Money Market Fund Regulatory Changes:

The Impact of 2014 Regulations on Investment Policies

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February, 2015

On behalf of

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Introduction

In July 2014, the U.S. Securities and Exchange Commission issued new regulations for U.S.-domiciled money market funds (MMFs). These primarily impact Institutional Prime and Municipal MMFs as Government and U.S. Treasury MMFs (both retail and institutional) are exempt from these structural reforms. There is a two-year transition period to allow fund companies and investors time to adapt with implementation scheduled for October 2016.

Federated Investors' corporate clients are asking how these regulations impact them: What is needed to "adapt" to these new regulations? And must our investment policies be revised? We asked Treasury Strategies, the well-respected treasury management consulting firm, to help our clients address this question.

This paper represents their suggested approach for corporate investors who are currently permitted to use Institutional Prime and Municipal MMFs in their short-term investment portfolios. Of course, every situation is unique so we encourage you to consider how their approach suits your specific circumstances.

Public sector and non-profit institutions typically are subject to more restrictive investment guidelines than private corporations. While the ideas in this paper are directionally useful for them, they may not strictly apply.

As always, your Federated account executive will be happy to discuss these concepts further.

Adapting to U.S. Money Market Fund Regulatory Changes of October 2014

Most corporate investors are aware that new MMF regulations have been approved and have some understanding of the impact. However, most are not yet sure whether their investment activities will be affected, and whether they need to change something to continue investing in MMFs.

THIS PAPER PRESENTS A FOUR-STEP PROCESS TO DEAL WITH THE NEW REGULATIONS, ACCORDING TO THE FOLLOWING THOUGHT SEQUENCE:

1. **Understand the new MMF regulations.**

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2. **Examine your investment policy.**
   - How does it compare to the new regulations?

+

3. **Have a conversation with your CFO.**
   - How do the changes impact the MMF value proposition for us?
   - How do the changed MMFs stack up to other permitted investments?

+

4. **Follow your CFO's guidance.**
   - No policy changes needed.
   - No policy changes, but let's inform the Board.
   - Let's tweak the policy (and how would you do that?)

I. Understand the New Regulations

In July 2014, the Securities and Exchange Commission implemented a series of amendments to Rule 2a-7 of the Investment Company Act of 1940 that will primarily impact Institutional Prime and Institutional Municipal MMFs.

The rule changes are designed to enhance the safety and liquidity of MMFs, protect investors and reduce systemic risk in the overall financial markets. In writing the amendments, the SEC had lengthy consultations with MMF investors, fund companies and market participants. They also consulted with the U.S. Department of the Treasury and the Internal Revenue Service.

The following amendments are scheduled to take full effect in October 2016 for Institutional Prime and Municipal MMFs:

A. Floating Net Asset Value

Perhaps the best way to understand this change is to contrast it with the current approach.

Historically, Prime and Municipal MMFs[1] have been able to maintain a constant net asset value (CNAV) of $1.00 per share by using the amortized cost and penny rounding methods of determining the value of their shares.

- With amortized cost, a fund would purchase a discounted money market instrument and use a daily accrual to value that instrument such that it reached par value at maturity. A fund would use the accrued value of its portfolio to calculate its net asset value per share, so long as the result did not deviate materially from the estimated market value of the portfolio.
- With penny rounding, a fund would be priced to the nearest penny (two decimal places). Minor fluctuations in the portfolio's market value would not impact the CNAV since any value between $0.995 and $1.005 would round to $1.00.

With both methods, this constant dollar in/dollar out feature provided institutional investors with a convenience not available to any other money market instrument.

The new amendments limit the use of amortized cost to valuing securities with remaining maturities of 60 days or less, and require that a fund be priced to four decimal places rather than two ($1.0000). This increases the likelihood that MMF prices will fluctuate in a small band around that $1.0000 value.

