California ISO

Money Market Mutual Fund Reforms

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NAPCO – San Diego, CA
February 25, 2016

Overview

- On July 23, 2014, the U.S. Securities and Exchange Commission (SEC) issued new rules for further regulation of money market mutual funds - building on reform rules adopted in March 2010
  - Institutional Prime and Municipal money market mutual funds must price and transact based on a floating net asset value (NAV)
  - Institutional and Retail Prime and Municipal money market mutual funds will be subject to liquidity fees and redemption gates
- Implementation of these rules must be completed by **October 14, 2016**
- ***Based on my understanding of these regulatory changes, these new rules have treasury and credit implications which will be conveyed here for your Company's own planning purposes***
- ***The information presented here is readily available from public sources and any conclusions I've derived from it, for purposes of this presentation, should not be taken as investment advice***

Background

- Today all money market mutual funds seek to maintain a daily stable or fixed NAV of $1.00 price per share and have an objective of not losing money
- To avoid “breaking the buck”, funds try to maintain a constant $1.00 share price through use of longstanding special pricing and valuation conventions (amortized cost accounting)
- Money market mutual funds are designed to be safe and highly liquid making them an important investment vehicle to meet short-term cash needs
- Although widely considered a very low risk investment, they are not risk free as evidenced by some notable examples of funds that broke the buck

Notable examples of funds that broke the buck

- **First Multifund for Daily Income** – 1978
  - The first money market mutual fund to break the buck
  - Liquidated and restated NAV at **94 cents per share**
- **Community Bankers US Government Fund** – 1994
  - Paid investors **96 cents per share**
- **Reserve Primary Fund** – 2008
  - The day after Lehman Brothers Holdings Inc. filed for bankruptcy, the fund fell to **97 cents per share** as a result of writing off the debt it owned that was issued by Lehman
  - Prompted significant redemptions from institutional money market funds
  - Led to widespread panic and nearly caused a run on the market

Source: Wikipedia

Reforms largely resulted from 2008 events

- Since the 2008 financial crisis, new rules adopted by the SEC make structural and operational reforms to money market funds
- Rules and subsequent amendments were designed to increase transparency and reduce the interest rate, credit and liquidity risks of money market fund portfolios
- Additional rules were introduced as tools to reduce the risk of investor runs on such funds in times of financial crisis, while preserving the benefits of the funds

