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THE FUTURE OF MONEY MARKET FUNDS: IMPLICATIONS OF THE RECENT TURMOIL

The adverse impact of the financial crisis on money market funds has exposed risks inherent in their regulatory scheme. As a result, the money market fund industry and regulators are considering changes to the existing regulatory model. The authors review the extraordinary steps taken in recent months by regulators to address the crisis and discuss changes in the business and regulation of money market funds in response to recent financial market developments.

By Joseph R. Fleming, John V. O'Hanlon, and Hila Shamir *

The recent events in the financial markets and their adverse effect on many money market funds have raised questions about the future of the money market fund industry, as well as calls for regulatory reform. Andrew Donohue, the director of the Securities and Exchange Commission's Division of Investment Management, has stated that "[m]oney market funds as we know them are likely to change forever."[1] More recently, a report on financial reform issued by the Group of Thirty called for the regulation of money market funds as banks.[2] The existing money market fund model has proven to be hugely popular with investors, and aspects of that model are likely to survive any review. It is clear, however, that the money market fund industry and regulators will consider several variations on the existing model that may address some of the shortcomings that have been exposed in the harsh environment of recent months. The industry began this process with the recent issuance of a report drafted by a working group established by the Investment Company Institute, the national association of the U.S. mutual fund industry.[3] The Report makes a

[1] Andrew Donohue, speaking at the Investment Company Institute's Equity, Fixed-Income & Derivatives Markets Conference, October 6, 2008, *cited in* Peter Ortiz, *SEC Director: Rethinking $1 NAV for Money Funds*, Ignites, Oct. 7, 2008.

[2] Group of Thirty, *Financial Reform: A Framework for Financial Stability*, 29 (Jan. 15, 2009).

[3] Report of the Money Market Fund Working Group (the "ICI Report"), March 17, 2009, *available at* http://www.ici.org.

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series of recommendations intended to improve the safety and oversight of money market funds.

This article begins with an overview of the extraordinary steps taken in recent months by the SEC, the Unites States Treasury and the Federal Reserve Board to address the crisis in the money market fund industry. We then discuss potential changes in the business and regulation of money market funds in response to financial market events.

STEPS TAKEN TO SUPPORT MONEY MARKET FUNDS

During the difficult weeks between mid-September and mid-October 2008, the federal government took a series of extraordinary steps designed to stabilize the financial system. During this period money market funds faced special challenges. A steep decline in the market value of shares of companies across a broad spectrum of the economy placed downward pressure on the valuations of corporate debt held by money market funds at the same time that investor insecurity resulted in record redemption requests from all funds, including money market funds.[4] The impact of the market turmoil on two large, high-profile money market funds was widely reported. Putnam Investments closed and quickly liquidated the Putnam Prime Money Market Fund.[5] The Reserve Primary Fund became only the second money market fund, and the first since 1994, to allow its net asset value ("NAV") to fall below $1.00 per share, and "break the buck."[6] Many other money market funds were on the brink of breaking the buck, and avoided that fate only by obtaining capital support from their management companies or affiliates.

The crisis facing money market funds highlighted the crucial role the funds play in the modern economy. By serving as the primary purchasers of commercial paper issued by corporate America, money market funds provide the short-term financing that a broad range of companies rely on to run their day-to-day operations.[7] When this critical source of funding began to dry up, concerns over the prospect of a "credit crunch" hobbling the economy became acute. In response, the SEC, the Treasury, and the Federal Reserve Bank ("FRB") took a series of steps in an attempt to support price stability and restore liquidity of money market funds. Four key measures were adopted:

- The Treasury established a Guarantee Program for money market funds;
- The FRB established an Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility that extended loans to banks to finance their purchases of high-quality, asset-backed commercial paper from money market funds;
- The FRB established a Commercial Paper Funding Facility which funds purchases of commercial paper of three-month maturity from eligible issuers;

[4] In September 2008 money market funds experienced a record monthly asset outflow of $147.2 billion. The record monthly outflow prior to that was $75.4 billion in June 2008. Connie Bugbee, presentation in *Securing Money Market Funds*, Ignites Exchange, Oct. 31, 2008.

[5] Press Release, Putnam Investments, *Putnam Announces Fund Closing and Distribution Of Assets for Putnam Prime Money Market Fund (Institutional)*, Sept. 18. 2008, *available at* https://content.putnam.com/shared/pdf/prime_money_mkt_inst.pdf.

[6] Press Release, The Reserve, *A Statement Regarding the Primary Fund*, Sept. 16, 2008, *available at* http://www.reservefunds.com/pdfs/Press%20Release%202008_0916.pdf; Press Release,

footnote continued from previous column…

The Reserve, *A Statement Regarding The Reserve Funds*, Sept. 18, 2008, *available at* http://www.reservefunds.com/pdfs/Press%20Release%20Subscription%202008_0918.pdf; Press Release, The Reserve, *A Statement Regarding The Reserve Primary and U.S. Government Funds*, Sept. 19, 2008, *available at* http://www.reservefunds.com/pdfs/Press%20Release%20PrimGovt%202008_0919.pdf.

[7] For example, in June 2008, money market funds held more than 40% of outstanding U.S. commercial paper, almost 20% of all municipal securities, 20% of all marketable treasury bills, and at least 25% of all repurchase agreements. Paul Schott Stevens, opening address at the Investment Company Institute's Equity, Fixed-Income & Derivatives Markets Conference, October 6, 2008, *available at* http://www.ici.org/statements/remarks/08_equity_stevens_spch.html.

