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# The SEC's money market reform will have a big impact on money funds

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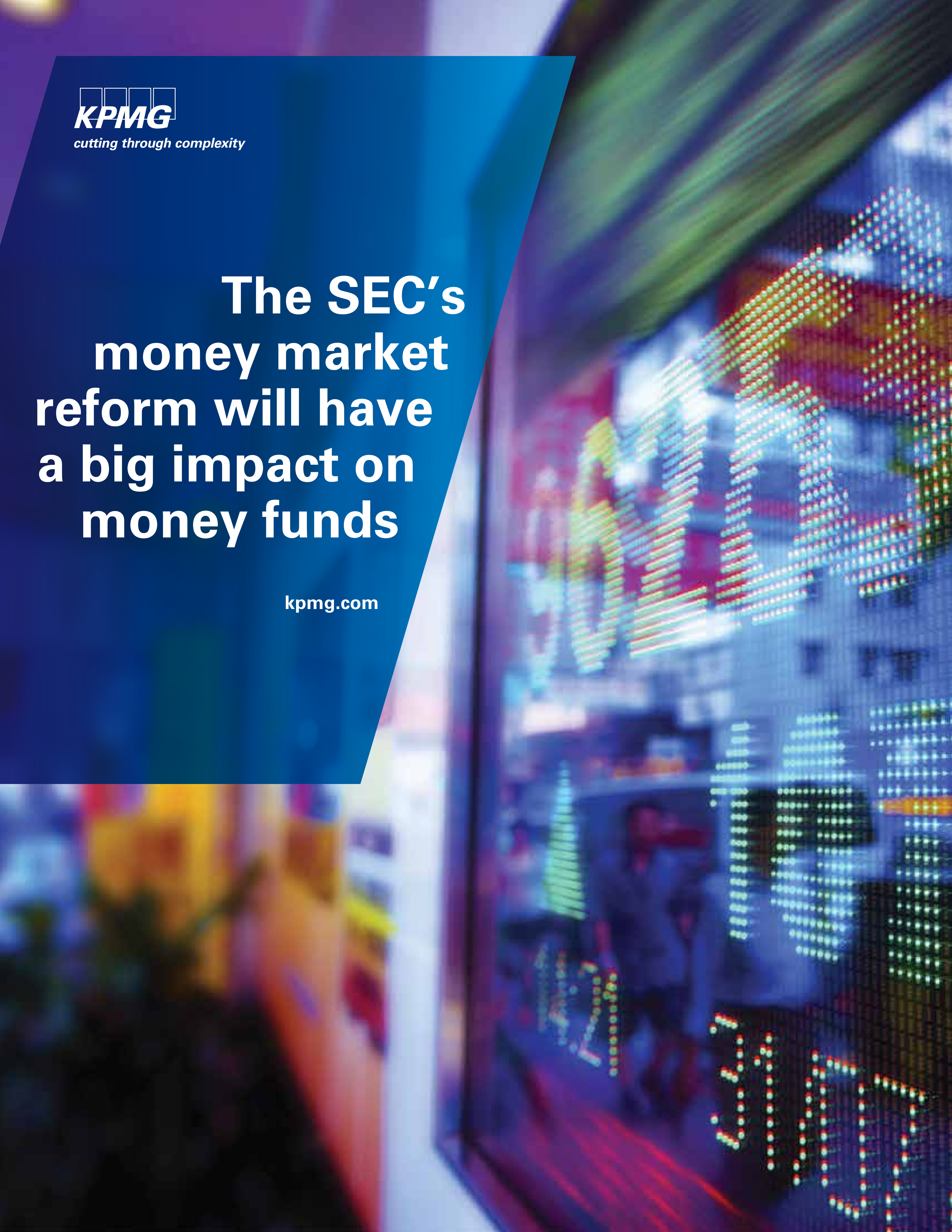


# Rules designed to prevent "run" risk may require significant operational changes

The U.S. Securities and Exchange Commission (SEC) recently adopted rules designed to reduce the risk of investor runs on money market funds in times of financial crises, and increase the transparency of risks to investors. "The reforms may have a significant impact on all money market funds, but particularly on institutional prime money market funds," stated Chad Gazzillo, Audit partner with KPMG LLP (KPMG).

The cornerstone of the SEC's reform—and the most widely publicized change—requires institutional money market funds to "float" their net asset value per share (NAV), or share price, so that it reflects fair value of the investments held by the fund. This is a significant change from the current structure in which all money market funds generally maintain a stable $1 per share NAV.

