

SEC adopts MMF reform rules

- Yesterday, the SEC approved final rules on money market fund (MMF) reform in a narrow 3-2 vote.** The final rules concluded a nearly four-year struggle between regulators and market participants on how best to restructure MMFs to reduce and mitigate potential systemic and run risks in MMFs. To be sure, the implications of these changes are significant as it impacts \$2.6 trillion of assets currently managed by domestic MMFs (Exhibit 1).
- By and large, the final rules were in-line with our expectations** that we outlined in our commentary last week, though there were a few surprises as well. Please see appendix for a high level summary.
 - As expected, **the SEC moved forward with a combination approach that would require targeted MMFs to convert from a stable NAV to a floating NAV and to adopt liquidity fees and gates.** The conversion to a floating NAV would be met with new proposed rules/guidance from US Treasury as well as Internal Revenue Service that would provide relief to MMF shareholders on related tax and accounting implications, thus treating shares of floating NAV MMFs similar to those of stable NAV MMFs. An aspect of this combined approach that was different from the proposal was the discretionary nature of the fees and gates component. Under the final rules, if a MMF's level of weekly liquidity falls below the 30% regulatory minimum, the fund's board would be allowed to impose a liquidity fee of up to 2% on all redemptions and/or suspend redemptions for up to 10 days, if the board felt these actions are in the best interest of the fund. While this discretionary aspect is less likely to prompt shareholder flight than stricter rule-based triggers would, it remains to be seen if some shareholders will still interpret this level as a limit at which they liquidate, or if they're willing to trust in fund management if the limit is pierced. Concern about the discretionary trigger could prompt funds to hold higher levels of liquidity.

Short Duration Strategy

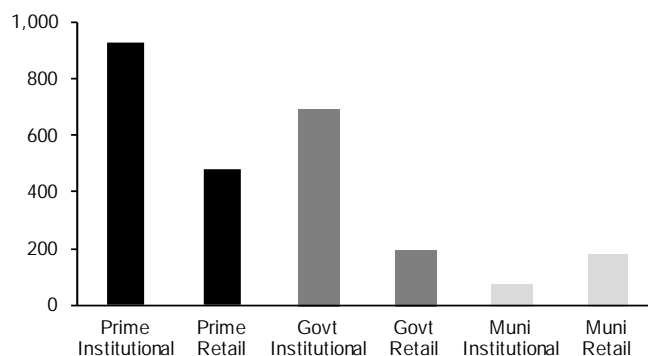
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Exhibit 1: The final MMF reform rules impact \$2.6 trillion of assets currently managed by domestic MMFs

MMF AuM by fund type as of 7/22/2014 (\$bn)



Source: iMoneyNet

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- 2) Not surprisingly, prime institutional funds were the bulls-eye that the SEC targeted. They were hit with the most stringent reforms relative to other types of MMFs given their sensitivity to run risks. Under the new regulatory environment, **prime institutional funds would be required to both float their NAVs and to use liquidity fees and gates on a discretionary basis.** Meanwhile, prime retail MMFs would be able to maintain their stable NAV but would be subject to liquidity fees and gates.
- 3) As anticipated, **government MMFs were exempt from structural reforms altogether.** However, municipal (or tax-exempt) MMFs were not. Under the final rules, municipal MMFs are treated the same as prime MMFs - that is, institutional municipal funds would be required to both float their NAVs and adopt fees and gates, while retail municipal funds may retain their stable NAV structure but would have to adopt the latter.
- 4) Retail funds are defined as MMFs that are designed to limit their beneficial owners to natural persons. Also, **government MMFs are defined as MMFs that invest 99.5% or more of their total assets in cash, government securities and/or repos that are collateralized solely by government securities or cash.** This is a revision to the existing definition which defines government MMFs as MMFs that invest 80% or more of their total assets in the aforementioned products. While the change was not anticipated, this should not particularly alter the way how governments MMFs behave today. As of June month-end, we estimate that roughly 90% of individual government MMFs, comprising about 98% of total government AuMs, already comply with this new definition.
- 5) MMFs would also be required to provide additional disclosures and be subject to stronger diversification requirements. On a daily basis, MMFs would be required to disclose their daily and weekly liquidity levels, net shareholder inflows or outflows, market-based NAVs, imposition of fees and gates, and any of use of affiliate sponsor support on their websites. They would also be required to promptly disclose certain material fund-related events like sponsor support on a new Form N-CR. From a diversification perspective, affiliates would be aggregated and treated as a single issuer subject to the 5% issuer diversification limit. The 25% guarantor basket is also eliminated and replaced with a 10% and 15% diversification limit for guarantors and demand feature providers for prime funds and municipal funds respectively.

