The SEC’s Proposed Money Market Fund Reform: New Challenges for Market Participants

Implementation of either of two approaches to the SEC’s proposed money market fund reform will pose its own set of challenges for market participants, but one appears to be more daunting.

Executive Summary

In June of 2013, the U.S. Securities and Exchange Commission (SEC) proposed money market fund (MMF) reforms, which offered two approaches: one based on floating net asset value (NAV); the other involving liquidity fees and gates. Some additional disclosure, diversification and stress-testing requirements were also presented.

The reforms are intended to curb systemic risks, such as a “run” on MMFs, which occurred in 2008. At the same time, the proposed changes will present significant challenges for market participants looking to implement them. This could very well prompt some sponsors to consider the economic viability of continuing to manage MMFs.

In this paper, we explain the proposed MMF reforms and examine the challenges that market players will likely face when applying them.

The SEC Proposal: An Overview

Money market funds have traditionally been a preferred cash-management tool for retail and institutional investors, largely due to their stable share prices, and their ability to afford liquidity and pay short-term yields.

In September of 2008,1 the share price of the Reserve Primary Fund plummeted below US$1.00 (i.e., “broke the buck”), owing to its investments in Lehman Brothers’ commercial paper. This triggered a run on the fund by investors. Other MMFs faced a similar fate – prompting the Securities and Exchange Commission to take a hard look at the regulation and disclosure practices of MMFs.

MMFs are regulated by Rule 2a-7 under the Investment Company Act. The SEC made some amendments to Rule 2a-7 in March of 2010 to reduce the interest rate, credit and liquidity risks faced by MMFs. In June of 2013, the SEC proposed two alternatives for further reforms:

- **Floating Net Asset Value** requires MMFs to value their portfolios based on market-driven factors, instead of on the current amortized cost method. This approach also obliges MMFs to price their shares based on the basis-point rounding method, rather than on the current penny-rounding system.

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The rationale is that MMF share prices will always reflect true market value, and thus curb the propensity for redemptions during times of stress.

- **Liquidity Fees and Gates** proposes that MMFs continue to trade at a stable NAV until weekly liquid assets fall below 15% of the total assets. If the 15% level is breached, an MMF would be expected to charge up to a 2% fee (liquidity fee) on any redemption. MMFs would also be allowed to stop redemptions for up to 30 days in a 90-day period, i.e., impose a “gate.”

The logic here is that a liquidity fee will dissuade investors from redeeming during times of stress. If the liquidity fee fails to ease the redemption pressure, then the board would apply a gate to halt the redemptions.

### Additional Requirements
The SEC has also put forward additional requirements related to diversification, stress testing and disclosure.

#### Diversification
The SEC has proposed to amend the existing 5% issuer diversification rule. Under the current directive, an MMF can invest up to 5% of its assets in the first-tier securities (government securities) of a single issuer. Under the new proposal, the 5% restriction will apply to an MMF’s aggregate exposure across all affiliated issuers – effectively treating all as a single issuer.

The current rule specifies that MMFs are not permitted to invest more than 10% of their fund assets in securities, subject to a demand feature or a guarantee from any one provider. However, the rule provides for a so-called “25% basket,” under which as much as 25% of the value of securities held in a fund’s portfolio may be subject to guarantees or demand features from a single institution. The amendment proposes to include sponsors of asset-backed securities as guarantors and do away with the 25% basket.

#### Stress Testing
The current regulation mandates that MMFs conduct stress tests to ascertain their ability to transact at stable prices if the following events occur:

- Changes in short-term interest rates.
- An increase in shareholder redemptions.
- A downgrade of or default on portfolio securities.
- An increase/decrease in yield spreads against an appropriate benchmark.

The SEC proposes to modify the stress tests under the Floating NAV approach. Instead of testing a fund’s ability to trade at stable NAV, the stress test would focus on gauging the fund’s ability to avoid having its weekly liquid assets fall below 15% of its total assets.

