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Money Market Reform

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Investors will recall that at the peak of the Financial Crisis in 2008, The Reserve Primary Fund "broke the buck" by reducing its net asset value (NAV) below $1, a consequence of failed short-term loans issued by Lehman Brothers. Panic ensued, the fund lost two thirds of its assets overnight, and it eventually had to liquidate.

In response to the panic, the Securities and Exchange Commission (SEC) imposed a series of new regulations beginning in 2010, which were designed to make all money funds more stable and resilient. Some of the implications involved tighter restrictions on portfolio holdings, enhanced liquidity and credit quality requirements, and greater transparency.[1]

Money market investors' reaction to the new restrictions was generally favorable. But during periods of enhanced volatility, the behavior of institutions, whose redemptions were far greater than purchases, was in stark contrast to the more balanced stance of retail investors, whose purchase and redemption flows tended to offset one another. This imbalance, which contributed more stress to markets during these turbulent periods, gave the SEC added incentive to issue even stiffer rules, with an overarching goal of distinguishing between retail and institutional investors.

The theory behind the stronger rules is to protect retail investors from the actions of institutional investors, who historically have been more inclined to make redemptions during periods of high volatility. When institutions redeemed, retail investors were subjected to losses in cash positions that they had assumed were stable. These enhanced rules become effective on October 14, 2016.

The most significant change is that institutional money market funds now must have a floating NAV, rather than a fixed share price, presenting a principal risk that didn't exist before. Although this provision will not affect individual investors (who will continue to see a stable NAV), institutional prime and municipal money market funds must comply with this floating NAV stipulation, as investors in these funds are considered to be more likely to redeem during times of market stress.

However, both individuals and institutions will be subject to provisions that can temporarily suspend withdrawals (also known as gates) for up to 10 business days during a 90-day period, or incur fees on redemptions during times of extreme volatility.

Strict rules will govern classification of a retail fund, which must maintain a stable $1.00 share price, or NAV. The fund must be limited to accounts that are associated with a social security number, denoting 'beneficial ownership'. Included in this definition are accounts that are individual beneficiaries of revocable trusts, or participants in tax-deferred accounts, such as IRAs and 401Ks. However, some individual 401K plans may invest in prime money market funds within these accounts. If so, these funds are considered to be institutional in nature, and are subject to the new rules. Therefore, those plan sponsors now must either offer a government money market fund (with at least 99.5% of its assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities), or provide another alternative for these funds.

Accounts not beneficially owned by individuals (otherwise known as natural persons), may access only institutional money funds, whose NAV will float. Among examples of

[1] October 2014 https://personal.vanguard.com/pdf/VGMMR.pdf

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these accounts are corporate accounts, defined benefit plans, foundations, irrevocable trusts, and endowments. These institutional accounts will no longer be permitted to invest in retail funds.

For both retail and institutional funds, and tax-exempt money market funds, the assessed liquidity fees are computed based on trigger levels that reflect a fall in a fund's weekly liquid assets. Should a fund's liquid assets decline by up to 30% of the fund's total assets, the liquidity fee can run as high as 2%. Required liquidity fees for non-government funds whose liquid assets drop by 10% of total assets are assessed at 1%, unless its board determines that either the fee is not in the fund's best interest, or that a higher (not to exceed 2%) or lower fee is more appropriate. US government money market funds may levy liquidity fees, but they are not required to do so.

Other stipulations apply as well, including greater diversification, disclosure, reporting, and stress testing requirements.

- **Diversification –** The rules govern the level of fund holdings issued by a specific entity or affiliated group, as well as those guaranteed by a specific sponsor or demand feature provider.]
- **Disclosure –** A fund must disclose on its website both its daily and weekly assets, net inflows or outflows, NAVs per share, fees imposed, and redemption restrictions to prevent a run on the fund.
- **Reporting –** A fund must report to the SEC whenever it assesses either liquidity fees or gates, or when a security defaults in the portfolio.
- **Stress testing –** A fund must routinely perform a test of its ability to maintain at least 10% of its portfolio in liquid assets and minimize volatility.

In summary, retail investors will see limited change under the new rules. Institutional investors, on the other hand, face significant changes. They may either invest in US government money markets, which will not carry a floating NAV, but will generate a lower yield, or select other options that may have higher yields but also heightened volatility.

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