PROPOSED MONEY MARKET FUND REFORMS RELATED TO NEGATIVE INTEREST RATES FAVOR CONVERSION TO FLOATING NAV AND PROHIBIT OTHER STABILIZING MEASURES

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INTRODUCTION

On 15 December 2021, the Securities and Exchange Commission (the SEC) proposed amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the 1940 Act) (the Proposed Rule), which governs the structure and operation of money market funds (MMFs). The amendments reflect the SEC's concern over market stresses impacting MMFs in very low interest rate environments including, most recently, the COVID-19 pandemic in March 2020, and it is the SEC's belief that such measures will improve the resiliency of MMFs, in particular, government and retail MMFs.

As part of the Proposed Rule, the SEC proposed several measures intended to address negative interest rates or negative yields. In particular, if adopted as proposed, the SEC will require government and retail MMFs to convert to a floating share price from a stable net asset value (NAV) if future market conditions result in negative fund yields. Additionally, the SEC proposes to prohibit MMFs from operating a reverse distribution mechanism, routine reverse stock split, or other device that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price.

Shortly after the Proposed Rule was released, on 21 December 2021, the SEC announced the appointment of William A. Birdthistle, who in his academic career has written extensively about the MMF industry, as director of the Division of Investment Management (the Division). As discussed below, Birdthistle's academic writings may shed light on the potential for his views to shape certain parts of the rule making process for the Proposed Rule.

II. AMENDMENTS RELATED TO POTENTIAL NEGATIVE INTEREST RATES

a. Conversion to Floating NAV

In the Proposed Rule release, the SEC notes that in the past 15 years, the Federal Reserve has established a target federal funds rate of 0%–0.25% in response to two separate economic crises.[1] During persistently low interest rate environments, it is difficult for MMFs, particularly government MMFs, to generate substantial returns from investments in U.S. Treasury securities and other high-quality government debt securities. While government and retail MMFs could still maintain a non-negative stable share price in such environments, it would be increasingly difficult for a government or retail MMF to maintain a non-negative stable share price if the environment remains at or near zero for extended periods of time, and even more so in a negative interest rate environment.

The Proposed Rule seeks to respond to low and negative interest rate environments that may occur by requiring government and retail MMFs to convert to a floating share price if future market conditions result in negative fund yields. This proposed requirement would be similar to requirements applicable to stable NAV MMFs established in the European Union (EU), which are required to convert to a floating share price if the shadow NAV and stable NAV deviate outside of a euro. Currently, under Rule 2a-7(c)(1)(i), government and retail MMFs may use amortized cost and penny-rounding accounting methods in order to maintain a stable share price. Currently and under the Proposed Rule, a fund is only permitted to adopt this strategy if the fund's board of directors (board) believes that the stable share price continues to fairly reflect the fund's market-based NAV per share. In particular, during volatile market conditions, the board would play a critical role in making this assessment and may be required to act quickly in determining whether a fund is able to generate sufficient income to support a stable share price. To the extent the board decides that, in light of a low or negative interest rate environment, use of an amortized cost or penny-rounding accounting method is no longer resulting in a fair reflection of the fund's NAV, the fund must convert to a floating share price. As discussed in more detail below, the Proposed Rule would prohibit the use of other stabilizing measures like reverse distribution mechanisms or reverse stock splits to seek to support a stable share price. As is permitted currently, a fund's board would continue to be able to choose to liquidate the fund, should it determine that the fund's stable share price no longer fairly reflects the fund's market-based NAV per share.

The Proposed Rule also requires a stable NAV fund's board to oversee certain procedural standards such that the fund must periodically calculate the market-based value of the portfolio (shadow price) and compare it to the fund's stable share price. In an expansion of a board's current obligations with respect to the monitoring of the differences when valuing the portfolio at amortized costs as opposed to the shadow price, the board must consider what action, if any, it should take if the deviation between these two values exceeds one-half of 1% (50 basis points). In a negative interest rate environment, the SEC believes that a board could reasonably require the fund to convert to a floating share price if the board believes that the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders.

In addition, the SEC is proposing to require government and retail MMFs (or their principal underwriters or transfer agents) to determine whether financial intermediaries that submit orders have the capacity to redeem and sell securities at prices that do not correspond to a stable price per share. Under the Proposed Rule, MMFs would have flexibility in how they make this determination for each financial intermediary but would be required to maintain records of these determinations. As part of the Proposed Rule, the SEC also requests comment on whether it should mandate that a MMF make these determinations or provide additional guidance with respect to how a MMF could make such determinations. In addition, the SEC seeks information regarding whether a MMF should be required to report the basis of its determinations to its board, to shareholders, or to the SEC.

