

Money Market Fund Reform Discussion of Reform Proposals



The money market fund industry has come under heightened scrutiny in the wake of the worst financial crisis in recent history. The events of 2008, including the historic “breaking of the buck” by the Reserve Primary Fund in September of that year, brought to light both idiosyncratic (fund-specific) and systemic (industry-wide) risks associated with money market mutual funds, and gave rise to several reform measures designed to mitigate such risks and enhance the overall value and viability of this important investment vehicle. The Securities and Exchange Commission (SEC) money market fund reform rules, effective in May 2010, outlined more conservative investment parameters related to credit quality, maturity and liquidity, as well as enhanced guidelines around risk oversight and transparency to investors. Shortly after, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) imposed further safeguards that touch nearly every part of the financial industry.

More than two years later, additional proposals related to money market funds (MMFs) remain on the table. In this paper, we review several proposals outlined in the “Money Market Fund Reform Options” report issued by the President’s Working Group on Financial Markets. While the proposed solutions are many, we believe the goal of the investment community and policymakers is one and the same: reduce systemic risk without damaging money market mutual funds’ important role as a source of value to investors and funding to the short-term capital markets.

The Role of Money Market Funds

MMFs play a unique role in the economy by providing short-term funding to commercial and municipal borrowers through purchases of commercial paper and other short-term debt. The flexibility to borrow through short-term debt markets is an important alternative to borrowing from banks for many commercial and governmental entities. In many cases, banks are not equipped nor inclined to provide comparable lending.

MMFs also provide value in the form of liquidity and market-level yields to a broad array of institutional and retail investors. For many investors, this represents a favorable alternative to bank deposits or to the direct purchase of instruments in terms of both liquidity and diversification. In addition, tax-exempt MMFs provide a unique source of funding to municipalities and income to investors that bank deposits cannot replicate. Prior to the unprecedented credit crisis of 2008, MMFs successfully provided this service to the financial markets since the early 1970s, never requiring government intervention.

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Reform to Date: Have We Done Enough?

BlackRock, as one of the world’s largest cash management providers, fully supports the premise of strengthening the MMF industry while reducing systemic risk. Throughout and in the aftermath of the financial crisis, the swift, decisive and concerted actions taken by policymakers were essential in restoring confidence and order to the markets in a time of uncertainty.

Before addressing the specific options outlined in the report of the President’s Working Group, we believe it is important to consider not only the events that enveloped the financial markets over the past three years, but also the substantial strengthening of MMF regulation that already has occurred as a result of actions taken by Congress, the SEC and other agencies in the past year. In particular:

Rule 2a-7 Enhancements. The changes to SEC Rule 2a-7 under the Investment Company Act of 1940 (Rule 2a-7) that went into effect in 2010 have enhanced the credit quality, diversification and liquidity of MMFs. New requirements for portfolio stress-testing and disclosure of market valuations provide additional protections and transparency. Other rules adopted at the same time provide a MMF board of directors or trustees the ability to suspend redemptions from a fund if the board determines that the fund is about to break or has broken the \$1.00 net asset value (NAV).

Establishment of Financial Stability Oversight Council (FSOC). The newly created FSOC has the ability to provide proactive and more comprehensive monitoring of the financial markets — including money market instruments. The FSOC

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also is able to coordinate action across agencies in a way that was not possible before.

Additional Financial Reform Worldwide. Numerous efforts have been undertaken to strengthen the broader financial system, including the Dodd-Frank Act in the United States and the new international regulatory framework for banks known as Basel III. These actions should improve the safety of MMFs by reducing risk in the instruments issued by financial institutions and held by MMFs.

We agree that it is prudent to continue to review the regulation of this important asset class. When contemplating additional reform, we believe it is critical to review the current proposals in view of the substantial strengthening of the MMF industry that already has occurred as a result of actions taken in the past year.

Consideration also should be paid to the important role MMFs play in the overall short-term financing markets for corporations and municipalities. Care is necessary to ensure that the reforms, both individually and collectively, achieve the objective of protecting MMFs and the shareholders who invest in them without inadvertently destabilizing financial markets.

