Evaluating the Impact of 2014 SEC Money Market Reforms

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Due to their stability of principal, liquidity, and ability to handle same-day redemptions or investments, money market funds are popular cash management vehicles for institutional investors. On July 23, 2014, the US Securities and Exchange Commission (SEC) adopted some of the biggest reforms to the rules that govern money market funds since their inception more than 30 years ago. These reforms will bring new transparency to a market that experienced turmoil in 2008 and may cause corporate treasurers, cash managers, and other investors with cash reserves to reconsider their asset allocation and cash management solutions.

The reforms may provide investors with cash reserves a catalyst to reconsider asset allocations and cash management solutions.

MONEY MARKET FUND BACKGROUND

Money market funds are a type of mutual fund registered under the Investment Company Act of 1940 and regulated under Rule 2a-7. Money market funds pay dividends that reflect prevailing short-term interest rates, are redeemable on demand, and—unlike other investment companies—have traditionally sought to maintain a stable net asset value (NAV) of one dollar per share.[1] They are required to maintain a weighted average maturity of 60 days or less. Money market funds that primarily invest in corporate debt securities are referred to as "institutional prime funds."[2]

REFORMS

The three main pillars of the SEC's reform package include (1) requiring institutional prime funds to move to a floating

1. As defined by the Securities and Exchange Commission.

2. SEC reforms also apply to institutional tax-exempt or municipal money market funds.

NAV, (2) giving these funds the ability to charge liquidity fees, and (3) giving them the ability to impose redemption gates. While funds will have two years to comply with the reforms, they are likely to have a more immediate impact on the industry.

- **Floating NAV:** Institutional prime funds will be required to value their portfolio securities daily using market-based pricing rather than using a stable NAV (or fixed $1 per share). As a result, the sale and redemption of shares will be based on a floating NAV. Institutional prime funds are also required to use a more precise pricing methodology by extending share prices to four decimal places for $1 NAVs or three decimal places for $10 NAVs. Funds defined as government or retail money market funds in accordance with the rules promulgated by the SEC are exempt from this requirement and may maintain a stable NAV, though government money market funds may opt to use a floating NAV.

- **Liquidity Fees:** Money market funds may impose liquidity fees of up to 2% on all redemptions after weekly liquid assets[3] fall below 30% of the fund's total assets, if the fund's board of directors determines it to be in the best interest of the fund. If weekly liquid assets fall below 10% of a non-government money market fund's total assets, the fund is required to impose a 1% liquidity fee unless the board determines this is not in best interest of the fund. Cash raised from the fees may be used by the fund to offset the cost of future redemption requests during times of market stress.

- **Redemption Gates:** Under the new rules, if a money market fund's level of weekly liquid assets falls below 30%, the fund's board can decide to temporarily suspend redemptions. Gates are required to be lifted within 10 business days and cannot be used for more than 10 business days in any 90-day period.

Liquidity fee and redemption gate provisions affect retail and institutional money market funds but exclude government money market funds. However, government money market funds could voluntarily opt into the liquidity fee and gate provisions if previously disclosed to investors. Other measures approved by the SEC include new reporting requirements, stronger diversification requirements, and enhanced stress testing. In coordination with the SEC, the Internal Revenue Service (IRS) proposed a simplified reporting method that allows shareholders to aggregate transactions to account for net gains and losses for the year. The IRS also proposed a ruling that exempts sellers of money market funds from the wash sale rule.[4]

Together, these structural and operational reforms are intended to negate "the first mover's advantage" where an investor could exploit the possibility of redeeming shares at the stable share price in the event that the fund has suffered a loss. These reforms also give money market fund boards tools to directly address runs on their funds.

RE-EVALUATING CASH MANAGEMENT NEEDS AND ALLOCATIONS

These historic reforms serve as an inflection point that may change the way investors consider their objectives and risk preferences as they relate to cash management and liquidity. Institutions will be faced with new challenges that may include complex accounting for gains and losses due to a floating share price. Institutional and retail investors alike must consider the effect that gates and redemption fees may have on their ability to retrieve assets during times of stress. For institutions invested in institutional prime funds, the stable-to-floating NAV reform is likely to trigger revisions in cash management investment policies and review of eligible investments.

The three primary tradeoffs institutions face when determining an appropriate investment policy and resulting allocation are safety (or capital preservation),

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3. Weekly liquid assets are defined as: (1) cash, (2) direct obligations of the US government, (3) government securities issued by a person controlled or supervised by and acting as an instrumentality of the government of the United States pursuant to authority granted by the Congress of the US, that are issued at a discount to the principal amount to be repaid at maturity and have a remaining maturity of 60 days or less, and (4) securities that will mature or are subject to a demand feature that is exercisable and payable within five business days. The minimum weekly liquidity requirement under Rule 2a-7 is 30%.

