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I. INTRODUCTION

On July 23, 2014, the Securities and Exchange Commission (“SEC”) issued the final Money Market Fund Reform rule (the “Reform”), which amended the rules governing money market mutual funds under the Investment Company Act of 1940 by requiring institutional, non-governmental money market mutual funds (“MMMF”) to transition away from the historical use of a stable net asset value (“NAV”) of $1.00 per share to a floating NAV. Essentially, the Reform requires MMMFs to base the value of their shares on the current market-based value of the securities in their underlying portfolios. This new requirement, along with newly imposed liquidity fees and redemption gates, is a significant change to institutional

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4. Id. at 47739.

5. Id. (“Rounded to the fourth decimal place (e.g., $1.0000).”).

6. Liquidity fees are a new tool allowing funds to impose a fee of up to 2% on shareholder redemptions if the fund’s weekly liquidity level falls below the required regulatory threshold of 30% of its total assets and the fund’s board of directors “determines that imposing a fee or gate is in the fund’s best interests.” Id. at 47747.

7. Redemption gates are a new tool allowing funds to “temporarily suspend [shareholder] redemptions for up to 10 business days in a 90-day period, if the fund’s weekly liquid assets fall below 30% . . . and the fund’s board of directors . . . determines that imposing a fee or gate is in the fund’s best interests.” Id.
MMMFs.\textsuperscript{8} The sponsors of the MMMFs will face implementation, accounting, recordkeeping, and taxation issues in addition to the onslaught of competition from banks that will result from the changing regulatory scheme.\textsuperscript{9} The funds’ investors may face recordkeeping and liquidity issues.\textsuperscript{10}

This Note considers the impact that the Reform will have on the financial products industry, and specifically, on banks that offer money market deposit accounts (“MMDA”), which are direct competitors of MMMFs.\textsuperscript{11} Part II provides a background on MMMFs and the “breaking the buck” phenomenon.\textsuperscript{12} Part III addresses attempts to decrease the riskiness of MMMFs in the wake of the 2008 financial crisis and the “breaking of the buck” event in September 2008.\textsuperscript{13} Part IV details the requirements of the Reform and the issues discussed by commenters to the Proposed Rule.\textsuperscript{14} Part V analyzes the costs and opportunities that the Reform will present to banks that provide MMDAs.\textsuperscript{15} Part VI concludes by offering some final thoughts on the future of MMMFs.\textsuperscript{16}

\textsuperscript{8} Id. The Reform does not impose any changes to “retail” MMMFs. See infra Part III.B.

\textsuperscript{9} See infra Part V.

\textsuperscript{10} KATHLEEN JOAQUIN ET AL., INV. CO. INST., OPERATIONAL IMPACTS OF PROPOSED REDEMPTION RESTRICTIONS ON MONEY MARKET FUNDS 6 (2012), available at http://www.ici.org/pdf/ppr_12_operational_mmf.pdf (observing that MMMFs have created arrangements with investors that will be “drastically impaired” by redemption restrictions, even under normal conditions).


\textsuperscript{12} See infra Part II.

\textsuperscript{13} See infra Part III.


\textsuperscript{15} See infra Part V.

\textsuperscript{16} See infra Part VI.
II. Money Market Mutual Funds and “Breaking the Buck”

A. An Overview of Money Market Mutual Funds

An MMMF is a type of mutual fund typically offered by investment companies as a short-term alternative to interest-bearing bank accounts. MMMFs typically generate greater yields on “idle funds” than interest-bearing bank accounts. For example, while funds in a bank savings deposit account accrue interest at “artificially low” rates set by the bank, MMMF shareholders receive interest based on the current market rates. Although MMMFs do not have the benefit of federal deposit insurance, they are required to invest in low-risk, highly liquid securities such as Treasury bills and certificates of deposit (“CDs”). MMMFs also invest in commercial paper issued

17. “A mutual fund is a type of investment company that pools money from many investors and invests the money in stocks, bonds, money-market instruments, other securities, or even cash.” Mutual Funds, SEC. & EXCH. COMM’N, http://www.sec.gov/answers/mutfund.htm (last visited Oct. 14, 2014).


21. Id.; Money Market Funds, supra note 19.

22. Money Market Funds, supra note 19.

23. Id.


26. Commercial paper consists of short-term, promissory notes with maturities of thirty days, but sometimes ranging up to 270 days, issued primarily by corporations. Commercial Paper, Bd. of Governors of the Fed. Reserve Sys.,
by financial institutions, including banks. Historically, MMMF managers have maintained a stable NAV of $1.00 per share, meaning that $1.00 invested may be redeemed at any time in the future for at least $1.00.

