SECURITY
SELECTION
SERVICE
WORLDWIDE

ICD COMMENTARY:

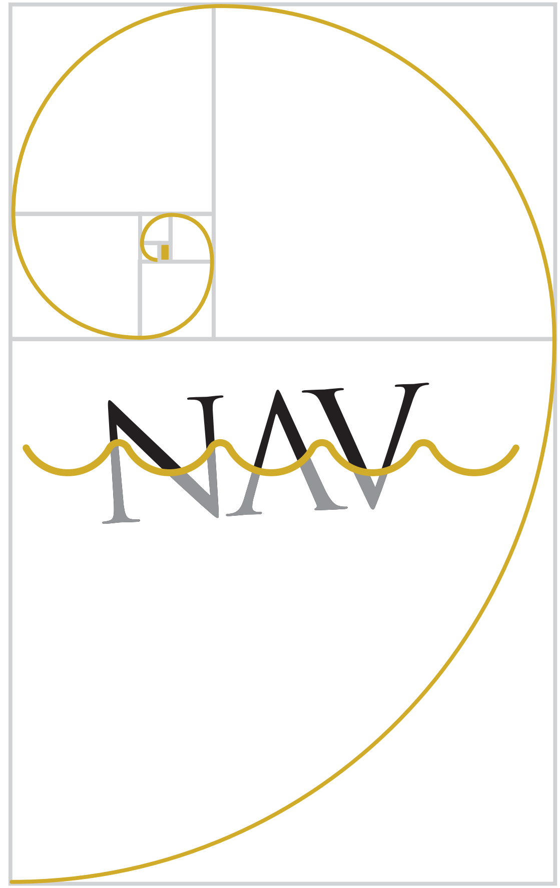
OPERATIONAL AND ACCOUNTING ISSUES WITH THE FLOATING NAV AND THE IMPACT ON MONEY MARKET FUNDS

JULY 2013

Institutional Cash Distributors, LLC
580 California St., Suite 1335
San Francisco, CA 94104
Member FINRA/SIPC
icdportal.com

ICD COMMENTARY:

OPERATIONAL AND ACCOUNTING ISSUES WITH THE FLOATING NAV AND THE IMPACT ON MONEY MARKET FUNDS



INTRODUCTION

The floating NAV is back on the table as one of three measures in the SEC's 2013 proposal on Money Market Fund regulation reform. This recurring concept is a regulatory initiative that was first introduced by the President's Working Group Report in October 2010. To date, the arguments for and against the implementation of a fluctuating NAV have been reasoned and passionate, but nearly all of the deliberation has taken place at the 30,000 foot level. This ICD Commentary takes a closer look, examining the transactional realities of implementing a floating NAV from an accounting and execution perspective. What emerges is a problematic methodology whose operational repercussions could not only bring fundamental changes to Money Market Funds but could marginalize investment in these products and drive corporate cash to alternative and riskier investments.

Editor's Note

When we originally presented this argument in February of 2012 it was in response to media reports of the SEC deliberations on a Money Market Fund Floating NAV. In reviewing the proposal currently on the table, while some of the details and arguments at the periphery have changed, the core challenges surrounding the operational and accounting hurdles of a Floating NAV still remain as relevant as ever. Presented for your consideration is an updated look at the Floating NAV and what it might mean for participants in the Money Market Fund industry.

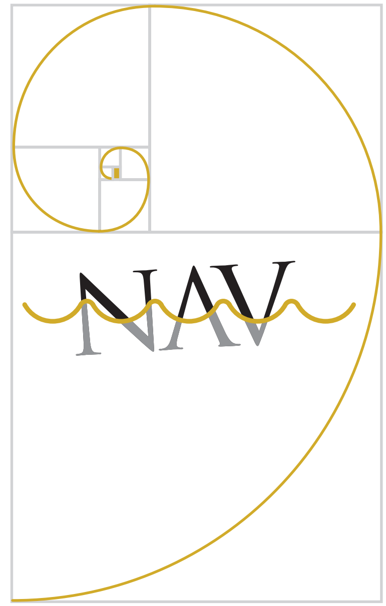
- Sebastian Ramos, SVP

THE STABLE NAV – FACT OR FICTION?

