

Perspective On The Recent Money Market Fund Reforms

By: Carolyn Cross

On January 27, 2010, the SEC approved new reforms constraining risk in money market funds. The reforms modify Rule 2a-7 of the Investment Company Act of 1940 which governs money market funds. To provide investors principal protection and liquidity, Rule 2a-7 imposed strict investment guidelines on money market funds, and, in turn, allowed funds to use the amortized cost method of pricing and to transact at a stable \$1.00 NAV.

When questioned about the reforms, some money managers have indicated that the new investment rules were more conservative than they anticipated. Indeed, the maturity and liquidity restrictions were more conservative than industry proposals outlined in the 'Report of the Money Market Working Group.' While the amendments may have tightened investment requirements more than some expected, the reforms have been criticized by some regulators as too limited in scope, partly because the current set of reforms did not mandate that funds move to a floating NAV.

The recent credit crisis revealed cracks in the regulatory structure, jeopardizing the ability of money market funds to provide liquidity at par. In the summer of 2007, structured investment vehicles (SIVs) holding asset-backed commercial paper fell into bankruptcy or were moved onto the sponsoring banks' balance sheets. Some sponsors entered into capital support agreements to defend the price stability of their money market funds which held SIVs.

In September 2008, the Reserve Primary Fund 'broke the buck' as its holdings of defaulted Lehman Brothers commercial paper pushed the fund's NAV below the 99.5 cent threshold. The Treasury temporarily stepped in to insure the holdings of money market funds in order to protect investors and unfreeze short-term credit markets. Now that order has been restored in money markets, regulators and the industry have shifted their focus to tightening regulations to make certain that money market funds can withstand future market crises. The new reforms aim to bolster liquidity, increase credit quality, and improve the flexibility and transparency of operations. Some of the key provisions of the new regulation are:

- **Liquidity:** The new rules introduce minimum liquidity requirements of 10 per cent daily liquidity (for taxable funds only) and 30 per cent weekly liquidity.

Money market funds must also shorten the maturity of their investments, since these amendments reduce the weighted average maturity limit from 90 to 60 days. During the recent crisis, investors were surprised by the degree of risk in long-term floating rate securities held by money market funds.

Thus, the new regulation has introduced a weighted average life measure to be calculated on the basis of final maturity (rather than the next reset date, as used in the weighted average maturity calculation) and has limited the weighted average life to 120 days. Adopting a weighted average life restriction helps curb money market funds' holdings of floating rate securities with long ultimate maturities, but investors should be aware that funds may continue to hold some longer maturity issues.

Additionally, illiquid securities (those that cannot be sold at carrying value within seven days) cannot exceed five per cent of the portfolio – down from 10 per cent under the existing rules.

- **Credit Quality:** To restrict credit risk, the amendment further narrows the allowable percentage of second tier securities (those receiving a rating agency's second highest rating) from five per cent to three per cent of the total portfolio.

The new rules shorten the maximum maturity of second tier securities from 397 to 45 days. The new regulations also mandate that the portfolio be periodically stress tested to assess its ability to maintain a stable NAV.

- **Transparency:** At the peak of the crisis, investors fled prime money market funds *en masse*, partly because they were unsure of the risks embedded in their fund.

To alleviate investors' concerns, the new rules seek to improve transparency. Funds will be required to post their holdings on their website on a monthly basis. Additionally, every month, money market funds must report their mark-to-market or 'shadow' NAV to the SEC, which will make the information available to the public with a 60-day lag. Operational reforms were also included to ease sponsors' ability to suspend redemptions and to purchase distressed securities out of money market funds in times of crisis.

How will these changes impact investors in money market funds? The new rules afford investors tighter protection and improved transparency, reining in the extent to which money market funds can unwittingly compromise principal protection while stretching for yield. However, the stricter guidelines could push down yields, since funds must have more liquidity on hand, shorter maturities, and less credit risk. The restrictions may narrow the investment universe of prime funds, since prime funds may need to hold a larger percentage in treasuries to stay within the bounds set by the new rules. For our clients who have followed our commentaries on tiered structures for liquidity pools, we believe that the new guidelines reflect Tier I or 'bullet proof' liquidity.

From a broader perspective, investors with liquidity pools should consider how the lower yields and greater risk controls in money market funds impact their current structure. Investors may find more attractive yields by moving slightly further out on the curve with a portion of their liquidity pool, since demand from money markets may constrain yields in the shortest maturity issues. However, the size and composition of a liquidity pool should be tailored to investment objectives that reflect the broader mission of the institution.

Although the new regulation reduces risk in money market funds, investors should not assume a passive role in assessing their liquidity needs and in determining the most appropriate investments to meet their objectives.

The SEC indicated that further reforms may be forthcoming. Broader issues concerning the money market industry will be considered. For example, the SEC will evaluate whether the money market funds should be required to use a floating NAV. This change would be consistent with the broader industry move towards mark-to-market accounting, but would represent a seismic change for the money market industry. Regulators will also decide whether or not to mandate that money market fund sponsors establish liquidity facilities to support the funds.

At Rogerscasey, we expect the financial industry to undergo more changes in the coming years as a result of an active regulatory environment. We will continue to assess how the shifting regulatory landscape impacts our clients. ■

Carolyn Cross, CFA, is an associate director in the beta research group at Rogerscasey.