The $2.6 trillion MMMF industry consists of three primary types of MMMFs: retail funds, government funds, and institutional prime funds. Retail funds are those that have “policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.” Government funds principally hold debt of the U.S. government, including obligations of the U.S. Treasury and federal agencies. Institutional prime funds, on the other hand, are invested primarily in corporate securities and the shares of the fund are purchased by institutional investors.

Institutional investors include all sizes of companies, state and local governments, and financial institutions. These investors “use [MMMFs] as a cost-effective way to manage and diversify credit risk while providing same-day liquidity with market-based yields.” Historically, the advantage of being able to redeem shares on demand at a stable value of $1.00 per share has been a cornerstone of the benefits of investing in institutional MMMFs. As will be discussed later, the


28. Except where they have “broken the buck.” See Money Market Funds, supra note 19; see also infra Part II.B.

29. Michaels, supra note 27, at 206.


31. Id. at 47738.

32. Id. at 47794.

33. Id. at 47738.

34. They also invest in governmental securities. JOAQUIN ET AL., supra note 10, at 6.

35. Id.

36. Credit risk is “the probability that a loan will not be repaid according to the terms of the contract.” EDGAR RUSSELL FIEDLER, MEASURES OF CREDIT RISK AND EXPERIENCE (GENERAL SERIES/NATIONAL BUREAU OF ECONOMIC RESEARCH) 10–18 (1971).

37. For purposes of this section, a market-based yield is a yield that is similar to yields from investments in the same market and with similar risk levels. JOAQUIN ET AL., supra note 10, at 6.

38. Press Release, U.S. Sec. & Exch. Comm’n, supra note 1 (describing the provisions of the finalized rule and providing information about proposed Treasury and IRS rules); see Michaels, supra note 27, at 206.
removal of this benefit by the Reform will cause major issues for institutional MMMF sponsors, investors, and other stakeholders in the MMMF industry.39

B. "Breaking the Buck"

A MMMF “breaks the buck” when the value of its shares falls below their standard $1.00 value because the quantity of shares redeemed in a short period of time is so large that the resulting change in the liquidity of the fund cannot support the $1.00 valuation.40 When this occurs, the MMMF’s shareholders are not able to redeem their shares for the $1.00 that they originally invested. As a result, the shareholders recognize a loss if they redeem shares when the MMMF’s share value has fallen below $1.00.41 A decline in share value in one MMMF can lead investors in other MMMFs to make a “runs” on their shares.42 If allowed to continue, “breaking the buck” can create a market-wide “run” on all MMMFs and widespread financial panic.43

Fortunately, MMMFs have only “broken the buck” twice in U.S. history.44 The most recent example occurred when the Reserve Primary Fund (the “Fund”)45 reduced the price of its shares to $0.97 the day after Lehman Brothers announced its bankruptcy in September 2008.46 The Fund broke the buck when Lehman Brothers’ short-term debt, which represented just 1.2% of the Fund’s portfolio, drastically

39. See infra Part V.
42. A “run” occurs when a large number of shareholders redeem their shares in a short amount of time. Id.
43. Id.
45. The Reserve Primary Fund was very large money market mutual fund that “broke the buck” following the downfall of Lehman Brothers and Merrill Lynch in 2008. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47744.
46. The Reserve Primary Fund held a $785 million (1.2% of the fund’s assets) position in Lehman Brothers commercial paper when they declared bankruptcy. Id. at 47744. Default in a position held by a MMMF that is greater than 0.5% of the fund’s assets can cause a MMMF to “break the buck.” Id. at 47741.
dropped in value.\textsuperscript{47} This relatively low percentage-based exposure was well below the 5% single-issuer maximum set by the SEC rules then in effect.\textsuperscript{48} After the Fund announced it would break the buck, shareholders began redeeming large amounts of shares not only in the Fund, but in other institutional MMMFs as well.\textsuperscript{49}