Let's start by dispelling the notion that the stable NAV – which is the cornerstone of today's Money Market Fund – is a fallacy or accounting gimmick that does not represent the true value of the underlying investments. In truth, all Money Market Funds are priced daily and the value of the holdings in the portfolio is affirmed at $1.00/share. This "shadow" NAV is reported to the SEC and increasingly made public to investors on a daily basis, and if at any moment the portfolio should fall below .995 or hit 1.005 the fund would be forced to re-price its shares to reflect that new value.

In fact, what has been missed in this discussion of a floating or variable NAV is the reality that in order to actually capture the minute variability in the value of the portfolio, the fund would need to move the decimal point and price their shares to an accuracy of 1/100 of a percent (or $1.0000) to prevent small changes in price from being lost in the rounding to an even currency implement (in this case $.01). If anything, this move to "basis point" rounding, a standard above and beyond even the 1/10 of a percent requirement for most traditional mutual funds, could be seen as the real accounting gimmick, essentially forcing variability on a product whose value is inherently stable.

So if these are inherently stable products, why would a transition to a floating NAV be so disruptive to this market? The answers are the intrinsic efficiencies of the stable NAV both from an accounting and operational perspective. Each of these benefits would be severely impaired under a switch to a floating NAV that would serve to marginalize the products in the eyes of the fixed income investor.



"Those who criticize the amortized cost methodology of calculating MMF NAVs as insufficiently precise need to understand that the proposed alternative "mark-to-market" accounting is likewise imprecise, given the lack of real-time asset prices for many of the portfolio assets. In light of MMFs practice of holding short-term assets to maturity, the amortization method produces the appropriate valuation. Moreover, amortized cost is the normal form of accounting for assets that the holder does not intend to sell and will hold back to maturity.

A floating NAV would reduce investor demand for MMFs, because of operational, tax, accounting and legal impediments or because of convenience and efficiency considerations."

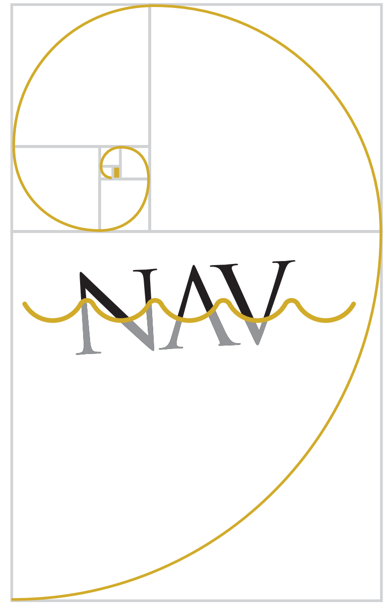
- Jonathan R. Macey
Financial Advisor, Gregory Breisiger
March 6, 2013

THE FIRST IMPAIRMENT: ACCOUNTING FOR MINUTIA

Taking each issue at a time, let's review the first impairment from an accounting and regulatory standpoint. Corporations are, by far, the largest users of Money Market Funds and the principal benefit is the treatment of the stable NAV on the balance sheet. Indeed, corporations are allowed to carry these funds as cash equivalent investments without having to track and report on the daily fluctuations in the value of their portfolio. Were the funds to change to a floating NAV, corporations would have to begin monitoring their mark to market value and report on any minute gains or losses. Though these movements may be extremely small they would still exist and, absent a significant overhaul of the general accounting standards, these slight gains and losses would have to be reported.

Considering the multitude of ultra-short-term bond funds for whom the treatment on the balance sheet would be identical to fluctuating NAV Money Market Funds, it would be logical to conclude that any investor that had previously enjoyed the convenience of cash equivalent treatment on the balance sheet would have little incentive to sacrifice performance without the accompanying reporting efficiencies. Additionally, as the ultra-short-term bond funds are not similarly regulated by the tight portfolio constraints of Rule 2a-7 Money Market Funds, investors may find themselves taking on additional risk by investing in products that are farther out on the yield curve.

