Impact of Money Market Regulatory Reform

EXECUTIVE SUMMARY

Written By:

RVK, Inc.

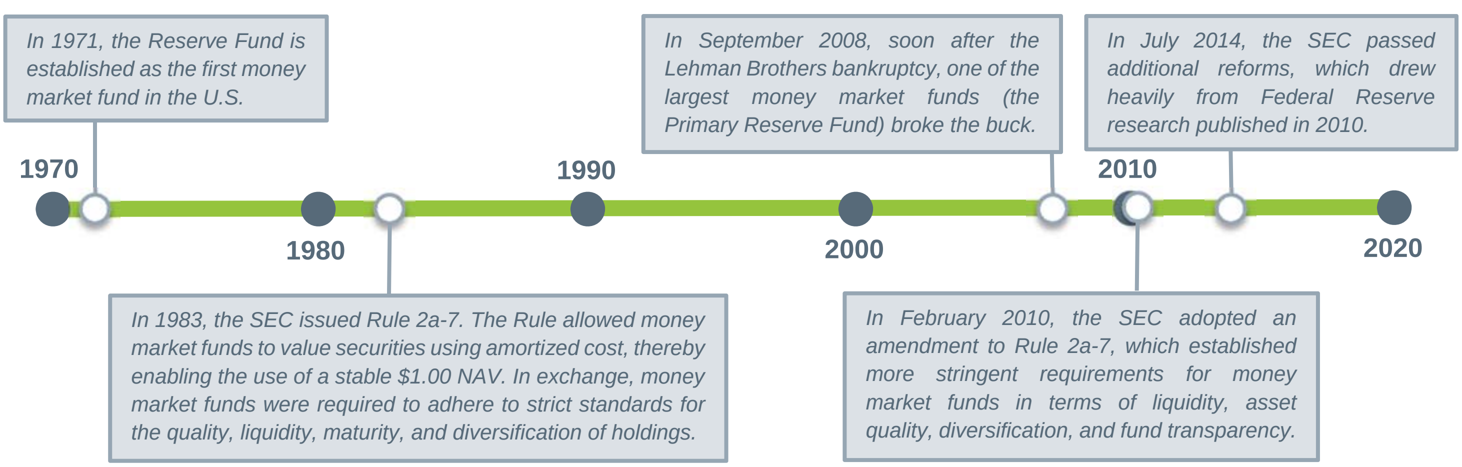
On July 23, 2014, the United States Securities and Exchange Commission (SEC) adopted amendments to rules governing U.S. money market funds. The amendments were designed to address unexpected distress experienced by money market funds during the global financial crisis of 2008 and 2009. During this period, one fund (the Reserve Primary Fund) became only the second money market fund in history to "break the buck" when it failed to redeem investor funds at a $1.00 Net Asset Value (NAV).[1] Widespread panic quickly ensued, and the Federal Reserve intervened by instituting a temporary liquidity guarantee to prevent a full-scale run on money market funds.

The 2014 amendments enacted by the SEC will have a material impact on how retail and institutional investors can access money market funds in the future. The objective of this paper is to provide investors and plan sponsors with a concise, yet thorough, explanation of why these changes were enacted, how these changes may impact investors, and how investors can adapt their investment strategies in response. The paper also serves as a reference to summarize several key provisions of the reforms, as well as implementation dates of which investors should be aware.

EVOLUTION OF MONEY MARKET REFORM

In 1971, the Reserve Fund was established as the first money market fund in the United States. In the wake of its success, many competitors began offering money market funds, and the SEC soon determined that regulations were required in order to ensure appropriate safeguarding of investors' assets. **Figure 1** shows key milestones and reforms enacted for the money market industry over the past several decades.

Figure 1: Money Market Fund History



As indicated in **Figure 1**, in July 2014, the SEC passed additional reforms, which drew heavily from the following three insights presented in a 2010 research paper published by the Federal Reserve.[2]

1. Prime money market funds (as opposed to government money market funds) had a substantially higher probability of breaking the buck during a financial crisis.
2. Institutional investors (as opposed to retail investors) were more likely to withdraw assets when money market funds presented a significant risk of breaking the buck.
3. Prime funds (especially those serving institutional investors) demanded greater regulation in order to reduce the risk of future panics by eliminating structural incentives for investors to withdraw funds.