Overview of final 2014 SEC rules

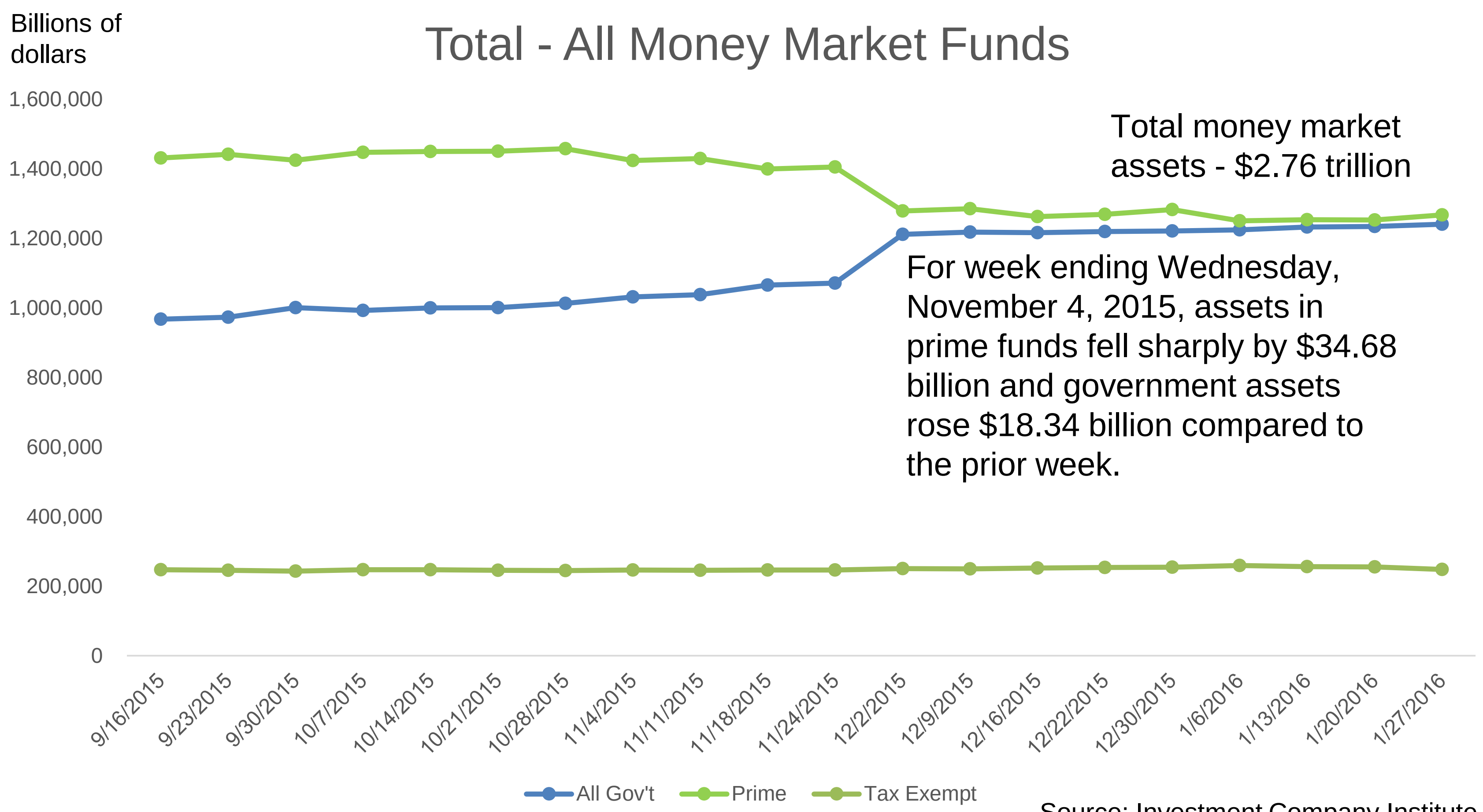
Fund Type	Net Asset Value (NAV)	Liquidity Fee	Redemption Gate
U.S. Treasury	Stable	No	No
Government	Stable	No	No
Retail Municipal/Tax-Exempt	Stable	**Yes**	**Yes**
Retail Prime/General Purpose	Stable	**Yes**	**Yes**
Institutional Municipal/Tax-Exempt	**Floating**	**Yes**	**Yes**
Institutional Prime/General Purpose	**Floating**	**Yes**	**Yes**

Source: Fidelity Investments

How have funds responded?

- The fund companies have been actively reviewing their fund lineup and amending their fund investment policies to align with these new rules
- Fund companies are beginning to disclose which funds are subject to these rules and clarifying their policies as they pertain to their expected use of liquidity fees and redemption gates
- Experts expect to continue to see a number of fund mergers and name changes in the months leading up to the October implementation deadline
- There is already evidence of a number of fund conversions (from prime funds to government funds) underway

Prime fund to government fund conversions



Source: Investment Company Institute

Floating NAV

Applicable funds will price and transact (*i.e.*, sell and redeem shares) at a net asset value per share that can change, or "float," based on pricing the underlying fund holdings at their present market value out to four decimal places

- Affects institutional prime/general purpose and institutional municipal/tax exempt funds
- Will no longer be eligible to use amortized cost accounting to price and transact at a constant share price of $1.00
- Unlike other mutual funds which set their NAV at the end of the trading day, these funds will set intraday NAVs four times per day

Liquidity fees

For investors who require access to their cash in times of stress (*i.e.*, redeem shares), a fee may be levied in order to pay for that liquidity

- May be applied at the discretion of the board of directors if such fees are determined to be in the best interest of shareholders of the fund
- If a fund's weekly liquid assets were to fall below 30%, the fund's board may impose a 2% fee on redemptions
- If a fund's weekly liquid assets were to fall below 10%, the fund's board must impose a 1% fee on redemptions but may impose a higher fee of 2% if it's in the best interest of shareholders