Within one week, institutional investors withdrew a staggering $300 billion from the institutional prime MMMF market, representing 14% of the assets in those funds, and causing further panic in the market.\textsuperscript{50} As the redemptions increased, the managers of the funds attempted to maintain liquidity by holding cash instead of investing it in short-term investments like CDs and commercial paper.\textsuperscript{51} As a result, issuers of CDs and commercial paper, such as banks and large corporations, were unable to finance their short-term cash needs because the liquidity in the short-term financing markets had frozen.\textsuperscript{52} Because investors feared the liquidity risk\textsuperscript{53} of institutional prime MMMFs, they moved hundreds of billions of dollars into governmental funds over the course of a few months.\textsuperscript{54} This large transition away from institutional prime MMMFs triggered the SEC to adopt rules to address the risk of “runs” on MMMFs.\textsuperscript{55}

III. ATTEMPTS TO DECREASE THE RISK OF MMMFS IN THE WAKE OF THE FINANCIAL CRISIS

A. \textit{2010 Amendments to Rule 2a-7 of the Investment Company Act of 1940}

In 2010, the SEC adopted several amendments to Rule 2a-7 of the Investment Company Act of 1940 to address concerns over

\begin{itemize}
\item \textsuperscript{47} See Gordon & Gandia, \textit{supra} note 44, at 315.
\item \textsuperscript{48} Id.
\item \textsuperscript{49} Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47744.
\item \textsuperscript{50} Id.
\item \textsuperscript{51} Id.
\item \textsuperscript{52} Id.
\item \textsuperscript{53} The risk that MMMFs would freeze redemptions.
\item \textsuperscript{55} Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47745.
\end{itemize}
MMMFs that arose during the 2008 financial crisis. The SEC commented that the 2010 amendments “were designed to make money market funds more resilient by reducing the interest rate, credit and liquidity risks of fund portfolios.” Specifically, the amendments restricted the amount of low-quality securities that MMMFs were allowed to hold, provided liquidity thresholds for the funds, and increased the amount of information that the funds are required to report to the SEC and to the public. While these amendments reduced the risk of MMMFs, the SEC proposed amendments in 2013 to address additional concerns in the MMMF market.

B. 2013 Proposed Rule

In 2011, after the Eurozone sovereign debt crisis and a U.S. Government debt ceiling impasse, the SEC proposed additional amendments to Rule 2a-7 (“Proposed Rule”). Along with imposing redemption gates and liquidity fees for institutional funds, the Proposed Rule narrowed the definitions of retail and government MMMFs and provided that institutional prime MMMFs were required

56. The Investment Company Act of 1940 regulates the organization of mutual funds. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789. The purpose of the Act is to “minimize conflicts of interest that arise in” many areas of the finance industry, including mutual funds. The Laws that Govern the Securities Industry, SEC. & EXCH. COM’N, http://www.sec.gov/about/laws.shtml#invcoact1940 (last visited Nov. 16, 2014). “The Act requires [mutual funds] to disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis.” Id. Thus, the Act requires disclosure “to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.” Id.; see also Press Release, U.S. Sec. & Exch. Comm’n, supra note 1. Rule 2a-7 of the Act specifically addresses the regulation of MMMFs and “governs the maturity length, credit quality and diversity of debt that money-market funds can hold.” See Daniel E. Levin, Breaking the Buck: The End for Money Mark Mutual Funds as We Know Them, 28 REV. BANKING & FIN. L. 747, 771 (2009).


58. See Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47745. Additional requirements include: “posting portfolio information on their Web sites each month, providing investors with important information to help them make better-informed investment decisions.” Id. (internal citations omitted).


60. Id.

61. See Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47739.

62. Apart from narrowed definitions of retail and governmental MMMFs, these mutual funds were not affected by the proposed amendments. Id. at 47759.
The Proposed Rule narrowed the definition of “retail” funds to those MMMFs that limit daily redemptions to $1 million. “Government” funds were defined by the Proposed Rule as MMMFs that invest at least 80% of their assets in cash, government securities, and/or fully collateralized repurchase agreements. The Proposed Rule also required institutional MMMF managers to impose a 2% liquidity fee on shareholder redemptions if the fund’s weekly liquid assets fell below 15%. Additionally, the Proposed Rule allowed an institutional MMMF’s board of directors to suspend redemptions for up to thirty days if the fund’s weekly liquid assets fell below 15%. This gate would automatically lift once the fund’s weekly liquid assets rose above 30% of the fund’s total assets.

