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BRACING FOR NEW MONEY FUND RULES

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Bracing for New Money Fund Rules

When prime funds switch to a floating net asset value this fall, many investors are expected to find other places to stow their cash.

BY SUSAN KELLY

The approach of the October implementation date for new rules governing institutional prime money market funds is shaping up as a dividing line for corporate treasuries and other institutional investors, with many observers predicting a mass exodus from prime funds in the months before the rules take effect.

"There is an expectation that sometime this summer—the end of the second quarter, certainly going into the third quarter—a significant amount of the money that is in institutional prime funds will move over into government money market funds," said Roger Merritt, managing director at Fitch Ratings.

"Treasurers are either undecided about how they feel about the new features of institutional prime funds or they're just sort of nervous about getting through this period of transition," Merritt said. "I think many of them will choose the safest route and move the money into government money market funds."

Michael Berkowitz, head of North America and global liquidity product management at Citi, said a Citi survey last year of its institutional and corporate clients showed they expected from $200 billion to $400 billion of the roughly $900 billion in prime funds at the time would flow out of the funds.

Berkowitz predicted that the move out of prime funds "is likely to ramp up in the September time frame.

"My expectation is that there would be a number of corporate investors as well as institutional investors who would want to play it cautiously for that time around the reform," he said.

The Securities and Exchange Commission rules that take effect on Oct. 14 mandate that institutional prime funds switch to a floating net asset value (NAV) from the stable, $1-a-share value the funds currently use. The new rules also require that funds' boards consider instituting redemption fees or gates if a fund's weekly liquidity falls below 30%. The new requirements also

apply to institutional municipal money market funds, but not to government funds.

The changes make prime funds less attractive to companies; the floating NAV complicates accounting for short-term investments, while gates and fees raise the prospect of not being able to access all of their cash when they need to, a daunting prospect given that companies use prime funds to store funds they might need to access quickly.

As a result, there are forecasts that as much as 50% of the assets in prime funds may flow out in coming months.

Assets held in institutional prime funds have already declined over the last six months or so as fund companies converted prime funds into government funds. Since late October of last year, 55 institutional and retail prime funds, with $221.8 billion in assets, have been converted into government funds, according to the Investment Company Institute, while another four prime funds, with $1.8 billion in assets, were turned into short-term bond funds. As of May 11, institutional prime funds held $771.9 billion, down from $934.7 billion on Oct. 21, before the conversions began, according to ICI data.

It is a new world for short-term investing. There are new products that are out there. Corporates may certainly want to revisit not only their policies, but their procedures as well.

—MICHAEL BERKOWITZ, CITI

Brandon Semilof, managing director at StoneCastle Partners, said prime funds' turning themselves into government funds indicates what the fund companies expect investors to do.

"If fund companies thought there would be demand for funds when there are gates and fees, they wouldn't have converted," Semilof said. "To me, that's a sign that the appetite for these products is going to be significantly less than it is today."

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Temporary Moves?

Many observers expect, though, that corporate investors' move out of prime funds will be temporary and that companies will filter back into prime funds once they see how they're operating under the new regime.

Ben Christensen, corporate cash team lead at Clearwater Analytics, which provides investment reporting and analytics for institutional investors, compared attitudes about the October rule changes to the run-up to Y2K, the shift into the year 2000 that created fears of problems with computer software.

Ahead of Y2K, "even the most realistic person still bought a couple of cans extra on the last day of the year," he said. Some corporate investors feel the new rules won't pose that big of a problem, but "they still are taking the appropriate measures to prepare," Christensen said. "Most people expect to sell out in August and then reinvest in October after analyzing the changes that have been made."

Others question whether treasurers will flee prime funds at all.

"The companies we know that invest in institutional prime intend to keep doing it in the future," said Paul LaRock, a partner at consulting firm Treasury Strategies.

Tory Hazard, president and chief operating officer at ICD, a trading portal for institutional investors, said monitoring the NAVs of prime funds shows there's very little movement. Since funds began providing daily data in mid-April, "four of the biggest funds on our portal have not had any variability and two have varied by a basis point," Hazard said.

The gains and losses that would result from such small moves in NAVs are dwarfed by the additional return that prime funds provide compared with government funds, he added.