Moreover, for corporate investors looking to preserve this accounting treatment, the other alternative would be to pursue Money Market Funds offshore, outside of the jurisdiction of the SEC. The offshore fund market has experienced fairly consistent growth over the past few years; a trend that would continue and indeed accelerate if U.S.-based investors can no longer find the right investment products domestically.



"Money market funds can maintain a $1.00 share price only under limited conditions. A stable share price is critical to the existence of the money market fund industry. A required floating NAV would eliminate the fundamental attraction of money market funds for investors, and, as a result, jeopardize the availability of short-term capital."

- Jill Fisch and Eric Roiter:
A Floating NAV For Money Market Funds: Fix or Fantasy
August 25, 2011
University of Pennsylvania
Institute for Law and Economics

THE SECOND IMPAIRMENT: DISRUPTING OPERATIONAL EFFICIENCIES

To understand the disruption of the operational efficiencies garnered by a stable NAV, let's discuss briefly how today's Money Market Funds work. Because they are allowed to carry the cost of their shares at amortized cost, Money Market Funds are able to provide same day liquidity to their clients, permitting them to sell shares and receive the proceeds from their redemption on the same day, often within hours. This enables corporations to better manage their day-to-day operating cash and draw down on their investments only on the day that it is needed.

What no one is talking about, and it deserves much greater consideration, is how a floating NAV would affect this immediate liquidity. Indeed, with the need to re-price shares for marginal fluctuating valuations, Money Market Funds would be faced with the following choices:

FLOATING NAV SETTLEMENT ALTERNATIVES:

1 **DELIVERING PAYMENTS POST END OF DAY PRICING**

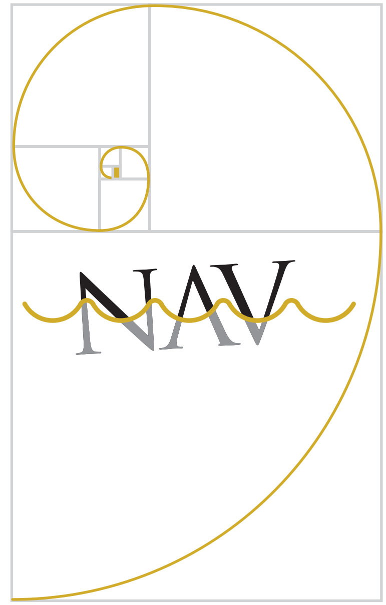
Continue to deliver cash same day but after the funds are priced for the day

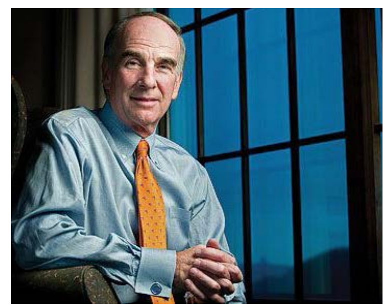
2 **PRICING MULTIPLE TIMES PER DAY**

Price multiple times per day to be able to deliver to the investor in a more timely manner

3 **TRANSACTIONS THE DAY AFTER (T+1)**

Move settlement to T+1 more in line with other fixed income mutual funds





"The $1 NAV is not an accounting gimmick as has been portrayed by some in favor of the draconian proposals. Money fund shares price at a dollar on a daily basis not because they have promised to repay shares at a dollar, but because the underlying assets are required to meet very stringent portfolio requirements under current SEC regulations.

The ability to transact at the $1 NAV provides a real benefit to corporations, government entities and other money fund users by allowing them to use automated cash management processes, facilitating same day transaction processing, shortening settlement cycles, and reducing float balances and counterparty risk. These are measurable benefits that translate directly into lower costs of capital and higher returns on assets."

