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Implications of Negative Yield on Money Funds

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Recent reductions in the Federal Funds Rate and decreasing market interest rates have resulted in historically low yields on government debt and other types of money market investments. Very low market yields have, in turn, made it increasingly difficult for many money funds to achieve an investment return in excess of their overall expense ratios. When the yield of a money fund is less than its overall expense ratio, the money fund is said to have a "negative yield."[1] Concern about negative yield was heightened recently when the Federal Reserve lowered the Federal Funds Rate to between 0.00% and 0.25%.

Similar to the effect of a default on a portfolio security or other impairment of value affecting portfolio holdings, negative yield can cause a money fund to "break the buck." This alert discusses the impact that negative yield has on money funds and outlines various options to assist money funds and their directors in confronting the issue of negative yield.

Discussion and Analysis

During the turmoil in the financial markets in September 2008, many money funds adopted a more defensive investment posture by reallocating assets away from higher-yielding investments and toward investments with higher credit quality and correspondingly lower credit risk. As a result, many "prime" money funds increased holdings in U.S. government securities, resulting in higher credit quality but lower yields. In addition, money funds that, by the terms of their investment policies, limit their investments to U.S. government and U.S. Treasury securities, further limited their portfolios to some of the safest, but lowest-yielding, investments.

When a money fund's yield is less than its overall expense ratio, the money fund is said to have a "negative yield," meaning that the expenses it incurs effectively exceed the income it derives from investment activities. When this occurs, the fund must continue to pay its expenses, but essentially must do so out of shareholder capital. Over time, the use of shareholder capital to pay expenses will cause a deviation between the intrinsic value of the money fund's portfolio (which is reduced by the payments out of capital) and its $1.00 per share net asset value (which is held steady, despite the payments). If the deviation between the money fund's intrinsic portfolio value and its net asset value exceeds 0.5%, without corrective action, the money fund will no longer be able to maintain a stable net asset value of $1.00 per share.[2] The end result is the same as when a money fund "breaks the buck" because of principal impairment or other direct loss on a portfolio holding.

When a money fund is faced with the prospect of persistent negative yield, several options may be available to address the situation. The fund's board, in consultation with the fund sponsor and investment adviser, generally

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1. We note that a number of money funds have been reported to have a negative yield in the press or fund performance databases. However, we believe these reports likely reflect fund yields determined using the yield calculation required under applicable Securities and Exchange Commission (SEC) rules. Because the SEC-mandated calculation does not reflect gains on sales of securities, such funds may, nonetheless, have a positive total return when factoring in sales of portfolio securities. For purposes of this alert we use "negative yield" to mean a money fund with a total return, inclusive of proceeds from sales of securities, that is less than its overall expense ratio.

2. We note that Rule 2a-7 does not provide that a money fund must automatically "break the buck" if its intrinsic portfolio value falls below $0.995 per share. Rather, the fund board is required to take action to address the issue, which may include determining that it is no longer appropriate for the fund to continue to maintain a stable net asset value of $1.00 per share.

should consider which options are feasible and most desirable under the circumstances. The intention of the first set of options listed below is to address the issue of negative yield directly by either minimizing the negative return or, preferably, by preventing a fund from generating negative return. These approaches generally will have no immediate negative financial impact on a fund or its shareholders, although they do potentially have significant costs and risks associated with them.

The second set of options listed below may technically prevent a money fund from breaking the buck, but do not address the underlying problem that the fund's expenses exceed its investment income. Therefore, these alternatives can be expected to have more immediate negative financial consequences on both a fund and its shareholders.

Options to Limit or Prevent the Impact of Negative Yield

We note that each of these options has been implemented, to varying degrees, in the current marketplace. Based on recent press reports and prospectus supplements, it appears that various fund sponsors have closed money funds to new investors, broadened investment strategies, maximized temporary defensive positions, waived management and distribution fees, and reimbursed expenses in order to maintain a positive yield.

- ***Close or Limit Money Funds to New Investors.*** One problem in a declining yield environment is that new cash (whether from new shareholder investment or from maturing securities) is invested in securities that are likely to have a lower yield than securities purchased when available yields were higher. Accordingly, minimizing inflows to a fund by, for example, closing the fund to new investors, is one way to reduce the need to buy into the very-low-yield market environment. A fund may implement a soft close (meaning that existing shareholders can invest additional assets) or a hard close (meaning that no new funds, whether from new or existing shareholders, can be invested). This strategy might not avoid the "negative yield" problem indefinitely, but it can make it easier for the fund's adviser to manage the problem. From a board perspective, this strategy also can be justified because it preserves the benefit of the fund's older, higher-yielding investments for current fund shareholders.