Funds exempted from the Floating NAV requirement are expected to stress-test their capability to trade at stable NAV and to maintain liquidity.

In the Liquidity Fees and Gates proposal, a fund would be required to test its ability to transact at stable NAV and avoid having its weekly liquid assets fall below 15% of its total assets.

All funds would be asked to increase the scope of their stress testing to incorporate:

- Correlation among securities and concurrence of events.
- The effect of downgrades or default of securities on other securities, instead of only checking the effect of a downgrade or default of securities in isolation.
- The ability to meet increased redemptions, rather than testing only for an increase in redemptions.
- Increases in short-term interest rates, rather than changes in short-term interest rates.
- Testing for the widening or narrowing of spreads among the indexes to which the interest rates of their portfolio securities are linked. The current rule requires stress testing for “widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund.”

#### Disclosure
The SEC amended rule 2a-7 to require MMFs to provide additional and more frequent disclosures and increase transparency. The objective is to enable investors to evaluate the risks associated with each fund and allow the SEC and financial regulators to obtain the information necessary to administer the funds’ progress.

- **Financial Support Provided to MMFs**

  MMF sponsors have often provided liquidity support during market crises, especially during the 2008 financial industry meltdown. Disclosures about the nature and amount of support
offered by the fund's sponsor can help investors understand the performance and risks associated with the fund.

The SEC has proposed that MMFs should disclose information on both present and past instances of sponsor support.

- **Daily Disclosure of Daily Liquid Assets and Weekly Liquid Assets**
  As part of the 2a-7 amendments, MMFs would be required to disclose on their Web sites the percentage of the fund's total assets invested in daily and weekly liquid assets. Additional information, such as net inflows and outflows as of the previous business day (end of day), would also have to be disclosed.

  Funds would also be mandated to provide historical information about daily and weekly liquid assets in charts or graphs on their Web sites. Additionally, information on capital stock activity, such as subscriptions and redemptions in the previous six months, would have to be displayed and updated every business day.

- **Current NAV per Share**
  Another part of the proposed 2a-7 amendments states that MMFs will be required to disclose the fund's current NAV per share, rounded to the fourth decimal place for a US$1 share price (or an equivalent rounding level in case of a different share price) on a daily basis, on their Web site.

- **Portfolio Holdings: Harmonization of Rule 2a-7 and Form N-MFP**
  The current portfolio-related disclosure requirement mandates MMFs to disclose the portfolio holdings information on Form N-MFP within five business days of the end of each month, and also disclose most of the portfolio holdings information required by Form N-MFP on the fund's Web site each month with a 60-day delay.

  The proposed amendments will impact the categories of portfolio investments disclosed on Form N-MFP, thus also affecting the categories of portfolio investments reported on the fund's Web site. MMFs will also be required to report the maturity date for each security held in their portfolio on their site. This would be the same maturity date that is used to calculate the dollar-weighted average life maturity.

  Under the current requirement, funds disclose the amortized cost value of each portfolio security. The SEC has proposed that funds declare the market-based value of the portfolio securities on the fund's Web site at the same time it is disclosed on Form N-MFP.

