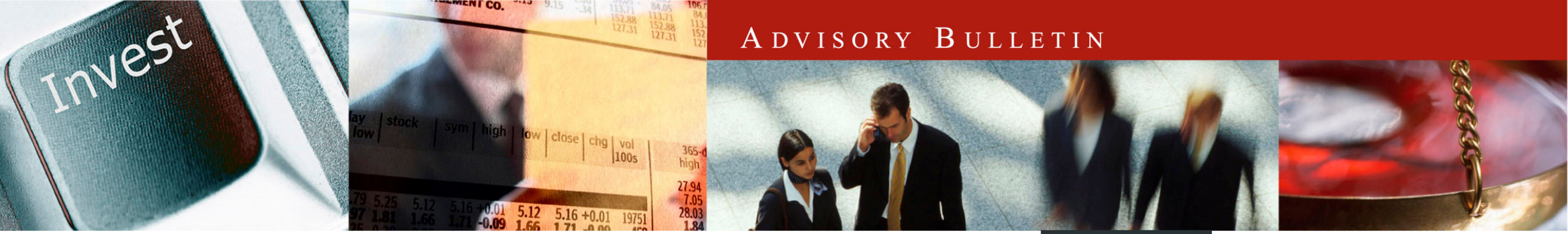

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INVESTMENT MANAGEMENT UPDATE

Report Examines Money Market Reform

On October 21, the President's Working Group on Financial Markets (PWG)[1] released its long-awaited report ("PWG Report") on money market fund reform options.[2] The genesis of the PWG Report dates back to the run on money market funds that began in September 2008 following the bankruptcy of Lehman Brothers Holdings, Inc. ("Lehman") and the subsequent failure of the Reserve Primary Fund to maintain a net asset value (NAV) of $1 per share and its ultimate collapse following a massive wave of redemption requests. Although the collapse of the Reserve Primary Fund, a unique event in and of itself, must be viewed in the context of the Lehman bankruptcy and the chaos that event produced, which one commentator called a period of "some of the most cataclysmic failures in our economic history," the failure of the Reserve Primary Fund provided a clear indication to many observers that money market funds had moved increasingly away from their traditional role of providing short-term liquid investments for retail investors and grown increasingly risky.[3]

In June 2009, the U.S. Department of the Treasury issued a white paper proposing reforms to financial regulation that, among other recommendations, proposed that the PWG prepare a report assessing whether fundamental changes were necessary to address systemic risk and reduce the money market fund industry's susceptibility to "runs."[4] Any proposals offered by the PWG were intended, in the view of the Treasury White Paper, to be in addition to proposals by the SEC to amend Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act") to strengthen the regulatory framework applicable to money market funds. The amendments to Rule 2a-7, which the Treasury White Paper discussed, were adopted in February 2010. In response to the Treasury White Paper, the PWG undertook a study of possible reforms to money market fund regulation that could, individually or collectively, mitigate systemic risk.

The PWG Report presents eight possible policy options. The options range from measures that could be implemented through SEC rule-making to broader changes that would require new legislation, coordination by multiple government agencies and the creation of new private entities. The PWG Report also notes that the effectiveness of the various reform options would be enhanced by the imposition of "new constraints" on less regulated or unregulated money market fund substitutes, including offshore money market funds and stable value vehicles. Without such new constraints, the PWG Report suggests that systemic risk may be increased as a result of a shift from registered money market funds subject to increased regulatory oversight (and presumably fewer investment options) as a consequence of the adoption of the proposals in the PWG Report to investment vehicles with substantially less oversight offering the prospect of a stable NAV or other features.

Rather than advocating for any particular proposal, the PWG Report requests that each option be further examined by the Financial Stability Oversight Council (FSOC) established under the Dodd-

Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[5] To assist the FSOC in its analysis, the PWG Report would have the SEC solicit public comments on the various proposals.

The policy options offered by the PWG Report include:

Floating NAV. The PWG Report proposes requiring money market funds to report variable NAV, on the theory that this would reduce the likelihood of money market fund runs by removing the perception that money market funds are risk-free and somewhat reducing the incentive for investors to redeem shares from distressed money market funds when a fund's NAV is dropping. However, as the PWG Report notes, "the elimination of the stable NAV … would be a dramatic change for a … sector that has been built around the stable share price." Such a shift could have several unintended consequences, including, but not limited to, the following:

- As a consequence of reduced demand for money market funds that might result from the implementation of a variable NAV, the ability of money market funds to serve as intermediaries between shareholders looking for liquid, stable investments and borrowers, including financial institutions and state and local governments, looking for short-term funding would be significantly reduced;
- A shift of assets to less-regulated or unregulated money market fund substitutes such as offshore money market funds, enhanced cash funds and other stable value vehicles offering a stable NAV that are not subject to the restrictions governing money market funds as set forth in Rule 2a-7 under the 1940 Act; and
- Risk management practices at money market funds may deteriorate if such funds are no longer required to maintain a stable NAV, potentially resulting in a less risk adverse investment methodology.

Private emergency liquidity facilities for money market funds. The PWG Report observes that liquidity risk greatly contributes to the susceptibility of money market funds to runs of the sort experienced in 2008. To help lessen liquidity risk, the PWG Report proposes that a "private facility, adequately capitalized and financed by the fund industry, could be set up to supply liquidity to funds that most need it at times of market stress." In theory, the emergency lending facility would operate in similar fashion to the liquidity backstops provided to banks and other institutions and, as demonstrated by the success of the Treasury's Temporary Guarantee Program for Money Market Funds in 2008, could be effective in stopping runs on money market funds.