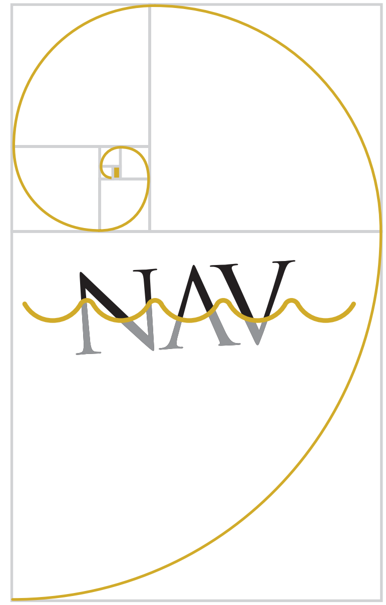
- J. Christopher Donahue
CEO, Federated Investors Inc.
Why Floating NAV For Money Market Funds Is A Terrible Idea
May 23, 2012, Forbes

1 SETTLEMENT ALTERNATIVE 1: DELIVERING PAYMENTS POST END OF DAY PRICING

The first option, delivering payments post EOD pricing, is perhaps the most damaging of the three but may wind up being the most likely course. If we consider what this scenario would look like, remember that the vast majority of institutional Money Market Funds remain open for trading until 5PM ET. This is critical to their functionality both as a provider of liquidity in the repo market and as an investment vehicle that allows investors to find a safe haven for their late day cash. Were Money Market Funds to continue this schedule, this would mean that each fund would only be able to price their shares after all trading has closed for the day.

If all institutional Money Market Funds were to attempt to pay on all redemptions, post EOD pricing, this would mean literally trillions of dollars on a day to day basis would need to move through the Fed wire system during the last hour (or more likely the last 30 minutes) of operation. This would put considerable stress on the system, not to mention on transfer agents, as they struggle to price and deliver on a multitude of funds in less than an hour's time.

Moreover, a switch to end of day settlement would significantly reduce the attractiveness of these products for any cash that needs to be deliverable before the end of the day. Faced with the choice of paying late on large acquisitions, taxes, and routine vendor payments, corporations will choose to redeem the cash the day before, bringing large quantities of intraday cash back onto the banks' balance sheets and losing a day's worth of income in the process.



"Simply put, forcing funds to float their NAVs doesn't address the problem that most preoccupies many regulators – how to avert heavy redemptions out of money market funds.

Let's check the count against floating NAVs. They don't address regulators' goals. They eliminate key benefits to investors. They harm the economy. They increase systemic risk. And they carry immense costs and operational complications."

- Paul Schott Stevens
President & CEO, ICI
Crane's Money Fund Symposium
June 19, 2013

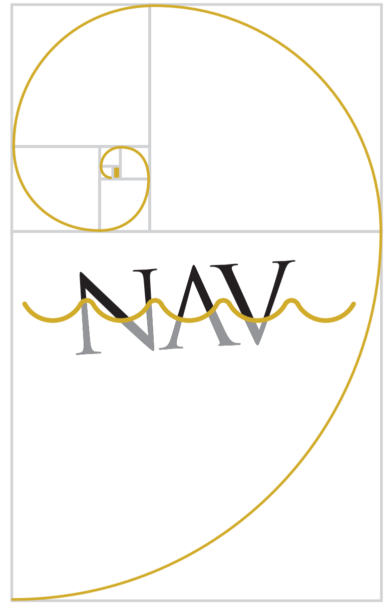
2 SETTLEMENT ALTERNATIVE 2: PRICING MULTIPLE TIMES PER DAY

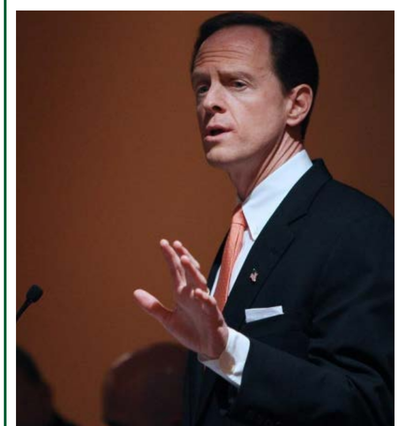
The second option, pricing multiple times per day, could prove nearly as difficult to implement. In addition to being a significantly expensive proposition, the decision to value the shares at intervals throughout the day could conceivably cause a self-fulfilling run on a fund that experiences a momentary impairment of its NAV. Consider the scenario: a fund announces its first intraday price for the day, and either as an error or temporary dip in the value of a security, that price were to come in below the previous NAV reported for the fund. Fearful of losses in a product whose primary investment objective is preservation of capital, it's conceivable that investors would begin selling en masse out of the fund. This would have the effect of creating a run and an exacerbated NAV impairment where one did not previously exist. Though it is not likely we'll see this option embraced by many funds, it would be the only way to preserve the current liquidity profile the funds enjoy while maintaining a fluctuating NAV.

