Morgan Stanley Investment Management

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Global Liquidity Solutions: U.S. Money Market Fund Reform

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On July 23, 2014, the Securities and Exchange Commission (SEC) voted to amend Rule 2a-7, of the Investment Company Act of 1940, which governs U.S. money market funds. The majority of these amendments, except for certain disclosure enhancements, will not take effect for two years. Importantly, given this extensive implementation period, there will be no immediate impact on the operations of U.S. money markets funds. Investors and fund providers will have significant time to prepare for the amended rules.

The final rule, in the words of the SEC, is "designed to address money market funds' susceptibility to heavy redemptions in times of stress, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, their benefits."

Overleaf (*Display 1*) we present a summary of how the new rules differ from the existing rules and follow with a more detailed discussion of the new rules.

Floating NAV

A floating NAV is intended to reduce the economic incentive for investors to redeem shares ahead of other investors when there is a price discrepancy between the market-based NAV and the stable share price. The purpose of this is to reduce the chance of unfair shareholder dilution by weakening the incentive for certain investors to take a "first mover advantage." Additionally, a floating NAV increases transparency as to the risks associated with the principal volatility of a money market fund's portfolio securities which can be obscured by the pricing (penny rounding) and valuation methods (amortized cost[1]) that allow these funds to maintain a stable NAV. The focus of this reform is those money market funds that have tended to exhibit greater volatility.

Institutional prime and institutional municipal money market funds will be required to sell and redeem shares at a floating NAV based on the current market-based value of the securities in their underlying portfolios rounded to the fourth decimal place (e.g. $1.0000). Currently, money market funds are priced using amortized cost and penny rounding (e.g. $1.00); this limits the sensitivity that a fund has to changes in the NAV of the underlying assets. Despite these changes, institutional prime and institutional municipal money market funds will still be able to use amortized cost for securities maturing in 60 days or less.

U.S. government, treasury, retail prime funds and retail municipal money market funds will continue to be able to transact at a stable $1.00 NAV and use amortized cost and/or penny rounding to seek to maintain this stable share price.

The move from a stable NAV to a floating NAV raises several tax and accounting questions. On July 23, 2014, the Treasury Department and the IRS issued proposed guidance simplifying the tax treatment related to floating NAV money market funds and provided a 90-day comment period. This guidance specifically:

- Allows shareholders to measure net gain or net loss without transaction-by-transaction calculations, simplifying tax compliance for shareholders. The net gain (or loss) is generally determined as:
  - The increase (or decrease) in the value of the investor's shares during a period (such as the tax year), minus the net investment in those holdings (purchases minus sales) during the period
- Extends to floating-NAV MMFs the same waiver of gross-proceeds reporting, basis reporting, and holding-period reporting rules that now applies to stable-value MMFs.
- Provides relief from "wash sale" rules

Additionally, the SEC used its plenary authority provided by the federal securities law to set accounting standards to state that the adoption of a floating NAV alone for money market funds will not, under normal circumstances, preclude shareholders from classifying their investment in money market funds as cash equivalents for purposes of U.S. GAAP.

[1] Values the asset at its purchase price, and then subtracts the premium/adds back the discount linearly over the life of the asset, the asset will be valued at par at its maturity.