"The clients that we've spoken with that are in prime funds don't intend to move, once they understand it," Hazard said. "We don't think there will be a huge migration."

In another soothing note, Sagar Patel of Morningstar Inc. said some fund managers are rejecting fees and gates. "We've seen a number of disclosures start to come out in the company prospectuses for these money market funds, particularly these prime funds," said Patel, who's Morningstar's database leader for U.S. open end funds. "And it's been interesting to see that the overwhelming majority of them have been saying that though this fund could utilize these fees and gates, we are choosing not to employ those tools."

Reading the Tea Leaves

In mid-April, prime funds began providing daily data on their daily and weekly

Practical Aspects of the Move to a Floating NAV

The shift to a floating net asset value has some practical implications for treasuries that invest in prime funds. Most importantly, instead of settling once a day at the end of the day, funds will have multiple strikes during the day.

Most fund managers have announced schedules with three strikes a day, at 8 a.m. or 9 a.m. ET, noon ET, and 3 p.m. or 4 p.m. ET. Companies will have to be aware of funds' schedules and time their redemptions according to when they need the money.

Tory Hazard, president and chief operating officer at trading portal ICD, cites the example of a company that wants its settlement to arrive during the morning. Assuming the first strike is at 9 a.m., the company would have to make a redemption trade by that time. "The fund will price between 9 and 10 or 10:30, and the corporate can expect settlement between 10:30 and 11:30," Hazard said. If the company wants its money during the afternoon, it could trade by noon to receive settlement between 1:30 and 2:30 p.m., or trade by 3 p.m. to receive settlement between 4:30 and 5:30 p.m., he said.

"One of the things corporates will need to be mindful of is that depending on when they invest or redeem during the day, they could wind up with a different share price for that investment or redemption," said Michael Berkowitz, head of North America and global liquidity product management at Citi.

"And if they're going to make a redemption, at what price did they buy into that fund, and do they want to take a gain or loss, or do they want to look for a fund to redeem that won't involve a gain or loss?" Berkowitz added.

Hazard noted that systems such as portals and workstations will need to be updated to be able to account for fund shares, since prime funds will go from trading on the amount of money involved to the number of shares.

A company will still place an order to invest, say, $10 million in a fund, he said. "But the workflow and operations will show the shares and whatever the strike price is." T&R

liquidity levels, net asset values, and flows. That information, particularly the weekly liquidity levels, will become important for treasury investors as the October implementation of the new SEC rules approaches, bringing with it the possible imposition of redemption fees or gates.

Lance Pan, director of investment strategy and research at Capital Advisors Group, said institutional prime funds currently are posting weekly liquidity levels in the neighborhood of 45%, well above the 30% trigger the SEC has set for considering fees or gates.

Pan predicted prime funds' liquidity levels will go even higher as October approaches. Managers of the funds will brace for possible redemptions by buying shorter, more liquid securities, which will hold down both the weighted average maturities of the funds and their yields, as well as boosting liquidity levels.

"Going into October, I would not be surprised if that [weekly liquidity] goes to 60% or even higher," he said. "It's just to accommodate the potential shareholder outflow. No one has a crystal ball, and the portfolio managers would rather be more prudent, which is the right thing to do."

Institutional investors need to track the liquidity levels of their prime funds every day going into the fall, Fitch Ratings' Merritt said.

While a fund's liquidity may have been 40% when the company invested in it last week, "where is it today? And is it trending down toward 30%? And is that leading other investors to preemptively take money out?" he said.

"If [corporates are] going to make use of prime money market funds, they have to monitor on a daily basis," Citi's Berkowitz agreed.

ICD's portal recently implemented an upgrade that allows clients to specify the weekly liquidity level they want on prime funds, Hazard said. The portal will stop clients from investing if a fund is below that level and alert them if a fund they've already invested in breaches the level.

Greg Fayvilevich, a senior director at Fitch Ratings, said the number of a fund's investors is another factor to consider. If two funds both have 40% weekly liquidity, but one has 1,000 investors and the other has just 15, the fund with the larger investor base is likely to have an easier time maintaining its liquidity level, he said.