Additional MMF Reforms Under Consideration

The report of the President's Working Group, released in October 2010, contains several proposals for additional changes. Following is a summary of these proposals as well as our views.

Proposal 1: Floating Net Asset Values

MMFs are unique in their objective of seeking to preserve investor principal by maintaining a \$1.00 NAV per share. Many investors use MMFs specifically for this feature.

For these investors, floating the NAV negates the value of the product. Many retail investors use MMFs to facilitate day-to-day transactions or as a convenient sweep vehicle within a larger account. Institutional investors principally use these products to manage their working capital. When asked, the vast majority of MMF investors have indicated an unwillingness to invest in floating-NAV funds for these activities.

We discuss this topic in detail in a separate *ViewPoint* entitled "Money Market Funds: The Case Against Floating the NAV" and believe this could be the most detrimental of all proposals related to MMFs, essentially altering the very foundation of the industry. In short: If MMFs move to a floating NAV, we believe investors will move the bulk of their assets to bank deposits, Treasury bills or direct purchases of commercial paper. It is our belief that banks have neither the infrastructure nor the profit incentive based on minimum leverage capital requirements to provide short-term funding to the economy in the way that MMFs do through the purchase of commercial paper and other short-term debt instruments. Additionally, most investors are not equipped to invest directly in commercial paper and would lose the protections of diversification that MMFs provide them. Floating the NAV could result in a meaningful disruption for borrowers who currently depend on short-term capital markets and to economic activity financed by those markets. In the absence of other funding alternatives, this could result in a long-term contraction of the capital markets available to these borrowers, with a corresponding decrease in overall economic activity.

The Case Against Floating the NAV: Key Considerations

- ▶ A floating-NAV fund would generate taxable gains and losses with each subscription and redemption, creating a tax and accounting burden for institutions that use these funds on a daily basis for their working capital.
- ▶ Eliminating the stable-NAV feature would force MMF investors such as corporate treasurers, pensions and municipalities to alter or replace various systems that have been designed on the assumption that MMF shares do not change in value.
- ▶ Over the past few years, several firms introduced "enhanced cash" and/or "low duration" funds as alternatives to MMFs. Collectively, these fluctuating NAV funds never achieved significant scale, performed poorly in the financial crisis and were subject to redemption runs. Investors do not consider these suitable alternatives to MMFs.
- ▶ Rule 2a-7 technically does not require a MMF to maintain a stable NAV; it merely provides a framework that permits a fund to publish a stable NAV. The fact that no fund complex has offered a floating-NAV Rule 2a-7 product indicates a lack of interest from investors.
- ▶ The clear risk in floating the NAV on MMFs is the substantial contraction of a product with \$3 trillion of financial intermediary activity, causing both issuers and investors to seek a replacement.

Proposal 2: Private Emergency Liquidity Facilities for MMFs

The industry has proposed the creation of a Liquidity Facility (LF). The LF would be funded by the industry and would have the ability to provide liquidity to MMFs should a need arise that cannot be met in other ways. The LF would provide liquidity in certain circumstances by buying money-good assets from MMFs. Perhaps more importantly, the LF would have access to the Federal Reserve's Discount Window, the facility that allows banks to borrow funds directly from the Federal Reserve.

We support the idea of an LF in that it could provide an incremental liquidity cushion for the industry. More importantly, it could provide for an orderly way for the industry to access the Federal Reserve Discount Window in the case of a systemic crisis.

However, there are challenges inherent in "shared" capital that merit further consideration and study. First, it is difficult to ensure that an LF with finite purchasing capacity is fairly administered in a crisis such as the one experienced in recent years. This could lead to MMFs attempting to optimize the outcome for themselves, rather than working cooperatively to solve a systemic crisis. Shared capital also poses the danger of increased risk-taking by industry participants who believe they have access to a large collective pool of capital.

As a result, we support the LF only to the extent that its capital levels are modest. As capital requirements are increased, the problems of shared capital become more pronounced and we begin to favor a solution like the Special Purpose Entity, discussed later under Proposal 7. This solution is similar in concept to an LF, but envisions each player owning and controlling its own capital.

