Money Market Mutual Funds

A Report on the History and Potential Implications of Recent SEC Rule Amendments

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On July 23, 2014, the Securities and Exchange Commission (SEC) adopted amendments to the rules under which money market funds can operate. The new regulations will dramatically increase money market funds' price volatility and decrease their liquidity. When implemented, the rules prevent prime and tax-exempt money funds from sheltering market price fluctuations and force them to have a daily floating net asset value (NAV). Additionally, money market fund boards will have the authority to prevent investor withdrawals and/or charge liquidity fees in distressed market environments. Investor's perceptions should change and money market funds should no longer be perceived as a substitution for savings investment accounts because in times of stress one's money market assets might not be available for withdrawal.

There is a difference between a money market fund and a savings investment account ... and it isn't the yield.

WHAT IS A MONEY MARKET FUND?

Money market funds are a type of mutual fund registered under the Investment Company Act of 1940 and regulated under SEC Rule 2a-7. The mandate of the Securities and Exchange Commission with regard to money market funds is to disclose the funds' risks, not insure the investor against losses. Investors in money market funds are susceptible to market movements and real investment losses.

Currently, to be compliant under Rule 2a-7, money market funds must maintain a dollar weighted average portfolio maturity (WAM) of 60 days or less and are prohibited from owning securities with maturities of more than 397 days. There are three main money market fund categories:

Prime Money Funds
Invest in short-term corporate debt, government debt, and other fixed/floating rate money market securities. Any money fund not explicitly categorized as a government or tax-exempt fund is considered a prime fund.

Government Money Funds
Required to invest 99.5% (increased from 80% due to the July 2014 rule amendment) of its total assets in cash, government securities, or fully U.S. Government collateralized repurchase agreements.

Tax-exempt Money Funds
Invest in short-term tax-exempt municipal bonds.

THE BEGINNING OF THE MONEY MARKET FUND

In the 1970s, banks operated under the Glass-Steagall Act, including Regulation Q. Regulation Q capped the level of interest rates that banks could pay on customer savings deposits. A variation of this rule had been in effect since 1933, but it wasn't an issue until the 1970s when short-term U.S. Treasury rates rose significantly above the constrained rates banks were allowed to pay on deposits. This dislocation attracted fund managers and thus began the money market fund.

Money market funds gave investors the ability to pool funds together to earn a higher collective uncapped interest rate on their cash balances via investing in short-term corporate debt, government securities, and other short-term asset-backed securities. According to St. Louis Federal Reserve data, from September 1977 to September 1982, money market mutual funds' total financial assets increased from $3.87 billion to $235.25 billion. Thus, the money market fund category announced itself to the world's investor base.

Unable to compete with money market funds, banks lobbied Congress for changes in Regulation Q. Later in 1982, banks were allowed to offer uncapped money market deposit accounts for customers with over $2,500 minimum balances. Money market funds immediately lost assets as their yield advantage over the banks disappeared, and investors returned to the safety of FDIC insured bank accounts. By June 1983, money market fund assets were down almost 25%.

Recognizing that they lost their competitive advantage over the banks, the money market fund industry persuaded their regulator, the SEC, to allow them to adopt new accounting policies that would decrease market price volatility and increase the perception of stability. On July 18, 1983, the SEC amended Rule 2a-7 of the Investment Act of 1940, allowing money market funds to value their securities using the "amortized cost" method of valuation. This sheltered the funds from market fluctuations as they were able to calculate the funds NAV based on the individual securities acquisition cost adjusted for premium or discount rather than at their value based on current market conditions. Furthermore, the funds could use the "penny rounding" method of NAV pricing, thereby letting funds round their NAV to the nearest "penny" or $1.00. Both of these amendments encompassed tools that made it easier for money market funds to keep a stable net asset value of $1.00.