4. An IRS rule that prohibits a taxpayer from claiming a loss on the sale or trade of a security. A wash sale rule occurs when a shareholder sells a security at a loss, and within 30 days before or after the sale, acquires a substantially identical security.

liquidity, and yield. A 2014 survey of corporate cash programs found that 75% of the respondents' cash balances are maintained in banks, money market funds, and US Treasury securities. While safety (68%) and liquidity (28%) remain the top priorities for cash managers, yield (73%) was cited as the primary consideration for selecting money market funds.[5] We expect that many investors re-evaluating cash management options may consider ultra-short duration investments, as a properly designed ultra-short duration strategy can pursue higher expected returns while maintaining an emphasis towards more liquid investments.

Some investors employ a tiered approach to cash allocations, where assets are split into multiple "buckets" with more specific objectives. In this scenario, cash managers would rely on estimates for cash needed "on-hand" to meet short-term obligations and allocate those assets appropriately. The current yield curve environment could be evaluated to determine opportunities to pursue additional expected returns on the remaining reserves. Dimensional has used a market-driven approach focused on managing these kinds of tradeoffs for more than 30 years with a focus on offering diversified, efficiently managed solutions.

A FLEXIBLE APPROACH TO ULTRA-SHORT DURATION FIXED INCOME INVESTING

Risk management is essential for ultra-short duration strategies as liquidity is vital. While recent market developments have heightened investors' sensitivity to risk, Dimensional has always used market-based information to design strategies that dynamically adjust duration (within ranges) based on whether expected term premiums are high or low. The use of market-based information allows portfolio managers to systematically trade off the higher expected volatility of longer-duration bonds versus expected term premiums, increasing duration (within ranges) when expected term premiums are high and reducing duration, and the associated volatility, when expected term premiums are low.

ANNUALIZED RETURNS	YTD	1 YR	3 YRS	5 YRS	10 YRS	SINCE FIRST FULL MONTH (AUG 1983)	10 YEAR ANNUALIZED STANDARD DEVIATION (%)
One-Year Fixed Income Portfolio	0.21	0.40	0.52	0.76	2.22	5.09	0.74
Lipper Institutional Money Market Index	0.02	0.05	0.09	0.12	1.78	4.37	0.57
BofA Merrill Lynch 6-Month US Treasury Bill Index	0.07	0.15	0.17	0.26	1.93	4.67	0.64
BofA Merrill Lynch 1-Year US Treasury Note Index	0.15	0.29	0.29	0.50	2.07	5.00	0.79

As of June 30, 2014. Returns for periods shorter than one year are not annualized. Performance data represents past performance and is no guarantee of future results. Current performance may be higher or lower than the performance displayed. Investment return and principal value will fluctuate so that an investment's shares, when redeemed, may be worth more or less than their original cost. Visit us.dimensional.com for month-end performance.

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5. 2014 Association for Financial Professionals Liquidity Survey.

Research indicates the shape of the current yield curve contains information about expected term premiums. Historical analysis and academic literature demonstrate a reliable relationship between current term spreads—that is, the difference between long- and short-maturity bond yields—and future term premiums. More specifically, wider (narrower) term spreads predict larger (smaller) term premiums. A variable maturity investment strategy uses the information in current yield curves to target securities with higher expected returns, extending maturities when the yield curve is steeply upwardly sloped and there is greater anticipated return for holding longer maturity bonds. When the yield curve is flat or inverted, these strategies reduce term risk by investing in shorter-maturity bonds. For clients who desire more discretion in determining maturity and credit constraints for an allocation, this market-based approach can be applied in a separate account designed to focus on a pre-determined eligible universe.

Investors willing to take on additional term risk through a systematic, market driven approach may be able to generate additional yield while being exposed to slightly greater volatility. For the 10 years ended June 30, 2014, Dimensional's ultra-short duration strategy (the One-Year Fixed Income Portfolio) achieved an annualized return of 2.22%, versus 1.78% for the Lipper Institutional Money Market Index.

CONCLUSION

The SEC's reforms will fundamentally change the way institutional prime funds operate and has the ability to alter the retail money market fund landscape as well. Institutional and retail investors alike may reconsider the role of money market funds in their portfolios. Safety and liquidity remain top priorities for corporations, and these changes could also provide a catalyst for institutions to revisit cash management programs by evaluating alternatives to money market funds.