Proposal 3: Mandatory Redemptions in Kind

Under existing rules, MMFs can elect to make in-kind redemptions to shareholders above a minimum cash threshold when it is in the interest of the fund (and its remaining shareholders). We expect this option to be used rarely, if at all, as most shareholders do not want in-kind redemptions and many cannot receive and hold direct investments in money market assets. Some money market assets, such as repurchase agreements and Eurodollar time deposits, are over-the-counter contracts and cannot be transferred to retail or to multiple investors. For these reasons, it often is not possible to deliver a pro-rata slice of fund holdings to redeeming shareholders. Notably, this approach also does nothing to satisfy the demand for liquidity that begins this chain of events and could make the situation worse if recipients of an in-kind redemption attempt to sell the assets immediately.

Under the rules issued in January 2010, MMF boards have the ability to suspend redemptions if a fund either breaks the dollar or is about to break the dollar, goes into liquidation and notifies

the SEC of its decision. Rather than mandating in-kind redemptions, we support the existing rules that already give MMFs the option to make in-kind redemptions or to suspend redemptions under extreme circumstances.

Proposal 4: Insurance for MMFs

During the financial crisis, the US Treasury put in place a Temporary Guarantee Program, an insurance program for investors who were MMF shareholders as of September 19, 2008. This program remained in effect for one year and played an important role in restoring investor confidence. At the program's conclusion, the government had collected \$1.2 billion in fees without paying any claims.

Although the program accomplished its goals at no out-of-pocket cost to the taxpayer, we believe there are several issues that make the establishment of a permanent government-sponsored MMF insurance program problematic, including the potential to encourage excessive risk-taking by individual fund companies. In addition, a permanent government-sponsored insurance program could have unintended consequences by creating flows of capital into MMFs from insured bank deposits or into prime MMFs from government MMFs.

Private insurance has been made available in the past, but has been unsuccessful due to the cost to MMFs and their sponsors. Private MMF insurance products present the risk of being cancelled by insurers when insurance is most needed or of having claims disputed during a crisis. Furthermore, it is unlikely that any private insurance program would be large enough to protect against systemic issues.

Proposal 5: A Two-Tier System of MMFs, With Enhanced Protection for Stable-NAV Funds

This proposal is intended to allow investors flexibility in choosing the MMFs that match their risk-return objectives, offering the option of either stable-NAV or floating-NAV MMFs. In this case, the stable-NAV funds would be subject to tighter regulation.

A two-tier system of short-term funds is already an option today. Investors can choose between stable-NAV MMFs and floating-NAV short-term bond funds. It is worth noting that fund sponsors are not precluded from creating a floating-NAV Rule 2a-7 fund, but have never done so, which indicates a lack of investor interest in such a product. In general, investors have expressed a strong preference for stable-NAV products. Introducing a two-tier system, with both stable-NAV and floating-NAV funds investing in money market securities, is likely to cause confusion without addressing the issues.

The proposals adopted by the SEC in 2010 tightened risk-limiting constraints on MMFs through liquidity requirements and more conservative investment standards. We believe the imposition of more extreme portfolio management constraints for MMFs designed to induce investors into floating-NAV MMFs could

endanger the commercial viability of MMFs and instead push investors into MMF alternatives with negative consequences to issuers and investors similar to those discussed earlier under Proposal 1.

Proposal 6: A Two-Tier System of MMFs, With Stable-NAV MMFs Reserved for Retail Investors

There has been substantial discussion around the behavior of “institutional” versus “retail” clients, and the possibility of creating funds with different characteristics for the two groups of investors. Stable-NAV MMFs would be reserved for retail, or individual, investors.

For all practical purposes, many MMFs intermingle institutional and retail clients, and it would be difficult, if not impossible, to differentiate between the two types of investors. Fund complexes that use a structure in which there is a single portfolio with multiple share classes would find it difficult to define themselves as “retail” or “institutional.”

Moreover, retail investors increasingly act through institutional advisors who manage and invest their assets. For example, retail shareholders often invest in MMFs through institutional share classes — through 401(k) plans or broker or bank sweep accounts — where one institutional decision-maker acts on behalf of many retail customers. A two-tier approach to MMFs that delineates between retail and institutional funds would be difficult to implement and may lead to gaming behavior by investors (e.g., investors may have incentive to appear to be “retail” investors to qualify for stable-NAV funds). For these reasons, we support the use of a single set of portfolio characteristics and liquidity requirements rather than a segregated or tiered approach.