The information isn't easy to come by, though. "For investors, it's either looking at the rating or making sure they talk to a fund manager and make sure they understand who the other investors in the fund are," Fayvilevich said.

Fed Tightening as a Factor

One wild card going into the fall is Federal Reserve monetary policy. The first Fed interest-rate increase in December boosted prime funds' yield advantage over government funds to about 20 basis points. If the Fed tightens again and the spread widens more, that could convince some corporate investors to stay put in prime funds.

"Once the yield differential between prime and government funds gets between 25 to 40 basis points, that would make prime funds significantly more attractive to investors," Berkowitz said. That spread probably wouldn't be enough to keep investors from exiting ahead of the October regulatory changes, but could encourage them to move balances back into prime funds after the changes have occurred, he said.

Government funds, which will continue to offer a stable NAV and are not subject to redemption fees or gates, are expected to see a good share of any assets flowing out of prime funds.

Given the amount of money that could be in motion heading into October, that sounds like a challenge. But there should be plenty of U.S. securities for government funds to buy.

Capital Advisors' Pan noted that the U.S. Treasury has boosted its short-term issuance this year and plans to issue more very short-term bills, maturing in one to four weeks. And the Federal Reserve's reverse repo program has $2 trillion of capacity, up from a previous cap of $300 million. "That conceivably could satisfy all of the outflows," he said.

Companies that decide to pull money out of prime funds will consider a number of short-term investments in addition to government funds, Berkowitz said. "We would expect some corporates to look at different bank deposit instruments as a way of retaining safety of principal and liquidity and achieving their yield objectives."

He noted that Citi has rolled out 31-day minimum maturity time deposits, in which investors provide notice when they want to exit. The bank also made improvements in its earned credit rate (ECR) structures, which provide companies with an interest equivalent on deposits that they can use to offset bank fees, by allowing ECRs to be used against additional types of fees and making them available in Western Europe.

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> —TORY HAZARD, ICD

Bank deposits have been the go-to place for companies to park their cash, with the Association for Financial Professionals' 2015 liquidity survey showing 56% of companies' short-term funds were in bank deposits. The survey showed just 15% of companies' short-term money was in money funds, a sharp drop from 30% in 2011.

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Preparing for Investment Policy Change: Navigating U.S. Money Market Fund Reform

By Michael N. Berkowitz

Impending U.S. money market fund (MMF) reforms are creating new investment challenges for organizations. Understanding these reforms is vital when it comes to navigating the changing landscape.

Beginning on October 14, 2016, new SEC rules come into effect that will seek to strengthen the MMF industry through the imposition of a floating Net Asset Value (NAV). This rule will also allow for liquidity fees and redemption gates on prime and municipal institutional funds, and it has already increased the amount of government securities and the equivalent that government funds have to hold.

While implementation is still months away, several funds have chosen to comply earlier. This means that companies investing in MMFs should be aware of the impact of these changes and develop a concrete plan that best fits their investment strategies.

Understanding the Changes Coming To Funds

With the new reforms comes a greater focus on the potential implementation of liquidity fees and redemption gates. While gates are not necessarily a new function of the funds, the regulations give boards a specific guideline of when they have the option to implement fees or gates, based on predetermined weekly asset liquidity levels.

Such weekly assets include those with a maturity within seven days, those that have a callable feature due within five days, cash, obligations of the U.S. government, and securities of government agencies maturing within 60 days. If these weekly assets fall below 30% of overall fund assets, the fund's board may impose a fee of up to 2% — should the fee be in the best interest of other shareholders — and they also may impose gates limited to 10 days within any 90-day period. If weekly assets fall below 10%, the fund is required to impose a minimum 1% fee, or up to 2%, but the fund manager has certain discretion to waive the fee, and continues to be able to impose gates limited to 10 days within any 90-day period. Funds will be required to report weekly liquidity percentages to provide transparency to investors if the potential for a fee or gate is on the horizon.

