MONEY MARKET REFORM UPDATE

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Background

On July 23rd, the SEC voted to enact more restrictive requirements and recommendations for prime institutional money market funds. Specifically, these funds will now be required to use floating NAVs and permitted to employ redemption restrictions and liquidity fees during times of extreme market stress. As you may recall, the SEC has been discussing some combination of rules changes for several years now, and today's vote provides a resolution to these debates. Importantly, affected money market fund companies will have at least two years to comply with the changes, as rules are expected to be fully implemented by September 2016.

To be clear, these rules changes will *not* apply unilaterally to retail and government money market funds. Only prime institutional money market funds and institutional municipal funds will be directly affected. Retail funds are distinguished from institutional funds in that all investors in retail funds are characterized as natural persons, identified by an item such as a social security number; in the event that a fund has both retail and institutional investors (i.e. multiple share classes), the fund will have to split in order to avoid subjecting retail investors to the new floating NAV requirement. Prime funds are distinguished from government funds in that they invest in short-term corporate debt, posing greater potential risk of "breaking the buck." In examining historical data from financial crises throughout history (with particular emphasis on the most recent crisis precipitated by Lehman's collapse), the SEC determined that institutional shareholders are much more likely to redeem their fund holdings much faster than their retail counterparts; as a result, the SEC judged that institutional funds are in greater need of having the ability to limit outflows.

Specifics on the New Rules

Floating NAV

The floating NAV requirement applies only to prime institutional money market funds and tax free municipal funds catering to institutional investors. The use of floating NAV will eliminate the stable $1 per share value that currently characterizes all money market funds; instead of "penny rounding," prime institutional money market funds will be required to "basis point round" their share price to the nearest 1/100th of one percent (i.e. "four decimals"). Of course, it is quite possible that fund companies will use their own cash to prevent NAV from floating below $1 per share. Government and retail money market funds may continue to use "penny rounding" going forward. The only material change for government funds is the requirement that they invest a minimum of 99.5% or more of total assets in cash and cash equivalents, government securities, and repurchase agreements; previously, these funds were only required to invest 80% of total assets in the aforementioned categories. Finally, municipal funds will be required to adopt a floating NAV unless the fund meets the definition of a retail money market fund, which generally requires that all beneficial owners of the fund are "natural persons."

Many money market fund companies, as well as the U.S. Chamber of Commerce, fought hard to oppose this new rule, largely due to concerns over the potential tax treatment. Importantly, the Treasury and the IRS have announced that provisions will be made to avoid the triggering of wash sale rules and to allow for aggregated/annual tax treatment on gains and losses; theoretically, this should limit the increased costs associated with the shift to floating NAV. More specific details should come forward in the near future.

Liquidity Fees and Redemption Gates
The new rules allow money market fund boards to impose a liquidity fee of up to 2% on all redemptions if the fund's "weekly liquid assets" drop below 30%; the decision to charge a fee is at the discretion of the fund board, which should only impose a fee if doing so is determined to be "in the best interest of the fund." In addition, if a fund's "weekly liquid assets" drop below 10%, the fund would be *required* to impose a liquidity fee of 1% on all redemptions. For reference, "weekly liquid assets" include cash, Treasury securities, other government securities with remaining maturities of less than 60 days, and securities that can be converted into cash within one week.

Regarding redemption gates, a money market fund board could choose to temporarily suspend redemptions if "weekly liquid assets" drop below 30%. Again, to impose a gate, the fund board must determine that doing so is in the best interest of the fund. Funds would be required to lift gates after a maximum of 10 business days, and funds would not be permitted to impose a gate for more than 10 business days over the course of any 90-day period. Government money market funds will not be subject to these new liquidity fee and redemption gate provisions, but they may choose to "opt in" as long as disclosure is provided.

Disclosure
Prompt public disclosure will be required in each of the following circumstances: 1) "weekly liquid assets" fall below 10%, 2) liquidity fees or redemption gates are imposed, and 3) liquidity fees or redemption gates are removed.

