Money Market Reform Commentary June 2015

The First Money Market Fund Reform Deliverable

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We're almost a year into the Securities and Exchange Commission's (SEC's) money market fund reform initiative. Much has been said in the press about the final October 2016 deliverables of floating net asset values (NAVs), liquidity fees and redemption gates. In fact, so much emphasis has been given to the final changes that many investors may not be aware that the first reform deliverable takes effect next month.

The SEC's stated objectives when they announced money market fund reform were to increase transparency, address susceptibility to runs and preserve the benefits of money market funds. The purpose of the July deliverable is to increase transparency of material events that may befall a fund. The requirement goes live July 14th and it calls for funds to file a new material events form, called Form N-CR, in certain well-defined instances.

Form N-CR will be required to be filed by funds with the SEC and prominently displayed on fund websites when specific events occur. The events which will trigger the filing of the form are detailed below, with the final one not required to be reported until that piece of the reform becomes effective:

> **Insolvency or default of a portfolio holding –** For issuers or guarantors representing 0.50% or more of a fund's holdings, a default or insolvency becomes a reportable event. Several pieces of information about the holding(s) would be disclosed in this event, including the default date, the value of the holding, the percentage of the portfolio it represents and what fund management is planning to do to address the issue. It is worthwhile to note that money market fund holdings are primarily top-tier (A-1 / P-1 / F1) short-term instruments and defaults in the short-term, investment-grade space are quite rare. An interesting way to look at the probability of a default occurring is to compare a fund's weighted average life (WAL) to the data showing the likelihood of default over an equivalent time period. In the case of First American Prime Obligations Fund, its May 29th WAL was 57 days. The most recent Moody's short-term default data available tell us that only 0.0062% of P-1 issuers default in any 60-day period.

> **Financial support from a sponsor –** The idea of support is not new to money market funds, nor is the reporting of it. Sponsor support has historically been given to allow a fund to continue accepting redemption requests at a $1.00 NAV. Under certain circumstances, a sponsor may step in if a portfolio security has lost value or liquidity in the market has been compromised. Support can take several forms, including purchasing a distressed security from a fund at par, making a capital contribution or executing a capital support agreement on behalf of the fund. The SEC sees all of these actions as a sponsor taking steps to stabilize or increase the value or liquidity of a fund's portfolio. Note that sponsor support would generally be utilized to allow fund shareholders to continue transacting with the fund normally; nevertheless, the SEC wants these instances to be communicated more openly than is the case currently. Today, sponsor support instances are generally disclosed in a fund's annual and semi-annual reports, meaning shareholders may not be aware of an instance until several months after the fact.

Declines in a fund's shadow price – The new reform calls for a Form N-CR to be filed if a fund's shadow price falls below $0.9975 per share regardless of whether a fund will be pricing at a stable or a floating NAV come October 2016. Funds with shadow prices below $0.9975 are moving the wrong way within the current penny-rounding rules, which allow a money market fund to strike a $1.00 NAV if the value of portfolio securities is at least $0.9950 (NAVs below $0.9950 are considered to have broken the buck). Asking funds to publicly announce when they have reached this new threshold makes good sense, as it brings shareholders' attention to the issue. That said, the reality is that for a fund to have a shadow NAV of $0.9975, either someone has been asleep at the wheel, the fund holds several impaired securities or there is significant dislocation in the market. The SEC itself noted in the adopting release that in normal market conditions, it expects very few filings for this trigger.

Imposition or lifting of a liquidity fee or redemption gate – Part of the ultimate reform implementation calls for fund boards to be able to assess a liquidity fee or a redemption gate if a fund's weekly liquidity falls below 30%. Should a board determine one or both of these levers is in the best interest of shareholders, the SEC has mandated that communication of such action be made public within one day through a Form N-CR filing. As part of the explanation included in these filings, a fund board will be able to provide context around why the decision was made. In practical terms, the operational implications for either action are significant and communication from fund families is expected to happen same day to ensure trade processing is as seamless as possible.

It is important to note that all money market funds – whether they are retail or institutional – are subject to the July Form N-CR deliverable. In terms of timelines, should a fund experience one of these trigger events, the SEC requires a Form N–CR to be posted within one business day. In some cases, a second form with more detail will follow within four business days.

When announced, the Form N-CR requirements were widely supported by fund families and industry participants. While we expect filings to be relatively infrequent events, we do feel they go a long way toward supporting the SEC's objective of increasing transparency for money market fund investors.

The shadow price of a fund is the NAV that is calculated using actual market prices for the portfolio securities. In today's environment, money market funds price shares for the NAV using amortized cost rather than market prices. Beginning in April of 2016, all money market funds will be publishing their shadow prices out to four decimals on a rolling six-month basis. In October 2016, only shareholders of institutional prime and institutional tax free funds will actually trade at the shadow price.

Author's Bio:

Lisa Isaacson is the Managing Director of Product Marketing and Communications for U.S. Bancorp Asset Management and leads the firm's money market reform steering committee. Prior to joining U.S. Bancorp Asset Management in 2006, she worked in operations and administration for Pine River Capital and Fidelity Investments. She earned a B.S. degree from the University of Minnesota.

Sources:

Moody's, Default and Recovery Rates of Corporate Commercial Paper Issuers, 1972 – H12013, October 9, 2013.
Securities and Exchange Commission, RIN 3235-AK61 (Money Market Reform; Amendments to Form PF, July 2014.

[See next page for definitions and important disclosure information]

Definitions

Liquidity is a characteristic of a security or commodity with enough units outstanding to allow large transactions without a substantial drop in price.
Net Asset Value (**NAV**) is a mutual fund's price per share, calculated by dividing the total assets – less any liabilities – by the number of shares outstanding.
Par value is the face value of a bond.
Retail Funds are funds having policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. The types of accounts that will qualify to purchase retail prime funds in the future include individual retirement, health savings and education savings accounts.
Securities and Exchange Commission (**SEC**) is the federal agency that regulates the registration and distribution of mutual funds.
Weighted Average Life, also known as Weighted Average Final Maturity, (WAL) is the average time to maturity of all the securities held in the portfolio, weighted by each security's percentage of total investments. Unlike WAM, the WAL calculation takes into account the final maturity date for each security held in the portfolio. WAL measures a fund's sensitivity to potential credit spread changes.