Money Market Reform Commentary

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Two Down, One To Go

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Whew! That collective sigh of relief you just heard is from all of the money market fund managers who have just gotten through the second Money Market Reform deadline. Hopefully, it seemed like a non-event to investors, but we can assure you a lot happened behind the scenes to meet the Securities and Exchange Commission's (SEC's) April 14, 2016 deliverable. What, exactly, has changed and how do the changes satisfy the SEC's stated reform objectives of increasing transparency, addressing susceptibility to runs and preserving the benefits of money market funds? Let's take a look:

Form N-MFP – This form has been a standard holdings filing for money market funds since November 2010. The form is used to provide detailed holdings information to the SEC and, by extension, the general public. It provides a level of holdings transparency that can assist investors in comparing money market fund investments. The April reform required a few significant changes, the most notable being the immediate publication of the information on the SEC's EDGAR database upon filing, where there used to be a 60-day lag. Additionally, funds are now required to provide weekly mark-to-market values at both the overall fund and individual shareclass levels and also to populate shareholder flow and liquid asset percentages.

SEC Objective, as we understand it: Increase transparency (well, actually, in the adopting release the objective was, "Help investors understand the risks of their investments.").

Mission accomplished? Yes, we believe so. More fund information, available in a standard and timely format can only help investors understand their investments. We are all for transparency and ensuring investors have the data needed to make informed decisions.

Enhanced Stress Testing – Money market fund portfolios have been stress testing portfolio holdings since 2010 to assess each fund's ability to maintain a stable share price. The revised stress tests are designed to assess a fund's ability to not only control principal volatility, but also to maintain weekly liquid assets at or above 10%. When conducting a stress test, various hypothetical adverse scenarios / events including increases in interest rates, downgrades, defaults, shareholder outflows, spread widening of various securities and sectors and any combination thereof are applied to a fund's holdings. Tests are conducted monthly and results are presented to each fund's board of directors at the next regularly scheduled meeting. The results can assist the board in understanding the fund's risk exposure, which can directly influence oversight priorities and may result in adjustments to portfolio construction and risk mitigation protocol.

SEC Objective, as we understand it: Preserve the benefits of money market funds

Mission accomplished? Yes, we believe so. Making stress testing more stringent and standardizing the testing parameters will assist fund families in assessing whether their portfolios are positioned to withstand market events. Results may ultimately be incorporated into portfolio composition. Stress testing models can also be utilized off-cycle to assess how a specific market event may impact a portfolio's liquidity or share price. Ultimately, fund families want the same thing as investors want – a stable share price and ample liquidity to honor redemptions – and enhanced stress testing is another tool to help managers achieve these objectives.

Enhanced Diversification – The idea of diversification is central to managing a money market fund portfolio. Essentially, diversification is the idea of investing in many different securities in order to protect a portfolio against a severe loss should a portfolio holding lose value. Money market funds have been diligently fostering portfolio diversification for decades. The new reform made several slight changes to issuer and sponsor limitations in order to decrease the chance that a portfolio could be too heavily invested in any single ultimate entity.

SEC Objective, as we understand it: Preserve the benefits of money market funds

Mission accomplished? Yes, we believe so. The 2014 reforms limited the maximum exposure to an entity by requiring funds to aggregate affiliate issuers and also put more stringent limits on exposure to asset-backed commercial paper sponsors and demand-feature guarantors. Admittedly, that may be a bit hard to follow and the rules are quite technical. An example may help: Under the 2010 reforms, if an ultimate parent had three subsidiaries or related entities that all issued debt, a money market fund could have potentially held a 5% position in each of those three issuers. The 2014 reform limits the exposure to a total 5% position. These diversification enhancements are designed to spread out the risk in money market funds and limit any potential downside impact should an issuer or guarantor get into trouble. At First American Funds, we agree so much with these changes that we were actually following similar guidelines several years before the SEC proposed them.

Enhanced Disclosure Reporting – This new requirement calls for each money market fund to make a daily website posting with a six-month look-back on certain fund data elements. It is intended to give investors a longitudinal view of trends in a fund's shareholder flows, market-based net asset value (NAV) and daily and weekly liquid asset percentages. The purpose of this reporting is to increase transparency and help investors understand risks in a portfolio.

SEC Objective, as we understand it: Increase transparency

Mission accomplished? Yes, we believe so. The key in this case is to ensure investors understand what the report is showing. Each fund's enhanced disclosure report provides six months' worth of data, affording some historical context. The history provides a gauge of what range of values is normal for a particular fund. Taking it a step at a time, the **market NAV** represents what the share price of the fund would be if the underlying portfolio holdings were being priced at the market price rather than amortized cost. This number is expected to fluctuate slightly over time as market conditions change. Of note is the fact that only prime and tax-free funds open to institutional investors will actually transact at this value beginning in October 2016. Retail and government type funds will continue to rely on amortized cost pricing and offering shares at $1.00, making the market NAV a simple point of interest. **Shareholder flows** are next, and represent the net of all shareholder trades for a given day. Shareholder flows can be cyclical and tend to increase around quarter-end periods.

Additionally, many fund families request pre-notification for large trades so the portfolio manager can ensure the fund has enough liquidity on hand to meet redemption requests. Finally, the **daily and weekly liquid assets** metrics allow for investors to see what percentage of the fund is invested in securities maturing overnight or within seven days. The weekly liquid assets value will come into play in October for all prime and tax-free funds (the provisions are also available for government portfolios, though the First American funds have issued a press release stating they do not intend to rely on them). Beginning October 14, 2016, prime and tax-free funds will be subject to the liquidity fee and redemption gate provisions of the reform if weekly liquid assets fall below 30%. The actual rule states these funds may impose a liquidity fee of up to 2% if weekly liquid assets fall below 30% and, further, that a fund must impose a fee of 1% if weekly liquid assets fall below 10% – but only if a fund's board feels it is in the best interest of shareholders. Prime and tax-free funds would also be allowed to suspend redemptions for up to 10 days in any 90-day period should weekly liquid assets fall below 30% – again with the caveat that the board would need to deem the gate to be in the best interest of shareholders. In reviewing historic weekly liquid asset percentages of the First American Prime Obligations Fund, one can see that our portfolio manager has carried liquidity well in excess of 30%, a trend we expect to continue. It is our position that shareholders invested in money market funds expect principal preservation and daily access to their investment. We will continue striving to manage our portfolios with weekly liquid assets in excess of the 30% fee and gate trigger.

So, there you have it – Money Market Reform, Part II. Hopefully, that gives our shareholders an idea what we have been up to for the past several months. The next and final piece of the 2014 Money Market Reform will be completed in October. Look for more information from us in the coming months to help you understand how these reforms and the resultant changes may impact your liquidity investments.

Author's Bio:

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Sources:

Securities and Exchange Commission, RIN 3235-AK61 (Money Market Reform; Amendments to Form PF, July 2014.

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.
Securities and Exchange Commission (**SEC**) is the federal agency that regulates the registration and distribution of mutual funds.

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