Implications

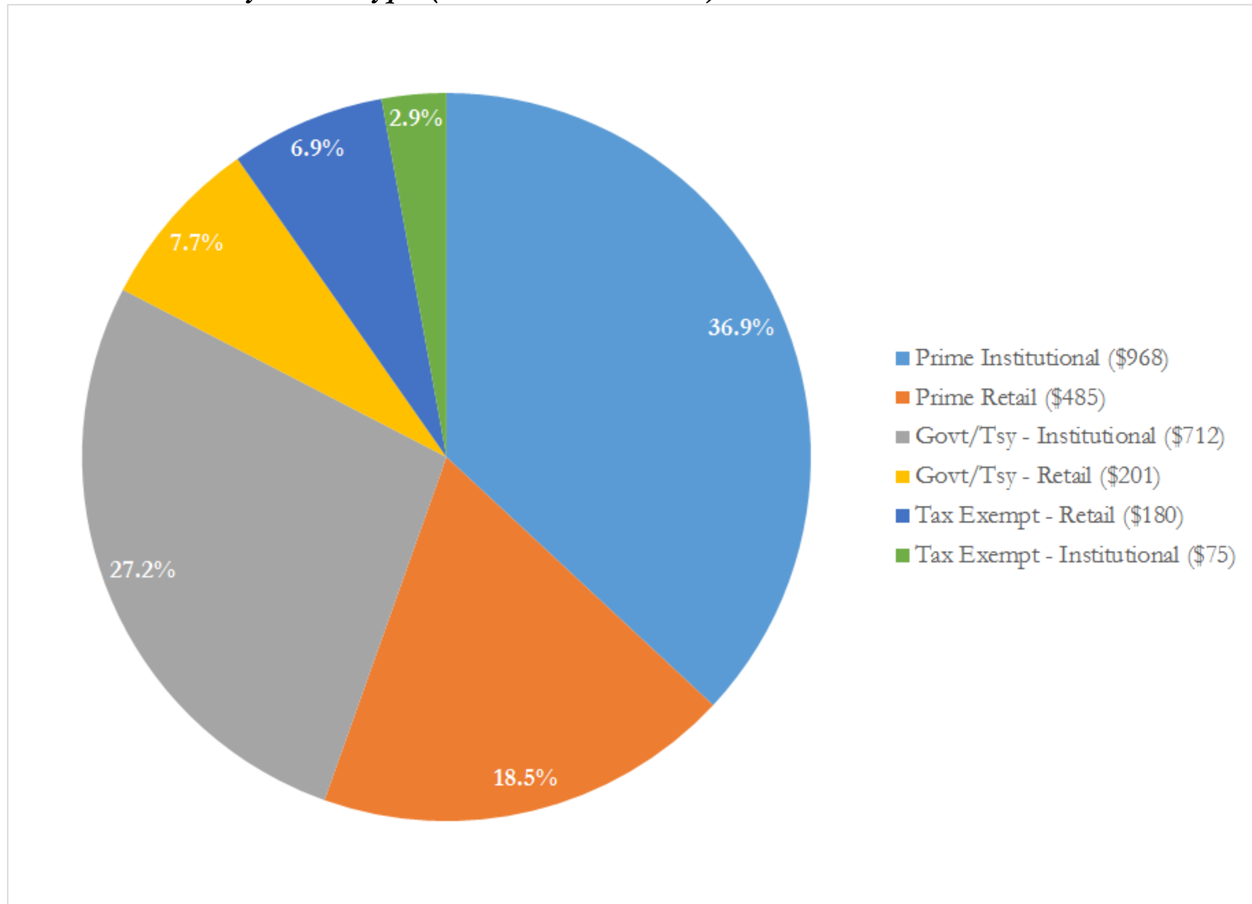
The floating NAV provision was introduced and ultimately approved under the assumption of increased stability and transparency, while also reminding investors that such funds are neither explicitly nor implicitly backed by the federal government. Specifically, the SEC hopes to mitigate the impact of "first mover advantage," in which "smart money" institutional investors redeem large sums in anticipation of a liquidity crunch in short-term lending markets. Of course, opponents of the new floating NAV requirement, including SEC Commissioner Kara Stein, argue that these new rules will only exacerbate this "first mover advantage" and compel institutions to redeem even faster than before to beat the crowd and avoid the fees and gates.

While it is difficult to predict how redemption behavior might change going forward under these new rules, it should be emphasized that firms which do not charge liquidity fees and redemption gates may succeed in attracting more investor assets in the long run. Theoretically, investors are unlikely to continue to invest in funds that place gates and/or fees on their assets. Of course, in order to avoid gates and fees, fund managers may opt for more conservative portfolios, which could reduce yields that are already historically low.

BAML rates strategist Brian Smedley expects a massive exodus from institutional funds going forward, noting that "we would not be surprised to see half a trillion dollars move out of prime funds and into government funds in the next couple of years." For reference, prime institutional money market funds total nearly $1 trillion, or over one-third of total money market fund assets; tax exempt funds total roughly $75 billion (see Exhibit 1 for more details on AUM by fund type).

Appendix

Exhibit 1: AUM by Fund Type (in billions of dollars)



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