Some Approach-Specific Disclosure Requirements

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<thead>
<tr>
<th>Disclosure – Floating Net Asset Value</th>
<th>Disclosure – Liquidity Fees and Gates</th>
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<tbody>
<tr>
<td>• Risks associated with investing in a floating NAV MMF (except for government and retail MMFs) should be disclosed in any advertising or sales material that the fund disseminates (including on the fund’s Web site).</td>
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<td>• The statement about the primary risks of investing in MMFs included in those materials should be re-worded to emphasize that MMF sponsors are not liable to provide financial support, and that MMFs may not be an appropriate investment avenue for investors who are averse to accepting losses.</td>
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<td>• For government and retail MMFs, disclosure should be made in the fund’s advertising and sales material, and in the summary section of the fund’s statutory prospectus, informing investors about the risks involved in investing in MMFs in general.</td>
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<td>• Disclosure regarding the tax consequences to the shareholders of buying, holding, exchanging and selling the shares of the floating NAV fund should be made in the fund prospectus.</td>
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<td>• MMFs (except government and retail MMFs) will no longer be required to state that they will strive to maintain a stable NAV of US$1.00.</td>
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<tr>
<td>• Risks involved in investing in a fund that may impose liquidity fees or redemption restrictions should be disclosed in any advertising or sales material that it disseminates (including on the fund’s Web site).</td>
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<tr>
<td>• The statement about the primary risks of investing in MMFs included in those materials should be re-worded to emphasize that MMF sponsors are not liable to provide financial support, and that MMFs may not be an appropriate investment avenue for investors who are averse to accepting losses.</td>
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<td>• For government MMFs exempted from liquidity fees and gate requirements, the disclosure should be made in the fund’s advertising and sales material, and in the summary section of the fund’s statutory prospectus, informing investors about the risks involved in investing in MMFs in general. The registration statement (except for government MMFs exempted from the liquidity fee and gate requirement) should disclose the probable effects of imposition of fees and/or gates on a shareholder’s ability to redeem shares of the fund.</td>
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<td>• Existing and potential shareholders should be informed when: (1) the fund’s weekly liquid assets fell below 15% of its total assets; (2) the liquidity fee is imposed by the fund’s board of directors; or (3) redemptions are temporarily or permanently suspended by the fund’s board of directors.</td>
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<td>• Existing and potential shareholders should be informed of historical occasions when the fund’s weekly liquid assets fell below 15%, or the fund imposed liquidity fees or redemption gates.</td>
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The Operational and System Impact on MMFs and Their Intermediaries

Implementation of either of the two approaches – Floating NAV or Liquidity Fees and Gates – will present operational and system changes and challenges for MMFs and their intermediaries.

Operational and System Changes: Floating NAV Approach

The table below depicts at a high level the requirements that need to be addressed by MMFs under the Floating NAV approach.

| Floating Net Asset Value | • Portfolios should be valued based on market-driven parameters – not on an amortized cost basis.  
| | • Provisions should be made for using the amortized cost method subject to certain criteria, such as when the board is able to ascertain that the debt instruments having maturity of less than 60 days have a fair value that is equivalent to their amortized cost.  
| | • Pricing of shares should be based on basis-point rounding, rather than on the current penny-rounding method.  
| MMF Exemptions Under Floating Net Asset Value | Government and retail MMFs will be excluded from the Floating Net Asset value requirement. They can continue using the penny-rounding method for pricing to maintain a stable price, but will not be able to use the amortized cost method of valuation.  
| | The system will need to have checks in place to ensure that a shareholder of record (for a single account or multiple accounts) in a retail MMF will not be able to redeem more than US$1mn in a single business day.  
| | A shareholder can, however, redeem more than US$1mn in a single business day if he/she provides advance notice.  
| | If a retail investor tries to redeem more than US$1mn in a single business day without advance notice:  
| | • The system could treat the entire order as a bad order and reject it, or  
| | • Treat up to US$1mn as a good order while rejecting the rest, or  
| | • Treat the rest (amount above US$1mn) as a redemption request for the next business day.  
| Omnibus Account Treatment Under Floating Net Asset Value | • A retail MMF will not have to impose its daily US$1mn redemption limit on an omnibus account holder, provided it can ensure that the account holder will not allow more than US$1mn in redemption by any of its beneficial owners on any single day.  
| | • A retail MMF will have to ensure that an omnibus account holder does not breach the US$1mn redemption limit while trading for its own account.  
| Tax implications Under Floating Net Asset Value | Taxable investors will be subject to tax implications, based on gains/losses arising out of their transactions. Hence, the system should be able to:  
| | • Track when and at what price shares have been purchased and sold in order to determine the profits/losses realized.  
| | • Identify “wash sales” transactions and their impact on loss computations.  
| | • Incorporate tax reporting.