C. Industry Response to Regulatory Changes

The SEC received over 1,400 comments in response to the Proposed Rule, yet industry professionals conceded that the SEC had “struck a reasonable balance.” Others, however, argued that the new

63. Id. at 47739.
65. Id. at 5.
66. Weekly liquid assets include cash, direct obligations of the U.S. Government, government securities, securities that will mature within five business days, and amounts receivable and due unconditionally within five business days on pending sales of portfolio securities. Money Market Funds, 17 C.F.R. § 270.2a-7(a)(34) (2014).
67. “Unless the MMMF Board determines that imposing the liquidity fee is not in the fund’s best interest.” ROPES & GRAY, supra note 64, at 6.
68. Money Market Funds, 17 C.F.R. § 270.2a-7(a)(34).
69. ROPES & GRAY, supra note 64, at 5–6.
70. See Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47735, 47739 (Aug. 14, 2014) (noting comments received from “money market funds, investors, banks, investment advisers, government representatives, academics, and others”) (internal citation omitted).
rules “impose ‘significant[] and costly daily operational burdens on money-fund users, limiting the utility of such funds as a cash management tool[]’ without preventing the runs on MMMFs that the rules were designed to address.” Federated Investors, for example, stated that the SEC acted without “any evidence that instituting a floating net-asset value would do anything to eliminate runs.”

Other commenters have pointed out additional negative effects of the Reform. M&T Bank Corporation observed that splitting funds which have historically served both retail and institutional investors, into separate retail and institutional funds will pose a significant cost to existing MMMFs that service both retail and institutional investors. Commenters also stated that requiring institutional prime MMMFs to use a floating NAV will push investors out of the market, and likely into MMDAs.

Furthermore, commenters pointed out that the liquidity fees and redemption gates required under the Proposed Rule would cause preemptive runs by institutional investors who anticipate that an MMMF may be approaching the liquidity threshold of 15%. As one might expect, if investors anticipate that liquidity fees or redemption gates will be imposed by the funds and the investors then redeem their

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72. Id.
73. Federated Investors is one of “the most vulnerable” institutional MMMF managers, according to some, with MMMF assets generating about 40% of the firm’s annual revenue. Id.
74. Id.
76. The Proposed Rule as well as the Reform provide that MMMFs which have both retail and institutional investors will need to reorganize in separate money market funds for retail and institutional investors, in order to qualify as a retail fund and maintain exemption from the floating NAV requirement faced by institutional MMMFs. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47735, 47799 (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274 & 279).
77. Comment Letter from William J. Farrell, supra note 75 (“[R]equiring the creation of ‘retail’ and ‘institutional’ prime money market funds will place a significant burden on prime money market fund sponsors . . . .”).
78. See Comment Letter from Cecelia A. Calaby, Senior Vice President, Am. Bankers Ass’n, to U.S. Sec. & Exch. Comm. (Sept. 17, 2013), available at http://www.sec.gov/comments/s7-03-13/s70313-181.pdf; Comment Letter from William J. Farrell, supra note 75; see also infra Part V.
shares before the thresholds are met, the resulting preemptive action may be equivalent to an actual “run” on the fund.\textsuperscript{80} As a result of the issues identified and discussed by industry professionals and academics, the SEC made several significant changes to the Proposed Rule before adopting the Reform.

IV. THE REFORM

A. Changes to the Proposed Rule

One of the key differences between the Reform and Proposed Rule is the loosening of the definitions of “retail” and “government” funds. These funds were only affected by the final Reform due to changes in what constitutes each, and then only to those funds which were subject to the new requirements of institutional funds under the final Reform due to their reclassification as “institutional.”\textsuperscript{81} In the Reform, unlike the Proposed Rule, “Retail” funds are designated as those with “policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.”\textsuperscript{82} “Government” funds, on the other hand, are defined in the Reform as those MMMFs that invest at least 99.5\% or more of their assets in cash, government securities, or fully collateralized repurchase agreements.\textsuperscript{83}

The Reform also relaxes the liquidity fee and redemption gate thresholds.\textsuperscript{84} A liquidity fee of “1\% [is required] if the fund’s weekly liquid assets fall below 10\%. . . unless the MMMF board determines that imposing the liquidity fee is not in the fund’s best interest.”\textsuperscript{85} The Reform also allows suspension of redemptions\textsuperscript{86} for up to ten days in a rolling ninety-calendar-day period if weekly liquid assets fall below

\textsuperscript{80} The substantive requirements of the Reform are not imposed on retail and government money market funds. These funds are mentioned here to address the disparate treatment that the Reform imposes on institutional, retail and government funds, which were treated equally prior to the 2010 and 2014 amendments. \textit{Id}.

\textsuperscript{81} The liquidity fees and redemption gates, however, do apply to retail funds. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47739.