3 SETTLEMENT ALTERNATIVE 3: TRANSACTIONS THE DAY AFTER (T+1)

The third and final option would be to resort to settling on all transactions the day after pricing (or T+1). This is how most fixed income mutual funds operate, and while it would be the least disruptive to the financial markets, it would also put Money Market Funds at a considerable disadvantage when compared with other short-term fixed income funds. Absent the benefit of immediate liquidity and the conveniences brought about by the current accounting treatment of the stable NAV, unintended consequences could arise, including:

- *Reductions in Money Market Funds' capacity to provide short-term credit due to lower investor demand*
- *A shift of assets to less regulated or unregulated Money Market Fund substitutes such as offshore Money Market Funds; enhanced cash funds, and other short-term cash management vehicles*





"Most funds are currently providing daily disclosure of the net asset value (NAV), which allows investors to know the precise value of their assets. Forcing funds to float the NAV operationally provides no additional information to the investors but does impose significant increases in administrative costs on individual investors and main street businesses that use money market funds for cash management."

- Senator Pat Toomey (R-PA)
Senate Banking Committee
Press Release
June 5, 2013

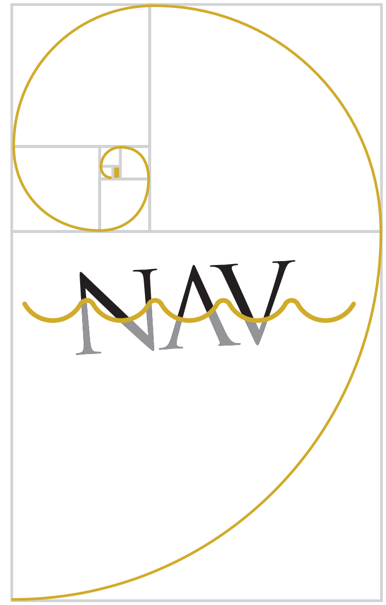
DEFYING LOGIC. DISMISSING INVESTORS.

The logical question would be: Why propose a change of this magnitude at all? If Money Market Funds are inherently stable and the only way to capture the minute fluctuation in the value of their short term investments is to impose pricing accuracy requirements above and beyond the rest of the mutual fund industry, why risk the prospect of marginalizing the product and the ensuing shock to the entire short term funding market?

If you cut through all of the various opinions and rhetoric surrounding the prospect of a floating NAV, the only real justifications provided by the advocates of a floating NAV are 1) that it will – somehow – end a false "perception" of stability in the marketplace. Investors, they argue, are not adequately assessing the risk inherent in these products; either out of ignorance or a misguided belief that the funds will not lose value. And 2) that imposing a floating NAV will help acclimate investors to negative movements in the funds price, reducing the likelihood of triggering large redemptions.

The first argument ignores the fact that every fund marketing document and prospectus is required to state that the fund may lose value, and that the principle investors in this market, and those primarily subject to the proposed regulations are institutional investors. These investors, by definition, are sophisticated market participants armed with the expertise, knowledge and motivation to make informed investment decisions. The idea that these investors do not adequately grasp the reality that a Money Market Fund could lose value, particularly on the heels of one that actually did, strains credibility.