"This money market fund reform stems from the difficulties that occurred during the financial crisis, which culminated in one registered money market fund 'breaking the buck,' and numerous others receiving support from their sponsors to prevent doing so," said Gazzillo.

"This actually is phase two of the SEC's reform effort," he continued. "The first phase occurred in 2010, and involved tightening the risk-limiting conditions of Rule 2a-7, requiring disclosure of money market fund portfolio holdings to the SEC, and allowing a fund that has broken the buck to suspend redemptions. These recent SEC rules are the culmination of a long process."

In addition to the floating NAV change, the SEC reform rules contain several other important provisions, including:

- Liquidity fees and redemption gates: A fund's board of directors may—and in some cases is required to—impose "liquidity fees" and "gates" on fund redemptions.
- Increased disclosure requirements: These include posting liquid asset levels, asset flows and market-based NAVs, and instances of sponsor support on fund Web sites, and a new form to be filed regarding certain material events.

In conjunction with the SEC reform rules, the Treasury issued rules that simplified reporting requirements and revised the "wash sale" rules regarding money market fund transactions.

"The rules may impact all funds—retail and institutional—as well as business development companies because they include expanded guidance on fair value, and this applies to all investment companies," Gazzillo added. "The rules specifically address the use of amortized cost, fair value for thinly traded securities, and the use of pricing services. Fund directors and management may want to consider this expanded guidance, and evaluate and measure them against their existing policies and practices."

All of the changes are being phased in over time, with the floating NAV and liquidity fee/redemption gate provisions taking effect in October 2016 (see Compliance Dates sidebar on page 4).

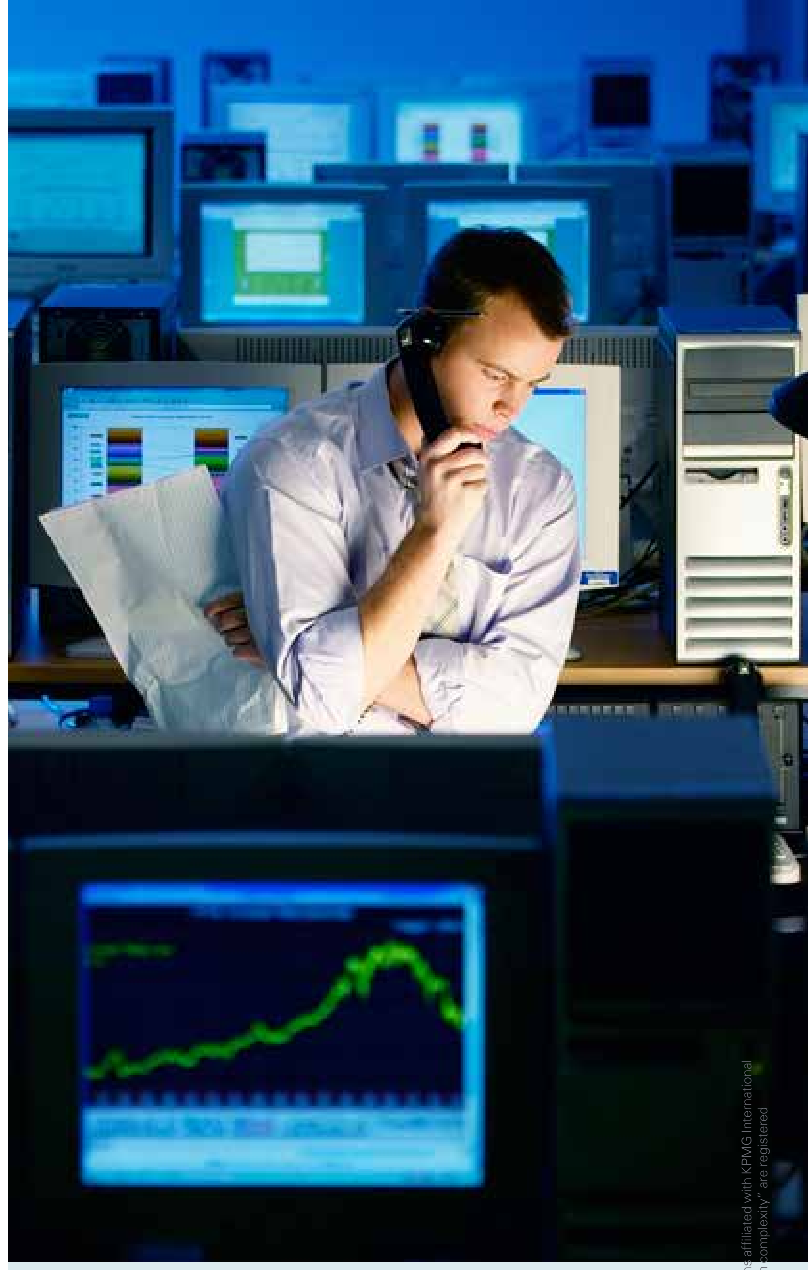
### A closer look at the changes

**1. Floating NAV:** Currently, a money market fund's NAV, or per-share value, may remain stable at $1.00, provided certain requirements are met. Under the new rules, institutional prime money market funds must use a "floating NAV." This means the fund's per-share value would be based on the current market price of its securities and would, therefore, fluctuate based on the market value of its investments.