- The FRB established a Money Market Investor Funding Facility that seeks to improve liquidity by allowing money market funds to sell certain assets that they might otherwise have difficulty selling under current market conditions to private-sector, special purpose vehicles financed by the Federal Reserve Bank of New York.

These programs were preceded by a series of steps taken by the SEC to support money market fund liquidity and stability:

- The SEC staff provided no-action relief permitting affiliates of money market funds to purchase certain securities from the funds, notwithstanding that the securities remained eligible assets of the funds. The SEC staff also permitted affiliates of money market funds to enter into capital support agreements with the funds to facilitate the maintenance of a stable NAV. During the height of the market turmoil in September and October 2008, a number of money market funds utilized both forms of relief to avoid breaking the buck.

- The SEC staff allowed funds to use amortized cost for purposes of the "shadow pricing" requirement of Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act") for certain short-term securities.

Each of these measures is discussed in detail below.

SEC Measures to Support Money Market Funds

Capital Support by Affiliates

In the past year, and increasingly in recent months, money market funds under stress have turned to affiliates to obtain capital support to avoid breaking the buck. Common forms of support include (i) the purchase of troubled assets from the fund by the management company or an affiliate; and (ii) the use of a capital support agreements ("CSA"), in which a third party, typically the management company or an affiliate, commits to provide a capital contribution to the fund to the extent that the fund's market-based NAV per share drops below $0.995 (or a greater amount, as specified in the agreement).

Both forms of support raise an issue under the 1940 Act where the party purchasing the securities, or entering into a CSA, is an "affiliated person" of the fund, as defined in Section 2(a)(3) of the 1940 Act. In such a case, the support may be prohibited under Sections 17(a)[8], 17(d)[9], and 12(d)(3)[10] of the Act, absent relief from the SEC.

Recognizing the challenging circumstances facing money market funds, the SEC staff, on a case-by-case basis, has granted no-action assurance permitting affiliates to purchase troubled assets from the funds,[11] and to enter into capital support arrangements with the funds.[12] The same permissive approach was taken by the SEC in relation to banks acquiring asset-backed commercial paper ("ABCP") from affiliated money market funds under the FRB's ABCP Money Market Mutual Fund Liquidity Facility (discussed below).[13]

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[8] Section 17(a) of the 1940 Act, in the pertinent part, prohibits affiliated persons, and affiliated persons of such persons, from purchasing or selling securities or other property from or to a fund.

[9] Section 17(d) of the 1940 Act and Rule 17d-1 thereunder generally prohibit an affiliated person, or an affiliated person of such a person, acting as principal, to effect any transaction in which the fund is a joint or joint and several participant with such person without first obtaining an SEC order permitting the transaction.

[10] Section 12(d)(3) of the 1940 Act generally prohibits a fund from acquiring any security issued by, or any interest in the business of, a broker-dealer, any person engaged in the business of underwriting, or an investment adviser.

[11] Rule 17a-9 under the 1940 Act provides an exemption from the prohibition of Section 17(a), and permits affiliates to purchase securities that are no longer "Eligible Securities" from the fund at amortized cost. "Eligible Securities," as defined in Rule 2a-7(a)(10), are short-term securities that are rated by a national rating agency in one of the two highest short-term rating categories. Because 17a-9 permits purchase of ineligible securities, no-action relief is necessary only for purchases of securities that remain Eligible Securities.

[12] For CSAs, *see, e.g*., Legg Mason Partners Money Market Trust, SEC No-Action Letter (June 30, 2008); Mount Vernon Securities Lending Trust, SEC No-Action Letter (Oct. 24, 2008); Legg Mason Partner Institutional Trust, SEC No-Action Letter (Oct. 22, 2008); Russell Investment Company, SEC No-Action Letter (Oct. 24, 2008). For purchases of Eligible Securities by an affiliate, *see, e.g.,* Phoenix Edge Series Fund and Phoenix Opportunities Trust, SEC No-Action Letter (Oct. 22, 2008); Russell Investment Company, SEC No-Action Letter (Oct. 22, 2008).

[13] ICI, SEC No-Action Letter (Sept. 25, 2008).

Use of Amortized Cost for Shadow Pricing of Short-term Securities

On October 10, 2008, the staff of SEC's Division of Investment Management issued a no-action letter to the Investment Company Institute ("ICI"), in which it permitted money market funds to comply with the requirement of Rule 2a-7 under the 1940 Act by "shadow pricing" short-term, high-quality securities by reference to their amortized cost value, rather than available market quotations.[14]

Rule 2a-7 generally permits money market funds to use amortized cost to value their holdings. The rule requires, however, that funds periodically calculate the deviation, if any, between the current NAV calculated using amortized cost, and the NAV calculated using market prices. This monitoring procedure is referred to as "shadow pricing." If the deviation exceeds a certain threshold, the fund may be forced to break the buck, in the absence of extraordinary measures.

The ICI argued that under prevailing market conditions, the shadow pricing provisions of Rule 2a-7 were not working as intended in relation to short-term securities, since their market price did not reflect the amounts that issuers were likely to pay upon maturity. The ICI further asserted that pricing vendors that are customarily used by money market funds were unable to provide a meaningful price because the inputs used to derive market prices had become less reliable indicators of value.