It is worth noting that regardless of the decision over “institutional” and “retail” funds, under the new “know-your-customer” rules, managers will need additional disclosure about underlying clients from portals and other aggregators for the intent of the rule to be fully achieved.

Proposal 7: Regulating Stable-NAV MMFs as Special Purpose Banks

This proposal suggests that stable-NAV MMFs be regulated as Special Purpose Banks (SPBs), thereby subjecting them to banking oversight and regulation (such as cash reserve requirements, capital buffers, access to a liquidity backstop and insurance coverage). Such a plan could present many challenges for the MMF industry, fund sponsors and investors, making MMFs cumbersome ventures for all but the largest sponsors with the greatest resources, and potentially unattractive to investors if the requirement to hold capital were to result in lower returns.

While BlackRock does not find the SPB option, as currently proposed, to be viable, we do find merit in an alternative structure that would leave the existing stable-NAV MMF product

intact with manageable capital costs and a workable regulatory structure. Our proposal would require the sponsor or investment manager, not the MMF itself, to be regulated as a Special Purpose Entity (SPE) and to hold capital. We believe the SPE structure, combined with access to liquidity through the Federal Reserve Discount Window, would address both idiosyncratic and systemic risk while permitting the current Rule 2a-7 MMF structure to continue with its advantages for investors and the financial markets firmly intact.

MMFs currently are pass-through vehicles in which interest earned, less fees and expenses, is passed through to investors. Under current FASB (Financial Accounting Standards Board) rules, the manager of a MMF cannot accrue a liability or record “capital/reserves” in retained earnings to cover future potential losses. Our proposal entails a new structural approach in which MMFs would be managed by an SPE with a charter limited to managing MMFs. The SPE would be a regulated subsidiary of the investment manager. This entity would be required to have capital, the level of which would be determined based on the total assets under management and the composition of those managed assets. Importantly, this entity also would have access to the Federal Reserve Discount Window as a source of emergency liquidity. The details of BlackRock’s proposal are outlined in “An Alternative Solution: The Special Purpose Entity” on the following page.

Proposal 8: Enhanced Constraints on “Unregulated MMF Substitutes”

This proposal suggests changing or strengthening the regulation of other stable-NAV cash fund products (referred to as Unregulated MMF Substitutes) to prevent or minimize client movement from MMFs to these products. The report acknowledges that such stable-NAV cash fund products are not, in fact, unregulated, but rather, are regulated under guidelines other than Rule 2a-7. These include state and federal bank regulation, insurance regulation and the regulations of non-US jurisdictions. This proposal suggests that these bodies adjust the regulation of products under their authority to coordinate with any changes applicable to Rule 2a-7 MMFs.

BlackRock, like many other sponsors of MMFs, manages non-Rule 2a-7 cash fund products for a variety of clients both in the US and abroad. In our experience, these products are typically used for clients and purposes that are different from and narrower than those for which Rule 2a-7 MMFs are used. As examples, they are often limited in scope to retirement assets, trust assets and other assets under the fiduciary control of intermediaries. In some securities lending applications, these funds’ assets can only be moved by first terminating a broader asset management/lending relationship, which can only occur over time. These specialized uses expose these funds to different liquidity needs than MMFs. We believe the principal regulators of these funds are more familiar with their uses and are in the best position to determine if these funds should be regulated differently or consistently with Rule 2a-7.

An Alternative Solution: The Special Purpose Entity

BlackRock's proposal for the establishment of a Special Purpose Entity (SPE) system aims to address both idiosyncratic risk and systemic risk in the money fund industry. Essentially, individual investment management firms will have capital available to address credit and some liquidity issues. These firms will have a strong incentive to manage their MMFs prudently, as they will have direct capital at risk, in addition to the substantial reputational risk that they already bear.