Figure 2
Key Challenges – Floating NAV Approach
We foresee the following challenges for MMFs and their intermediaries in fulfilling the above requirements:

Revamp of Fund Accounting Engine
MMFs’ core fund accounting engines will need to be revamped to incorporate:

• Market-based MMF portfolio valuation.
• Basis-point rounding.

Market-Based MMF Portfolio Valuation
The valuation methodology will need to be changed from an amortized cost method to one that uses market factors for valuation. A market-based valuation methodology relies on valuation estimate models, rather than daily actual market prices of MMF securities, to value a portfolio. This is because several MMF portfolio securities, such as commercial papers, repos and certificates of deposits, are not actively traded in the secondary markets.

Currently, MMFs source portfolio security prices from the pricing vendors while calculating the “shadow prices” for their funds. MMFs could perhaps use these sourced market prices to perform portfolio valuation under Floating NAV, instead of completely overhauling the core fund accounting engine.

Basis-Point Rounding
With the introduction of basis-point rounding for pricing, shares of MMFs will need to be calculated to the nearest 1/100th of 1%, instead of to the nearest 1% under the penny-rounding method. For example, if a fund has a target price of US$1.00, then its prices would have to be computed up to four decimal places, instead of the two decimal places currently calculated.

This change will not only impact the core fund accounting engine, but also all other relevant downstream applications.

Intraday Settlement at Risk
Under the stable NAV regime using the amortized cost method of valuation, trades can be settled on the same day at various intervals. This could become difficult to achieve in the Floating NAV scenario. Valuing a portfolio several times a day will require obtaining market prices of the portfolio securities at different points throughout the day. Computing prices numerous times a day for securities that are not actively traded will pose a significant challenge. Also, pricing vendors currently send pricing data only once a day. Getting them to send this data throughout the day will call for substantial changes to the existing system.

New Price Confirmation Process Needed
Unlike in the stable NAV regime, a new price confirmation procedure will have to be introduced before a trade is settled, as prices are expected to vary.

“Retail” MMF Concept Fraught with Challenges
Currently, there is no uniform industry or regulatory definition for retail investors or retail MMFs. If required, funds themselves can make this classification, and the criteria for doing so might vary from fund to fund. Also, there are several MMFs that have both retail and institutional investors. The fund houses will have to re-designate existing funds either as “Retail” or “Institutional” and remove institutional investors from the retail funds. This will be a daunting task.

Applying Retail Exemption in Omnibus Accounts
MMFs will have to put policies and procedures in place in order to ensure that the redemption limit is applied to the beneficial owners by the omnibus account holder – all the way down the chain of intermediaries.

If the fund fails to ensure this, it must apply this limit at the aggregate level, i.e., at the omnibus account holder level. However, the US$1mn redemption limit per business day at the omnibus account holder level might prove too small an amount as a trading limit at the aggregate level.

Policies and procedures will also have to deal with possible exceptions, such as if an intermediary has allowed a beneficial owner to redeem more than the limit of US$1mn in a single day.

Currently, investor behavior within omnibus accounts is largely unknown to most MMFs. Designing appropriate policies and procedures in collaboration with their intermediaries will pose considerable challenges for these funds.

Tax Implications
MMFs and their intermediaries and shareholders will have to be ready for the tax implications under the new regime. Tracking of tax basis, tax computation and reporting should be addressed by the operational and system landscape.
Operational and System Changes: Liquidity Fees and Gates Approach

The table below displays the high-level requirements for the Liquidity Fees and Gates approach, which must be addressed by MMFs' operational and system resources.