If the determination described above cannot be made, the relevant financial intermediaries are prohibited from purchasing the fund's shares in a nominee name.[2] Since many investors purchase shares through financial intermediaries, the SEC believes it is important that such intermediaries are able to process shareholder transactions if a stable NAV fund converts to a floating NAV. Intermediaries that are currently unable to process such transactions may need to take certain steps, including upgrading their processing systems and renegotiating certain agreements with affected MMFs, to be able to continue transacting in government and retail MMFs.

b. Practical Implications

The proposed amendments could have the following practical implications for government and retail MMFs:

- New or updated prospectus disclosures.
- Changes to internal policies and procedures, including (without limitation):
    - A requirement that a fund must convert to a floating share price if the conditions for using amortized cost or penny-rounding accounting methods are not met;
    - A board's oversight duties when a fund calculates the shadow price and compares it to the fund's stable share price; and
    - Additional obligations on the part of government and retail MMFs to confirm that the funds and the intermediaries that distribute their shares can fulfill shareholder transactions if the funds convert to a floating share price.
- Operational changes, including (without limitation):
    - Determine whether financial intermediaries that submit orders to purchase or redeem a fund's shares have the ability to redeem or sell a fund's shares at prices that do not correspond to a stable share price;
    - If such determination cannot be made, prohibit those financial intermediaries from being able to purchase the fund's shares in nominee name;
    - Funds would have flexibility with how they make this determination for each intermediary but would be required to maintain records identifying those financial intermediaries that can and cannot transact at non-stable prices; and
    - SEC requests comments on whether funds should be required to determine whether intermediaries can transact at non-stable share prices or whether there are alternative approaches to ensure that intermediaries can handle a fund's potential transition from a stable NAV to a floating NAV. SEC also requests comments on the process of maintaining records identifying whether intermediaries can or

cannot accommodate non-stable prices, including how and how often these determinations should be reassessed.

c. Reverse Distribution Mechanisms and Other Similar Methods

The SEC has also considered various industry-proposed operational responses to negative interest rates, including the potential for stable NAV MMFs to adopt a “reverse distribution mechanism.” This involves allowing a fund's share price to remain stable during times of negative yields with the fund reflecting the resulting loss in value by reducing the total number of its outstanding shares. This process would involve automatically reducing the number of shares held by each shareholder on a pro rata basis and would result in shareholders holding a decreasing number of shares in the fund instead of holding the same number of shares at a declining value. Certain MMFs established in the EU had adopted reverse distribution mechanisms to address negative yields; however, such a mechanism was prohibited upon the EU reforming money market fund regulations in 2018.

In the SEC's view, a reverse distribution mechanism could potentially mislead or confuse retail investors in government and retail MMFs since such investors may assume if the MMF is maintaining a stable price, then their investment is holding its value, whereas, in fact, their investment will be losing value each time a negative yield causes the mechanism to be applied. The SEC believes that such a mechanism would not be intuitive for retail investors and that it would be easier for retail investors to understand declining share prices in the event that a fund's gross yield turns negative. Consequently, the SEC is proposing that Rule 2a-7 be amended to expressly prohibit MMFs from operating a reverse distribution mechanism, routine reverse stock split, or other device that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price.

Prior to the release of the Proposed Rule, the MMF industry, including the Investment Company Institute (ICI), had engaged at length in discussions regarding the viability of certain responses to a negative interest rate or negative yield environment, including the implementation of reverse distribution mechanisms. As part of these discussions, the MMF industry and the ICI had sought guidance from the SEC, but, prior to the Proposed Rule, the SEC had not provided any such guidance or insight into whether the use of reverse distribution mechanisms or other similar tools would be permissible.

With respect to reverse stock splits, the ban on such splits, if adopted as proposed, would run counter to guidance provided by the staff of the SEC as part of its 2014 money market fund reforms, which acknowledge the use of reverse stock splits and that, if implementing a reverse stock split, MMFs would have to consider the extent to which the split would be considered an attempt to stabilize a MMF's NAV.[3] It should also be noted that the proposed ban on reverse distribution mechanisms, reverse stock splits, and similar devices supports the SEC's position that the only appropriate alternatives for MMFs in such circumstances would be either liquidation pursuant to Rule 22c-3 under the 1940 Act or conversion to a floating NAV.