We expect that certain funds will limit their investments to securities with remaining maturities of 60 days or less. To the extent the amortized cost value is approximately the same as the market value for such securities (and the fund is not required to dispose of securities for more or less than their amortized cost), the fund's per share price is not expected to fluctuate. If the market value and amortized cost value are not approximately the same, the fund's NAV would fluctuate.

B. Liquidity Fees

Under the 2010 amendments to Rule 2a-7, funds must maintain weekly liquidity equal to at least 30% of the portfolio value. Under the new regulations, if the 30% threshold is breached, a fund's Board of Directors is allowed (but not required) to impose up to a 2% liquidity fee on redemptions if they determine it is in the best interest of fund shareholders.

Further, if weekly liquidity drops below 10%, the Board is required to impose a 1% liquidity fee unless it specifically determines such a fee is not in the best interest of fund shareholders. The Board also has the alternative of imposing a higher (up to 2%) or lower redemption fee.

C. Redemption Gates

Under the 2010 amendments, redemption suspensions were permitted in connection with the liquidation of a MMF if needed to protect shareholders.

If the 30% weekly liquidity threshold is breached, the new regulations allow (but don't require) temporary redemption suspensions if the fund's Board determines it to be in the best interest of fund shareholders. The gate could be imposed for up to ten business days within any 90-day period while the fund resolves its liquidity issues. Once liquidity rises above 30%, the gates must be removed at the start of the next business day.

D. Enhanced Disclosure

The amendments provide several enhanced disclosures to investors. The most significant are daily website reporting of daily and weekly liquid assets, net investor inflows or outflows and the estimated market value NAV. These added disclosures are designed to give investors greater transparency and insight into a fund's liquidity position.

E. Stronger Portfolio Management Requirements

The amendments stipulate several changes in the way a MMF portfolio can be managed that strengthen diversification requirements and enhance stress testing. These proposed changes are designed to improve fund safety.

II. Examine Your Current Investment Policies

Once you understand the new money fund regulations, the next step is to examine your investment policies. Most companies and institutions maintain approved investment policies at either a Board level or with the CFO. Some policy statements are broad while others are more prescriptive.

To help you evaluate your own policies, we examined over 20 investment policy statements from our corporate clients representing a cross section of industries, revenue and portfolio sizes.

As you evaluate your policies with respect to the new money fund regulations, pay particular attention to three sections:

A. **Investment objectives**
B. **Permitted investments**
C. **Prohibited investments and other considerations**

A. Investment Objectives

This section establishes the broad framework for your policy. While it is highly unlikely that anything in this section will limit continued use of money funds, you should review it to be sure.

Here is a representative cross section of investment objective statements from the policies we examined.

- **Company A:** The basic objectives of the company's short-term investment program are, in order of priority:
  1) Safety and preservation of the invested funds
  2) Liquidity of investments sufficient to meet operating requirements
  3) Diversification to limit risk
  4) Maximized net after-tax yield
- **Company B:** The objectives of the global short-term investment program, in order of importance, are:
  1) Guarantee return of principal
  2) Maintain liquidity
  3) Achieve returns commensurate with risks assumed

- **Company C:** Manage the company's investment assets based on the following principles:
  1) Compliance–ensure compliance with all applicable securities laws in each jurisdiction.
  2) Capital preservation–invest with counterparties that pose minimal credit risk and in financial instruments that minimize the risk of principal loss.
  3) Liquidity–ensure adequate liquidity to meet all operational requirements.
  4) Yield–achieve a fair after-tax return in consideration of the parameters defined above.

It seems clear that the new regulations would not impact Company A.

Company B would have an issue with "guarantee return of principal." This requirement is so restrictive that only government securities or government guaranteed bank deposits qualify. According to this objective, the company should not have been investing in MMFs to begin with.

Company C is likely not impacted. If it had historically invested in MMFs, that would be evidence there are no prohibiting jurisdictional securities regulations. If it had not used MMFs before and wanted to start now, it would be necessary to verify that no jurisdictional securities regulations prohibit their use.