<table>
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<tr>
<th>Table 3</th>
<th>Description</th>
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<tr>
<td><strong>Liquidity Fees and Gates</strong></td>
<td>Under the Liquidity Fees and Gates approach, MMFs will be able to use the penny-rounding method for pricing, but will not be allowed to use the amortized cost method for valuation. Funds will need to be valued using market-driven parameters. <strong>Fees</strong></td>
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<td><strong>Gate</strong></td>
<td>The Board can impose a gate if the fund’s weekly liquid assets fall below 15% of its total assets. However, the liquidity fee should be imposed first as a default, followed by a gate if required. <strong>Any redemption requests should be rejected if a fund is gated.</strong> <strong>The imposed gate should be automatically removed if weekly liquid assets become greater than or equal to 30% of total assets.</strong> <strong>Provisions should be made to allow the board to lift the imposed gate at any point in time.</strong> <strong>A gate can remain in effect for a maximum of 30 days at a time.</strong> <strong>A gate cannot remain in effect for more than 30 days within a 90-day period.</strong> <strong>There should be a provision to allow gating beyond the 30-day limit (since the adviser to an MMF could seek an exemptive order from the Commission).</strong></td>
</tr>
<tr>
<td><strong>MMF Exemptions Under Liquidity Fees and Gates</strong></td>
<td>Government MMFs (including Treasury MMFs) would be excluded from fees and gates if it is so disclosed in the funds’ prospectus.</td>
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<tr>
<td><strong>Omnibus Account Treatment Under Liquidity Fees and Gates</strong></td>
<td>Imposition of fees on omnibus accounts is expected to be similar to mutual funds’ redemption fees.</td>
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</table>
| **Tax Implications Under Liquidity Fees and Gates** | Ideally, there should be no tax implications for the funds with respect to the fees imposed. As for the shareholders, fees would reduce their redemption amount and impose losses (as the funds are expected to trade at stable NAV). However, under certain conditions there could be tax implications for funds as well: **Redemptions with liquidity fees might push up the fund’s shadow price to or above US$1.0050. To stop the fund from “breaking the buck,” additional dividends might have to be distributed to the remaining shareholders. This becomes taxable and would need to be deducted by the fund.** **In case of insufficient income and profit, the above-mentioned additional distribution will amount to “return of capital.” This might impose tax obligations on the shareholder, the fund and other intermediaries.**

Figure 3
Key Challenges: Liquidity Fees and Gates Approach

We believe that MMFs and their intermediaries will face several challenges arising from the above requirements:

Market-Based MMF Portfolio Valuation

This was discussed in the challenges under the Floating NAV approach. (See page five).

Tax Implications

An MMF, its intermediaries and shareholders will have to be ready for the tax implications arising out of liquidity fees. Tracking of tax basis, tax computation and reporting will need to be addressed by the operational and system landscape.

Applying Liquidity Fees to Net Redemptions

Applying liquidity fees to net redemptions of a shareholder of record who is a direct shareholder and not a financial intermediary would add substantially to the complexity of the system modification. With the proposed recommendation, the system would have to net redemptions against subscriptions and then apply fees on the net redemptions. This scenario could be further complicated when the same shareholder of record is the beneficial owner of multiple accounts, since the netting might have to be done across the accounts.

Discretion to Lower the 2% Liquidity Fee

Granting discretion to the fund’s board to lower the 2% liquidity fee would add to the complexity of the system modification. In such a scenario, the system should be able to accommodate and store different authorized fee rates and their corresponding effective business dates for accounting, reporting and notification purposes.

Floating NAV or Liquidity Fees and Gates?

In our view, both approaches will pose their own set of challenges, but implementing the Floating NAV will be more complicated. This method will impose high costs of compliance on the MMF industry. Many fund houses might withdraw their MMF offerings, and their intermediaries stop rendering MMF services. Also, the risk of losing the “stable NAV” and “intra-day settlement” features under the floating NAV approach will reduce the attraction of MMFs as a cash-management instrument for investors.

The Liquidity Fees and Gates approach appears to be easier to implement, since it will not involve complex challenges like applying retail exemptions to the omnibus accounts and facing intra-day settlement risk.

The SEC is expected to schedule a public meeting to vote on the two approaches – Floating NAV or Liquidity Fees and Gates (or a combination of both), along with the additional disclosure, diversification and stress-testing requirements. The SEC is expected to announce the final ruling sometime in the second half of 2014. Regardless of which approach the SEC chooses, the MMF industry will have to gear up to address the associated challenges.

References


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