The SEC staff accepted these arguments, and in light of prevailing market conditions stated that money market funds could use the amortized cost method in shadow pricing for portfolio securities that (i) have a remaining maturity of 60 days or less, (ii) are First Tier Securities (as that term is defined in Rule 2a-7),[15] and (iii) the fund reasonably expects to hold to maturity.

[14] ICI, SEC No-Action Letter (Oct. 10, 2008).

[15] Rule 2a-7(a)(12) defines First Tier Security as: "any Eligible Security that: (i) Is a Rated Security that has received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); or (ii) Is an Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in paragraph (a)(12)(i) of this section, as determined by the fund's board of directors; or (iii) Is a security issued by a registered investment company that is a money market fund; or (iv) Is a Government Security."

The relief would not apply in cases in which the impairment of the creditworthiness of the issuer suggests that amortized cost is no longer appropriate. Funds were permitted to rely on the relief in the no-action letter through January 12, 2009.

Steps taken by the Treasury and the FRB to Support Money Market Funds

Treasury Guarantee Program

On September 19, 2008, the Treasury announced the establishment of a Temporary Guarantee Program for Money Market Mutual Funds. The program was designed to restore investor confidence by providing a federal guarantee of certain money market fund assets. Under the program, a participating money market fund that broke the buck could utilize the program to pay certain shareholders $1.00 per share upon liquidation of the fund. Participating money market funds are insured with assets from the Treasury's Exchange Stabilization Fund. The program was made available to money market funds that are regulated under Rule 2a-7, maintain a stable share price of $1.00, are publicly offered, and are registered with the SEC. The guarantee is triggered when a participating fund's NAV falls below $0.995. Once a triggering event occurs, the fund must provide the Treasury with a Guarantee Event Notice, and is required to begin liquidation promptly. Only after the fund liquidates can it turn to the Treasury for financial support. The Treasury will then cover the shortfall between the proceeds of the liquidation and $1.00 per share.

The program provides a guarantee to shareholders with respect to shares held by them as of the close of business on September 19, 2008. Participation in the program was voluntary. A money market fund that elected to participate completed a Guarantee Agreement and paid an upfront fee. The program is temporary and designed to exist, at the discretion of the Secretary of the Treasury, for up to a year from inception.[16]

[16] The program's original termination date was December 19, 2008. On November 24, 2008, Treasury extended the program until April 30, 2009. The extension was made available to all money market funds already participating in the program, and required the payment of an additional fee. *See* Press Release, U.S. Department of the Treasury, T*reasury Announces Extension of Temporary Guarantee Program for Money Market Funds*, Nov. 24, 2008.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility

On September 19, 2008, the FRB established the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"). The AMLF extends non-recourse loans at the prime rate to U.S. depository institutions and bank holding companies to finance their purchases of high-quality ABCP at amortized cost from eligible money market funds. Under the program, the borrower is at no risk of loss on the eligible ABCP. The facility is temporary and expires on October 30, 2009.[17]

In order to facilitate ABCP purchases from money market funds by depository institutions and bank holding companies, the FRB temporarily adopted regulatory exemptions from its leverage and risk-based capital rules for ABCP held by such companies as a result of participation in the AMLF. Further regulatory exemptions adopted by the FRB include a temporary limited exemption from sections 23A and 23B of the Federal Reserve Act, which establish certain restrictions on and requirements for transactions between a bank and its affiliates. The latter change is designed to increase the capacity of a member bank to purchase ABCP from an affiliated money market fund in connection with the ABCP lending facility.

To enable the effective implementation of the AMLF, on September 25, 2008, the staff of the SEC's Division of Investment Management issued a no-action letter to the ICI stating that it will not recommend enforcement action under Section 17(a) of the 1940 Act or the rules thereunder if an eligible borrower purchases ABCP from an affiliated money market fund, at the amortized cost value of the ABCP, with cash borrowed through the AMLF.[18]

Commercial Paper Funding Facility

On October 7, 2008, the FRB announced the creation of a Commercial Paper Funding Facility ("CPFF"). The CPFF was designed to provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle ("SPV") that purchases three-month unsecured ABCP directly from eligible issuers. The FRB finances the SPV through the Federal Reserve Bank of New York. The lending is secured by all of the SPV assets, and in some cases by the retention of up-front fees paid by the issuers or by other forms of security acceptable to the FRB.

The CPFF helps to address the liquidity pressures on money market funds, and the resulting reluctance of money market funds and other investors to purchase commercial paper with longer-dated maturities. The CPFF is designed to eliminate much of the risk that eligible issuers will not be able to repay investors by rolling over their maturing commercial paper obligations. The CPFF began operation on October 27, 2008. The SPV will cease to purchase commercial paper under the facility on October 30, 2009, but will be funded until the SPV's underlying assets mature.[19]

Money Market Investor Funding Facility

On October 21, 2008, the FRB created the Money Market Investor Funding Facility ("MMIFF"). Under the MMIFF, the Federal Reserve Bank of New York finances the purchase of eligible assets from eligible investors at amortized cost via a series of private-sector SPVs. The SPVs, which are managed by JP Morgan Securities, Inc., will purchase up to $540 billion in frozen assets from money market funds and other eligible institutions.[20] Eligible assets include U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less.

