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Could the SEC's New Regs Kill Prime Money Market Funds?

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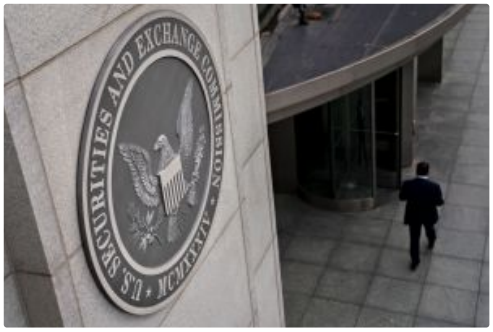

Fund-industry giants are pushing back against proposed SEC regulations meant to avert liquidity crunches.
Andrew Harrer/Bloomberg

To the untrained eye, the debate over the Securities and Exchange Commission's proposed new money market fund regulations may seem like a fight over nothing. But it is causing a dustup between regulators and fund providers all the same. And it could have big ramifications for investors.

Money market funds have undergone a tremendous transformation since the financial crisis of 2008-09, but interest rates have been so low for so many years—you're lucky to get 0.1%—that most investors don't give these funds much thought. One of the biggest changes was breaking them into two categories: government and prime. Government money funds have $4.1 trillion in assets; they buy Treasury bills and other short-term government securities. Prime money funds own corporate debt; today, they're primarily used by institutions and have $831 billion in assets.

There are also differences in liquidity—how fast they can get investors their money, and prevent the proverbial bank run—and whether they can have a steady net asset value, or NAV, of $1 per share. Now, the SEC wants to put new restrictions on prime funds, citing the 2020 economic crisis as the reason.

According to the proposed regulation's 325-page text, prime money funds' panic sales of short-term commercial paper—debt issued by blue-chip companies with maturities

less than 270 days—exacerbated the financial crisis: "Commercial paper and certificates of deposit markets in which prime money market funds and other participants invest became 'frozen' in March 2020," and that lack of liquidity forced the Federal Reserve Bank to create a facility to backstop the funds.

Many of the industry's leading players—Fidelity, Federated Hermes (ticker: FHI), BlackRock (BLK), and Bank of New York Mellon (BK)—have sent letters to regulators stating that the new rule would effectively kill prime funds.

The Biggest Money-Market Funds

A handful of firms hold the most in money-fund assets. Government funds are far larger than higher-yielding prime funds.

Largest Government Money Funds

Fund / Ticker	Assets (bil)	Yield
Fidelity Government Money Market / SPAXX	$250	0.01%
Fidelity Governmentt Cash Reserves / FDRXX	225	0.01
Vanguard Federal Money Market / VMFXX	203	0.01
Largest Prime Money Funds		
Fund / Ticker (Cusip)		
Capital Group Central Cash / CMQXX	$110	0.09%
Vanguard Market Liquidity (92202X209)	104	0.10
BlackRock Cash / BISXX	64	0.10

Note: Yields as of Jan. 12; assets as of Jan. 12 except for Vanguard Market Liquidity which is as of Dec. 31

Sources: Crane Data; company reports

Ironically, 2020's rush to the exits might have been caused by an earlier set of prime fund regs. In 2014, the SEC gave the funds' boards of directors the power to reduce redemptions by gating funds for 10 days when liquid assets fell by more than 30%. It also required prime fund boards to consider imposing exit fees as high as 2% if assets fell by more than 10%.

Meant to stabilize money fund flows, those rules caused institutional investors to flee prime funds in 2020 in order to get out before any gates closed. The new regs would scrap the gates and the exit fees, but impose something else that the industry likes even less—swing pricing.

Swing pricing is widely used in Europe, but not in the U.S., although it was authorized by the SEC in 2016 for regular mutual funds. Basically, it allows a fund's manager to lower its NAV when outflows of securities exceed some threshold. The reason to do this is so the first investors to exit a fund don't get better prices as managers sell off their most liquid securities, while the remaining shareholders are stuck with an illiquid portfolio that trades at fire-sale prices.

Pricing and liquidity can be especially problematic with debt investments, which don't change hands constantly like stocks. "Money markets don't trade like other markets," says Peter Crane, CEO of money fund tracker Crane Data. "Almost everything in the money fund space is buy-and-hold. You don't get a whole lot of people selling a one-month T-bill because they need the money in two weeks. But when that does happen, you get these odd price distortions."

The new rule would require prime funds to adjust their net asset values by a "swing factor" reflecting trading costs on days when funds have redemptions.

Where things get really tricky is if funds have redemptions that exceed 4% of their portfolio value. Then, to calculate the NAV's swing price, managers would have to examine a "vertical slice" of their entire portfolios and estimate what it would cost to sell every security in that slice, even though funds aren't currently selling those securities. Such an estimate requires analyzing the potential "market impact costs" of sales, such as the cost of selling illiquid securities in a distressed market where there are few potential buyers and in which the sale would drive the price down. First-mover sellers would get the swing-adjusted price to discourage them from panic selling.

Money fund managers say such calculations are too difficult. "What swing pricing does is take the place of the [money fund redemption] fees, but does it in a way that is operationally almost impossible," says Deborah Cunningham, Federated Hermes' chief investment officer of Global Liquidity Markets. "It takes away the capability of funds to

be able to do same-day transactions, because you can't price [a money fund's portfolio] until you know clearly, at the end of the day, what your redemptions have been."

The industry's solution to such liquidity crunches would be to keep fund exit fees, but make them more flexible. "We actually liked the concept of liquidity fees," says Jane Heinrichs, associate general counsel at the Investment Company Institute, a fund industry trade group that has petitioned the SEC not to require swing pricing. "But it would be better if they were at the discretion of the board, rather than tied to a specific [liquid asset] number."

Yet the SEC proposal notes that the industry has not shown a willingness to employ redemption fees when needed: "In March 2020, no money market funds imposed liquidity fees, despite the fact that many institutional prime and tax-exempt funds were experiencing significant outflows and some were selling portfolio holdings to meet redemptions, sometimes at a significant loss due to wider spreads, given liquidity conditions in the market at that time."

Fund boards may have ulterior motives for not imposing exit fees. "Giving the board discretion over how much and when to impose [redemption fees] creates a pretty big conflict of interest," says Andy Kapyrin, co-CIO of RegentAtlantic, a financial advisor with $6 billion under management. "If you impose the fee, you're potentially going to spook investors from ever investing in your funds again."

With near-zero yields for prime funds, Kapyrin now favors government ones—a wise decision with the regs still undecided.

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