*Key point:* The floating NAV rule **doesn't** apply to retail and government money market funds.

***KPMG observation:*** "The floating NAV rule applies to institutional funds, but not retail funds, because the SEC is concerned that, during a financial crisis, institutional investors, which hold a larger portion of the fund, are more likely to pull their money out first," observed John Russo, Audit partner at KPMG. "The concern here is that this could potentially jeopardize the overarching financial system and also leave individual investors bearing the brunt of any losses."

"Institutional investors have the resources and ability to figure out more quickly than retail investors that the underlying assets are beginning to deteriorate," he added. "During the financial crises, they began pulling money out on a large scale, and it might have been worse if fund sponsors and the federal government didn't come in to backstop money market funds."



**2. Liquidity fees and redemption gates:** A fund's board of directors may impose liquidity fees of up to 2 percent on redemptions, or temporarily suspend or gate redemptions for up to 10 days in a 90-day period, if a fund's weekly liquid assets fall below 30 percent of its total assets. Further, if the weekly liquid assets drop below 10 percent of total assets, the board would be required to impose a liquidity fee of 1 percent on all redemptions unless it determines that imposing such a fee would not be in the best interest of the fund.

*Note:* The fees and gates provisions do not apply to **government** money market funds, although their boards may impose such measures if they feel it's in the best interest of the fund.

*KPMG observation:* "These measures are also designed to discourage runs on money market funds by investors," said Russo. "In addition, the liquidity fee will allocate the costs of providing liquidity to those shareholders that imposed such costs on the fund through redemptions."

**3. Enhanced disclosure:** The rules require increased transparency for money market funds, including added disclosures of daily and weekly liquid asset levels, flows and market-based NAVs, and instances of sponsor support on their company Web sites. In addition, enhanced reporting is required on amended Forms PF and N-MFP.

Also, funds will have to disclose certain material events on a new Form N-CR, including:

- Portfolio security defaults
- Use of sponsor support
- The imposition or removal of liquidity fees and/or gates
- A decline in a fund's market-based NAV per share below $0.9975[1]

*KPMG observation:* The SEC's view is that voluntary support provided by money market fund sponsors and affiliates has played a role in helping some funds maintain a stable share price and that support may not be provided in all circumstances.

**What is an institutional money market fund?**
An "institutional money market fund" has no specific definition. Rather, Gazzillo noted, "It's defined by what it is not; that is, ***it's not a retail fund or government fund***."

"Government funds hold securities, including U.S. treasuries, U.S.-backed debt, or securities issued by U.S. federal agencies.[2] And to be a retail fund, you need to have reasonable policies and procedures in place to ensure that your fund is only being sold to 'natural persons,' as opposed to institutions such as corporations or pension funds," stated Gazzillo.

"So if you can't say that you're a retail fund, and if you're not a government fund, then you're an institutional fund," he concluded.

[1] This provision applies only to retail and government funds.

[2] For purposes of the SEC rules, government securities do not include securities issued by state or city governments; in other words, they do not include municipal funds, which are the types of assets held by most tax-exempt money market funds.

"This support may have had the effect of reducing the perception of money market fund risk in the eyes of investors," observed Russo. "The new required disclosures are designed to inform investors of this support, and may impact fund sponsors' decisions regarding the types—and frequency—of financial support they provide to their money market funds."

**4. Taxes and accounting changes:** According to the Treasury Department and Internal Revenue Service (IRS), money market funds that use a floating NAV will be able to use simplified accounting methods that will eliminate the need to track individual buy and sell transactions for tax reporting purposes. Also, the IRS will be easing the "wash sale" rules on shares of floating NAV money market funds, which will allow investors to claim losses that they otherwise may not have been able to use under current tax rules.

In addition, for tax purposes, liquidity fees imposed on redeeming investors will be treated similarly to redemption fees; that is, as an offset to the amount a shareholder realizes on the redemption (i.e., decreasing the shareholder's gain or increasing his or her loss), with no associated tax effect for the fund.