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[17] The AMLF was originally set to expire on January 30, 2008. However, on December 2, 2008, in light of continuing strains in financial markets, the FRB extended the AMLF until April 30, 2009. *See* Press Release, Board of Governors of the Federal Reserve, Dec. 2, 2008. On February 3, 2009, the FRB extended the AMLF through October 30, 2009. *See* Press Release, Board of Governors of the Federal Reserve, Feb. 3, 2009.

[18] ICI, SEC No-Action Letter (Sept. 25, 2008).

[19] Under the original terms of the CPFF, the SPV was to stop purchasing commercial paper on April 30, 2009. However, on February 3, 2009, the FRB extended the CPFF through October 30, 2009, in light of continuing strains in financial markets. *See* Press Release, Board of Governors of the Federal Reserve, Feb. 3, 2009.

[20] The MMIFF was originally designed to finance the purchase of eligible assets from money market funds. On January 7, 2009, the FRB expanded the set of institutions eligible to participate in the MMIFF to also include the following money market investors: U.S.-based securities-lending, cash-collateral reinvestment funds, portfolios, and accounts (securities lenders); and U.S.-based investment funds that operate in a manner similar to money market mutual funds, such as certain local government investment pools, common trust funds, and collective investment funds. *See* Press Release, Board of Governors of the Federal Reserve, Jan. 7, 2009.

The facility was established to help money market funds satisfy redemption requests and meet portfolio rebalancing needs by facilitating the sales of money market instruments in the secondary market. The facility, in combination with the AMLF and the CPFF, was designed to improve liquidity in short-term debt markets and increase the availability of credit for businesses and households. The facility is temporary and, unless extended by the FRB, will cease providing funding to purchase assets on October 30, 2009.[21]

To facilitate the operation of the MMIFF, the SEC issued a no-action letter that permits money market funds to satisfy the diversification requirements of Rule 2a-7 under the 1940 Act while obtaining liquidity under the MMIFF.[22]

POSSIBLE TRENDS AFFECTING THE MONEY MARKET FUND INDUSTRY

In a recent speech, FRB Chairman Ben Bernanke warned that the "potential fragility of the money market mutual fund sector" needed to be addressed. He discussed insurance and tougher restrictions on the types of investments that money market funds may hold as two possible areas of reform.[23] We consider these and other business and regulatory changes to strengthen money market funds below.

Consolidation

A likely result of the recent turmoil is the consolidation of the money market fund industry. The financial crisis highlighted the risk that is inherent in offering money market funds. Following the Lehman bankruptcy and the widespread drop in the market values of commercial paper, many fund groups that offer money market funds found that they had to provide substantial capital support to their funds in order to avoid breaking the buck. Others fund groups, without the ability to provide capital support, came very close to breaking the buck.

The increased focus on the risks involved in offering money market funds likely will lead some fund groups to consider whether this line of business is worth the financial and reputational risk exposure. Some of the fund groups whose cost-benefit calculation leads them to conclude that offering money market funds presents too much risk may choose to sell their money market fund businesses to other fund groups that have greater financial resources and/or a willingness to provide support when necessary. Other fund groups may consider "private label" alternatives to an in-house money market fund. In this structure, fund group A, which is dedicated to money market fund management, offers a series of an investment company that is distributed under fund group B's brand. This structure allows fund group B to offer its shareholders the convenience of a money market fund, while outsourcing the management of the money market fund to fund group A.

Insurance Mechanisms

Private Insurance Mechanisms

Fund groups that continue to offer money market funds, as well as the funds' boards of directors/trustees, may look for ways to minimize risk through insurance. The need for an external support mechanism became apparent when the recent market turmoil tested the implicit assumption that sponsors of money market funds will support the $1.00 NAV, and some sponsors were unable or unwilling to provide the needed support. It is possible that private insurance alternatives may develop. These can take one of two forms.

Self-Insurance: Private insurance companies may develop new products that provide money market funds with some form of insurance against a break-the-buck scenario. Due to the unpredictability of the risk involved, however, such products may be cost prohibitive.

In the 1980's the Vanguard Group offered a money market fund that was insured against credit and interest rate risk, but the high cost of the insurance deterred investors and the fund closed in 1989.[24] Self-insurance

[21] Under the original terms of the MMIFF, the facility was to cease providing funding to purchase assets on April 30, 2009. However, on February 3, 2009, the FRB extended the MMIFF through October 30, 2009, in light of continuing strains in financial markets. *See* Press Release, Board of Governors of the Federal Reserve, Feb. 3, 2009.

[22] ICI, SEC No-Action Letter (Oct. 22, 2008). JP Morgan also received relief from Sections 17(a)(2), 17(d), 17(e) and 10(f) of the 1940 Act and Rule 17d-1 thereunder to allow its affiliated money market fund to participate in the MMIFF despite the involvement of JP Morgan in the design and operation of the SPVs.

[23] Ben S. Bernanke, speaking at the Council on Foreign Relations, March 10, 2009, *available at* http://www.federalreserve.gov/newsevents.

[24] Robert McGough & Charles Gasparino, *Fidelity May be Winner in Insurance Plan*, Wall Street Journal, Aug. 19, 1996.

was attempted again in the late 1990's by Fidelity Investments. In 1996, Fidelity sought exemptive relief from various provisions of the 1940 Act in order to set up an affiliated insurance company to guarantee Fidelity money market funds against losses of up to $100 million.[25] The insurance was designed to cover only losses attributable to default by the issuer of a security, and not losses from other market risks (such as interest rate changes). The SEC granted Fidelity's request in 1998. The SEC's order placed strict limitations on how a money market fund could publicize its insured status, considering that it was unlikely that the insurance would cover all of the fund's assets. However, Fidelity did not ultimately implement its plan.

