# Client Alert.

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# SEC Proposes Floating NAV for Institutional Prime Money Market Funds; "Fees and Gates" for Non-Government Funds

**By Oliver I. Ireland**

The Securities and Exchange Commission today unanimously proposed two alternative requirements for money market funds. First, the SEC would require institutional prime money market funds to operate with a floating net asset value (NAV). Separately, the SEC would require non-government money market funds to adopt "fees and gates" to stem redemptions in times of stress.

In her remarks at the open meeting, Chairman Mary Jo White said that it has been "a journey to get to this point." She said that the proposals are important "because they advance the public debate that will shape the final rules to address one of the most prominent events arising from the financial crisis."

The proposals are framed as two alternative reforms that could be adopted separately, or combined into a single set of rules designed to address risk in money market funds.

*Floating NAV.* The SEC's proposed rules would require all institutional prime money market funds to operate with a floating NAV. That is, these funds would be unable to use amortized cost to value their portfolio securities, except to the limited extent all mutual funds are able to do so. Rather, a money market fund's share price would fluctuate daily, rounded to the nearest $1/100^{th}$ of one percent.

The proposal specifically exempts government and retail money market funds. The rules would define a retail money market fund as one that limits each shareholder's redemptions to no more than $1 million per day. The SEC seeks public comment on whether to extend the floating rate requirement to government and retail funds.

Chairman White said that the floating rate proposal is important because:

- By eliminating the ability of early redeemers to receive $1.00 per share—even when the fund has experienced a loss and its shares are worth somewhat less—the proposal should reduce incentives for shareholders to redeem from institutional prime money market funds in times of stress;
- The proposal increases transparency and highlights investment risk because shareholders would experience price changes as an institutional prime money market fund's value fluctuates; and
- The proposal focuses reform on the segment of the market that experienced a run during the financial crisis.

Commissioner Troy Paredes stated that while he endorsed the SEC staff's recommendations, he remained "unconvinced that floating the NAV is justified on a cost-benefit analysis." He noted that the floating NAV is just one of the proposed alternatives, and that it was significant to him that the fees and gates were being proposed as a separate, stand-alone alternative.

*Fees and gates.* Under the second alternative, non-government money market funds would continue to transact at a stable share price, but would be able to use liquidity and redemption gates in terms of stress.

The proposal would require a fund whose level of “weekly liquid assets” falls to below 15 percent of its total assets (half the amount required) to impose a 2 percent liquidity fee on all redemptions, *unless* the fund’s board of directors determines the fee is not in the best interests of the fund, or that a lesser fee would be more appropriate. That determination would be subject to the board’s fiduciary duty. The Chairman said that the SEC believes a board would have to meet a “high hurdle” in order to waive this requirement.

As proposed, if a fund falls below the 15 percent weekly liquid assets threshold, the board would also be able to temporarily suspend redemptions of fund shares for up to 30 days; that is, to “gate” the fund. The proposal would limit gates to a maximum of 30 days in any 90 day period. The gating requirement would reduce the likelihood of “contagion” that could spiral into a crisis, the staff believes.

Money market funds would be required to “promptly and publicly” disclose when they cross this 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.

Chairman White offered the following justifications for the fees and gates proposal:

- It could more equitably allocate liquidity risk by assigning liquidity costs in times of stress (when liquidity is expensive) to redeeming shareholders, that is, the ones who create the liquidity costs and disruption;
- Fees and gates would provide new tools to allow funds to better manage redemptions in times of stress, and thereby potentially prevent harmful contagion effects on investors, other funds, and the broader markets; and
- The proposed approach is targeted, focusing the potential limitations on a money market fund investor’s experience to times of stress when unfettered liquidity can have real costs.

*Other proposals.* The SEC also proposed other reforms for money market funds that would tighten diversification requirements, strengthen stress testing, and improve reporting by both money market funds and unregistered liquidity funds that could serve as alternatives to money market funds for certain investors.

Among other things, money market funds would be required to aggregate affiliated funds for purposes of determining whether they comply with the five percent concentration limit of investments in securities of any one issuer. In addition, all of a money market fund’s assets would have to meet the concentration limits for guarantors and “put” providers, effectively removing the 25 percent basket that permitted a single guarantor to guarantee 25 percent of a money market fund’s assets.

Money market funds would also be required to disclose on their website, each day, their levels of daily and weekly liquid assets and their market-based NAVs per share.

*Comment.* The SEC’s proposals conclude a long odyssey that saw many bumps, twists and turns involving multiple regulators and industry participants. The proposals avoid a standoff with other federal regulators, including the Federal Stability Oversight Committee (FSOC), which proposed more dramatic remedies. After all the passionate debate coming from all sides, it is significant that all of the Commissioners agreed to this proposal.

Significantly, the SEC rejected proposals to require retail money market funds to float their NAVs, or to require funds to establish a capital buffer.  While these alternatives may still arise during the comment period, the SEC's proposal reflects a well-considered compromise.

The SEC's fee and gate proposals would put money market fund directors on the spot.  For example, they would be required to determine, in their fiduciary duty, whether to waive the redemption fee requirement.  To be sure, any decision by a board to waive that requirement would invite regulatory scrutiny.

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