The SPE would have access to the Federal Reserve's Discount Window. In return for this access, the SPE would be subject to regulatory oversight by the Federal Reserve Board and might be assessed an annual fee from the Fed. This Fed oversight would be in addition to regulation under the Investment Advisers Act of 1940 and the Investment Company Act of 1940, to which managers of MMFs already are subject. In the event of market deterioration or a credit event, the SPE would have capital to support the share value of the MMFs it manages. The manager would have some discretion, if needed to support a fund, to allocate the capital among the MMFs that the SPE sponsors.

We believe the SPE's capital requirement should be significantly lower than that of a commercial bank, to reflect the special nature of these entities and the specific funds being offered. We believe the required capital levels should be calculated based on a risk-weighted asset approach.

While we recognize that this proposal requires a number of legislative and regulatory changes, with many details to be ironed out, we believe it creates an alignment of interests in addressing idiosyncratic risk and provides a practical solution to mitigating systemic risk.

The risk the government faced in 2008 and 2009 in support of the money fund industry was in dealing with market illiquidity. Once the Fed provided the industry with indirect access to the discount window (by putting the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility in place), MMFs quickly returned to normal operations, providing a critical source of credit to the economy within a very short period of time. The establishment of SPEs would ensure a source of liquidity and remove that burden from the broader system.

BlackRock agrees that there should be formal and informal information sharing among the SEC, Treasury, the Federal Reserve and the FSOC to increase transparency and help ensure that regulatory approaches between the 2a-7 and non-2a-7 worlds are appropriately coordinated. However, we caution that there is no "one-size-fits-all" structure that is correct for all funds and all clients in all markets.

Conclusion

When considering MMF reform, it is important to reflect on the important role MMFs play in the overall short-term financing markets for corporations and municipalities and, by extension, the tremendous impact they have on the functioning of our economy. We agree with the SEC and the Investment Company Institute (ICI) that it is prudent to review the rules and regulations governing this important product. In this process, it is critical to review the current proposals in view of the substantial strengthening of the MMF industry that already has occurred as a result of actions taken by Congress, the SEC and other agencies in the past year. Care should be taken to ensure that the reforms, both individually and collectively, achieve the objective of protecting MMFs and the shareholders who invest in them without inadvertently destabilizing financial markets. BlackRock's recommendations include the following:

Limit Shareholder Concentration

We believe further modification of Rule 2a-7 can help to manage risk and strengthen the industry. For example, we suggest MMFs be required to limit shareholder concentration. Specifically, no shareholder shall be permitted to purchase a MMF's shares if, after such purchase, the shareholder would own more than 5% of the fund's outstanding shares. Omnibus accounts and portals should be required to provide sufficient information about the underlying shareholders to verify that the rule is not violated or otherwise be subject to the 5% limitation themselves.

Foster Dialogue Among Key Parties

BlackRock sees significant opportunity to use the new oversight structure to flag potential problems well before they become full-blown crises. The goal should be to establish a regular dialogue between MMF managers, large issuers of commercial paper, the SEC's Division of Investment Management and the FSOC to broach issues and concerns about the short-term credit markets. This would be comparable to the dialogue between the Treasury Department's Assistant Secretary for Financial Markets and various market makers and large bond investors. Over time, such regular communications would provide the FSOC with valuable insight into cash markets generally, rather than just MMFs specifically.

BlackRock supports financial regulatory reform that increases transparency, protects investors and facilitates responsible growth of capital markets, while preserving customer choice and assessing benefits versus implementation costs.

Establishment of a Special Purpose Entity (SPE) System

As discussed earlier, BlackRock recommends a new structural approach to the industry in which MMFs would be managed by Special Purpose Entities with charters limited to operating money market mutual funds. These entities would be regulated subsidiaries of each investment manager and would be required to have capital, the level of which would be determined based on the total assets under management and the composition of

those assets. These entities would have access to the Federal Reserve Discount Window as a source of emergency liquidity. We believe this combination of capital and access to the Fed window would address both idiosyncratic and systemic risk in a way that none of the other proposals do. This structure could be an alternative to, or exist in conjunction with, some form of the industry Liquidity Facility.

Related ViewPoint Papers

Money Market Mutual Funds:
The Case Against Floating the Net Asset Value

The New Regulatory Regime for Money Market Funds:
A Window Into the Mark-to-Market NAV

Money Market Funds:
A Proposal for a Capitalized Special Purpose Entity

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