its responsibility for administering the liquidity fee to the fund’s investment adviser or officers. The SEC believes that the board’s written guidelines generally should specify the manner in which the delegate is to act with respect to any discretionary aspect of the liquidity fee mechanism (e.g., whether the fund will apply a fee to a shareholder based on the shareholder’s gross or net redemption activity for the relevant day and the fund’s approach to determining the reasonable period after the last pricing period of the day when the delegate will measure the fund’s flows for purposes of the 5% net redemption threshold). The board also will need to periodically review the delegate’s liquidity fee determinations.

F. Money Funds as Cash Equivalents Notwithstanding These Fees. The SEC believes that an investment in a money market fund that has the ability to impose a discretionary or mandatory liquidity fee will continue, under normal circumstances, to qualify as a “cash equivalent” for purposes of U.S. generally accepted accounting practices (GAAP) and presumably for determining investment company status. However, if a fund experiences credit or liquidity issues, the SEC believes shareholders would need to reassess if their investments in a particular money fund would continue to meet the definition of a cash equivalent.

IV. Increased Portfolio Liquidity Requirements

As proposed, the adopted amendments increase the daily and weekly liquid asset requirements for money market funds as follows:

	Current Minimum Requirement	Adopted Minimum Requirement
Daily Liquid Assets	10%	25%
Weekly Liquid Assets	30%	50%

Many fund sponsors consider these minimum requirements to be on the high side. That said, historically, the SEC observed that many prime money market funds have maintained levels of liquidity that are close to, or that exceed, the adopted thresholds. The adopted thresholds apply to all types of money market funds except tax-exempt money market funds, which continue to be exempt from the daily liquid asset requirements.

Consequences for Falling Below Minimum Daily and Weekly Liquidity Requirements. The daily and weekly liquid asset requirements are currently measured at the time each security is acquired. Therefore, a money market fund’s portfolio does not fail to satisfy the conditions if it drops below the minimum liquidity thresholds; the fund simply may not acquire any assets other than daily liquid assets or weekly liquid assets, respectively, until it

meets the thresholds. The adopted rules maintain this approach. However, if the fund invests 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 rules require the fund to notify its board within one business day of the liquidity threshold event. The rules also require the fund to provide the board with a brief description of the facts and circumstances that led to the liquidity threshold event within four business days after its occurrence.

Amendments to Liquidity Metrics in Stress Testing. The new rules include technical changes to the stress testing requirements for money market funds. The changes decouple stress testing from a stated level of weekly liquid assets.

V. Potential Negative Interest Rates

Although interest rates on government debt securities have been negative in countries outside the United States, the Federal Reserve (Fed) has never established a lower bound of the target range for the federal funds rate below 0%. However, the SEC explains that if interest rates were to turn negative, it would be challenging or impossible for a stable NAV money market fund to maintain its stable share price. Such a fund would begin to lose money. If this were to occur, the fund’s board could reasonably require the fund to convert to a floating share price to prevent material dilution or other unfair results to investors or current shareholders.

In two significant changes from the proposed rules, the new rules (i) permit a stable NAV fund, in the event of negative interest rates, to reduce the number of its shares outstanding to maintain a stable NAV per share (referred to as share cancellation, reverse distribution mechanism, or RDM) and (ii) do not require stable NAV funds to determine that each financial intermediary in the fund’s distribution network has the capacity to redeem and sell the fund’s shares at nonstable prices or, if this determination cannot be made, to prohibit the relevant intermediary from purchasing the fund’s shares in nominee name.

Share Cancellation. The adopted rules allow stable NAV funds to use share cancellation to seek to maintain a stable NAV if certain factual and disclosure conditions are satisfied. Under the share cancellation mechanism, a fund will maintain a stable NAV per share, despite losing value, by reducing the amount of its outstanding shares. In other words, investors in such a fund would observe a stable NAV but a declining number of shares for their investment.

Floating NAV Conversion. While not codified in the adopted rules, the SEC suggests that if a stable NAV fund plans to convert to a floating NAV if it has negative gross yield due to negative interest rates, it generally should consider disclosures similar to those discussed above for share cancellation, given investors’ lack of experience with negative interest rates and their potential expectation that the fund will continue to maintain a stable NAV. To the extent a fund has not already done so, it generally should have a proactive plan in place that takes into account how different intermediaries in the fund’s distribution network would address a fund’s use of a floating NAV.

VI. Calculation of Weighted Average Maturity and Weighted Average Life

The SEC recognizes that a majority of money market funds calculate weighted average maturity (WAM) and weighted average life (WAL) based on the percentages of each security’s market value in the portfolio, while other money market funds base calculations on the amortized cost of each portfolio security. Because this discrepancy can create an inconsistency of WAM and WAL calculations across funds, including in data reported to the SEC and on fund websites, the adopted amendments require, as proposed, that money market funds calculate WAM and WAL based on the percentage of each security’s market value in the portfolio (not amortized cost).