Market implications

At a high level, the final rule fundamentally changes the way certain MMF shareholders will manage their cash with MMFs. Most impacted would be the institutional shareholders that currently invest with prime MMFs, given the requirement to convert these funds into floating NAVs and utilize fees and gates in times of stress. **The biggest unknown is to what extent and how fast these changes would prompt them to shift their money from prime MMFs into other cash alternatives like government MMFs and bank deposits.** According to the 2014 Association of Financial Professionals (AFP) Survey, 27% of 740 respondents said they would not invest in prime funds altogether if they were to operate with a floating NAV. Using this as an indicator of how much money could exit prime institutional funds, this would imply that \$250bn (\$930bn x 27%) could eventually leave the complex. We suspect the AFP crowd would like the floating NAV and fees/gates combo even less, implying a still higher outflow number.

Moreover, **the new definition of retail funds would likely prompt some money to shift between institutional money funds and retail money funds.** Across the money fund business, there are many cases where investors in institutional share classes of prime funds would actually qualify as "retail" under the natural persons rule. The converse is also true (institutions in retail share classes), although we suspect to a lesser degree. As a result, there's a great client sorting that needs to take place in the prime fund business after which our understanding of what is institutional and what is retail may change substantially. The bigger the actual institutional exposure, the larger the potential exodus from prime institutional funds, and the bigger the potential pullback from banks in the wholesale funding markets.

Whatever the shifts may be, **we expect prime fund managers will be building their liquidity in anticipation of potential outflows.** To that end, we could see the average aggregate Fed RRP usage increase in the coming months as funds establish more overnight liquidity. Portfolio weighted average maturities (WAM) could also decrease over time as funds invest a lesser amount in longer-term maturities. We wouldn't be surprised if the Libor curve begins to steepen as funds reinvest maturing securities into shorter-term paper or into government securities that are generally more liquid. As of June month-end, we estimate prime MMFs held ~\$245bn of unsecured CP/CDs exposures with Libor panelist banks. The WAM of those exposures was 90 days.

As liquidity builds and outflows are anticipated, we expect to see cheapening in the bank credit space in money markets, and in Libor. In response to the Eurozone crisis in 2011, about \$200bn in AuMs left prime institutional funds over a span of about six-months, during which time 3m Libor climbed over 30bp, as many Eurozone banks struggled to find sufficient wholesale funding. **Although prime fund outflows due to reform are potentially large, yield moves may not be of the same magnitude.** Any cash shifting into retail prime funds will be redeployed into bank paper, partly cushioning any institutional pull-back. Also, relative to 2011, the crisis element is lacking, banks should have had time to anticipate this change and manage their liabilities better. It's also the case that any pullback will be shared across a broader group of banks (Exhibit 2). Furthermore, macro prudential regulation will be, over the next two years, pushing banks to decrease use of wholesale funding like that obtained from money funds. MMF reform may accelerate the reality of that shift for many banks, but after nearly four-years of discussion, it's hard to think the banks didn't know this was coming and plan accordingly.

What's next?

Without question, it will take some time for the market to fully digest the 869-page final rule¹. Participants will also need to consider the proposed rules/guidance² from the US Treasury and the Internal Revenue Service that will alleviate MMF shareholders of related tax and accounting implications developed as a result of adopting a floating NAV reform.

The final rules become effective 60 days after the date of publication of the rules in the Federal Register (the 2010 MMF reforms took slightly over a week to be published in the Federal Register after the release of the final rule). From a compliance perspective, MMFs have two years from the effective date to comply with the floating NAV as well as the fees and gates amendments. For the new Form N-CR, MMFs have 9 months. For everything else, they have 18 months. Taken together, MMFs would be fully compliant of all amendments by mid-to-late 2016.

Exhibit 2: Prime MMFs are heavily invested in bank obligations

J.P. Morgan estimate of prime MMF exposures to banks (\$bn)