Redemption gates

A redemption gate is a temporary measure that may be implemented by a fund's board of directors that limits redemptions in a fund for a short period of time

- May be applied at the discretion of the board of directors if it's determined to be in the best interest of shareholders of the fund
- If a fund's weekly liquid assets were to fall below 30%, the fund's board may suspend redemptions for up to 10 business days in a 90-day period
- Redemption gates were designed to prevent a run on a fund in times of market stress

Retail fund definition

A money market fund that implements policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons (*i.e.*, individuals)

- Institutional investors will be restricted from investing in retail money market funds
- The retail versus institutional distinction is important as it will determine whether an investor in a prime or tax-exempt fund will be subject to a floating NAV
- Individuals may still invest in institutional money market funds
- The SEC is expected to provide further guidance as to which types of accounts would be classified as a retail account

Treasury and credit considerations

Treasury

- Tax, accounting and disclosure implications
- The U.S. Department of the Treasury and IRS have provided guidance that floating NAV shareholders will be able to report a single net number for the gains and losses over the course of a year
- Funds must disclose market NAV ($1.0000) daily on its website

Credit

- Floating NAV may result in your holding more or less collateral than you think you have
- Less collateral any given day may result in more frequent collateral calls
- Less liquidity increases risk of default
  - Counterparty liquidity may affect their ability to pay
  - Inability to access enough funds to cover any shortfall in a timely manner