\textsuperscript{82} \textit{Id.} at 47794; \textsc{ropes \\& gray}, supra note 64.

\textsuperscript{83} Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47794.

\textsuperscript{84} Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47739.

\textsuperscript{85} Compare \textit{id. with} 78 Fed. Reg. 36834, 36848 (proposed June 19, 2013) (requiring a 2\% fee under the Proposed Rule).

\textsuperscript{86} \textit{i.e.}, a redemption gate.
30%, instead of the thirty business day suspension and 15% threshold suggested by the Proposed Rule.87

B. Requirements of the Reform

1. Floating Net Asset Value

By removing the valuation exemption allowing for a stable $1.00 per share value, the SEC now requires institutional MMMFs to value their shares at a floating NAV.88 A main purpose of a floating NAV is to remove the “first mover advantage” found in a stable NAV fund.89 The “first mover advantage” is the investor’s incentive to make early redemptions from a stable NAV fund90 when the investor perceives that the redemptions will continue until all liquidity is removed from the fund and the fund will break the buck, thereby potentially causing the investor to lose money if he redeems his shares.91 The floating NAV achieves this goal through a system of valuation known as “basis point rounding,” whereby the MMMF shares are valued to the nearest 1/100th of 1%—one basis point.92 Traditionally, this “penny rounding” method was used for stable NAV funds, which resulted in shares being valued to the nearest 1%.93

The basis point rounding method adopted through the Reform eliminates “the first mover advantage” inherent in the stable NAV model by removing the disparity between the fund’s redemption value.

87. The requirement that gates will automatically lift once the fund’s weekly liquid assets increases above 30% of the fund’s assets did not change from the Proposed Rule. ROPES & GRAY, supra note 64.
88. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47739.
89. Id.
90. Id. at 47775.
91. This is also referred to as an investor attempt to avoid the “cliff effect”. The “cliff effect” occurs in a stable NAV fund when the fund has large losses in its portfolio assets and simultaneously experiences heavy redemptions, causing remaining investors to “receive at most 99 cents for every share remaining, while redeeming investors receive the full $1.00, even if the market value of the fund’s portfolio had not changed.” Id. at 47778. Under the final Reform, a MMMF which transacts under a floating NAV, the “cliff effect is minimized because (assuming pricing to four decimal places) the “cliff” is 1/100 of the size compared to when a money market fund is priced using penny rounding. Id.
92. Id.
and the value of its underlying securities. The “first mover advantage” of redeeming shares in a stable NAV MMMF is the benefit realized by “the first investors to redeem from a stable value MMMF that is experiencing a decline in its NAV...as a result of valuation and pricing methods, which allow[ed] them to receive the full stable value of their shares even if the fund’s portfolio value [was] less.”

Thus, by eliminating the “first mover advantage,” the basis point rounding model relieves funds of the stress of honoring redemptions using liquidity that may already be limited by losses in their holdings.

While only directly affecting institutional MMMF sponsors, investors, and stakeholders, a floating NAV results in much greater daily fluctuations of fund share prices. Under current tax law, MMMFs are required to track the timing of these fluctuations, the purchase price of sales executed, and other transaction data in order to determine and report capital gains and losses for tax purposes. The SEC claims that these tax burdens will be eliminated by the Treasury Department (the “Treasury”) and Internal Revenue Service (“IRS”). Accordingly, the Treasury and IRS proposed rules on July 28, 2014—that would allow MMMFs and their investors to treat floating NAV MMMFs as though they have a stable NAV—eliminates the need for burdensome basis tracking and complicated gain and loss

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94. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47774.
95. Id.
96. Id. at 47775.
97. Entities that rely on the funds for short-term financing.
98. See infra Part IV.
99. Id. at 47783. The New Rule reads as follows:

First, under tax rules applicable at the time of the Proposing Release, floating NAV money market funds (or their shareholders) would be required to track the timing and price of purchase and sale transactions in order to determine and report capital gains or losses. Second, floating NAV funds would be subject to the “wash sale” rule, which postpones the tax benefit of losses when shareholders sell securities at a loss and, within 30 days before or after the sale, buy substantially identical securities. These tax consequences generally do not exist today, because purchases and sales of money market fund shares at a stable $1.00 share price do not generate gains or losses.

Id.
100. Id.
calculations. The Treasury and the IRS also released a final revenue procedure on July 23, 2014, providing that the wash-sale rules will not apply to redemption of floating NAV MMMF shares. If the new proposed rules are not adopted, funds will face significant accounting and reporting burdens related to gain and loss tracking and the wash sale provisions.