VII. Form N-CR and Form N-MFP

The adopted amendments make certain changes that affect money market funds’ reports on Form N-CR. Notably, there will be a requirement to file a Form N-CR report when a liquidity threshold event occurs (i.e., when the fund has invested either less than 25% of its total assets in weekly liquid assets or less than 12.5% of its total assets in daily liquid assets). The adopted amendments also require a large number of new reporting items for money market funds under Form N-MFP

VIII. Form N-1A

The adopted amendments make certain changes that affect money market funds' registration statements on Form N-1A, including the following:

- In a fund's summary prospectus and prospectus, in the risk/return section, adding a requirement that institutional funds disclose that they may impose a fee upon the sale of shares and that the fund generally must impose a fee when net sales of fund shares exceed certain levels.
- In a fund's summary prospectus and prospectus, in the risk/return section, adding a requirement that retail funds and government funds that have opted into the discretionary liquidity fee framework disclose that they may impose a fee upon the sale of shares.
- In a fund's statement of additional information, modifying an existing requirement such that funds disclose, during the past 10 years, any occasion on which the fund has imposed a mandatory or discretionary liquidity fee. References to weekly liquid assets and gates are removed. References to Form N-CR reporting regarding liquidity fees are also removed.

IX. Form PF

As part of a separate proposing release⁶ from January 2022, the SEC proposed amendments to Section 3 of Form PF that were intended to require large liquidity fund advisers to report substantially the same information that money market funds would be required to report on Form N-MFP.

Consistent with the final amendments to Form N-MFP, the SEC, as part of the same adopting release, adopted Form PF amendments largely as proposed, with some modifications to tailor the reporting to private liquidity funds and to remain consistent with the final requirements for money market funds under amended Form N-MFP. The Form PF amendments 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.

XI. Recordkeeping Requirements

The adopted amendments include amendments to the recordkeeping rules (specifically, Rule 31a-2 under the 1940 Act) to require money market funds to retain records evidencing and supporting each computation of a liquidity fee.

XII. Compliance Dates

The adopted rules include the following tiered approach to compliance periods:

Rule Requirement	Compliance Date
Amendments to Forms N-MFP, N-CR, and Form PF	June 11, 2024 (same effective and compliance date)
Rule 2a-7 amendment regarding how funds categorize their portfolio investments for purposes of website disclosure	June 11, 2024 (same effective and compliance date)
Rule 2a-7 amendments regarding mandatory liquidity fee framework	12 months after the effective date
Rule 2a-7 amendments regarding discretionary liquidity fee framework	6 months after the effective date
Rule 2a-7 amendments regarding increased portfolio liquidity requirements	6 months after the effective date
Rule 2a-7 amendments removing redemption gates, removing the tie between liquidity fees and liquidity thresholds, and allowing share cancellation	Effective 60 days after publication in the <i>Federal Register</i> with no separate compliance date
Rule 31a-2 amendments requiring money market funds to preserve records regarding their liquidity fee computations	Effective 60 days after publication in the <i>Federal Register</i> with no separate compliance date
Form N-1A amendments	Effective 60 days after publication in the <i>Federal Register</i> with no separate compliance date

¹ See Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A, Investment Company Act Release No. IC-34959 (Jul. 12, 2023) (adopting release).

² See SEC Chair Gary Gensler, “Statement on Money Market Funds” (Jul. 12, 2023), available at <https://www.sec.gov/news/statement/gensler-statement-money-market-funds-07122023>.

³ See Investment Company Institute President Eric Pan, “ICI: SEC Has Missed the Mark in Money Market Fund Rulemaking” (Jul. 12, 2023), available at <https://www.ici.org/news/23-news-mm-f-reform-rulemaking-stmt>.

⁴ See SEC Commissioner Hester M. Pierce, “Air Dancers and Flies: Statement on Adoption of the Latest Round of Money Market Fund Reforms” (Jul. 12, 2023), available at <https://www.sec.gov/news/statement/peirce-statement-air-dancers-flies-adoption-latest-money-market-fund-reforms>.

⁵ See SEC Commissioner Mark T. Uyeda, “Statement on Final Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A” (Jul. 12, 2023), available at <https://www.sec.gov/news/statement/uyeda-final-money-market-fund-reforms-07-12-2023>.

⁶ See Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Investment Advisers Act Release No. 5950 (Jan. 26, 2022) [87 FR 9106] (proposing release).

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