The three policies above (and the others we examined) would have no liquidity issues with MMFs since their liquidity language is very general:

- Company A–Liquidity of investments sufficient to meet operating requirements
- Company B–Maintain liquidity
- Company C–Ensure adequate liquidity to meet all operational requirements

However, if the policy said something like "maintain 100% daily liquidity at all times," the fees and gates aspect of the new regulations might be problematic. In reality, no money market instrument or bank deposit can absolutely meet that requirement.

To further meet the liquidity plank, most investment policy statements have diversification requirements and position limits. Should one investment in the portfolio become illiquid, other investments in the pool would be sources of liquidity and thus meet the objective.

B. Permitted Investments

This section of the investment policy enumerates the investment instruments that are specifically approved and requires careful review.

Virtually all the statements we looked at include government securities, bank CDs, bank time deposits and Tier 1 commercial paper as permitted investments.

Here are several examples of how MMFs are included:

- Company D: MMFs with AAA rating required
- Company E: MMFs with assets of greater than $1 billion
- Company F: U.S.-domiciled 2a-7 MMFs registered under the Investment Company Act of 1940
- Company G: MMFs that strive to maintain a net asset value of $1.00 per share

For Companies D, E and F, the rating, size and registration requirements are straightforward. It seems that no policy change would be required.

Company G's "strive to maintain" language raises questions. Since most fluctuating NAV money funds will still strive to maintain a $1.00 NAV, the language seems to allow room for a fluctuating NAV MMF. The key word is "strive" rather than "require." In addition, Company G should change the $1.00 to $1.0000 to reflect the new four decimal place pricing. Yet, it seems advisable to discuss the interpretation with the CFO or Board.

Company G may also consider funds that will limit portfolio securities to maturities of 60 days or less that can continue to value these securities at amortized cost and, by so doing, strive to maintain the value of their shares at $1.0000.

C. Prohibited Investments and Other Considerations

You should review several additional sections of your investment policy in light of the new regulations. Some of these may be problematic and should be addressed. One-off examples in the policies we examined lead us to suggest you look for the following:

- Prohibited investments–Are money funds specifically prohibited?
- Credit quality–Is there a minimum rating required for the fund? Is there a minimum rating required for the fund sponsor?
- Concentration limits–Is there a limit that can be invested in a single fund? Is there a limit that can be invested across funds of a single sponsor?
- Maturity limits–Is there a maximum weighted average maturity requirement?
- Look-through requirements–Does the policy require you to look through the money fund to the underlying investments and place limits at that level?
- Aggregation requirements–Does the policy require you to look through ALL your money funds and place limits on aggregate counterparty exposure?

III. Have a Conversation With Your CFO

Based on the policies we reviewed, we think few companies will have to formally change their investment policies to continue investing in MMFs. However, even if this is the case for your firm, it is certainly wise to brief your CFO (or head of the Investment Policy Committee or other appropriate person) about continuing to use MMFs.

We suggest this discussion center around three ideas:

A. **The value proposition of using MMFs has not changed.**
B. **Even with changes, MMFs still compare favorably with other permitted investments.**
C. **New products are likely to be introduced and may need to be incorporated in the investment policy.**

A. The MMF Value Proposition Has Not Changed

MMFs have a long history of providing investors with an ideal combination of safety, liquidity and yield, plus an additional benefit of operational convenience relative to other money market instruments.

Prior to enactment of the new regulations, investors and fund companies gave negative feedback on several early proposals, fearing they would compromise this value proposition and reduce investor utility. Investors were concerned that tracking minuscule daily gains and losses would be costly and unwieldy. Many worried that the tax consequences of daily transactions would trigger IRS "wash sale" rules. They thought a fluctuating NAV might run afoul of investment policies or statutory requirements.

Three mitigants in and around the final regulation go a long way toward addressing these concerns.

- First, the U.S Treasury and IRS proposed significant recordkeeping relief, which eliminates the need to track daily purchases and redemptions for tax reporting.

- Second, the IRS provided relief from the "wash sale" rule.