2. Other Requirements of the Reform

As discussed in Part IV(A) of this Note, the Reform requires imposition of liquidity fees and redemption gates if certain conditions are met and the MMMF’s board determines that such actions are in the best interest of the fund. Additionally, the Reform imposes new reporting requirements on MMMFs. Among these reporting requirements is an increase in website disclosure based on the daily

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104. Section 1091(a) disallows recognition of a loss which was realized by a taxpayer on a sale of shares of stock or securities if, within thirty days before and after the date of the sale, the taxpayer acquires substantially identical stock or securities. I.R.C. § 1091(a) (2014).
106. See Michaels, supra note 27 at 206 (citing several industry professionals who feel the change is positive); Tax News Flash, supra note 105.
107. Press Release, U.S. Sec. & Exch. Comm’n, supra note 1. The Reform specifically provides that the MMMF board of directors have the ability to determine whether liquidity fees and redemption gates are in the best interest of the fund. Id. Liquidity fees and redemption gates serve as a tool MMMF managers can use to immediately and directly address runs. Id.
108. See id. at 5 (describing the provisions of the finalized rule and providing information about proposed Treasury and IRS rules).
fluctuations in the basis of the shares, including “levels of daily and weekly liquid assets, net shareholder inflows or outflows, market-based NAVs per share, imposition of [liquidity] fees and [redemption] gates, and any use of affiliate sponsor support.”

The Reform also contains new “material event” disclosure requirements, which include notifications of liquidity fees and redemption gate issuances, portfolio security defaults, and sponsor or fund affiliate support. MMMFs are now required to immediately release information relating to the fund’s holdings, including information relevant to assessing risk.

In addition, MMMFs must comply with increased diversification requirements for the securities in their underlying portfolios. The Reform requires that an MMMF not invest more than 10% of its assets in any one issuer or group of affiliated entities. These requirements, together with the outstanding tax implications and the two-year implementation period, have yet to be resolved by the Treasury and IRS, represent significant changes to the MMMF industry, and present both obstacles and opportunities for investors, sponsors, stakeholders, and competitors of institutional prime MMMFs.

109. Id.
110. Which must be filed on Form N-CR with the SEC.
113. Id. at 47783. The Reform requires that “all of a money market fund’s assets meet the 10 percent diversification limit, . . . thereby removing the so-called 25 percent basket that permitted as much as 25 percent of the value of securities held in a money market fund’s portfolio to be subject to guarantees or demand features form a single institution.” Press Release, U.S. Sec. & Exch. Comm’n, supra note 1.
114. Affiliated entities include an investment advisor. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47783. Id. Additionally, “[MMMFs] would be required to treat the sponsors of asset-backed securities as guarantors subject to the 10% diversification limit . . . unless the [MMMF’s] board of directors . . . determines that the fund is not relying on the sponsor’s financial strength . . . to determine the asset-backed security’s quality or liquidity.” Id.
115. The final implementation date is October 14, 2016. Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47932.
V. COSTS AND OPPORTUNITIES CREATED BY THE REFORM

The Reform requires only institutional MMMFs to implement a floating NAV system, providing a compliance date of October 14, 2016. Investors in institutional MMMFs “use the same-day liquidity [of the fund] to fund . . . payroll, purchases of inventory, insurance premiums, equipment purchases, and capital improvements.” In addition, businesses that regularly engage in short-term financing and rely on MMMFs to purchase their commercial paper, will also be affected because tightened liquidity and diversification requirements imposed by the Reform will disincentivize, if not outright bar, MMMFs from purchasing riskier and less-liquid commercial paper. While many of these entities are banks, a significant number are large corporations as well as state and local governments.

State and local governments will be hit particularly hard because MMMFs hold nearly 72% of their outstanding short-term bonds greater than $500 billion. A decrease in demand for MMMF shares will cause a corresponding decrease in MMMFs portfolios, which will inevitably cause a decrease in demand for MMMF purchases of municipal securities. With the demand for state and local government commercial paper reduced, governmental entities will be
forced to look for other, likely more expensive, short-term financing, such as bank loans.\textsuperscript{124} As a result of the increase in financing costs, state and local governments may be forced to delay or cancel crucial infrastructure projects, which were planned assuming the availability of stable and affordable financing provided by MMMFs.\textsuperscript{125}