*KPMG observation:* "The change in the transaction reporting requirements should eliminate certain potentially significant costs that would otherwise occur as a result of the floating NAV rule," Gazzillo stated. "The IRS is going to let money market fund investors determine gains and losses on a net basis over a year, rather than requiring them to track individual transactions. At the same time, the fund sponsor won't incur the additional time and expense of recording and reporting thousands of transactions."

## What money market managers need to consider

"The industry currently is evaluating the new rules and trying to get a better sense of the potential impact," observed Russo. "There's a major concern that the changes, particularly with respect to calculating the floating NAV for institutional funds, will require significant changes to the way funds operate. But since the compliance date for that change isn't until **October 14, 2016**, funds have some time to explore various alternatives."

However, there are steps that forward-looking money market funds should be taking now in preparation for the upcoming changes. "A number of funds we've spoken with are considering reorganizing their funds. For example, sponsors may split up multiclass funds with both retail and institutional classes into retail and institutional funds," said Russo.

"Another example is that fund sponsors may have to involuntarily redeem investors from single class funds that are currently offered to both retail and institutional investors," he added. "And if they're thinking about taking advantage of the retail fund exception [for the floating NAV], they'll also have to evaluate the ***intermediaries*** they use to sell funds. For instance, they'll need to understand their intermediaries' systems and verify there are controls in place to ensure the ultimate investor is a 'natural person,' not an institution."

To get ahead of the curve, Russo and Gazzillo suggest that money market funds consider the following:

- Determine whether you're operating an institutional fund, a retail/government fund, or a combination of the two. (See sidebar, "What is an institutional money market fund?" on page 2.)
  - How are you going to determine initially and going forward whether investors are "natural" persons?
  - Consider the need for product offering/structure changes.
- If you determine that you're in the institutional space, ask yourself the following:
  - How are you going to price money market securities on a more regular basis?
    - If investors are allowed to come in and out of the fund on an intraday basis, there will be operational challenges in pricing your portfolios multiple times a day instead of once. What additional controls and resources are needed to do this?
    - What is the impact of the SEC's new valuation guidance on "shadow pricing"[3] for instruments with maturities of less than 60 days that are valued at amortized cost?
- Retail and government funds that continue to use amortized cost should, likewise, consider the impact of the SEC's valuation guidance on shadow pricing.
- If you are going to obtain pricing information from a third-party vendor:
  - How reliable is the information that you will be using?
  - Do you understand the information that you're getting from third-party pricing services? "You can't blindly rely on their pricing," cautioned Russo.

[3] Short-term money-market instruments, such as commercial paper or bank CDs, generally lack readily available market prices. As a result, they are priced based on their "fair valuation"—a reasonable estimate of the price at which they could be sold currently. Almost all money market funds rely on independent pricing services to help determine this fair valuation, or "shadow price."