Fees and gates are left up to the fund's discretion and are put in place to prevent runs on the fund and take away any "first mover" advantage. Fees and gates are designed to protect those investors who remain in the fund, by imposing a cost on those who exit the fund. The fees are paid to the fund itself, rather than the fund manager, to compensate shareholders left in the fund. The gates give fund managers a chance to successfully navigate a short-term market stress scenario. Despite the amount of attention given to the fees and gates in this regulation, the majority of funds already have wording in their prospectuses that allow them to deny redemptions or charge a redemption fee, if it is in the best interest of the majority of the shareholders. This regulation standardizes the practice across all prime funds. Even though funds will have the ability to implement gates and fees, many managers will remain extremely cautious, attempting to avoid the reputational risks associated with imposing them.

The Floating NAV is Changing the Way Corporations View MMFs

The floating net asset value (NAV) poses a significant change in how corporations view prime and municipal institutional MMFs. Historically, MMFs have been treated as stable, fully liquid funds. Going forward, those funds will be required to strike intraday NAVs, to the 4th decimal place, putting investments at risk of potentially losing, or gaining, value of principal. For example, a fund could strike a NAV at 9:00 a.m. for 1.0000, and they could strike again at 12:00 p.m. for 0.9999, which would be a $10,000 loss for every $100MM invested in the fund.

Despite the floating NAV, funds strive to provide stable pricing. As of April 14, 2016, they have been required to provide historical NAVs on a trailing six month basis to show stability, and many funds are choosing to provide even longer history to demonstrate their stability. Funds are also required to run stress testing scenarios to prove fund price stability. Exact timing and number of NAVs per day will differ from fund to fund, the timing of which many funds have already disclosed. Once NAV strike times are established, corporations will need to

be cognizant of new processing times when investing and redeeming funds. Because funds have to process and strike multiple NAVs each day, the handling of investments and redemptions could be delayed. Tax implications of floating NAVs may be an additional consideration; consultation with tax professionals is critical.

For companies that require a stable NAV, government and treasury funds will remain a viable option. Government funds will be required to hold 99.5% of their assets in government or equivalent securities, as opposed to the prior limit of 80%. Some prime funds are reclassifying themselves as government/treasury funds so they can continue to offer stable pricing. While these funds will offer a stable NAV, they also will generally have lower yields. For treasurers looking for a yield greater than treasury and government funds, while satisfying capital preservation and liquidity needs, bank earnings credit rate programs and direct securities or bank deposits with tenors of greater than 31 days may help to achieve these goals.

The Impending Shift from Prime Funds to Other Investments

Based on a Citi survey, a total of $200–$400 billion is expected to move from prime funds into other investments, such as treasury and government funds, bank deposits or other securities. As October 2016 approaches, prime funds are expected to shorten their weighted average maturity (WAM) to prepare for any major shifts in the market, which could potentially lower the spread between government and prime funds. If a significant amount of funds convert from prime to government, the yields on government funds could also be depressed, due to the increased demand of applicable securities by the fund families. Citi's survey results indicated that once the spread between prime and government funds reaches 20–40bps, deposits will start to flow back to prime funds.

In response to MMF reform, Citi is making several upgrades to Citi Online Investments, which is a multi-fund family portal that offers investment analytics and new reporting functionality to help ease the burden of the reform. In combination with MMF reform, Basel III, and the anticipated continued rise in USD rates, an increased focus on segmentation of cash into various liquidity buckets will be critical. For longer-dated cash, Citi has released competitive yielding Minimum Maturity Time Deposits, with tenors of 31, 45, 60 and 95 days, with further tenor options to come. Fund managers are also responding with new product offerings, including 7-day and private funds to help ensure compliance with liquidity requirements and/or maintain stable NAVs.

As the MMF reform deadline nears, it is highly recommended that treasurers review and update their investment policies, focusing on wording that may limit certain MMF investments following these regulatory changes. Regardless of regulatory change, best practice would dictate reviewing and updating one's investment policy at least once per year. While many will still consider prime funds a viable investment option, it is important to remember that fees and gates may be imposed, but only as tools to be used in times of extreme market stress. Tools such as these already exist today and are not new to the market. Finally, it's important to note that fund managers will, in all likelihood, act very cautiously when it comes to utilizing these tools because they want to avoid the reputational risk of implementing liquidity fees and gates.

