The Impacts of the Securities and Exchange Commission ("SEC") Adoption of Money Market Fund Reforms on Shareholder Servicing - Part Three of Three: Floating Net Asset Values

Part Three of Three

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As outlined in Part one and two of this series (see STA Newsletter, January, 2015 and April 2015) the money market fund reform package adopted by the Securities and Exchange Commission (SEC) in 2014 has significant impact on the participants in the money market fund industry. From a shareholder servicing perspective, four reforms in particular will require money market fund transfer agents, and intermediaries, to design and implement solutions that involve enhancing systems and modifying operations processes. These reforms are: (1) Retail fund investor eligibility (see STA Newsletter, January 2015); (2) Liquidation fees; (3) Redemption gates (see STA Newsletter, April 2015); and (4) "Floating" net asset values ("NAVs") – the prices at which shareholders purchase and redeem their shares. The compliance dates for each of these particular reforms is October 14, 2016.

FLOATING NET ASSET VALUES ("NAVS")

The requirement that certain money market funds must "float" their net asset values presents arguably the greatest impact that the reforms have on money market funds and their investors. As of the October, 2016 compliance date, non-government money market funds that permit institutions to be shareholders will no longer be able to use the amortized cost and penny rounding methods for calculating NAVs, and will therefore have a floating NAV which will be used for processing transactions as well as other purposes (e.g., website disclosures). NAVs will need to be calculated and rounded to the "basis point" level rather than the "penny" level. For funds with a target price of $1.00, the NAV must go out 4 decimal places ($1.0000). If a fund has a target price of $10.00, the NAV must go out 3 decimal places ($10.000).

Floating NAVs will result in taxable gains and losses, although the IRS is proposing new rules to address the treatment of gain/loss calculations and reporting, as well as wash sale rule situations. It is anticipated that most institutional fund shareholders are exempt recipients for tax reporting purposes.

INTRADAY SETTLEMENT IN "TRADITIONAL" INSTITUTIONAL MONEY MARKET FUNDS

Traditional institutional money market funds provide same-day settlement for purchases and redemptions, where shareholder purchases and redemptions are settled by fed wire at intervals (sometimes as often as hourly) on trade date. Currently, the ability to achieve same-day settlement has been predicated on the predictability that the NAV will remain at a constant $1 per share.

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In order to facilitate intraday settlement, the SEC anticipates that funds will adopt procedures and controls that support the accounting systems to be able to calculate a floating NAV periodically each business day and to communicate that value to others in the distribution chain. These NAVs will be used by transfer agents and intermediaries each time the fund closes to price transactions and transmit redemption proceeds to shareholders. The frequency and intervals of these closes are not prescribed by the SEC, and are being driven by market forces.

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For transfer agents, the need to support multiple NAVs per day will require significant enhancements to facilitate the squeezing of a full day of operations and processing into multiple cycles per day. Most transfer agent recordkeeping and ancillary systems are designed to support only one NAV per day, and most transfer agent operations are set up to process, reconcile, and report activity to the fund once per day. In order to make the changes necessary to support multiple NAVs per day, new operating models are being developed that orchestrate the processes for pricing services, portfolio managers, fund accountants, transfer agents, and even the shareholders that hold fund shares directly or through an intermediary.

BROKER-DEALER SWEEP PROGRAMS

Just as the predictability of a $1 per share NAV is important for traditional institutional money market funds, so too is this predictability crucial for broker-dealers that provide cash sweep programs to their customers. These cash sweep programs typically conduct an overnight batch process that recognizes the cash credits and debits that occur in their customer's account throughout the day. Excess cash that remains in the customer's account is "swept" into the money market fund as a purchase, and if there is a negative cash position in the brokerage account, money is swept out of the money market fund as a redemption.

In order to operate as designed, the brokerage sweep system needs to "know" that the NAV in the money market fund will be $1, so that the system will be able to compute the money market fund transaction necessary to sweep cash into or out of the brokerage account. Faced with this new money market fund floating NAV environment, many broker-dealers are considering redirecting their sweep programs away from non-government money market funds to government money market funds or other financial products. Consequently, it is likely that some non-government money market funds will lose significant assets, causing their sponsors to contemplate changes to their fund product line-ups.

THE HYBRID INVESTOR

Certain investors, such as partnerships or investment clubs, are defined by these new rules as being institutional investors, because the money market fund shares are not beneficially owned by natural persons. However, they neither want nor need intraday settlement using fed wires. Because these hybrid shareholders will not be eligible to remain in the retail money market fund they own today, they will likely to be forced to liquidate or voluntarily exchange their assets to a government money market fund or other financial product that will accept them.

CONCLUSION

The money market fund industry and its service providers are working diligently to design, develop, and implement solutions to serve the investing public in a manner that is compliant with the money market reforms. This effort combines the talents and insights of all industry participant sectors, including shareholders, their intermediaries, money market fund sponsors and the service providers, including transfer agents that support money market funds.

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