Money Market Commentary

March 2015

What to Know About Prime Funds

Last July, the Securities Exchange Commission (SEC) announced additional money market reforms. All fund types are affected by the new regulations, but institutional prime and tax free funds will be the only types required to float their net asset values (NAV). Retail prime and tax free funds will continue to be eligible to price at stable NAVs. Since the announcement, fund families have been examining their product offerings to ensure they continue to meet client needs.

In discussions with shareholders and intermediaries, changes to institutional prime funds represent a significant portion of the questions we receive so this commentary was designed to build some framework around the prime fund changes. Since the changes affecting the way shareholders interact with prime funds are not effective until October 2016, we thought some perspective may be helpful as investment decisions are being considered over the coming months.

The table below depicts how prime funds operate today and how institutional prime funds will operate in the future. Please note: the same changes will apply to institutional tax free funds.

	Current Prime Funds	Institutional Prime Funds After October 14, 2016
Transaction Price	Rounded to two decimals, utilizing amortized cost	Rounded to four decimals, utilizing market price
NAV	Stable NAV	Floating NAV
Trade Proceeds	Same day	Same day
Redemption Gates	Possible in times of stress	Possible in times of stress
Liquidity Fees	N/A	Possible in times of stress
Accounting Treatment	Cash / cash equivalent	Cash / cash equivalent

So, what do these changes really mean for investors?

Prime funds of the future will look and feel quite similar to today's funds. They will continue to be subject to Rule 2a-7 and retain cash / cash equivalent accounting status. Funds that carry ratings from ratings agencies will likely continue to do so. Standard & Poor's (S&P) has stated fund ratings are not expected to change as a result of money market fund reform.

Many fund families will have separate prime funds for their retail and institutional shareholders. The retail funds will offer shares at a stable NAV and the institutional funds will have floating NAVs. Both retail and institutional prime funds will be subject to liquidity fees and redemption gates. Let's take a closer look at how these changes impact shareholders:

Floating NAV for Institutional Funds (required implementation October 14, 2016) – Historically, funds have been able to utilize amortized cost accounting to price portfolio holdings and fund NAVs have been rounded to the nearest penny. Under the new rules that become effective in October 2016, prime funds that are not limited to retail investors will need to price portfolio holdings at a current market price and shareholders will transact at a NAV that is expressed out to four decimal places, or rounded to the nearest basis point. Several

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What is a retail fund?
The SEC defines retail funds as those 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. Examples of account types that will be deemed institutional include corporation, insurance company and defined benefit plan accounts.

prime funds, including First American Prime Obligations, currently publish a daily market NAV so interested shareholders can already monitor this data point. Beginning in April 2016, all money market funds will need to have available on their websites six months of rolling fund data, including the daily market NAV. Once this information is available, investors will be able to have a longitudinal view of market NAVs for their money market funds and track how market conditions are impacting them.

The First American Prime Obligations Fund has been proactively publishing its daily market NAV on the shareholder documents page of the institutional investor website since 2013. There has been very little variation in the market NAV.

Money market portfolio managers are – and historically have been – very focused on limiting NAV variability. The credit research process is built around assessing issuer credit worthiness. Portfolio construction is carefully considered with the goal of maintaining a stable NAV and preserving principal. It is our expectation that shareholders will see very little change in funds' market NAVs.

Pricing at market values rather than amortized cost does create a change in the timing of when institutional investors will receive redemption proceeds. Today, when an institutional shareholder redeems shares at any time prior to a prime fund closing, the $1.00 NAV is assumed and a wire transfer is generally generated shortly after the trade is received in good form. In the future, redemption proceeds will not be released until after the fund has calculated its NAV. In simple terms, if the prime fund you are invested in calculates a NAV at noon, your trade instruction would need to be received before noon and your proceeds would not be sent out until after noon. This timing change is one of the most salient points institutional shareholders will need to be aware of as time marches toward the October 2016 implementation.

Redemption Gates (required implementation October 14, 2016) – Suspending mutual fund redemptions is not a new idea. Currently, SEC rules allow mutual funds to halt redemptions in several situations including market disruption, exchange trading restrictions or in preparation for a fund's liquidation. In practice, this provision is rarely utilized. Likewise, once redemption gates become an available tool for fund boards to halt redemptions, we expect them to be rarely utilized. The SEC has given this tool to fund boards, allowing them to suspend redemptions in their funds for up to 10 days in any 90-day period. The industry has begun to adopt the term *emergency gates* as they are expected to be invoked only in the most dire circumstances.

The redemption gate provisions will give boards the flexibility to utilize a gate in a liquidity crisis without necessarily having to liquidate the fund.

How would emergency redemption gates work? Each fund's board will be allowed to choose to suspend redemptions if weekly liquid assets fall below 30% if – and this is a high standard of care – a gate is deemed to be in the best interest of the shareholders. What that means in practical terms is there would need to be significant and rapid deterioration of portfolio liquidity and / or credit quality and the best way to minimize NAV impairment for all shareholders would be to halt redemptions, giving some portfolio securities time to mature at par. Shareholders in prime funds will need to recognize the potential for gates to be in play during times of stress. Any redemption gate implementation will be required to be publicly announced on fund websites and in required regulatory filings.

Liquidity Fees – Applying a liquidity fee to redemptions in the midst of a liquidity crisis is a new idea for money market funds. The regulation allows for each fund's board of directors to assess a liquidity fee if weekly liquid assets fall below 30% of a fund's assets. It further requires a fee to be assessed if weekly liquid assets fall below 10% of a fund's assets, though the board can opt not to impose one. As with redemption gates, the industry has begun to adopt the term emergency fees to signify the infrequent expected use. The standard of care the board must consider for fees is the same as for gates – it must be deemed to be in the best interest of all shareholders.

Liquidity fees are a new idea for money market mutual funds. To reduce the likelihood of triggering a fee at the 10% weekly liquid assets threshold, our portfolio management team plans to carry significant front-end liquidity in the portfolios.

How would emergency liquidity fees work? In theory, a fund's board could assess a liquidity fee on shareholder redemptions while a fund is stressed and add the fee back into the portfolio net assets to help support the NAV. As with emergency gates, any board decision to impose a liquidity fee would need to be disclosed on the fund's website and in required regulatory filings.

Take-away Message

The primary features shareholders want in their money market fund investments – safety of principal, liquidity and yield commensurate with risk – will remain intact after all of the money market reforms are implemented. Investment managers understand that shareholder access to their fund shares at a known value is paramount. It is because of this that portfolio management teams will work hard to maintain fund NAVs and structure portfolios to avoid emergency fee and gate triggers. Of course, in emergency situations the potential remains that a prime fund may invoke fees and / or gates. As a fund advisor, we are keen to continue discussions about the future of prime funds and what the changes may mean for our shareholders and intermediaries.

Author's Bio:

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Sources:

SEC Money Market Fund Amendments, July 23, 2014.
Standard & Poors, "Principal Stability Fund Ratings Will Likely Hold Steady Amid Money Market Reform," August 5, 2014.

Definitions

Amortized Cost is the price a fund pays for a security, as adjusted over time for accounting changes in any discount or premium.
Basis Point (**bps**) is one one-hundredths of a percentage point. This term is often used in describing changes in interest rates. For example, if a bond yield increases from 7.50% to 7.88%, it has moved up 38 basis points.
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.
Securities and Exchange Commission (SEC) is the federal agency that regulates the registration and distribution of mutual funds.