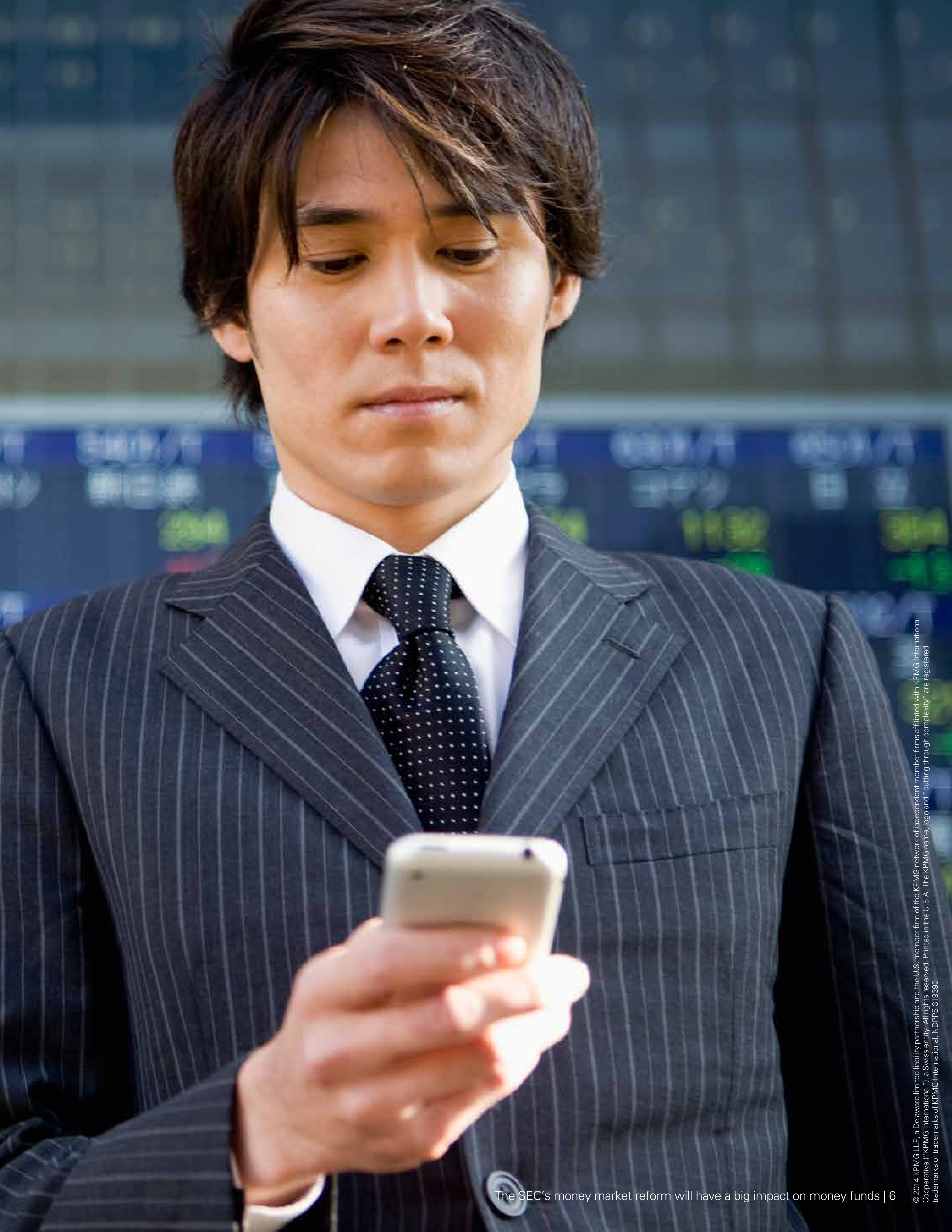
- Consider how you will present this pricing information to the board of directors. The board has a nondelegable responsibility to ensure that share pricing is consistent with fair value, so it needs to understand:
  - What the pricing service is doing and how its process works.
  - The interval of time between when pricing is calculated and when it is provided. Is the timing appropriate?
  - If you're getting "evaluated bids," the board has to have a reasonable basis for concluding that they approximate fair value.
- Consider what specific factors the board should use in determining whether to implement a liquidity fee and/or gate, and what level the liquidity fee should be. "The SEC provided guidelines for boards to consider when making these decisions," Gazzillo noted. "These guidelines should be the starting point for this discussion."
- Consider what policies and procedures may be required to ensure that intermediaries you use to sell your funds are able to verify whether account owners are natural persons.

**Compliance dates for the Money Market Reform rules:** Below are the key compliance dates for the SEC's money market reform rules:

| | |
|---|---|
| **Net Asset Valuation** | October 14, 2016 |
| **Liquidity fees and redemption gates** | October 14, 2016 |
| **Advertisement and prospectus disclosure** (related to floating NAV or liquidity fees/redemption gates) | October 14, 2016 |
| **Form N-MFP** | April 14, 2016 |
| **Amendments to disclosures on Forms N-1A, PF and N-MFP** | April 14, 2016 |
| **Web site disclosures** (**July 14, 2015** for Web site disclosure related to Form N-CR; see above) | April 14, 2016 |

# Conclusion

The SEC's money market fund reform rules undoubtedly will fundamentally change the way that many money market funds operate. In addition, the fair value guidance in the rules could affect many other registered investment companies. Although the provisions are being phased in and generally don't take effect until 2016, now is the time to begin planning for the transition and to consider what new policies, procedures, and technologies you may need to ensure compliance with the new rules.



### How KPMG Can Help

For more information on the SEC's guidance, or to discuss how this development may impact you and your firm, please contact one of the following KPMG professionals leading the firm's efforts with regard to this guidance:

**Chad B. Gazzillo**
**Audit Partner**
**T:** 267-256-2687
**E:** cgazzillo@kpmg.com

**John V. Russo**
**Audit Partner**
**T:** 267-256-8136
**E:** jrusso@kpmg.com

**Brent Oswald**
**Professional Practice Leader, Investment Management**
**T:** 612-305-5685
**E:** bdoswald@kpmg.com

**Sean McKee**
**National Leader, Public Investment Management**
**T:** 212-954-2433
**E:** smckee@kpmg.com

**kpmg.com**