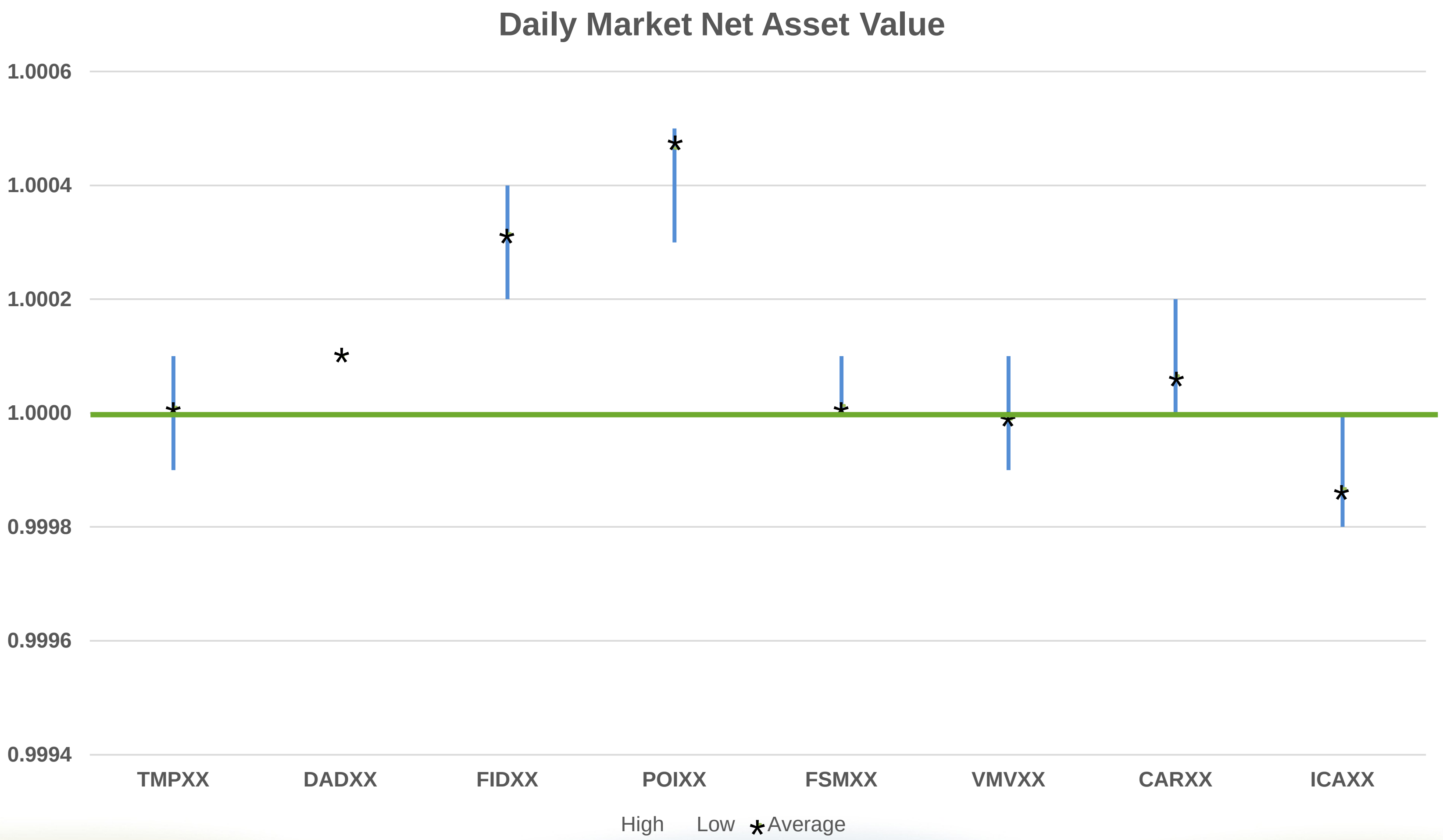
Impact of a $10 million payment default

	Portfolio valuation on day of default	
	$0.9999 NAV	$1.0005 NAV
Required draw	$10,000,000	$10,000,000
Available collateral	$9,999,000	$10,005,000
2% liquidity fee	$199,980	$200,100
Net draw amount	$9,799,020	$9,804,900
Payment shortfall subject to default allocation	$200,980	$195,100
Redemption gate	Delays access to funds up to 10 business days which could impact market clearing	

What can we expect?

- In tracking fund market-based NAVs over the past year, we've seen very flat to small day-to-day price fluctuations and experts don't foresee any changes after the October implementation
- Credit events, market instability and/or changes to economic forecasts could reasonably be expected to lead to larger, intra- and inter-day price volatility; the magnitude of the price changes and duration is difficult to predict since we don't have any historical perspective with the new rules in effect
- Experts believe there will be a rush to government funds in the months leading up to implementation
- As evidenced in 2008 when investors flocked to U.S. Treasury and government funds, some funds closed due to their inability to invest the large influx of cash
- Best advice – PLAN EARLY!

Daily Market NAV of select institutional prime funds (for the period 1/2/2015 – 2/5/2016)



Making the case – U.S. Treasury & government money market mutual funds

<u>PRO</u>

- Stable NAV
- No liquidity fees or redemption gates

<u>CON</u>

- Lower yields than prime and tax-exempt funds
- May temporarily close to new funds or investors in response to a large influx of cash

May be acceptable for funds requiring safety of principal and immediate accessibility (*e.g.*, collateral and short-term cash needs)

Making the case – retail prime and tax-exempt money market mutual funds

PRO

- Stable NAV
- Higher yields than U.S. Treasury and government funds
- Comparable yields to institutional funds

CON

- Liquidity fees and redemption gates
- Limited to individual investors

May be acceptable for funds requiring safety of principal (*e.g.*, short-term cash needs)

Making the case – institutional prime and tax-exempt money market mutual funds

<u>PRO</u>

- Higher yields than U.S. Treasury and government funds
- Available to individuals, small businesses and corporations

<u>CON</u>

- Floating NAV
- Liquidity fees and redemption gates

May be acceptable for funds that may be able to withstand brief periods of market instability and the resulting intra-day pricing volatility and/or lack of liquidity (*e.g.*, corporate investments and longer-term cash needs)

The ISO’s response

- Collateral and other market funds that are currently in institutional prime money market funds will be transitioned to U.S. Treasury and/or government money market funds
  - Ensures availability of and immediate access to full, posted collateral amount
  - Requires no tariff or Business Process Manual changes
  - Movement will likely begin soon – well ahead of the new rules’ effective date
- Letters of credit remain a viable alternative to cash collateral

Questions

For further information

SEC money market reform rules
http://www.sec.gov/rules/final/2014/33-9616.pdf

Search for “money market reforms” on Google or individual fund company websites

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