		Jun-14									
	Issuer # / Top 3	CP	CD	TD	ABCP	CCP	Agy RP	Tsy RP	Other RP	Other	Total
Total	76 / 14%	159	549	53	54	15	45	8	89	48	1,020
Eurozone	16 / 49%	23	106	21	21	2	15	5	16	4	214
Austria	1 / 100%	-	-	1	-	-	-	-	-	-	1
Belgium	1 / 100%	-	-	1	-	-	-	-	-	-	1
France	5 / 80%	10	64	15	12	1	11	4	12	1	130
Germany	4 / 94%	3	13	1	6	1	2	0	2	1	30
Luxembourg	1 / 100%	0	-	-	-	-	-	-	-	-	0
Netherlands	4 / 100%	10	29	4	2	-	2	1	2	2	51
Other Europe	13 / 49%	49	75	17	9	1	2	1	21	8	183
Norway	1 / 100%	7	3	-	-	-	-	-	-	-	11
Sweden	4 / 82%	28	32	15	-	-	-	-	-	7	82
Switzerland	2 / 100%	3	25	-	4	-	1	1	18	1	53
UK	6 / 78%	10	15	1	5	1	0	1	3	1	38
Other Regions	47 / 23%	87	367	15	24	11	29	3	51	36	623
Australia	6 / 81%	51	25	4	0	-	-	-	-	6	86
Canada	7 / 70%	5	121	6	8	4	4	1	5	6	160
Chile	4 / 91%	1	1	-	-	-	-	-	-	-	2
China	3 / 100%	0	3	1	-	-	-	-	-	1	4
India	1 / 100%	0	-	-	-	-	-	-	-	-	0
Japan	7 / 74%	8	141	3	7	-	3	0	4	2	169
Kuwait	1 / 100%	-	1	-	-	-	-	-	-	-	1
Singapore	3 / 100%	9	5	0	-	-	-	-	-	2	16
US	15 / 67%	12	69	3	9	8	21	1	42	20	186

Source: J.P. Morgan estimates, fund holdings reports, iMoneyNet

Note: J.P. Morgan estimates of exposures in prime money market funds are based on a sample of large funds including funds managed by Fidelity, BlackRock, JPMorgan, Vanguard, Federated, Dreyfus, Wells Fargo, Goldman Sachs, Morgan Stanley, UBS, Schwab, SSgA, American Funds, BofA, First American, Northern, Prudential, RBC, Western Asset Management. Sample represents 86% of US prime money market fund market in terms of assets under management. Allocation percentages are calculated from the sample and then applied to the period's total prime fund assets under management. Banks include unsecured CP, ABCP, CD, time deposits, repo, and other notes. Corporates include CP and other notes. US Treasuries include T-bills and coupons. US Agencies include discount notes and fixed/floating notes. US S&L Govt/Muni include muni CP, notes, and VRDNs. Foreign SSA includes CP, CDs, and other notes. Central banks include repo. Other includes investments in funds including other MMFs and tax-exempt preferreds.

¹ <http://www.sec.gov/rules/final/2014/33-9616.pdf>

² <http://www.treasury.gov/resource-center/tax-policy/Documents/MMF%20Acc%271%27q%20NPRM.pdf>

<http://www.irs.gov/pub/irs-drop/rp-14-45.pdf>

Appendix: The final MMF rules seek to reform MMFs by altering some of their structures, by changing their diversification requirements as well as demanding enhanced disclosures

High level reform changes to MMFs

Area of Reform: Structure		
Type of MMF	Institutional	Retail
Prime	Floating NAV / Liquidity Fees and Gates	Stable NAV / Liquidity Fees and Gates
Government	Stable NAV*	Stable NAV*
Municipal	Floating NAV / Liquidity Fees and Gates	Stable NAV / Liquidity Fees and Gates

* Government MMFs are exempt from liquidity fees and gates. However, they could voluntarily opt into them, if previously disclosed to investors.

Area of Reform: Portfolio Diversification		
Type of MMF	Institutional	Retail
Prime	Aggregation of affiliates subject to a 5% issuer diversification and 10% single institution diversification limit for guarantors and demand feature providers	Aggregation of affiliates subject to a 5% issuer diversification and 10% single institution diversification limit for guarantors and demand feature providers
Government	At least 99.5% of fund assets must be invested in cash, govt securities, and/or repo collateralized by govt securities/cash	At least 99.5% of fund assets must be invested in cash, govt securities, and/or repo collateralized by govt securities/cash
Municipal	Aggregation of affiliates subject to a 5% issuer diversification and 15% single institution diversification limit for guarantors and demand feature providers	Aggregation of affiliates subject to a 5% issuer diversification and 15% single institution diversification limit for guarantors and demand feature providers

Area of Reform: Enhanced Disclosures		
Type of MMF	Institutional	Retail
All Funds	1) Daily website disclosures 2) New material event disclosure: Form N-CR 3) Disclosure of sponsor support	1) Daily website disclosures 2) New material event disclosure: Form N-CR 3) Disclosure of sponsor support

Source: SEC, J.P. Morgan

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