Mandatory redemptions in kind. Large redemptions from a money market fund impose certain liquidity costs on shareholders of the fund that are disproportionately borne by the non-redeeming shareholders particularly where the fund is required to sell its most liquid assets to meet redemption requests during a crisis. Thus, the PWG Report would require money market funds to distribute large redemptions by institutional investors in kind, rather than in cash. In the view of the PWG, a redemption in kind requirement would reduce, but not eliminate, the systemic risk associated with

large, widespread redemptions and largely would force the redeeming shareholder to bear the costs associated with the redemption. For mandatory redemptions in kind to be effective, the PWG Report notes, "the SEC would have to make key judgments on the circumstances under which a fund must redeem in kind, as well as the criteria that funds would use for determining which portfolio securities must be distributed and how they would be valued."

Insurance for money market funds. In order to maintain a stable NAV during times of economic stress, money market funds historically have relied upon discretionary sponsor support. However, as was the case with the Reserve Primary Fund, a fund sponsor may not have the capital necessary to maintain a stable NAV in times of crisis. The PWG Report proposes that a form of insurance, somewhat akin to deposit insurance offered by banks, be provided to money market funds by the private sector, the government or a combination of the two. The PWG Report further suggests that any insurance for money market funds could operate with or without the emergency liquidity facility discussed above. However, the PWG Report observes that liquidity protection without some form of insurance may still leave money market funds vulnerable to runs.

A two-tier system of money market funds, with enhanced protections for stable NAV funds. Rather than a "one size fits all" regulatory approach to money market funds, the PWG Report proposes that Rule 2a-7 be amended in such a way as to accommodate two forms of money market funds: stable NAV money market funds and floating NAV money market funds. Under such a regulatory scheme, money market fund investors could choose between stable NAV funds, which would be subject to enhanced protections, including, for example, potentially higher liquidity standards and required participation in some sort of liquidity backstop, and floating NAV funds, which would have fewer restrictions and would presumably offer higher yields. Thus, money market fund investors would be able to choose the type of money market fund that best matches their risk-return preferences in much the same way as investors in other mutual funds can today.

A two-tier system of money market funds, with stable NAV money market funds reserved for retail investors. Another option for the creation of a two-tier system of money market funds would be to distinguish the two tiers by investor type—retail and institutional. The PWG Report suggests that it is appropriate to distinguish between institutional and retail investors for several reasons, including, but not limited to, the fact that institutional investors tend to have larger amounts at stake and, as a result, are quicker to redeem their interests during times of economic stress; and patterns showing that institutional investors regularly arbitrage small discrepancies between a money market fund's "shadow NAV" and the fund's $1 share price. Furthermore, by separating the two classes of investors, stable NAV funds could return to their original mission of providing retail investors with cost-effective access to diversified investments in money market instruments.

Regulating stable NAV money market funds as special purpose banks. Given the similarities that exist between money market fund investments and bank deposits, the PWG Report suggests that it would be appropriate to implement a form of a bank regulatory scheme in connection with stable NAV money market funds. Under this approach, a stable NAV fund would be required to reorganize as a "special purpose bank." The PWG Report notes that this would require complex

legislative and regulatory changes, would require tens of billions of dollars in capital, would substantially increase the government's potential liability from its guarantee of insured deposits and would not necessarily reduce the risk of runs. In light of the foregoing, it would seem highly unlikely that such a regulatory scheme would be implemented.

Enhanced constraints on unregulated money market fund substitutes. Because some of the proposals in the PWG Report, and money market fund regulatory reforms generally, could create certain incentives for money market fund investors, particularly institutional investors, to move assets to money market fund substitutes with stable NAVs and potentially increase systemic risks, the PWG Report recommends imposing new constraints on these less-regulated investment vehicles. Thus, effective mitigation of systemic risks may require policy reforms targeted outside of the money market fund industry to address risks posed by funds that compete with money market funds and "to combat regulatory arbitrage that might offset intended reductions in … risks" posed by money market funds. In that regard, the PWG Report suggests amending Sections 3(c)(1) and 3(c)(7) of the 1940 Act to make those exemptions from registration as an investment company unavailable to investment funds that seek to maintain a stable NAV. The PWG Report also suggests that "[b]anking and state insurance regulators … consider additional restrictions to mitigate systemic risk for bank common and collective funds and other investment pools that seek a stable NAV but that are exempt from registration under sections 3(c)(3) and 3(c)(11)."

For More Information

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[1] The PWG is comprised of the secretary of the Treasury (who serves as its chair), the chair of the Federal Reserve Board of Governors, the chair of the Securities and Exchange Commission (SEC) and the chair of the Commodity Futures Trading Commission.

[2] Report of the President's Working Group on Financial Markets – Money Market Reform Options (Oct. 2010). A copy of the PWG Report can be found at http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf.

[3] Andrew Ross Sorkin, "A Breakdown on Handling Big Failures," *NY Times*, Sept. 8, 2009, DealBook.

[4] Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009) ("Treasury White Paper"). A copy of the Treasury White Paper can be found at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[5] Pub. L. No. 111-203, 124 Stat. 1376 (2010).