Client Alert

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SEC's Proposed Rules for Money Funds May Significantly Impact Corporate Treasuries and Commercial Paper Issuers

After a prolonged internal debate, the Securities and Exchange Commission has unanimously proposed new rules for the regulation of money market mutual funds, also known as money market funds or money funds. If adopted, these rules would fundamentally change the basic characteristics of most money funds. In particular, institutional money funds could be required to (1) move from a stable net asset value to a floating asset value, or (2) impose liquidity fees and redemption gates in certain times of stress, or (3) contend with a combination of these approaches. Accordingly, corporate treasuries and other institutional investors in these funds may find them less attractive. Further, issuers of commercial paper and municipal securities, who frequently place their securities with institutional money funds, may lose a significant source of liquidity if there is widespread de-investment in this asset class. The proposed rules will be open for public comment for 90 days.

Background to Money Funds

Money funds are a subcategory of mutual funds first developed in the 1970s as an alternative to interest-bearing bank deposits. Like other kinds of registered investment companies, most money funds are subject to regulation under the Investment Company Act of 1940, and Rule 2a-7 adopted under that act lays out a variety of special operating restrictions for this product. Unlike traditional mutual funds whose net asset values and share pricing float daily, money funds are able to avail themselves of special valuation and pricing methods under Rule 2a-7 that generally allow them to maintain a stable share price, typically $1.00 per share. As a result, money funds have become a popular cash management product for both retail and institutional investors. Recent estimates indicate that money funds hold approximately $2.9 trillion in assets.

Money Funds During the Financial Crisis

When a money fund's market value deviates more than 0.5 percent, or $0.005 in the case of a fund seeking to maintain a $1.00 share price, a money fund is generally required to reprice. Because investors will no longer receive back their full dollar, in this situation a money fund is said to "break the buck." In September 2008, a money fund known as the Reserve Primary Fund broke the buck and repriced its shares below $1.00, leading many investors to seek to divest of that fund. At the same time, other institutional money funds also experienced significant redemptions that abated only after the US Treasury provided a government guarantee. In response to these developments, the SEC proposed and ultimately adopted a series of amendments to Rule 2a-7 in March 2010. At that time, then-chairman Mary Schapiro indicated that further amendments to Rule 2a-7 would be forthcoming.

Under increasing pressure from the President's Working Group on Financial Markets and later the Financial Stability Oversight Council, Schapiro sought to propose additional amendments to Rule 2a-7 almost immediately after the March 2010 rules became effective. Schapiro was unable to secure at least three commissioner votes to move forward with her proposal, however, and the proposal languished until the SEC's economists completed a detailed study of the product in December 2012. By that time, Schapiro had announced her resignation as SEC chairman and it was not until the arrival of her successor, Mary Jo White, that a consensus would form among the five SEC commissioners to move forward with a definitive proposal.

The June 2013 Proposal

Based on the experience of money funds during the financial crisis, the SEC's new proposal[1] seeks to mitigate potential systemic risks posed by money funds, limit their susceptibility to runs and increase their transparency. To do so, the proposal places money funds into one of three regulatory categories:

- "Government Money Market Fund," which holds at least 80 percent of its assets in cash; obligations of the US government, including obligations of the US Treasury and federal agencies; and repurchase agreements collateralized by such government securities.

- "Retail Money Market Fund," which invests in the full range of permitted investments under Rule 2a-7 (generally limited to instruments with short-term maturities and relatively low investment risk, such as commercial paper and some municipal securities), but restricts a shareholder of record from redeeming more than $1 million in any one business day, subject to certain exceptions.

- "Institutional Money Market Fund," which also invests in the full range of permitted investments under Rule 2a-7, but imposes no limit on daily redemptions by shareholders of record.

Based on these regulatory categories, the proposal provides for the following alternative modifications to Rule 2a-7 and other related regulations:

- Alternative One: Floating NAV: Under this proposal, institutional money funds would be required to price their shares using a more precise method and transact at a floating net asset value, or NAV, not at a stable $1.00 per share price. Government and retail money funds, however, would be permitted to continue transacting at the stable $1.00 per share. If adopted, the proposing release contemplates a two-year phase-in period.

- Alternative Two: Liquidity Fees and Redemption Gates: Under this proposal, all money funds would continue to transact at a stable share price, but boards of directors would have discretion to impose liquidity fees and redemption gates in times of stress. If adopted, the proposing release contemplates a one-year transition period.

    - Liquidity Fees: If a retail or institutional money fund's level of "weekly liquid assets" (cash, US Treasury securities, certain other government securities with remaining maturities of 60 days or less, and securities that convert into cash within one week) were to fall below 15 percent of its total assets (half the amount required under Rule 2a-7), the money fund would be required to impose a 2 percent liquidity fee on all redemptions. The fund's board of directors could waive the fee or impose a lesser one if it determines that such a fee is not in the best interest of the fund.

[1] The full text of the proposing release and accompanying rules may be found at http://www.sec.gov/rules/proposed/2013/33-9408.pdf. In the tradition of other recent SEC rulemakings, the release is gargantuan, running 698 pages in length, posing almost 1,100 discrete questions for public comment and including 1,249 footnotes.

- Redemption Gates: Once a retail or institutional money fund had crossed the 15 percent weekly liquid assets threshold, its board of directors also would have the discretion to impose a temporary suspension of redemptions, or "gate," for up to 30 days. Money funds would not be able to impose a gate for more than 30 days in any 90-day period.

- Public Disclosure: Retail and institutional money funds would be required promptly and publicly to disclose crossing of the 15 percent weekly liquid asset threshold, the imposition and removal of any liquidity fee or gate, and a discussion of the board's analysis in determining whether or not to impose a fee or gate.