Display 1

	NEW SEC RULE	CURRENT SEC RULE	COMPLIANCE DATES
Floating NAV	**Prime institutional & municipal institutional money market funds:** Will be required to sell and redeem shares at a floating NAV based on the current market-based value of the securities in their underlying portfolio rounded to the fourth decimal place (e.g. $1.0000). They will maintain the ability to use amortized cost for securities maturing in < 60 days when determining the value of securities within the portfolio	Money market funds are permitted to value their portfolio securities using amortized cost and value their shares using penny rounding to seek to maintain a stable $1.00 NAV	October 14, 2016
Stable NAV	**Government, treasury, retail prime funds and retail municipal money market funds:** Will continue to be able to transact at a stable $1.00 NAV and use amortized cost and/or penny rounding to seek to maintain this stable share price	No Change	
	Government Fund Definition: A money market fund that invests at least 99.5% of its total assets in cash, government securities,[2] and/or repurchase agreements that are "collateralized fully" (i.e., collateralized by cash or government securities)	A money market fund that invests at least 80% of its total assets, in cash, government securities, and/or repurchase agreements that are "collateralized fully" (i.e., collateralized by cash or government securities)	October 14, 2016
Liquidity Fees & Redemption Gates	**All government and treasury money market funds:** Will not be required to, but may choose to impose a fee or gate if the ability to do so is disclosed in a fund's prospectus	Money market funds may suspend redemptions for no more than 7 days. Or, in accordance with rule 22e-3, a money market fund can permanently suspend redemptions and liquidate if the fund's board determines that the fund is about to 'break the buck'	October 14, 2016
	All prime and municipal money market funds: Will be allowed to implement liquidity fees if a fund's level of weekly liquid assets falls below 30%. The implementation of liquidity fees will be required if a fund's level of weekly liquid assets falls below 10% unless the funds' board of directors determines that such a fee is not in the best interests of the fund. Additionally, if a money market's funds level of weekly liquid assets falls below 30%, the board of directors of the fund has the capability to impose a redemption gate. The gate may be in place for no more than 10 consecutive business days or 10 business days in any 90 day period		
Enhanced Disclosure Requirements	**Website Disclosures:** Money market funds will be required to disclose on a daily basis, their level of daily and weekly liquid assets, net shareholder flows, current NAV, if the fund received sponsor support and the imposition of liquidity fees and gates	No such requirement	April 14, 2016
	Form N-MFP: Money Market funds will continue to submit Form N-MFP on a monthly basis but the data will be made publically available immediately. Additionally, funds will provide certain limited information (NAV, liquidity and shareholder flows) on a weekly basis	Each fund must file the required information within 5 business days after the end of each month. The information is made publically available 60 days after the end of the month	April 14, 2016
	Material Event Disclosure: A money market fund will be required to file Form N-CR, which is a new requirement if a portfolio security defaults, an affiliate provides financial support to the fund, the fund experiences a significant decline in its shadow price, or when liquidity fees or redemption gates are imposed or lifted	No such requirement	July 14, 2015
	Disclosure of Sponsor Support: Money market funds will be required to provide in their statements of additional information any instance of sponsor support in the past 10 years (from the compliance date)	No such requirement	April 14, 2016
Stronger Diversification Requirements	**Elimination of 25 Percent Basket:** Municipal money market funds will be limited to having 15% of the value of securities held in their portfolio subject to guarantees or demand features from a single institution. Non-municipal money market funds will be limited to 10%	25% of the value of securities held in a money market fund's portfolio may be subject to guarantees or demand features from a single institution	April 14, 2016
	Aggregation of Affiliates: Money market funds will be required to treat certain entities that are affiliated[3] with each other as single issuers when applying rule 2a-7's 5% issuer diversification limits	No such requirement	
	ABS – Sponsors Treated as Guarantors: Money market funds will be required to treat the sponsors of ABS as guarantors subject to rule 2a-7's 10% diversification limit applicable to guarantees and demand features	No such requirement	
Enhanced Stress Testing	Among other things, money market funds will be required to test their ability to maintain weekly liquid assets of at least 10 percent and to minimize principal volatility in response to specified hypothetical events	Money market funds are required to periodically test their ability to maintain a stable price per share based on (but not limited to) certain hypothetical events	April 14, 2016

[2] A "government security" is backed by the full faith and credit of the U.S. government.

[3] Entities are affiliated with one another if one controls the other entity or is controlled by it or is under common control. Control is defined to mean ownership of more than 50% of an entity's voting securities.

Liquidity Fees and Redemption Gates

Liquidity fees can, at board discretion, allow funds to moderate redemption requests by allocating liquidity costs to those shareholders who impose such costs on the funds in times of market stress. Redemption gates provide another discretionary tool for fund boards to limit or suspend redemptions temporarily and can be helpful in managing heavy redemptions in times of market stress.

The following applies to all non-government money market funds. Government money market funds are not required to, but may choose to have these capabilities as long as they disclose this in their prospectus.

A fund's board can choose to impose a liquidity fee on all redemptions if a funds level of weekly liquid assets falls below 30%.[4] The liquidity fee can be up to 2% on all redemptions and requires the funds' board of directors to determine that such a fee is in the best interest of shareholders.