- Third, by allowing securities with remaining maturities of less than 60 days to continue to be fair valued at amortized cost, NAV fluctuations will likely be smaller than if estimated market values were used for the entire portfolio.

Let's now consider the four aspects of the investor's value proposition:

Safety–The regulations will make MMFs safer. Increased diversification will reduce credit risk. The continued use of amortized cost for securities maturing in less than 60 days will likely reduce the average maturity of a portfolio, thereby reducing interest rate risk in a portfolio.

Liquidity–The regulations will have little practical effect on investor liquidity. Although fees and gates sound onerous, the regulation requires only that the fund Board *consider* whether fees and gates would be in the best interest of the fund shareholders, and that they do this only in the rarest situation of a liquidity threshold breach. Fund Boards have always had the ability to withhold redemption proceeds for up to seven days. The liquidity fees are a way for fund Boards to give investors access to their liquidity during a time of presumed market stress. Although not identical, these fees could be likened to penalties for early withdrawal from a bank time deposit.

Furthermore, the regulations provide additional disclosure for investors to monitor a fund's liquidity well in advance of the triggers. Funds will be required to disclose their daily and weekly liquidity as well as net cash flows on their websites each day.

Yield–To the extent that funds shorten their portfolio maturities, there could be downward pressure on yield. However, numerous factors go into a fund's ability to generate yield, some of which could offset that pressure.

Convenience–The four decimal place fluctuating net asset value reduces the convenience of MMFs. Funds will now be subject to small daily market fluctuations, just like other short-term money market instruments that are not ultimately held to maturity, so the convenience advantage enjoyed by MMFs is diminished.

The U.S. Treasury and the IRS have proposed rules that aim to keep MMFs as convenient as possible for investors. MMFs have traditionally been more convenient to hold and transact than other types of investments, such as Treasury bonds.

MMF investors will continue to enjoy the very significant convenience of a highly diversified portfolio with professional management and rigorous credit analysis.

B. How the Changed MMFs Compare to Other Permitted Investments

FNAV–Some perspective is in order on this issue. Prior to the regulatory change, MMFs were the ONLY short-term securities with the constant net asset value feature (except for bank demand deposits, CDs and time deposits, which are not securities per se). All other short-term securities–commercial paper, Treasury bills, agency paper and notes, BAs, etc.–may fluctuate daily as interest rates, market conditions and credit conditions change.

After October 2016, Institutional Prime and Municipal MMFs lose their CNAV feature and will price like all other money market instruments in your portfolio.

FNAV Accounting Issues–As mentioned above, all money market securities can fluctuate daily. Many companies elect the amortized cost method to simplify accounting for these securities. Of course, if these other types of short-term instruments are liquidated prior to maturity, taxable gains and losses due to price fluctuations would occur.

We once feared the FNAV would create new operational accounting and tax headaches for the commercial investor. The worst case scenario would have required companies to record small daily gains and losses on each MMF transaction. Those fears were laid to rest by the U.S. Treasury's recommendation for recordkeeping relief and relief from the "wash sale" rule.

Fees–Under certain circumstances, the Board of a Prime or Municipal MMF may now impose temporary redemption fees of up to 2%, if the Board determines it is in the interest of fund shareholders.

This is actually less onerous than what an investor might encounter in a stressed liquidation of other money market instruments or bank deposits. In times of stress, investors typically incur haircuts to liquidate quickly. While short-term money market instruments are usually very liquid, we have all seen that liquidity can evaporate when investors attempt to convert to cash.

In the case of MMFs, investors now have an early warning feature not available with other instruments. The new disclosure requirements will give investors significant visibility into a fund's portfolio and liquidity status.

Consider the case of bank interest-bearing deposits where depositors face a liquidity fee to withdraw before maturity. This breakage fee can be as much as 90 days' interest. Unlike MMFs, this fee is assessed with *each* early withdrawal, not just in times of substantial market stress. It is a constant feature of this investment alternative, whereas the MMF liquidity fee would only be levied in extreme circumstances.