- Government Money Funds Exempt: Government money funds would be exempt from the redemption fees and gating requirement. However, these funds could voluntarily adopt these measures.

- Alternative Three: Combine Both Proposals: Under this scenario, institutional money funds would be required to transact at a floating NAV and nongovernment money funds would also be able to impose liquidity fees and redemption gates.

- Additional Proposed Changes: The proposal also includes a number of provisions independent of the three alternatives, intended to provide greater transparency and disclosure around money fund operations and investments, stronger portfolio diversification and enhanced stress testing.

Potential Impact of the Proposed Rules for Corporate Treasurers

Corporate treasuries and other institutional investors that invest heavily in money funds could see fundamental changes in the basic characteristics of these products, potentially making them a more-costly, less-attractive asset class. At base, money funds not subject to an exemption will, depending on the alternative adopted, suffer some diminution in principal stability, liquidity or yield.

One of the most attractive features of a stable NAV is that it produces no gain or loss on sale and obviates the need to keep track of the amount initially invested in the fund for tax and financial reporting purposes. Under a floating NAV scenario, an investor would be required to track timing and pricing of each purchase and sale transaction for purposes of measuring capital gains and losses, which could prove daunting for investors who frequently redeem and reinvest in the same funds. Absent relief from the IRS, the proposing release also indicates that "wash sale" rules under federal tax regulations would likely apply to funds that frequently redeem and reinvest their interests in the same money fund. For accounting purposes, the proposing relief seeks comment on whether commenters believe using a floating NAV would preclude money funds from being classified as "cash equivalents" under generally accepted accounting principles. Additionally, the proposing release posits that the imposition of liquidity fees may impose other tax payment or tax reporting obligations on investors that they do not bear under the current regulation of money funds.

The liquidity fees and gates alternative would preserve the benefits of the stable price per share that shareholders currently enjoy, but it would do so at the cost of potentially reducing (or making more costly) shareholder liquidity in certain circumstances. Liquidity fees also could decrease investors' incentives to redeem and could require investors to evaluate and price their liquidity needs. Of course, liquidity fees and redemption gates, if imposed, would increase costs on shareholders who seek to redeem fund shares.

Under any of the substantive proposals, current money fund investors would be forced to consider the tradeoffs related to investing in a money fund subject to a new regime. The SEC notes that investors may decide to remain invested in money funds subject to either a floating NAV or liquidity fees and gates, or they may choose to invest in a money fund that is exempt from the proposed reforms (such as a government money fund), invest directly in short-term debt instruments, hold cash in a bank deposit account, invest in another product that maintains a stable value (such as an unregistered private fund) or invest in other products that fluctuate in value, such as ultra-short bond funds.

Potential Impact of the Proposed Rules for Commercial Paper Issuers

Historically, money funds have been a significant source of financing for issuers of commercial paper, especially financial commercial paper, and for issuers of short-term municipal debt. If the SEC were to adopt the proposed reforms, investors may withdraw some of their assets from affected money funds. The SEC projects that investors may withdraw more assets under the floating NAV proposal than they would under the liquidity fees and gates alternative because the floating NAV proposal may have a more significant effect on investors' daily experience with money funds than the proposed liquidity fees and because many investors place greater value on principal stability. Eventually, a migration by investors from money funds to other investment alternatives could reduce demand for financial commercial paper and municipal debt, decreasing their issuers' access to capital from money funds and potentially creating shortages of short-term financing for such companies and municipalities.

Although the SEC does not have estimates of the amount of assets money fund investors might migrate to investment alternatives, it recognized that shifts from money funds into other asset classes could affect issuers of short-term debt securities and the short-term financing markets. If, for example, investors in money funds were to choose to manage their cash directly rather than invest in alternative cash management products, they might invest in securities that are similar to those currently held by money funds. In this case, the effects on issuers and the short-term financing markets would likely be minimal. If, however, capital flowed from money funds, which traditionally have been large suppliers of short-term capital, to bank deposits, which tend to fund longer-term lending and capital investments, the SEC observed that issuers and the short-term financing markets may be affected to a greater extent. Similarly, if capital flowed from institutional money funds to government money funds because government money funds are exempt from further reforms, the SEC noted in the proposing release that issuers that primarily issue to institutional money funds (and thus the short-term financing markets) would be affected.

What You Should Do Now

As with any rule proposal, these proposed rules could undergo significant changes before final rules are adopted. While the SEC sometimes proposes rules that do not ultimately become adopted into law, the significant political and systemic pressures currently associated with money funds mean that there is a high probability the Commission will look to adopt some version of the proposal into final rules within the next year. While the debate is ongoing, we recommend that potentially affected companies take the following steps.

- Corporate treasuries should determine what impact a change under any of the three alternatives would have on the company's cash management function.

- Issuers of commercial paper should assess the potential likelihood of future disruptions in their ability to issue short-term securities.

- Companies should consider whether disclosure of these potential impacts is warranted in future SEC filings, including possible disclosure of new operating risks, new regulatory developments, impacts on liquidity and capital resources, and whether the changes pose other known trends or uncertainties for purposes of MD&A.

- If any of the three alternatives is likely to have an adverse impact on a company's business, whether from a treasury or short-term funding perspective (or otherwise), consider submitting a comment letter to the SEC describing the potential impact on your organization. The proposing release frequently suggests that the SEC's data set is limited, and specific information about the impacts on individual firms and industries will be useful to the SEC and its staff as it considers the public's comments. Thoughtful comment letters do have an impact on final rulemaking.

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