PWC: Ten Key Points from the SEC's Final Money Market Rule.

No major surprises, but big open question After six years of debate over the risks and operations of money market funds (MMFs) – and events such as the fall of Lehman Brothers, breaking the buck at the Reserve Primary Fund, rancor between financial regulators, and hundreds of industry comment letters – the SEC finally adopted MMF reform on July 23rd. The final rule will fundamentally alter certain aspects of MMF operations and accounting, and the way these funds are viewed by investors.

The final rule combines approaches set forth in the SEC's proposal last summer to: (1) require institutional prime MMFs to float their Net Asset Values (NAV) and (2) provide tools to all MMF boards to discourage and prevent runs by investors through the use of redemption fees and gates. A key necessity for reaching the SEC's 3-2 vote in favor of the rule was the Treasury Department's and IRS's concurrent issuance of rules mitigating the tax compliance costs for institutional prime MMFs investors (whose investments will be subject to the floating NAV).

The clock is now ticking. MMFs have two years to implement the floating NAV and fees/gates requirements. MMFs also have 18 months to implement additional requirements for diversification, stress testing, disclosure, and reporting (Form PF and Form N-MFP), and nine months to implement requirements for reporting material events on a new Form N-CR.

Impact

1. Potential structural changes within the MMF industry. The floating NAV requirement may drive institutional prime MMF shareholders to move their cash to government MMFs or non-MMF alternatives that offer reasonable principal protection and slightly higher yield. This would likely cause industry repositioning as traditional sponsors – and new market entrants – innovate new products to meet investors' short-term cash management needs. Furthermore, institutional prime MMF advisers may decide that Rule 2a-7's risk-limiting provisions for MMFs are not worth the headaches without the stable NAV their funds have traditionally enjoyed.

2. Implementation challenges. MMFs and their sponsors will need to make necessary operational and compliance modifications to their systems and controls in order to implement floating NAV and fees/gates requirements by mid-2016. Two years may appear to be a long time, but in our view the challenges are significant (several comments on the proposed rule from key industry participants asserted that three years was a more reasonable implementation period). The SEC's Division of Investment Management has formed a working group to monitor the rule's impact and consider pragmatic solutions to assist with implementation challenges. There may be opportunities for engagement with SEC staff to work through these issues.

3. Will the reforms work? Until the next market crisis, it is difficult to know if the rule will achieve the objective of stabilizing MMFs, deterring investor runs, and preventing systemic ripple effects on other funds and financial asset prices – all without undermining the popularity of the $3 trillion industry among retail and individual investors. This is a clear concern of the industry who commented heavily on the proposal and of the regulators who made several changes to the proposed rule in response.

Key changes from the proposal

4. Reduced flexibility for government MMFs. Government funds remain exempt from floating their NAVs under the final rule, and can still opt into the gates and fees provisions if disclosed. However, the final rule defines a "government MMF" as one that invests at least 99.5% (increased from 80%) of its total assets in government securities, cash, or repos that are collateralized solely by government securities or cash. This significant decrease in the ability to invest in non-government securities will impact investment strategies and returns for these funds.

5. "Retail MMF" definition improved. Instead of distinguishing between retail and institutional MMFs based on maximum daily redemptions allowed (as proposed), a "retail MMF" will be one that has policies and procedures reasonably designed to limit its shareholders to natural persons. This change meets an industry request, but funds will still have to work with omnibus account holders (e.g., brokers and pension administrators) to make this definition workable.

6. More flexibility for MMF boards when imposing fees/gates. The SEC made three changes to the fees/gates proposal in order to address legitimate concerns from commenters that these tools could actually incentivize or exacerbate runs instead of prevent them:

The MMF board's discretion to implement redemption gates or liquidity fees (up to 2%) will kick in when weekly liquid assets fall below 30% (as opposed to 15% in proposal). The SEC views this change as making it more difficult for shareholders to out-guess and front-run the timing of board decisions.

A 1% default redemption fee would be required if weekly liquid assets fall below 10%, but the board would still have the ability to waive, increase, or decrease this fee upon determination of what fee (if any) is in the best interest of the MMF and its shareholders. The default rate changed from 2% to 1% as requested by many commenters.

The maximum gate period is 10 business days in any 90 calendar day period (instead of 30 business days as proposed). The hope is that this shorter gate will reduce run incentives.

7. Amortized cost accounting remains for retail and government funds. NAV calculations and transaction processing based on amortized cost accounting will still be allowed for MMFs other than institutional prime MMFs (the proposal would have done away with amortized cost accounting for all MMFs). This will allow intra-day NAV calculations and settlements, thus permitting retail and government MMFs to continue offering desirable features like check writing and ATM withdrawals. However, because all MMFs will still be required to post daily market-based NAVs on their websites, even retail and government funds will have to invest in additional operational/systems resources. The SEC also maintained the required basis-point rounding for all market-based NAV calculations (i.e., four decimal places for $1 NAV MMFs).

8. Refined stress testing. A key focus of required stress testing will now be on the MMF's ability to maintain weekly liquid assets of at least 10%, consistent with the new redemption fee threshold.

9. Modest relief for municipal MMFs. While municipal MMFs did not receive the industry's desired blanket-exemption from the floating NAV requirement, the SEC did give some diversification relief to these funds. The final rule allows municipal MMFs to concentrate up to 15% of their assets subject to guarantees or demand features from one entity (the proposal would have limited this to a maximum of 10% for each entity).

What's next?

10. SEC to share the spotlight with industry, investors, and … FSOC (again). MMF advisers and other service providers will begin assessing the rule's major impacts on systems, reporting, technology, and board communications. Meanwhile, investors – especially institutional investors – will evaluate the desirability of MMFs as their default home for short-term cash. Finally, the Financial Stability Oversight Council (FSOC), which has long been vocal on the need for MMF reform, will be weighing in on the sufficiency of the SEC's new reforms and providing clues as to whether the rule will impact its next steps for designating certain asset managers as systemically important.