- ***Expand the Investment Mandate.*** As noted above, in an effort to minimize portfolio credit risk, some funds recently moved to more conservative, but lower-yielding, investments. Other funds, such as U.S. government or U.S. Treasury money funds, have policies that limit their investments to the most conservative, but lower-yielding, investments. As one possible solution, therefore, a fund could seek to invest in securities that offer higher yields. Of course, this strategy has an important trade-off: *the higher yield likely comes with higher risk*. Fund boards and investment advisers must be careful that such investments are consistent with the fund's objective of maintaining a stable net asset value of $1.00 per share and that any new investments are consistent with the fund's investment policies. For U.S. Treasury money funds and U.S. government money funds, which generally are required to invest at least 80% (if not more) of their assets in U.S. government and U.S. Treasury securities, respectively, it may be possible to invest in other money market instruments as part of the "20% basket." In addition, these funds may be able to invest in other money market instruments in reliance on their "temporary defensive" investment policies when faced with the possibility of having a negative yield. Consideration also needs to be given to whether it would be advisable to file and distribute a prospectus supplement identifying the proposed change in investment strategy, both to provide appropriate risk disclosure and to avoid surprising shareholders.

- ***Implement Fee and Expense Limitations.*** As discussed above, the problem of a "negative yield" arises when a money fund's expenses exceed its income from investments. Thus, a money fund may have a positive absolute yield, but its expenses may be higher yet. One way to address the issue of a negative yield, therefore, is to reduce the fund's expenses to a level below the fund's current yield by negotiating with the fund's various service providers to reduce or waive fees or temporarily reimburse fund expenses. Such an arrangement should be documented, and it generally should be possible for the service providers to later recapture waived or reimbursed fees when the fund's yield increases, subject to timing restrictions imposed under accounting rules. If this option is selected, consideration should be given to whether the waiver or reimbursement, as well as any recapture arrangement, should be disclosed in a supplement to the prospectus. In addition, money funds offering multiple classes of shares should be careful to consider whether the arrangement complies with tax rules that require certain fees to be borne by all classes at the same rate in order to avoid a preferential dividend.

Options to Prevent a Fund from "Breaking the Buck"

A declining yield environment poses a heightened problem for money funds because of the market expectation that the funds will maintain a stable net asset value of $1.00 per share, despite the declining income from investments. Accordingly, when confronted with the possibility of a money fund "breaking the buck" as a result of persistent negative yield, it may be advisable for a fund to consider taking action to ensure that the fund can maintain a stable net asset value of $1.00 per share.

As described above, in a negative-yield environment, the total value of a fund's assets decline, thus the real per share net asset value declines. Accordingly, one way for a money fund to maintain equilibrium between its real per share net asset value and its $1.00 per share public net asset value is to reduce the number of shares outstanding. Two alternatives for limiting the number of shares outstanding are discussed below. Importantly, these options do not alter the reality that the fund and its shareholders are experiencing a negative return and are losing part of their investment. Rather, each of these alternatives simply permits the fund to maintain a stable net asset value of $1.00 per share, notwithstanding the gradual investment loss caused by negative yield. In addition, we note that these options are more theoretical and have not been tested in the market. To the best of our knowledge, none of these alternatives has been implemented by a fund, nor has the Securities and Exchange Commission provided any guidance as to the regulatory implications of these options.

- ***Assess Negative Dividends.***[3] One possibility that has been suggested as a way to reduce shares outstanding in order to compensate for investment loss caused by negative yield is for a money fund to assess a charge to investors, payable in shares, for each day that the fund is in negative yield position. In this method, any daily negative yields would be offset by such charges, while daily positive yields accrued during the same month would be declared as dividends. On a monthly basis, shareholders would "pay" any net negative yield (the difference between the amount of daily negative yield and the amount of daily positive yields) to the fund in the form of shares. This approach would have the effect of creating a "negative dividend." Funds considering this approach should make sure that their governing documents allow recoupment of the negative yield from the dividends otherwise earned or accrued during the month. Such a negative dividend would be calculated daily and assessed pro rata against all fund classes.

- ***Calculate a Daily Reverse Share Split.*** In the same vein as a daily negative dividend calculation, another way to potentially reduce the number of shares outstanding in order to maintain a $1.00 per share net asset value is for funds to effect a reverse share split periodically. Such a reverse share split would stabilize net asset value at $1.00 per share, but would result in each shareholder owning a fraction of the shares held prior to the reverse split. For example, if a fund has a −0.15% negative yield, the fund could effect a reverse split so that each investor in the fund would own 0.985 shares worth $1.00 per share instead of 1 share worth $0.985). Such a reverse share split is probably the most feasible means of addressing negative yield without breaking the buck because most fund governing documents allow for boards to implement share splits and reverse splits within their reasonable business judgment.

Regardless of the option selected, it is critical that money funds consider the need to ***disclose*** to investors the implementation of any potential actions to eliminate negative yield or maintain a stable net asset value of $1.00 per share. This disclosure could be provided through a prospectus supplement, as well as website disclosure, as appropriate.

Conclusion

Given the potential implications of negative yield, directors of money funds may wish to engage fund management in a discussion of the extent to which their funds have the potential to experience a negative yield. In particular, money funds with significant exposure to U.S. government and U.S. Treasury securities, as well as funds that have tightened their investment restrictions in the current market, will want to monitor their current yield. Directors of money funds that are at risk for experiencing a negative yield should consider the various benefits and detriments of the options described above, among others, in light of the specific circumstances of each particular fund.

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3. To our knowledge, this solution was most recently proposed by Peter Crane of Crane Data LLC, a money market fund research entity. *See* Christopher Condon, *Money-Market Fund Yields May Fall to Less Than Zero*, bloomberg.com, Dec. 10, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=axHG.5Dvl3P4&refer=home.

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