Rule 2a-7 Amendments

The additional amendments to Rule 2a-7 were designed to bolster money market fund resiliency in distressed markets, as well as account for the fact that institutional and retail funds require different rules to function effectively. The figures below describe the key provisions of the Rule 2a-7 amendments **(Figure 2)** and outline the impact on various types of funds **(Figure 3)**.

Figure 2: Overview of Key Provisions of Rule 2a-7 Amendments

Provision	Description
Investor Differentiation	Institutional and retail investors are treated differently under the amended Rule 2a-7. • Retail investors, as identified by a social security number, include individual investors and defined contribution plan participants. • Institutional investors, as identified by an institution's tax identification number, include legal entities. Prime and municipal money market funds must specify whether they are designed for retail or institutional investors, and institutional investors will not be permitted to invest in retail funds.
Use of Floating NAVs	Institutional money market funds must use a floating NAV rounded to the fourth decimal place. The intent of this requirement was to reduce the incentive for investors to exit funds rapidly during times of market stress. By mandating a floating NAV for money market funds, the SEC attempted to eliminate the perceived "first mover advantage" of selling in distressed markets, as price declines are immediately recognized in NAVs. Retail money market funds are still permitted to use a stable NAV, as this class of investor did not exhibit the same selling behavior as institutional investors during the global financial crisis.
Enforcement of Liquidity Fees and Redemption Gates	The boards of directors of prime money market funds will be permitted to impose redemption gates and up to a 2% liquidity fee if a fund's level of weekly liquidity falls below 30%. If weekly liquid assets fall below 10%, boards will be required to impose fees and gates unless the board determines it is not in the fund's best interest.

Figure 3: Amendments Impact by Fund Type

Fund Type	Investor Type	Liquidity Fees	Redemption Restrictions	Floating NAV
Prime & Municipal Funds	Institutional	Yes	Yes	Yes
	Retail	Yes	Yes	No
U.S. Government and Treasury Funds	Institutional	No Change*		
	Retail			

INVESTOR IMPACT

Although most of the provisions of Rule 2a-7 amendments are not effective until October 14, 2016, investors should be aware of the implications and prepare to make any required changes to their portfolio over the next year. RVK meets regularly with hundreds of investment managers and carefully evaluates how managers are adapting to this regulation. Listed below and on the following pages are several ways in which the amendments may impact investors.

1. **Fund Changes** — On October 14, 2016, institutional investors will no longer be permitted to invest in money market funds designated as “retail funds.” Although retail investors will be permitted to remain in institutional funds, RVK generally recommends against this simply due to the fact that retail investors will continue to have access to prime funds that lack the floating NAV requirement. Finally, some money market managers may seek to address the new requirements by converting some of their prime funds into a government or treasury fund. As we approach the effective date of October 14, 2016, both retail and institutional investors should determine whether their current money market investments will alter their allowable investors or investment strategy and transition their assets to a new fund if necessary.

2. **Increased Return and Yield Dispersion** — Capital preservation, rather than income generation, is generally the primary objective of money market investors. In the past, yield and total return dispersion between government and prime money market funds has been relatively narrow. In the future, we expect that many investors will transition funds from prime to government funds in order to avoid an increased regulatory burden. Should this occur, increased demand for government money market securities may place downward pressure on government fund yields. Conversely, demand for non-government securities may decline. This may lead to greater return and yield dispersion in the future. Therefore, investors should be aware that the relative similarity of past performance among prime and government funds may not continue.

3. **Potential Fee Increases** — Money market funds (particularly prime funds) may increase management fees in order to cover costs associated with meeting more stringent regulatory requirements. Furthermore, as yields increase, managers will likely reduce the amount of fees that they currently waive. In the current low interest rate environment, money market managers have waived a significant portion of the fee quoted on their prospectuses in order to maintain a positive and competitive return. Going forward, an increase in

* Although government and treasury funds are not required to use a floating NAV, liquidity fees, or redemption restrictions, there were regulatory changes to holding requirements in order to qualify as a government or treasury fund. In addition, these funds have the option of imposing liquidity fees and redemption restrictions if deemed necessary.

yield will be partially absorbed by discontinuations of fee waivers. The expected fee drag of funds must be considered in an overall competitive analysis.