Gates–Under certain circumstances, the Board of a Prime or Municipal MMF may now impose a temporary redemption gate for up to ten business days, if the Board determines it is in the interest of fund shareholders.

To put this in proper perspective, consider what happens in the case of a bank failure. When a small bank fails, the FDIC can quickly arrange for a larger bank to take it over, and deposits flow uninterrupted. However, things may not be that simple for depositors in a large bank failure, even in this era of Dodd-Frank "living wills." In fact, deposit insurance regulations require only that the FDIC *begin* resolving a failed bank within 48 hours of the failure, and there is no maximum time set for final resolution. The "gate" for depositors is indefinite.

Thus, the fee and gate components of this regulation merely codify for MMFs the market and regulatory realities already inherent in other approved investment or deposit instruments.

Ratings–There has been some confusion about credit ratings for MMFs.

The Dodd-Frank Act requires the SEC to "remove credit ratings" from MMF regulations. Some have erroneously assumed this meant the funds themselves would no longer be rated. Upon hearing this, corporate investors wondered: how can we meet an investment policy requirement to use only AAA-rated funds if they will no longer be rated?

This stems from a misunderstanding of what was in the Dodd-Frank Act. The credit ratings in question were the ratings of individual securities in a MMF portfolio, NOT the ratings of the funds themselves. While Rule 2a-7 currently requires credit ratings as the standard, the Dodd-Frank Act requires the SEC to adopt "alternative standards of creditworthiness" to regulate portfolio investments, which explains how the Act will "remove credit ratings" from Rule 2a-7.

Credit ratings will continue to be provided by investment ratings firms for both MMFs and the individual securities they invest in. However, credit ratings would no longer review a fund manager's evaluation of investment creditworthiness.

C. New Products May Need to be Included in the Investment Policy

A logical consequence of the new MMF regulations is that fund companies, banks and other investment firms will devise new short-term investment products aimed at the corporate investor.

We expect most new products will have features similar to money funds but with some structural differences. Some may be separately managed accounts (SMAs) with investment characteristics of money funds. Others may be commingled cash pools, again with MMF characteristics. Still others might register with the SEC as a type of ultra-short bond fund.

Funds taking advantage of the conditions of the private offering exemption will be able to offer their units at $1.00 per share. In addition, funds that undertake to hold only portfolio securities with maturities of under 60 days may effect purchases and redemptions at $1.0000 per share, so long as each security's amortized cost is approximately the same as its market value, and the fund is not required to dispose of securities for more or less than their amortized cost.

The process outlined in this paper can be applied to evaluating new investment products:

- Examine the investor utility attributes of safety, liquidity, yield and convenience.
- Consider the new product's investment policies and reporting transparency.
- Understand how the investment will operate.
- Get comfortable with the structure: SMA, commingled pool or non 2a-7 bond fund.
- Confirm that your investment policies permit such a structure.
- Talk with your CFO about the justification for using it.

To include a new product in your investment policy, it may suffice to incorporate "2a-7-like" language into the investment policy statement.

IV. Develop an Action Plan

Having talked with your CFO, you will hear four possible outcomes to the question of what is required to continue investing in Institutional Prime and Municipal MMFs:

A. No policy changes needed; continue investing as usual

This is straightforward. No change to the investment policy statement is required.

Based on the investment policies we reviewed, we believe this may be the case for most U.S. corporations. Most *will not* need to make any alterations to their written investment policies to continue to invest in MMFs.

B. No policy changes needed, but let's inform our Board about the regulatory changes.

The conversation with the Board can follow the outline of this paper.

- Describe the regulatory changes (Section I).
- Show that your current investment policy already covers those issues (Section II).
- Restate the value proposition of MMFs (Section III).
- Show that MMFs still compare favorably with bank deposits and other Board-approved investment instruments in terms of safety, liquidity and yield (Section III).

C. Let's tweak the policy to allow continued use of MMFs

The sample investment policies presented in Section II provide a good starting point.

