Client Alert

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SEC Requires Floating NAV for Institutional Money Market Funds; IRS Eases Tax Reporting Burden for Fund Investors

By Jay G. Baris

A divided Securities and Exchange Commission today adopted rules that will require floating net asset values (NAVs) for institutional money market funds and give most money market funds the discretion to impose liquidity fees and gates. The 3-2 vote, which closes the latest tumultuous chapter of money market fund regulatory reform, will fundamentally change the way that most money market funds operate.

The floating NAV requirement will not apply to retail money market funds, including retail funds and all government money market funds (whether or not they are institutional funds).

The new rules increase responsibility on money market fund boards. Fund boards will be authorized to temporarily "gate" redemptions and impose redemption fees of up to two percent when a fund's weekly liquidity falls below 30 percent of its total assets; but when weekly liquidity drops to 10 percent, the fund must impose a one percent redemption fee. The original proposal would have required a mandatory two percent redemption fee at the 15 percent level, although the fund's board could waive that fee or impose gates.

The rules will impose additional disclosure, reporting and stress testing requirements.

Chairman Mary Jo White said that while the new rules "could diminish the attractiveness" of some money market funds for investors, the rules strike a balance to address two principal risks that grew out of the 2008 global financial crisis.

These two risks are:

- The "first mover advantage" that encourages investors to be the first to redeem so they can receive the fixed one dollar NAV price even if the market value of the money market fund's holdings is less than one dollar per share; and
- The fear of widespread investor runs and the "potential for contagion from one fund" that can result in heavy redemptions.

Commissioners Kara M. Stein and Michael S. Piwowar voted against the proposals.

Commissioner Piwowar said that a combination of both a floating rate NAV and liquidity fees and redemption rates "impedes" the SEC's goals of preserving the benefits of money market funds. The floating NAV option, he said, would not reduce the "first mover advantage" because money market funds will exhaust cash on hand to pay early redeemers, and thus the market-based NAV may not capture the likely increasing illiquidity of a fund's portfolio. Other less onerous alternatives exist, he said.

On the other hand, Commissioner Stein did not object to the floating rate concept but believes that "gates are the wrong tool to address" the first mover risk, because, among other reasons, investors would have an economic incentive to redeem ahead of others to avoid the uncertainty of losing access to their capital.

In tandem with the Commission's new rules, the Department of the Treasury and the Internal Revenue Service are expected to provide tax relief that will "eliminate significant costs" of the floating NAV requirements. As a result, the IRS rules will let money market fund investors determine gains and losses on a net basis over a year, rather than requiring investors to track individual transactions. Also, the IRS will ease the "wash sale" rules for losses on shares of floating NAV money market funds.

The Commission also proposed amendments to Rule 2a-7 that would remove references to credit ratings, as required by the Dodd-Frank Act. If adopted, money market fund boards must determine that portfolio securities have "minimal credit risk" instead of relying in part on objective standards, such as credit ratings. The Commission also proposed a rule that would exempt money market funds from the confirmation requirements of Rule 10b-10 of the Securities Exchange Act of 1934.

The long-term effects of the new rules, including whether they will discourage or encourage first redeemer syndrome remain to be seen. But, at least for the short term, the rules are likely to reduce to intense pressure that the Commission has faced to adopt money market fund reform.

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