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Implications of Recent Money Market Fund Reform Passage

The 2008 financial crisis raised serious questions regarding the health, security and viability of the money market mutual fund industry. The Securities and Exchange Commission has adopted a series of reforms to rules governing money funds. The 2010 amendments focused largely on Rule 2(a)-7 parameters on the interest rate, credit and liquidity risks of the portfolios. Recognizing that more fundamental changes to this market might be necessary, the SEC pressed forward with debate on a number of other reform proposals. The resulting modifications were passed by a 3-2 vote of the Commission in July 2014, with a two year window for funds and managers to comply.

While the 2010 reforms focused on bolstering the quality and security of the money market portfolios, the 2014 changes address customer access to their accounts, preventing runs on the funds in crisis situations and the problem of funds "breaking the buck." The newly enacted guidelines are as follows:

> Floating NAV – Institutional prime funds (those which invest across government, corporate/bank and ABS short term paper) will now be required to report their actual NAV rather than constant $1.00 share price.
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> Liquidity Fees – If a fund's "weekly liquid assets or WAL" (defined as government securities maturing in under 60 days & other securities maturing within one week) fall below 30% of total assets, a fund would be allowed to impose a liquidity fee of up to 2% on all redemptions. If WLA fell below 10% of total assets, then the fund is required to impose a 1% redemption fee.
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> Redemption Gates – If WLA falls below 30% of total assets, funds can temporarily suspend redemptions. However, the fund must lift the "gate" within 10 days, and can impose suspension for no more than 10 days within any 90-day period.
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> Public Disclosure – Funds would be required to publicly disclose any instances where WLA falls below the 10% level, and any liquidity fees or gates imposed on fund investors.

The likely effects of these aggregate reforms for money market funds are substantial. The 2010 adjustments to Rule 2(a)-7 have severely reduced the ability of these funds to generate excess

returns through duration or credit decisions. Furthermore, these returns (which of course in the case of money market funds are 100% from yield as opposed to capital gains) are unlikely to benefit initially from any Fed tightening activity. Many fund management companies have resorted to waiving their management fee in order to prevent the net yield from going into negative numbers. Once rates move higher, they are likely to reinstate those fees. In addition to these 'steady state' outcomes, there could be more deleterious effects from the redemption gates and liquidity fees. One of the dissenting voters in the SEC panel (Kara Stein) specifically cited the redemption gates as a potential problem, asserting that the existence of the gates could spur investors to rush out of funds even earlier in times of crisis rather than remain invested.

There is broad consensus that the result of this new regulatory environment will be substantial asset departure from the affected (institutional prime) funds. A report from Barclays concluded that as much as 40% of the assets in institutional prime funds could exit, either to government money market funds, bank deposits, or to other highly liquid investment vehicles. One of the strongest positioned alternatives to institutional prime money market funds is separately managed short duration accounts. By moving to separate accounts from strictly controlled money market funds, investors could reap the following advantages:

- The ability to individually define investment guidelines on credit and duration without restrictions such as those in Rule 2(a)-7
- Separate account allows for use of laddering or barbell strategies to achieve desired targets
- Direct ownership of the securities in the portfolio, with complete transparency of holdings
- Assets are not subject to the potential negative effects of external inflows/outflows
- No liquidity fees or redemption gates
- Management fees explicitly stated and negotiable

The money market mutual fund industry grew from its beginnings in the early 1970's to over $3 trillion in assets due largely to the convenience for investors and the perceived safety of the funds (including a false perception among many that they are FDIC-insured). Both of those factors have been handicapped by recent events and the resultant new regulations. While a majority of assets are likely to stay in these vehicles even after all new regulations are implemented, a significant percentage of assets are likely to seek other investment vehicles consistent with the need for the highest levels of available safety and liquidity.

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