III. RECENT APPOINTMENT OF NEW DIRECTOR OF THE DIVISION OF INVESTMENT MANAGEMENT

On 21 December 2021, the SEC announced the appointment of William A. Birdthistle as director of the Division. Prior to his appointment, Birdthistle was a professor at the Chicago-Kent College of Law and visiting professor of law at the University of Chicago Law.

During his academic career, Birdthistle has written extensively about the investment funds industry. In particular, he has written about MMF reforms and has argued for stricter regulation of MMFs. In response to the SEC's request for comments prior to the publication of the Proposed Rule, Birdthistle had submitted a comment letter to the SEC proposing that: (1) all MMFs should adopt a floating NAV, (2) MMF sponsors should be required to hold capital sufficient to ensure that the sponsor can support their MMFs subject to redemptions or declines in asset prices, and (3) the MMF industry should consider adopting a systemic emergency insurance fund.[4] With respect to his proposal that all MMFs should adopt a floating NAV, he had also previously postulated that this would help prevent bank runs since investors are not “promised” a guaranteed return, as opposed to MMFs with stable NAVs, which could lead investors to misconstrue that there is an “implicit guarantee” that their investment is steadfast.[5]

In light of Birdthistle's recent appointment, and upon review of his academic writings and the comment letter discussed above, it is possible that the SEC may adopt a tougher stance with respect to the regulation and oversight of MMFs. As noted below, the SEC has requested comments from the industry on several aspects of the Proposed Rule, including whether it should consider requiring all MMFs, including government and retail MMFs, to adopt a stable NAV.

IV. REQUESTS FOR COMMENT

It is expected that the Proposed Rule will be published on SEC.gov and in the *Federal Register* on 8 February 2022. The comment period will remain open for 60 days after publication in the Federal Register. In contrast, the comment period for the 2014 amendments to Rule 2a-7 remained open for 90 days after publication in the Federal Register, and the SEC has received some criticism for imposing a shorter comment period for the Proposed Rule and several of its recently proposed rules.

As noted above, the SEC has requested industry comments on many of the details related to possible measures that MMFs will need to take in a potential negative interest rate environment under the Proposed Rule, including the following:

1. The SEC seeks comment on whether government and retail MMFs should be permitted to engage in a routine reverse stock split, reverse distribution mechanism, or other similar mechanism. Relatedly, would such a mechanism benefit, mislead, or confuse investors?
2. The SEC requests comment about whether all government and retail MMFs should be required to switch to a floating share price or permitted to respond to negative interest rates in a different manner.
3. The SEC requests information about whether investors would prefer the implementation of a floating share price or a reverse distribution mechanism for government and retail MMFs with a negative yield. The SEC would also like to know the likelihood that investors will remain invested in a MMF with a negative gross yield.
4. The SEC seeks comment on the likelihood that fund sponsors would continue to operate MMFs in a pervasively negative interest rate environment.
5. As proposed, government and retail MMFs are required to determine whether financial intermediaries in their distribution network have the capacity to redeem and sell the fund's shares at non-stable prices per share and to prohibit financial intermediaries from purchasing the fund's shares in nominee name if such

determination cannot be made. Furthermore, government and retail MMFs will be required to maintain records on the results of these determinations. The SEC seeks comment on whether these requirements should be adopted and whether there are alternative methods to ensure that financial intermediaries are able to handle such transactions.

FOOTNOTES

[1] In 2008, a crisis that originated in the financial sector quickly spread to the rest of the U.S. economy. In early 2020, another crisis occurred, amid growing economic concerns related to the COVID-19 pandemic and an overall flight by investors to liquidity and quality.

[2] The term “financial intermediary” has the same meaning as in 17 C.F.R. § 270.22c-2(c)(1).

[3] 2014 Money Market Fund Reform Frequently Asked Questions.

[4] Comment In Response to Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report, Release No. IC-34188, File No. S7-01-21, https://www.sec.gov/comments/s7-01-21/s70121-8587644-230907.pdf. See also William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WIS. L. REV. 5, pp. 1155–1201, 2010, https://ssrn.com/abstract=1728929.

[5] Birdthistle, *supra note* 4, at 1169.

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