Industry response to the idea of self-insurance was mixed. Self-insurance was perceived as a significant development by some participants, and for a while it seemed that Fidelity's initiative would be imitated by other large fund groups that offered money market funds.[26] Others showed skepticism about the need for such insurance as well as its benefits to shareholders.[27] In any case, a private self-insurance program for money market funds never developed.

Industry Insurance: It is possible that the industry could develop an insurance program for money market funds. The ICI has taken steps in the past to serve the insurance needs of the mutual fund industry. In 1988, the ICI established the ICI Mutual Insurance Company, which was organized to offer directors and officers' errors and omissions, and fidelity bond insurance for mutual funds, their directors, and advisers.

[25] Daily-Money Fund *et al.*, Release No. IC-23004 (Jan. 20, 1998) (notice); Release No. IC-23030 (Feb. 18, 1998) (order).

[26] Charles Gasparino, *Insurance Is Spreading for Money Funds*, Wall Street Journal, Aug. 27, 1996. The article reported that "a unit of Marsh and McLennan Cos., the New York insurance broker, [the parent company of Putnam Investments] says it has come up with its own program to help some of Fidelity's largest competitors insure their own money market funds against credit default". The article suggested that nine other money market funds showed interested in an insurance program.

[27] A Wall Street Journal article about the insurance suggested that "there is little chance that most money funds - especially Fidelity's - would ever incur a loss calling for insurance." Robert McGough & Charles Gasparino, *Fidelity May be Winner in Insurance Plan*, Wall Street Journal, Aug. 19, 1996.

Federal Guarantee Program for Money Market Funds

The Treasury may establish a permanent federal guarantee program for money market funds, extending the temporary program discussed above. The current guarantee program is designed to be temporary, with an option for the Secretary of the Treasury to extend the program for up to one year. The Treasury might consider seeking authority to establish a permanent version of the federal guarantee. Such a program could be similar in nature to the federal coverage of bank deposits by the FDIC. In response to current market events, the FDIC established a new Temporary Liquidity Guarantee Program guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and providing full coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount. Recognition of the significance of money market funds to the economy may justify a similar federal guarantee of money market funds.

There are both advantages and disadvantages to establishing a federal guarantee of money market funds. A federal guarantee would significantly reduce the risk exposure of money market funds and their investors, and thus would enhance financial market stability. In addition, a federal guarantee program would presumably include a participation fee. The program's fees would provide a significant source of revenue to the federal government.

A federal guarantee, however, may result in bank account deposits being viewed as less attractive for cash management, which might result in outflows of bank deposits. A federal guarantee program would also most likely be accompanied by increased regulation and oversight over the operation of money market funds, and could result in money market fund shareholders bearing higher expenses. In addition, a federal guarantee program could raise a public policy concern, to the extent that such a program is seen as effectively providing a backstop to poorly performing managers.

POSSIBLE DEVELOPMENTS IN THE REGULATION OF MONEY MARKET FUNDS

Regulatory Changes that Maintain the Current Framework

Rule 2a-7 under the 1940 Act includes three basic restrictions with respect to the composition of a money market fund's portfolio that are designed to limit the risk of investing in money market funds: restrictions in relation to maturity, quality, and diversification. Making any of these requirements more restrictive would

arguably make investment in money market funds safer, at the risk of reduced yields.

Shorter Maturity Period – Rule 2a-7(c)

Currently, a money market fund must maintain a dollar-weighted average portfolio maturity that is appropriate to the objective of maintaining a stable per-share NAV, provided, however, that the fund may neither (i) acquire any instrument that has a remaining maturity of greater than 397 calendar days, nor (ii) maintain a dollar-weighted average portfolio maturity of more than 90 days. Generally, the maturity of a portfolio security under Rule 2a-7 is the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date on which, in accordance with the terms of the security, the principal amount of the security must unconditionally be paid, or in the case of a security that is called for redemption, the date on which the redemption payment must be made.[28] While Rule 2a-7 includes several exceptions,[29] the general rule limits purchased instruments to those with a maturity period no longer than 397 days.

A possible way to reduce the risk of money market fund investment is to shorten the maturity period required of individual portfolio instruments to a period less than 397 days, and/or to shorten average portfolio maturity to a period less than 90 days. In general, instruments with shorter periods remaining until maturity have reduced market and credit risks, and thus tend to fluctuate less in value over time than instruments with longer remaining maturities.

Increase Credit quality – Rule 2a-7(3)(c)(i)

Under Rule 2a-7, money market funds may only purchase securities that are denominated in U.S. dollars, and that comply with two quality tests: first, the securities need to pose minimal credit risk to the fund (based on factors pertaining to credit quality in addition to any rating assigned to the security); second, the securities need to be "Eligible Securities," that is, short-term securities that are rated by a national rating agency in one of the two highest short-term rating categories ("First Tier", or "Second Tier").[30] A First Tier Security has a rating within the highest short-term category, or is unrated but is determined by the fund's board of directors (typically relying on the recommendation of the fund's adviser) to be of comparable quality.[31] A Second Tier Security is any Eligible Security that is not a First Tier Security.[32]

A possible way to reduce money market funds' NAV volatility would be to limit investments to First Tier Securities, tighten the criteria to be deemed a First Tier Security, or both. Like the previous risk-limiting proposal in relation to maturity, this option would limit the universe of permissible securities that may be purchased by money market funds, and would most likely reduce yields. It would, however, provide greater assurance to investors that money market funds will continue to be able to maintain a stable price per share that fairly reflects the current NAV of the fund.