OPTIONS FOR *INSTITUTIONAL INVESTORS*

In response to the new regulations, some managers are broadening their product portfolios, while others are narrowing their portfolios to specialize in a small subset of products. In addition, at least one manager has exited the money market business entirely. As the landscape shifts, we encourage investors to revisit their investment objectives, review all investment options, and select a fund that is most suitable to meet their long term objectives. Listed below and summarized in **Figure 4** on the following page are several options that investors may wish to consider.

1. **Prime Money Market Funds** — Prime funds will remain an attractive option for some institutional investors, particularly those with little sensitivity to a floating NAV or the potential imposition of liquidity restrictions. In addition, fund managers are already creating new products that may be attractive to institutional investors that have these sensitivities. Two such examples are described below.[†]

    a. **60-Day Prime Funds** — These funds take advantage of an SEC rule that allows funds to use amortized cost pricing for debt securities with remaining maturities of 60 days or less. By using amortized cost, 60-day prime funds are not forced to use a floating NAV. This new fund type was first introduced by Federated Investors, but many other managers have indicated their intention to launch similar funds.

    b. **7-Day Prime Funds** — These funds take advantage of the structural liquidity of invested assets to avoid the possibility of imposing liquidity restrictions. Under the new Rule 2a-7 amendments, a fund will only have the option to impose a liquidity fee or redemption gate if the fund's weekly liquid assets fall below 30%. By investing 100% of the fund in securities with a 7-day maturity (or longer dated government bonds, which are treated the same for liquidity purposes), the fund eliminates the possibility of imposing liquidity restrictions.

2. **Government & Treasury Money Market Funds —** Investors with limited tolerance for the floating NAV and liquidity restrictions imposed by Rule 2a-7 can invest in government or treasury money market funds. The tradeoff, however, is a lower yield and total return expectation for these types of funds.

3. **Short Duration/Ultrashort Bond Funds —** For investors with less frequent liquidity needs or investors looking for a secondary source of liquidity to supplement money market funds, short duration bond funds may be attractive. Since these funds are not considered money market funds, they are not subject to Rule 2a-7. Traditional short duration funds generally have an average duration of one to three years, while ultrashort duration funds tend to have a one-year average duration. Investors should be aware, however, that many short duration funds have high frequency trading restrictions. Although ultrashort duration funds are generally exempt from these restrictions, many traditional short duration funds will not allow investors to make multiple trades within a 30-day period or for a certain introductory period. An investor should ensure that its liquidity needs will line up with a fund's policy before investing in a short duration fund.

4. **Non 40-Act Funds —** Another method for avoiding the increased regulations from Rule 2a-7 is to avoid mutual funds or invest in funds that are not covered under the regulation. Examples of such funds include

[†] It should be noted that 60-day and 7-day prime funds will have a lower return expectation due to the lower risk profile.

short-term investment funds (STIFs), private liquidity funds, local government investment pools, and separately managed accounts. Generally, these funds are only available to larger investors that can meet high investment minimums. Investors considering these investment options should understand the quality and liquidity restrictions, as well as the compositions of investors within a fund, as they may vary substantially among different investment options.

Figure 4: Summary of Short Term Investment Options for Institutional Investors

Fund Attribute	Prime Money Market			Gov't/Treasury Money Market	Short Duration	Non-40 Act Funds
	Institutional	60-Day Institutional	7-Day Institutional			
Allowable Investors	Retail & Institutional	Retail & Institutional		Retail & Institutional	Retail & Institutional	Retail & Institutional
Yield	Higher than 60- or 7-day Institutional	Lower than traditional Institutional Prime Fund		Lowest	Higher than Money Market Funds	May be higher than Money Market Funds
NAV Methodology	Floating	Stable	Stable	Stable	Floating	Stable[‡]
Potential Liquidity Fees	Yes	Yes	No	No	No	No[‡]
Potential Redemption Gates	Yes	Yes	No	No	Yes	Yes[‡]
Primary Regulator	SEC	SEC	SEC	SEC	SEC	Various
Other Attributes						• Typically lower management fees • Potentially higher investment minimums

OPTIONS FOR *DEFINED CONTRIBUTION / DEFERRED COMPENSATION (DC) PLANS*

DC plan participants are considered retail investors; therefore, Rule 2a-7 amendments are less impactful in comparison to institutional investors. Despite fewer changes, DC plan sponsors should still take this as an opportunity to re-evaluate the conservative options offered in their plan's menu. It is important to recognize how participants are using the money market option to fulfill their investment objectives. Typically we see capital preservation and liquidity as the two most important objectives for money market funds within a DC plan, with yield as the tertiary objective. **Figure 5** illustrates the merits and drawbacks of four conservative investment options typically offered in a DC plan investment menu. While every DC plan is unique, we encourage plans to consider these issues as they work towards an optimal solution (or combination of solutions) for their participants.