The second argument is also flawed because it appears to equate all negative share movements instead of adequately accounting for the degree of price change in a true credit event scenario. If you consider the case of the Reserve Primary Fund, the only portfolio in recent history to sustain an investor loss and in turn experience a "run", the repricing of shares forced by the bankruptcy of the Lehman holdings within the portfolio resulted in a change in the NAV from $1.00 to $.97 (a loss of approx 3%). If the view is that changes to the NAV on the order of 1/100th of a percent (ie. $.0001) will make investors immune to a sudden loss of 3% then the committee isn't adequately assessing how institutional investors operate. Rather, what is more likely is that larger than average movements in an overly precise NAV will contribute to increased runs, as more and more

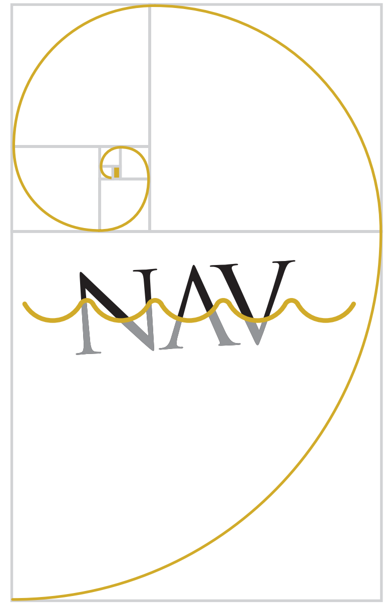


"If, in fact, floating the NAV does not stave off redemptions, one has to question whether abandoning the stable NAV is justified considering the costs and burdens investors would have to bear if a floating NAV undercuts the usefulness of the money market fund as a cash management vehicle."

- Commissioner Troy Paredes
Statement at Open Meeting
Regarding a Rule Proposal on
Money Market Fund Reform
June 5, 2013

investors try to liquidate into a declining fund. This will have the effect of forcing losses on a fund whose initial movements may have been well within the normal band. Losses by the way, that would not have been realized were it not for the forced selling of securities, originally intended to be held to maturity, to meet liquidity needs.

Finally note that each of these justifications, when you consider their core elements, are based on impressions of how a floating NAV might make investors behave – subjective arguments that ultimately may or may not provide an accurate reading of the way institutional participants operate (as we argue here). However, what can be quantified are the additional burdens, whether the accounting treatment within corporations, or the operational challenges and costs to the industry brought on by the restructuring of an asset class, that on balance argue strongly for the negative consequences of such a regulatory change.



"Policymakers in the U.S. have expressed concern that a floating NAV could have unintended consequences and increase, rather than decrease, risk. A floating NAV could create risks where none exist now, for example, by making MMF investors overly sensitive to miniscule fluctuations in the market NAV of MMFs. Moreover, a floating NAV would eliminate the utility of MMFs for many investors, requiring costly accounting adjustments and making MMFs ineligible investments for many investors."

- ***Melanie Fein***
Letter to the Financial Stability Board
January 14, 2013

SEC MMF SOLUTIONS ARE ALREADY IN PLACE

In light of all this, what can be done to protect the global market – and Money Market Funds in particular – from another liquidity crisis? The good news is that the real changes that were necessary after the events of 2008 have already been put in place. The core issues with Money Market Funds in 2008 revolved around a lack of liquidity and adequate disclosure of fund holdings, resulting in a decrease in investor confidence. The 2010 SEC regulations were enacted to directly address these issues.

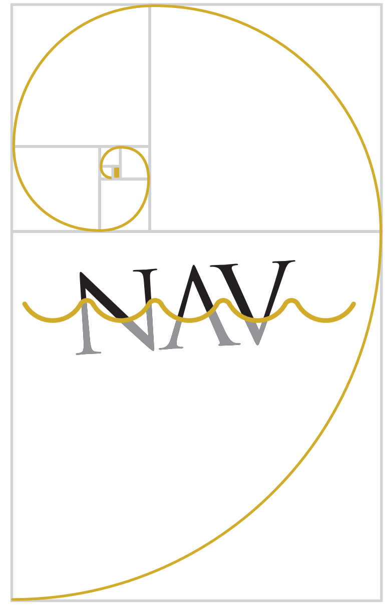
First there are the new liquidity provisions, requiring a Money Market Fund to maintain a minimum of ten percent (10%) of their portfolio in overnight instruments and with at least thirty percent (30%) maturing in less than a week. However, liquidity alone was not the sole cause of the problem. What started the firestorm that ultimately led to a full blown money market fund liquidity crisis was an ill-advised investment in a single fund portfolio.