Increased Portfolio Diversification

Rule 2a-7(c)(4) prohibits money market funds from exceeding certain levels of investment concentration in a single issuer. The diversification requirements, which are designed to limit a money market fund's exposure to the credit risk of any single issuer, do not apply with respect to U.S. government securities, or to securities that are subject to guarantees issued by non-controlled persons (although such guaranties are subject to certain diversification requirements under Rule 2a-7). The diversification requirements vary depending on whether the fund is taxable or single-state tax exempt. Generally,

[28] Rule 2a-7(d).

[29] These exceptions are available under various conditions, in relation to adjustable rate government securities (Rule 2a-7(d)(1)), variable rate securities (Rule 2a-7(d)(2)-(3)), floating rate securities (Rule 2a-7(d)(4)-(5)), repurchase agreements (Rule 2a-7(d)(6)), portfolio lending agreements (Rule 2a-7(d)(7)), and money market fund shares (Rule 2a-7(d)(8)).

[30] Rule 2a-7(a)(10).

[31] Rule 2a-7(a)(12). The Rule lists two additional types of securities as First Tier Securities: securities issued by a registered money market fund and government securities.

[32] On June 25, 2008, the SEC proposed an amendment to Rule 2a-7 that would have eliminated references to rating of securities by credit agencies from Rule 2a-7. Investment Company Act Release No. IC-28327, Jul. 1, 2008. The proposal would substantially alter the credit test by amending the definition of Eligible Securities and First Tier Securities to exclude reference to credit rating agencies. Instead, under the proposed amendment, a security would be a First Tier Security if the fund's board had determined that the issuer has the "highest capacity to meet its short-term financial obligations." Proposed Rule 2a-7(a)(12). The proposed amendment has not been adopted.

a fund must not invest more than 5% of its total assets in securities issued by a single entity.[33]

Recent market developments suggest that a 5% exposure to a single issuer might present too much risk for a fund that seeks to maintain a stable NAV. Significant exposure to Lehman Brothers, which declared bankruptcy on September 15, 2008, was seen as the primary cause of the Reserve Primary Fund breaking the buck on September 16, 2008, and caused other money market funds to come dangerously close to breaking the buck. Lowering the percentage of permitted holdings in a single issuer below 5% to as low as 1% would reduce the impact of exposure to a troubled issuer, and provide greater insulation from market volatility.

Section 12(d)(3) of the 1940 Act prohibits a registered investment company from purchasing or otherwise acquiring any security issued by, or other interest in, companies engaged in the following businesses: (i) a broker-dealer; (ii) an underwriter; (iii) an investment adviser to an investment company; or (iv) an investment adviser registered under the Advisers Act. Rule 12d3-1 under the 1940 Act provides certain exemptions from the prohibitions of Section 12(d)(3). Acquisitions of securities of issuers that derive 15% or less of their gross revenues from "securities-related activities" are exempt.[34] Securities that are acquired from an issuer that derives more than 15% of its gross revenues from securities-related businesses may be exempt if certain conditions are met. To rely on the conditional exemption, a fund may not own more than 5% of the outstanding securities of a class of the issuer's equity securities immediately after the acquisition. If the fund acquires debt securities, the fund may not, immediately after the acquisition, own more than 10% of the outstanding principal amount of the issuer's debt securities. In addition, the conditional exemption is available only if, immediately after any acquisition of equity or debt securities, the fund has not invested more than 5% of its total assets in securities (whether equity or debt) of the issuer.

To rely on the Rule 12d3-1 exemptions, a fund may not acquire a general partnership interest in a securities-related business, or any security issued by the fund's investment adviser, principal underwriter, or an affiliate thereof engaged in a securities-related business.

Section 12(d)(3) serves to limit a fund's exposure to the risks associated with securities-related businesses. The exemptions provided by Rule 12d3-1 may need to be reexamined, however, to take into account the credit risk exposure that a holding of a large financial services company presents to a money market fund's ability to meet the shadow pricing requirements of Rule 2a-7.

A possible regulatory response – in addition to or as an alternative to reform of the diversification requirement of Rule 2a-7 – would be to enhance the requirement for money market funds' portfolio diversification in relation to investment in securities-related businesses. Amending Rule 12d3-1 to further restrict a fund's ability to obtain exposure to a single issuer in the securities business would reduce the risk to the fund presented by issuers engaged in the financial sector. It may also be advisable to consider whether a money market fund's aggregate exposure to the financial sector should be limited.

Impose Portfolio Liquidity Requirements

Rule 2a-7 does not require money market funds to maintain a specified level of liquid securities. Pursuant to guidance issued by the SEC staff, however, money market funds must limit illiquid securities to no more than 10% of their assets.[35] To address concerns that money market funds may have insufficient liquidity to weather periods of heavy redemption activity, a possible response would be to impose heightened portfolio liquidity restrictions. For example, the ICI Report recommends that Rule 2a-7 be amended to require minimum weekly, and for taxable money market funds, daily liquidity standards.[36]

[33] A temporary "safe harbor" from this diversification requirement allows investment of up to 25% of the fund's total assets in First Tier Securities of a single issuer for up to three business days after the acquisition of the security. Rule 2a-7(b)(4)(i)(A).