In addition to state and local governments, commercial non-financial entities will also be affected by the tightening of the short-term financing market.\textsuperscript{126} With the decrease in MMMF demand for commercial paper, the largest issuers of such paper will be forced to meet their short-term financing costs through other options, including bank loans and government MMMFs.\textsuperscript{127} With the influx of the largest, most creditworthy businesses into less utilized short-term financing markets, such as government MMMFs, smaller, less creditworthy companies that traditionally found financing in these markets will find it increasingly difficult to secure funding.\textsuperscript{128} Consequently, these less creditworthy entities may be forced to look towards other, more expensive options, including bank financing.\textsuperscript{129}

\textbf{A. Opportunities for Banks as Alternatives to MMMFs}

The Reform presents opportunities for banks on two fronts.\textsuperscript{130} First, banks may become an alternative investment vehicle to MMMFs.\textsuperscript{131} Second, banks might serve as an alternative source of funding for entities which have typically relied on MMMFs.\textsuperscript{132}

\begin{itemize}
\item [124.] Natarjan, supra note 121.
\item [125.] McDonald, supra note 122. Margaret Hassan, Governor of New Hampshire, and Deval Patrick, Governor of Massachusetts, both commented that the reform will affect the ability of their respective states to fund school projects. Comment Letter from Margaret Hassan to U.S. Sec. & Exch. Comm’n (Oct. 4, 2013), available at http://www.sec.gov/comments/s7-03-13/s70313-257.pdf; Letter from Deval Patrick to U.S. Sec. & Exch. Comm’n (Sept. 17, 2013), available at http://www.sec.gov/comments/s7-03-13/s70313-217.pdf.
\item [126.] Natarjan, supra note 121.
\item [128.] Id.
\item [129.] Id.
\item [130.] See infra Part V.A.1–2.
\item [131.] See Comment Letter from William J. Farrell, supra note 75, at 5.
\item [132.] See infra Part V.A.2.
\end{itemize}
1. Banks are an Alternative Investment Vehicle

With many companies looking to avoid the floating NAV, liquidity fees, and redemption gates required of MMMFs after the Reform is fully implemented on October 14, 2016, there will be greater interest in storing cash in MMDAs.\textsuperscript{133} Banks will likely see an increase in investors interested in their MMDA offerings and thus, a corresponding increase in revenue from reinvestment activities.\textsuperscript{134} These reinvestments will likely help offset the costs of their own increased short-term financing costs.\textsuperscript{135}

With Federal Deposit Insurance Corporation (“FDIC”) insurance on most MMDAs covering up to $250,000,\textsuperscript{136} banks will be an attractive alternative for small to mid-size companies and state and local governments who previously invested in MMMFs, which have no FDIC insurance. While MMDAs will not earn as high as a return as MMMFs, companies have few comparable options. Thus, companies whose investment strategies require relatively liberal liquidity levels will likely increase their use of depository accounts such as MMDAs.\textsuperscript{137}

State and local governments that find themselves unable to meet the accounting and recordkeeping requirements mandated by the Reform will similarly be forced to look for alternative investments such as MMDAs, which usually produce a lower yield.\textsuperscript{138} The combination of the threat of liquidity fees and redemption gates, as well as the floating NAV requirements, will likely also influence their desire to seek alternatives to MMMFs.\textsuperscript{139} Additionally, state and local governments may be required by law to invest only in funds that have a stable NAV, which would preclude them from entering the MMMF market altogether.\textsuperscript{140} These factors will likely drive state and local governments to use MMDAs offered by commercial banks as a short-term investment vehicle. Banks with MMDA offerings should

\textsuperscript{133.} Kristof, supra note 11.
\textsuperscript{134.} See Comment Letter from William J. Farrell, supra note 75, at 5; see also infra Part V.B.
\textsuperscript{135.} See infra Part V.B.
\textsuperscript{137.} Gilligan, supra note 127.
\textsuperscript{138.} McDonald, supra note 122.
\textsuperscript{139.} Id.
\textsuperscript{140.} Id.
strategically advertise them to existing and potential corporate, state, and local government clients, while banks without MMDA offerings should work to develop and implement them into their product.