In general, while we recommend that all DC plans avoid institutional prime money market funds, there are situations in which a *retail* prime money market fund is viable, particularly if yield is a more important objective than liquidity. Although the risk of liquidity restrictions and gates being imposed does exist for retail prime money market funds, the probability is likely to be low. We generally anticipate that most DC plan sponsors will continue to value and desire liquidity as an objective of conservative investment options, and therefore, will look to government, non-40 Act, and stable value funds as the primary alternatives.

‡ Information shown represents OCC regulated STIF accounts. Regulations may vary among fund types and may change in the future to align with changes to money market funds.

Figure 5: Summary of Conservative Investment Options for DC Investors

Fund Attribute	Retail Prime Money Market	Gov't/Treasury Money Market	Non-40 Act Funds	Stable Value
Allowable Investors	Retail	Retail & Institutional	Retail & Institutional	Retail Investors in Defined Contribution Plans
Yield	Higher Expected Yield Relative to Gov't/Treasury Money Market Funds but Lower than Non-40 Act and Stable Value	Lowest	Higher than Money Market Funds but Lower than Stable Value	Highest
NAV Methodology	Stable	Stable	Subject to floating NAV§	Stable
Potential Liquidity Fees	Yes	No	No	No
Potential Redemption Gates	Yes	No	No	No restrictions for participants, but potential limitations at the plan level when replacing funds.
Primary Regulator	SEC	SEC	Varies	Varies
Other Attributes			• Typically lower management fees • Potentially high investment minimums	• Investment menu restrictions imposed by wrap providers • Typically higher wrap fees than money market funds

CONCLUSION

The amendments to Rule 2a-7 will materially impact many institutional and retail money market investors. Key dates of which investors should be aware are summarized in **Figure 6** below. Although the most impactful changes will not take effect until October 14, 2016, we encourage institutional investors and DC plan sponsors to study the changes, evaluate the impact on their portfolios and/or DC plans, and prepare to make changes in advance of the new regulatory regime. As is always the case with new regulations, the impact will inevitably create new risks to manage but also new opportunities. We look forward to assisting our clients in their efforts to address these regulations over the coming year.

Figure 6: Key Money Market Reform Dates[3]

April 14, 2016	1. Money Market Funds must use new Form N-MFP for reporting purposes.** 2. Money Market Funds must adhere to new standards for asset quality, diversification, fund liquidity, and fund transparency.
October 14, 2016	1. Prime and Municipal Money Market Funds must re-establish as either retail or institutional funds. 2. Institutional investors will no longer be permitted to invest in retail funds and must find an alternative if an existing money market fund transitions to a retail fund. 3. Money market funds must meet all new requirements related to use of floating NAVs and the potential use of liquidity fees and redemption gates.

§ Changes in NAV are minimal and rounded to the hundredth decimal place, therefore floating NAV appears stable.
** The new reporting form largely impacts money market funds, rather than money market investors.

References

[1] Condon, C. (2008). Reserve Primary Money Fund Falls Below $1 a Share. *Bloomberg News.* Retrieved from http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5O2y1go1GRU

[2] McCabe, P.E. (2010). The Cross Section of Money Market Fund Risks and Financial Crises. *Federal Reserve Board.* Retrieved from http://www.federalreserve.gov/pubs/feds/2010/201051/201051abs.html

[3] Pershkow, A., Cruz, L., & McCamman, P. (2014). U.S. Securities and Exchange Commission Adopts Amendments to Money Market Fund Rule (Rule 2a-7). *Mayer Brown*. Retrieved from https://www.mayerbrown.com/en-US/US-Securities-and-Exchange-Commission-Adopts-Amendments-to-Money-Market-Fund-Rule-Rule-2a-7-10-27-2014

About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Chicago and New York City. RVK is one of the ten largest consulting firms in the U.S. (as defined by Pensions & Investments) and has a diversified client base of over 190 clients covering 28 states. This includes endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.