[34] The 15% test is calculated based on the issuer's gross revenues from its own direct securities-related activities, as well as its ratable share of the securities-related activities of enterprises of which it owns 20% or more of the voting or equity interest. Rule 12d3-1(d)(2).

[35] *See* Investment Company Act Release No. 28327 (Jul. 11, 2008) (proposing to codify current standard with respect to illiquid holdings).

[36] The ICI Report recommends that all money market funds be required to maintain at least 20% of assets in securities accessible within seven days, and that taxable money market funds be required to maintain at least 5% of assets in securities accessible within one day. ICI Report, *supra* note 3.

Regulatory Changes that Alter Important Elements of Money Market Funds

In response to the market turmoil of 2007-2008, and especially the events in the fourth quarter of 2008, the Group of Thirty (G30) launched a financial reform project. The report issued at the conclusion of this project offers a set of recommendations regarding how the financial system might be organized to better assure stability, and includes a discussion of the regulation of money market funds. The report describes the current structure of money market funds as "institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk."[37] It therefore recommends increased supervision and various other restrictions on money market funds. First, the report recommends that money market funds that wish to continue to offer bank-like services (e.g., transaction account services, withdrawals on demand at par, and assurances of maintaining a stable NAV) would be required to reorganize as special purpose banks – thus guaranteeing appropriate regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities. Second, the report recommends that institutions that remain as money market funds offer only conservative investment options with modest upside potential at relatively low risk, and be differentiated from federal insured instruments offered by banks with no assurance that funds can be withdrawn on demand at stable NAV. Moreover, the report recommends that money market funds not be able to use amortized cost pricing, with the implication that they will carry a fluctuating NAV.[38] In response to this set of recommendations, some commentators suggested that their adoption would "essentially kill the money market fund industry."[39]

In this section we discuss other approaches to money market fund reform: money market funds would maintain their current regulatory framework, with restrictions on certain existing features of money market funds. Two examples of regulatory changes that would alter elements of the money market fund investment structure, without going as far as the G30 report recommends, are capping daily redemptions and limiting investment to Treasury securities.

Cap on a Shareholder's Daily Redemptions

During the recent period of volatile market conditions, money market funds experienced severe liquidity problems caused by an increase in redemption requests and an unprecedented outflow of assets. By limiting the redemption amount on a given day to a certain percentage of a shareholder's investment, the fund's adviser would be better able to manage the sale of portfolio securities to raise cash. If, for example, daily redemptions were limited to 20% of a shareholder's total investment, a shareholder could effect a complete liquidation within a week, while allowing the fund additional time to ensure that it could meet other redemption requests.

From the investor's perspective, the more restrictive the limitation on redemptions, the more investment in money market funds differs from cash management through a bank account. This might make investment in money market funds less attractive for the average retail investor. However, if the daily allowance for redemptions is not overly restrictive, many investors who do not require immediate access to the full amount of their investment would view the cap as inconsequential.

Although a cap on daily redemptions would not provide a guarantee that a fund could meet all redemption requests, a cap would provide a fund with more time to deal with redemption requests and a greater ability to plan for and predict the fund's liquidity needs.

Limiting Investment to Treasury Securities

The widespread drop in the market value of the debt of corporate issuers held by many money market funds caused large deviations between the funds' amortized cost NAV and market value NAV. The difficulties these funds faced raise the question of whether holding corporate debt is compatible with seeking to maintain a stable share price.

One approach to this issue would be to limit funds that seek to maintain a stable share price to investment in U.S. Treasury securities. Under this approach, "prime" money market funds, which are funds that invest principally in issues from large, high-quality corporations and banks, would use market valuations, rather than amortized cost, to price their shares, and thus would no longer seek to maintain a stable share price.

[37] Group of Thirty, *Financial Reform: A Framework for Financial Stability*, 29, Jan. 15, 2009.

[38] We note that the G30 Report's recommendations are likely to be influential with the Obama administration, because the G30 Steering Committee includes Paul A. Volcker. Mr. Volcker serves as a senior advisor to President Obama.

[39] Peter Ortiz, *Critics: Proposal Would Mean the End of Money Funds*, Ignites, Jan. 22, 2009.

The tradeoff to such a limitation is that Treasury funds would typically generate less yield than prime money market funds, and pay less income to investors. In addition, removing the stable NAV feature from prime money market funds could reduce the popularity of these funds and have a negative impact on the commercial paper market by reducing available capital.

REGULATORY CHANGES TO FUNDAMENTAL CHARACTERISTICS OF MONEY MARKET FUNDS

As a result of the challenges money market funds faced in the recent market crisis, fund groups and regulators may consider whether the current money market fund structure remains a viable model. Two potential fundamental changes to the money market fund structure are discussed below. Both reform measures risk making money market funds less attractive to some investors by reducing either safety or liquidity. Both options may cause money market funds to be viewed as more similar to a low-risk, short-term bond fund than to its current conceptualization as a higher interest alternative to bank accounts.

