Sweep Programs Likely to Accommodate Prime Funds

Both before and after the Securities and Exchange Commission approved a package of structural and operational reforms for money-market funds in 2014, fund providers and some large institutional investors expressed concerns that one particular provision of the new rules – the imposition of a floating net asset value on institutional prime funds – would make it difficult or impossible to use such funds in bank and brokerage sweep programs. It appears, however, that many of those concerns have been addressed, senior financial managers recently explained to Money Market Insight, adding that prime funds will continue to be important components of bank and brokerage sweep programs.

“There certainly were expressions of concern about the FNAV component of money-market-fund reform,” observed Tracy Hopkins, chief operating officer at BNY Mellon Cash Investment Strategies and a vice president of The Dreyfus Corp., “but over the course of the two-year implementation period, which ends this Oct. 14, there has been a growing realization that the challenges involved are essentially operational and therefore not insurmountable.” By October’s deadline, she added, “it’s very likely that we’ll see at least some banks that oversee large sweep programs supporting, if only on a limited basis at first, a certain number of prime funds in their programs.”

John Tobin, managing director at J.P. Morgan Global Liquidity, agreed. “Investors’ perceptions of the new money-fund rules have evolved since July 2014. At first, the FNAV was more disturbing to them than gates and fees, but over time investors have gotten more comfortable with that concept. In the same way, investors seem to be more comfortable now about the use of prime funds in sweep programs.”

Among sweep-fund providers, Tobin said the early concerns probably had less to do with the FNAV provision in the new rule – although that did present challenges – than with the operational aspects of gates and fees when including a prime fund in a sweep. “We at J.P. Morgan have worked through the operational challenges, and other large fund providers probably have done so as well, but it’s possible that some haven’t or simply may not be operationally ready or willing to do the required plumbing by October.”

Challenges Abound

As asked about how fund providers assessed the challenges and prioritized the strategies for accommodating prime funds to sweep programs, Hopkins noted that fund providers recognized the need to communicate with investors, revise lineups based on investors’ needs, and develop solutions that preserved the key elements of money-market funds to assure their continuing utility.

“To address the interest of clients in daily liquidity, we anticipated that our prime funds would need to strike a(n) NAV multiple times during the day, so we worked through the many implications of multiple NAV strikes with transfer agents and money-fund system providers that oversee recordkeeping services for our clients.”

Funds were realigned for efficiency and the number of prime funds involved was pared down. Multiple strikes, she noted, “are much more manageable when they apply to fewer funds within a fund family.”

“The default option for sweep programs seemed at first to be government funds, which are less complex operationally and which won’t need to float their NAVs or impose fees and gates,” Tobin explained. “As we move toward October, that may still be the option many investors choose, but as yield spreads widen, allocation decisions are likely to change.”

Historically, he noted, the prime-to-government fund spread has been 11 to 15 basis points. “We’re now at about 21 points, and by October the spread could easily rise to 30 or 40 basis points.” The widening spread may explain the absence of any significant investor-driven flows out of prime funds to date. “Even if investors move into government sweep funds as October nears, they may subsequently push back on their fund providers or intermediaries to provide a prime-fund sweep option,” Tobin maintained. “If the spread widens to 40 or perhaps even 50 basis points, I think investors will demand that.”

Striking Multiple NAVs

“Most providers who have made announcements about the number and timing of NAV strikes have settled on three – at 9:00 a.m., noon, and 3:00 p.m.” Hopkins pointed out. Within fund families, the number and timing of strikes may differ: Dreyfus will offer one prime fund that strikes just once a day and another that strikes three times, and those determinations, she said, are a function of both strategic decision-making as well as some experimentation.

“I wouldn’t be surprised if, over a relatively short period of time, the industry moves toward a general standard,” Hopkins added, although she said it is likely that variations will remain – perhaps with more strikes for large institutional funds and fewer for other funds – until the industry normalizes at some point in the future. Sweep funds, however, may not necessarily follow the trend for all funds. “Our view is that a single, late-day strike may be the industry standard for sweeps.”

Both the size and investor composition of a fund may drive decisions on the number of strikes per day, Tobin stated. “We at J.P. Morgan will offer one institutional prime fund that will strike three times a day, right about where the industry seems to have settled. Three is pragmatic and conservative, and the industry is confident that it can hit that mark,” but he added that operational and market efficiencies in prime funds are likely to lead to more, rather than to fewer strikes, in the foreseeable future.

Post-Reform Funds Retain Key Benefits

The latest round of money-market-fund reforms are certainly significant, Hopkins noted, but they are unlikely to change the way
providers manage money-fund portfolios. “The 2010 reforms introduced daily and weekly asset thresholds as well as new transparency requirements, so we have lots of experience managing funds to those high standards,” she observed. “The most recent reforms added the FNAV, gates and fees, and they made sweep programs more complex, but the industry is successfully addressing those challenges as well.”

She added that between now and October, and probably for some time thereafter, funds will be managed more conservatively, with higher levels of liquidity – trends that data reveal have already begun – but she maintained that the important benefits of money-market funds – safety, liquidity, diversification, professional management, and market-based yield – have not been impaired or lessened as a result of regulatory reform.

“I’m optimistic about the post-reform money-fund industry and continue to believe,” Hopkins concluded, “that for retail and institutional investors, money-market funds will remain the investment instrument of choice, with prime-fund sweeps still offering an attractive option for investors seeking to maximize returns on their short-term cash.”

– Paul Adams

An investment in any money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in a money market fund.

The statements and opinions expressed in this article are those of the author as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon or any of its affiliates. This article does not constitute investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. This information is not intended to provide any information about the advisability of owning BNY Mellon stock. BNY Mellon and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

BNY Mellon Investment Management is one of the world’s leading investment management organizations and one of the top U.S. wealth managers, encompassing BNY Mellon’s affiliated investment management firms, wealth management services and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. The Dreyfus Corporation is the primary mutual fund business of BNY Mellon. MBSC Securities Corporation, a registered broker-dealer, member of FINRA.