As prime funds shorten their WAM, government and treasury MMFs may prove appealing to conservative investment policies, but they will likely come with lower returns. The upshot is that in today's increased regulatory environment, it is imperative to sit down with your banking/financial, legal and tax partners to determine how your current investment strategy may be affected by new reforms.

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NEW RULES (continued from page 5)

But new regulations governing bank reserves mean large banks are discouraging companies from depositing non-operating cash.

> Going into October, I would not be surprised if that [weekly liquidity] goes to 60% or even higher. It's just to accommodate the potential shareholder outflow.
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> —LANCE PAN, CAPITAL ADVISORS GROUP

"Banks are forced to turn away some of their corporate depositors," Pan said, citing Basel III's liquidity coverage ratio and supplementary leverage ratios as factors that are "limiting banks' balance sheet capacities."

The liquidity coverage ratio "certainly does make holding non-operating deposits, particularly from financial institutions, much more costly for banks," Berkowitz said.

Banks have responded by dividing deposits according to whether they're operational or non-operational, he said, as well as looking at deposits with maturities greater than 31 days.

Banks should talk with corporate clients about what the regulations mean for them, Berkowitz said, and corporates should be clear about which of their cash is operational, "defining operational as that cash that will be needed for outgoing payments over the very near term, versus non-operational cash that can be termed out for 30, 60, or even 90 days."

Alternatives

Citi has also been talking to the fund companies it works with about possible new offerings, Berkowitz said, including seven-day funds and private funds.

Seven-day funds would buy only assets that mature in seven days or less, so their weekly liquidity ratio could never fall below the 30% level that triggers fees or gates, he said, and the very short maturity also suggests the net asset value would be unlikely to move.

Private funds would resemble prime funds but would be able to retain a stable NAV since they wouldn't be subject to the SEC's new rules.

Fund companies are also adding short-term bond funds, which have the same floating NAV as prime funds will have once the new rules go into effect, but aren't subject to fees and gates.

Hazard said products that ICD has added to its portal recently, partly in anticipation of demand if investors exit prime funds, include short-term bond funds; Federally Insured Cash Accounts, or FICAs, which are brokered bank deposits offered by StoneCastle Cash Management; and FDIC-insured brokered certificates of deposit from Saxon Securities.

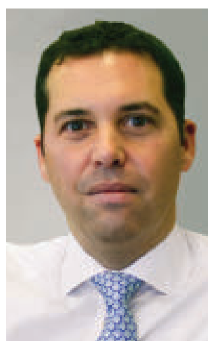
Fitch Ratings' Fayvilevich said corporate treasurers need to look closely at the investment parameters of other short-term investments they're considering.

"The thing with a lot of the alternatives, whether it's a private money fund or short-term bond funds: They don't have the same strict rules that [SEC rule] 2(a)7 imposes on money funds," he said. "A lot of these products can have different policies. One short-term bond fund is different from another short-term bond fund, while prime funds are pretty similar."

Tasks for Treasurers

The changes that will occur this fall in institutional prime funds and the possibility that companies may want to use other types of short-term investments once prime funds comply with the new regulations mean corporate treasuries should be reassessing their investment policies.

"If there's any language that would speak to only being able to invest in stable net asset value funds or constant net asset value funds, that would be language they would want to revisit," Berkowitz said. "If there is language regarding not being able to lose principal, that would also be important potentially to revisit, because with floating net asset value, while the amount of principal you could lose would be small, it is nonetheless principal [you would lose] if the NAV goes down by one or more basis points. It's important for clients to revisit those aspects of their investment policies."



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>
> —BRANDON SEMILOF, STONECASTLE PARTNERS

Treasurers should also meet with banks and other investment providers to discuss their investment policies and goals, he said.

"It is a new world for short-term investing," Berkowitz said. "There are new products that are out there. Corporates may certainly want to revisit not only their policies, but their procedures as well." T&R

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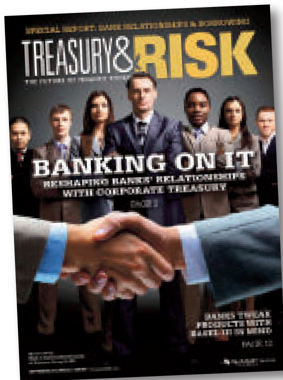

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