Floating Share Price

One of the fundamental characteristics of money market funds is that they seek to maintain a stable per-share NAV of $1.00.[40] This feature has contributed to the popularity of money market funds as a tool for cash management and, in the view of the SEC, has encouraged investors to "view investments in money funds as an alternative to either bank deposits or checking accounts."[41] Investors purchase shares of money market funds under the assumption that for each dollar invested they will be able to redeem shares worth the same amount.

One way to address the concerns over breaking the buck would be to move away from a stable per-share NAV of $1.00, and towards greater flexibility in share price. Under this approach, money market funds would seek to maintain a floating NAV, either at around $1.00 or at a higher dollar benchmark (e.g., $10). This approach would allow funds to address fluctuations in market values of their holdings without the stigma of being viewed as breaking the buck. Currently, a money market fund breaks the buck when its NAV drops below $0.995, allowing only a small 0.005 margin. Under a floating NAV approach, the permissible range would be wider, allowing the fund's per-share NAV to hover between, for example, $9.97 and $10.02, allowing a .05 margin.

The shift to a floating per-share NAV, possibly at a higher dollar benchmark, would change the nature of money market funds. A floating per-share NAV would mean somewhat greater risk for investors, who, in response, may no longer view money market funds as a viable alternative to bank accounts. Similarly, a higher dollar benchmark (such as $10) may be less attractive to the average retail investor.[42]

Liquidity and Redemptions

As noted above, money market funds experienced very high redemption requests driven by investor insecurity in a period of extreme market volatility. Indeed, in the week ended September 17, 2008, money market funds experienced a record $42.2 billion in net outflows.[43] During this period money market funds had to balance the demand for immediate liquidity to meet redemptions with the need to maintain a stable per-share NAV. The difficulty funds faced in meeting these countervailing demands suggests that alternative liquidity models should be considered.

Weekly/Monthly Redemption Window

Currently, money market funds, like other open-end funds, offer investors ultimate liquidity: investors can redeem their shares on a daily basis.[44] Many money market funds also offer bank account like features, such as the ability to write checks on the fund.

Moving to a model with weekly or monthly, rather than daily, redemptions, would allow funds the ability to

[40] Maintaining a stable per-share NAV at $1.00 is in fact an industry practice and not a regulatory requirement. Rule 2a-7 permit funds to stabilize NAV per share at a single value, rather than specifically at $1.00. Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), 82-83 CCH Dec., FSLR ¶83,400, Jul. 11, 1983.

[41] Investment Company Act Release No. 21,837 (Mar. 21, 1996), at Section I.

[42] In order to keep the floating per-share NAV within range of the benchmark, the fund could periodically engage in a reverse stock split to increase the per-share NAV.

[43] Daniel Bases, *Record Redemptions for Money Market Funds,* Reuters, Sept. 19, 2008, *available at* http://www.reuters.com/barticle/companyNewsAndPR/idUSN1939498420080919.

[44] Section 22(e)(1) of the Investment Company Act of 1940 permits a fund to postpone the date of payment for up to seven days.

better match the maturities of their holdings with the redemption window, and therefore would increase the fund's ability to meet redemptions without the need to sell securities at disadvantageous prices.

This reform would likely make money market funds less attractive to investors who are primarily looking for immediate access to cash. Other investors, however, who are interested primarily in capital preservation, rather than immediate liquidity, may find such funds to be attractive.

Splitting the Fund to Address Competing Demands

An alternative approach to the liquidity challenge is to tackle it by splitting a money market fund into two separate portfolios.[45] One portfolio (portfolio A) would cater to investors who seek immediate liquidity. The other portfolio (portfolio B) would cater to investors interested in a stable per-share NAV. Portfolio A would not seek to maintain a stable per-share NAV. Shares would be purchased and redeemed at a market-based NAV. This option will be attractive to retail investors that are generally interested in immediate liquidity. Portfolio B would offer and redeem shares at a stable per-share NAV, but would limit redemptions to periodic windows. Portfolio B could align the maturities of its portfolio holdings with these windows. As a result, portfolio B would have a greater likelihood of sustaining the $1.00 NAV per share. This option may be attractive to institutional and high net worth investors that are generally more interested in capital preservation than in immediate liquidity.

CONCLUSION

Certain of the approaches to reform discussed above may well prove not to be viable from a business or regulatory standpoint. We believe, however, that the unprecedented challenges to the money market fund industry resulting from the recent turmoil in the financial markets should cause industry participants and regulators to take a fresh look at the existing money market fund model, and consider whether there are alternatives to the existing model that would better serve the needs of investors and fund sponsors. ■

[45] This alternative was discussed by Andrew Donohue, the director of the SEC's Division of Investment Management, at an ICI Equity, Fixed-Income & Derivatives Markets Conference, October 6, 2008. *See* Peter Ortiz, *SEC Director: Rethinking $1 NAV for Money Funds*, Ignites, Oct. 7, 2008.

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1. Despite some turmoil in the industry, since 1994 no money market fund has "broken the buck." **True** **False**

2. In 2008 the SEC staff, on a case-by-case basis, has granted no-action assurance permitting affiliates to purchase assets from funds. **True** **False**

3. In 2008 the Federal Reserve Board created a facility to finance the purchase of frozen assets from money market funds at amortized costs using private sector SPVs. **True** **False**

4. In 1996 Fidelity Investments implemented a plan to offer an insured money market fund. **True** **False**

5. Rule 2a-7 under the 1940 Act requires money market funds to maintain specified levels of liquid securities. **True** **False**

A F F I R M A T I O N

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