2. Banks as an Alternative Source of Financing to MMMFs

The second opportunity for banks arises from those companies that borrow short-term money by issuing commercial paper, which is then traditionally purchased by MMMFs—in other words, those businesses who use MMMFs as a source of financing. Regarding these companies, banks have a significant opportunity to serve as an alternative short-term financing source. This relatively common practice of financing short-term operating needs with commercial paper, which has historically been purchased by MMMFs, presents a great opportunity for banks to expand their services. If the predicted outflow of $500 billion of corporate and governmental entity funds from institutional MMMFs is correct, the resulting decrease in demand for commercial paper by MMMFs will result in corporations searching for short-term financing elsewhere. Those companies that find themselves without MMMF funding will be forced to seek financing from other sources—likely banks. One of these options is the revolving bank credit line, which generally has higher interest rates and longer terms than commercial paper.

State and local governments that find themselves unable to secure buyers for their commercial paper—or who are forced out of similar short-term financing markets by their new, larger competitors—will also be forced to look for more expensive short-term financing alternatives. While banks will have to consider the composition of

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141. Natarjan, supra note 121.
142. Id.
143. Id.
144. Id. (quoting Thomas Deas, treasurer of FMC Corp., which had $600 million of commercial paper outstanding at the end of its first quarter); see supra Part V.
145. Natarjan, supra note 121.
146. Id.
147. Id. According to James Gilligan, assistant treasurer at Great Plains Energy Inc., his company’s short-term financing costs would increase by 500%. Id.
their portfolios and the costs associated with taking on low-yielding municipal debt, there may be tax-planning benefits that make the tax-free debt an attractive investment for banks as well as their clients. By working with their existing state and local government clients to develop short-term lending solutions, and by taking advantage of opportunities to lend money at increased rates compared to MMMFs, banks will be able to mitigate their short-term financing costs by capitalizing on their own opportunities.149

B. Increased Short-Term Financing Costs for Banks

Similar to large corporate entities and state and local governments, banks rely heavily on short-term financing from MMMFs purchasing their commercial paper.150 Any reduction in MMMF demand for commercial paper will have a significant impact on the short-term financing costs of banks, similar to the effect it has on businesses and governments.151

As previously discussed, MMMFs will likely purchase smaller quantities of commercial paper as a result of the Reform.152 As investors seek alternative options for short-term cash deposits, the institutional prime MMMF market will correspondingly shrink.153 As a result, MMMFs will purchase smaller amounts of bank-issued commercial paper, forcing banks to look for alternative sources of short-term financing.154 These alternatives will likely be more expensive, thereby increasing the short-term financing costs155 of the banks because it is extremely unlikely that banks will take on a heightened level of risk.157 This is due to the tight regulation on bank liquidity levels which will force them to avoid higher risk, lower cost alternatives.158 The most straightforward option for banks to mitigate

149. See infra Part V.B.
150. Natarjan, supra note 121.
151. Id.
152. See infra Part V.
153. See infra Part V.B.
154. See Natarjan, supra note 121.
155. See Wilczek, supra note 119.
157. Wilczek, supra note 119.
158. Banks can avoid higher risk alternatives by paying higher interest rates on their debt, extending the duration of their current financing agreements, or obtaining financing from other banks who are in a better financial position. See Natarjan, supra note 121.
the effect of these increased financing costs is to pass the costs along to their customers by increasing fees or increasing interest rates on loans.\textsuperscript{159} However, pushing these cost pressures onto customers will have a negative effect on the attractiveness of the bank’s services to its clients and potentially cause the bank to lose those clients to competitors who keep their short-term financing costs down by utilizing the most cost-efficient financing.\textsuperscript{160}

VI. CONCLUSION

The Reform finalized by the SEC on July 23, 2014, is a significant departure from the historical treatment of institutional MMMFs.\textsuperscript{161} The floating NAV requirement will discourage many institutional investors from investing in MMMFs in the future.\textsuperscript{162} If the market for institutional MMMFs is reduced, which this Note suggests will happen, the stress created by the reduction will be felt not only by sponsors and investors of the funds, but also by those borrowers who depend on the funds as a source of short-term financing.\textsuperscript{163} This strain presents an opportunity for banks to pull business away from MMMFs by offering attractive alternatives such as MMDAs and perhaps even new short-term financing and investment vehicles\textsuperscript{164} that trump the Reform’s negative effects on MMMFs.\textsuperscript{165} By taking advantage of this opportunity, diligent banks will be able to offset their own increased financing costs and perhaps earn a net profit from the effects of the Reform.

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\textsuperscript{160} See Natarjan, \textit{supra} note 121.


\textsuperscript{162} \textit{Id}.

\textsuperscript{163} Natarjan, \textit{supra} note 121.

\textsuperscript{164} Possible new financing and investment vehicles are not considered in this Note.

\textsuperscript{165} See \textit{supra} Part V.