If a funds weekly liquidity falls below 10% the fund would be required to charge a 1% liquidity fee on all redemptions. The funds' board of directors can determine that a higher fee (up to 2%), a lower fee or no fee at all is in the best interest of the fund and its shareholders.

Additionally, once a fund's weekly liquidity falls below the 30% threshold a fund's board of directors may in its discretion temporarily suspend redemptions (gate). A fund can be gated for no more than 10 consecutive business days or a total of 10 business days in any 90 day period.

It should be noted, that prior to the new rule money market funds have been able to suspend redemptions for seven days. Alternatively, under Rule 22e-3 money market funds can suspend redemptions permanently if a fund's board determines that the fund is in danger of 'breaking the buck' and proceed with an orderly liquidation of the fund.

U.S. Government and Retail funds

A U.S. government money market fund will now be defined as a fund that invests at least 99.5% of its total assets in cash, government securities, and/or repurchase agreements that are "collateralized fully" (i.e., collateralized by cash or government securities). Government money market funds may invest a *de minimis* amount (up to 0.5%) in non-government assets.[5] Previously a government money market fund was required to have 80% of its total assets in cash, government securities and/or repurchase agreements that are "collateralized fully."

[4] 30% is the minimum weekly liquidity prescribed by Rule 2a-7.

[5] Non-government assets would include all "eligible securities" permitted under rule 2a-7 other than cash and government securities.

Additional Elements of the Final Rule

Enhanced Disclosure Requirements

The rule amendments improve transparency related to money market funds' operations, as well as their overall risk profile. They ensure that investors have access to important information regarding the liquidity of the money market fund and the funds current NAV.

Website Disclosure: Money market funds will be required to disclose on a daily basis and as of the preceding 6 months, their level of daily and weekly liquid assets, net shareholder flows and current NAV. In addition to these disclosures a fund will need to disclose on it's website if the fund received sponsor support and the imposition of liquidity fees and gates.

New Material Event Disclosure: A money market fund will be required to file a new form, Form N-CR, if a portfolio security defaults, an affiliate provides financial support to the fund, the fund experiences a significant decline in its shadow price, or when liquidity fees or redemption gates are imposed, when they are lifted and if a fund falls below the 30% weekly liquidity threshold and the board determines to not impose a liquidity fee or redemption gate.

Disclosure of Sponsor Support: Money market funds will be required to provide in their statements of additional information any instance of sponsor support in the past 10 years (from the compliance date).

Immediate Reporting of Funds Portfolio Holdings: The current 60-day delay on releasing the information filed on Form N-MFP will be eliminated and the monthly form will become available immediately upon filing, within the first five business day of the month. Additionally, daily and weekly liquidity, market-value NAV and flows information will be required to be reported weekly.

Stronger Diversification Requirements

These stronger requirements are intended to more efficiently achieve the diversification contemplated by rule 2a-7's current 5% issuer diversification limit.

Aggregation of Affiliates: Money market funds will be required to treat certain entities that are affiliated with each other as single issuers when applying rule 2a-7's 5% issuer diversification limits.

Elimination of 25 Percent Basket: Municipal money market funds will be limited to having 15% of the value of securities held in their portfolio subject to guarantees or demand features from a single institution. Non-municipal money market funds will be limited to 10%.

ABS – Sponsors Treated as Guarantors: Money market funds will be required to treat the sponsors of ABS as guarantors subject to rule 2a-7's 10% diversification limit applicable to guarantees and demand features.

Enhanced Stress Testing

The rule amendments also call for enhanced stress-testing requirements to help ensure greater standardization in the quality and comprehensiveness of stress tests. Money market funds will be required to test their ability to maintain 10% weekly liquid assets and minimize principal volatility against, specified hypothetical events which include:

- Interest rate increases
- Credit events
- Credit spread increases in portfolio sectors
- Shareholder redemptions
- Combination of events

Money market funds will be required to report to their board, the magnitude of each hypothetical event that would cause a fund to "break the buck," and an assessment of the fund's ability to withstand events that are reasonably likely to occur within the following year. Money market funds are required to provide stress testing results to its board of directors on a periodic basis.

We look forward to continuing to serve the needs of our investors with a suite of investment products that best meet their needs in an evolving market.

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