The SEC has addressed the problem in two ways:

1) *They have tightened the restrictions on duration, risk, and fostered diversification to lessen the likelihood that a similar investment will be a part of a Money Market Funds portfolio.*

2) *They have mandated strict transparency rules that have allowed for more timely and complete disclosure of fund portfolio holdings. Giving investors access to their underlying investments on a timely basis has helped reduce the fear of the unknown that fueled the panic selling in late 2008.*

More importantly, the industry has fully embraced the increased transparency, developing technological tools that enable investors to not only see what makes up their investments, but actively drive the market by rewarding fund managers that pursue more conservative investment goals. This idea of leveraging technology and regulation to transform a marketplace is what ICD defined in a separate ICD Commentary ***"Money Market Fund Reform Option #9"***. Option #9 forms the basis for effective safety-minded, self-regulation by the industry and its constituents.



"The SEC should start by determining if the reforms it adopted in 2010 are working and examine how funds have performed in the wake of the U.S. debt ceiling negotiations and downgrade, as well as the European sovereign debt crisis. If it can prove additional changes are needed, it should find solutions that preserve the versatility and usefulness of the product. Needlessly reducing the choices companies have to finance their operations will neither help address perceived systemic risk nor advance our economic recovery."

- ***David Hirschmann***
U.S. Chamber of Commerce
Washington, D.C.
February, 2012

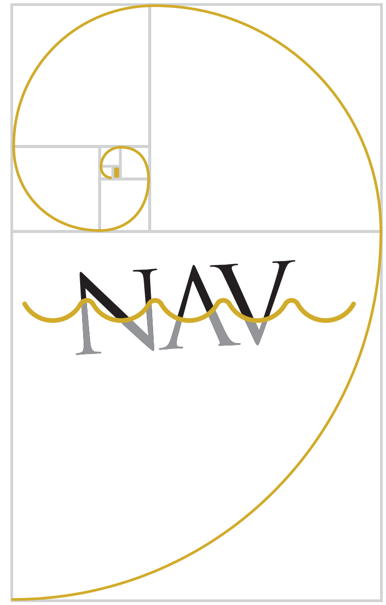

ICD COMMENTARY:
MONEY MARKET FUND REFORM OPTION #9
#9
INTRODUCTION

DOWNLOAD ICD COMMENTARY: MONEY MARKET FUND REFORM OPTION #9

MMFs ARE STABLE, SAFETY-MINDED, & SELF-POLICED

Some might question whether the 2010 reforms have gone far enough. Yet a careful analysis of the recent history surrounding the US debt crisis shows how the industry has responded. If you look at the outflows that occurred leading up to the critical 2011 default date for the US Treasury, the industry as a whole experienced redemptions of approximately $133 billion, in many ways similar to those that occurred during the credit crisis in 2008. What was enormously different was the increased liquidity and transparency of the funds, enabling fund managers and investors to maintain sufficient liquidity, preserving the stable NAV without any government intervention. In fact, Moody's in a separate report called the entire episode "credit positive for investors as it shows that money market funds are better able to handle future market disruption."

It is important to recognize that the debate over a floating NAV has repercussions that reverberate far beyond just the confines of money market funds and their corporate investor base. As the key providers of liquidity to the short-term funding market, Money Market Funds are the primary vehicles for securing the short-term loans critical to funding the day-to-day operations of corporations, municipalities and the Federal Government. Were we to see a floating NAV implemented and the subsequent marginalization of the funds that would ensue, all of these entities would see their borrowing costs increase. With the economy continuing to struggle through a tepid recovery, it would be a shame if regulators risk sinking the U.S. into another recession due to unintended consequences resulting from unnecessary Money Market Fund reforms.



"Money market funds are now a significant piece of the nation's financial system. Over the years, money market funds have become a popular investment product for both retail and institutional investors. They also have become an important provider of short-term financing to corporations, banks and governments. All told, money market funds hold nearly $3 trillion in assets, the majority of which are in institutional funds."

- Mary Jo White
Chairman of the SEC
Statement At Open Meeting
Regarding a Rule Proposal on
Money Market Fund Reform
June 5, 2013