- If any of the new MMF attributes make them "prohibited investments" as specified in your policy, you need to update or eliminate that language.
- If your current policy generically refers to this asset class as "money funds," "money market funds" or just "funds," you might simply add a phrase "subject to Rule 2a-7 of the Investment Company Act of 1940 as amended from time to time." This will keep your policy current with subsequent regulatory changes.

- In the interest of not being overly restrictive, private funds and funds with maturities of under 60 days may be included.
- You could add a ratings component, such as "all money market funds rated AAAm by Fitch, Moody's or S&P."
- You might also add an asset size requirement, such as "money funds with total assets in excess of $1 billion."
- Finally, you can add maximum portfolio concentration language to assuage Board concerns, such as:
  - "No more than 20% of our portfolio shall be invested in a single fund."
  - "No more than 50% of our portfolio shall be invested in a single fund family."
  - "Our holdings in a fund shall not comprise more than 10% of that fund's total assets."

D. Let's tweak the policy to allow for new managers or new instruments

As discussed earlier, it is likely that during the two-year implementation period, several new 2a-7-like products will be developed. If your policy is not sufficiently broad, now would be a good time to modify it. What you choose to include here is a matter of your company's preference.

To permit separately managed accounts, here is some possible language:

> "At the discretion of the Treasurer (or other officer) and with notification to the Board, company may hire outside manager(s) or invest in commingled pools managed by an outside manager. Such manager shall be licensed and demonstrate a five-year track record in managing similar accounts and shall have a minimum of $10 billion in assets under management in this asset class, excluding our assets. In no event can our company's assets exceed 20% of a manager's total assets under management in this asset class."

Other new products may be in the form of unregistered, commingled cash pools or registered ultra-short bond funds. It is not yet possible to know the precise features of these products, but the following hypothetical language added to the permissible instruments section might be broad enough to permit them:

> "Bond funds or commingled pools shall be managed in a manner consistent with the instrument and diversification characteristics of Rule 2a-7."

A tighter construction would add the "maturity" and "liquidity" characteristics of Rule 2a-7 as well. You could add a ratings requirement for the overall portfolio or for each instrument. Finally, you could add asset tests similar to those in the separately managed accounts language above.

Now you have a rational, well-thought-out plan to present to your CFO or investment policy committee.

V. Summary

Regulatory changes to Institutional Prime and Municipal MMFs are far less onerous than we once feared they would be. The value proposition of money funds remains intact, and the U.S. Treasury action will mitigate most, if not all, tax and recordkeeping concerns for the corporate investor.

MMF changes have been regularly covered in the financial press, frequently with bits of misinformation or hyperbole. CFOs and Investment Committees are bound to wonder how their corporate treasurer views this issue and whether they will continue investing in MMFs. It makes sense to have a discussion with them about the MMF value proposition constancy, the parallels between post-change MMFs and your other permitted investments, and the continued valuable role you see for MMFs in your firm's short-term investment strategy.

Historically, MMFs enjoyed an advantage over other money market instruments from net asset value, tax and recordkeeping perspectives. While some of those advantages are now diminished because of the fluctuating net asset value, MMFs are still on par with most other permissible short-term investments and deposits with respect to safety, liquidity, yield and convenience. Moreover, MMFs still enjoy an advantage over other instruments in terms of liquidity and transparency.

The notion that fees and gates are problematic is a red herring. As we show in this report, these provisions provide a fund Board with additional investor protection tools. Further, the fees and gates provisions merely codify for money funds the actual liquidity limitations that exist for *all* money market instruments and bank deposits in times of market stress.

After examining a large representative sample of our clients' investment policies, we conclude that most companies will not require formal policy change to continue investing in Institutional Prime or Municipal MMFs.

We recommend that you follow the four steps discussed in this paper. Most importantly, brief your CFO whether or not you believe a policy change is required.

As always, your Federated account executive will be happy to discuss these concepts further.

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