Even with these market price sheltering rules, there have been numerous occasions when money market funds' NAVs have fallen below $1.00 and "broken the buck". These instances often go unnoticed and the managing institutions will infuse undisclosed cash into the fund to make the NAV whole to preserve customer relationships and reputations. An internal SEC review uncovered more than 300 instances where fund sponsors have quietly bailed out their money funds. Then SEC Chairman, Mary Schapiro, was quoted as saying, "that number was conservative" *(Wall Street Journal updated June 26, 2012).*

All in all, these rule changes have had the desired effect of creating the illusion that money market funds and bank accounts are almost one and the same, and money market funds' assets exploded to $3.03 trillion at year end 2007.

THEN THERE WAS 2008...AND THE LIGHTS DIMMED ON THE MONEY MARKET PARTY.

On Monday, September 15, 2008, Lehman Brothers filed for bankruptcy, leaving its publicly traded debt, including its commercial paper outstanding, worth pennies on the dollar. This was the pebble that created the ripple throughout the financial markets. The next morning, The Reserve Primary Fund, one of the original money market funds with over $60 billion in assets (which included Lehman commercial paper), "broke the buck" and posted a NAV of $0.97. Almost immediately, The Reserve Primary Fund had withdrawal requests for nearly half of their total assets. Over the next two days there was panic in the markets and many money market funds were in survivor mode and unable to process withdrawal requests. **The supposed safest and most liquid mutual funds in the marketplace put the entire financial system in disarray.** By that Friday morning, the U.S. Treasury (and the U.S. taxpayer behind them) was forced to step in and insure all money market funds' NAVs at $1.00, thereby letting the market take a short lived breath. At the end of it all, many investors were unable to access their funds and those who didn't require withdrawals, saw real investment losses as their fellow investors forced fire sale withdrawals.

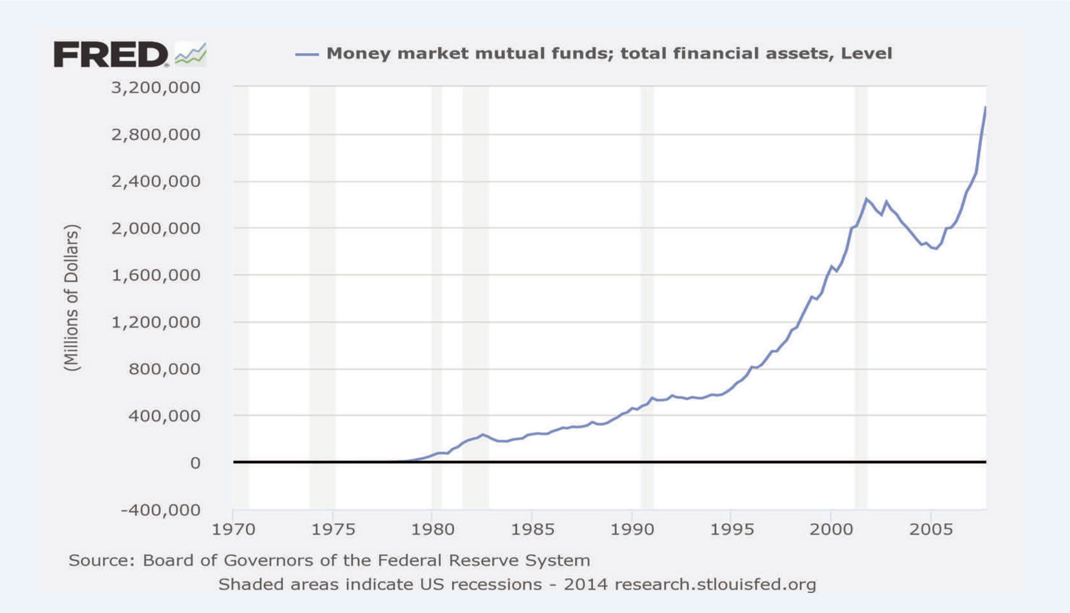
HOW DID 2008 HAPPEN?

The exponential growth of money market funds in the last twenty-five plus years gave corporations, foreign governments, sovereign banks, and finance companies a seemingly limitless buyer for any short-term debt instrument Wall Street could put/package in front of them. Commercial paper, for example, was typically a long-standing source of short-term financing for only the highest quality companies. This form of financing typically ran no more than 270 days, and loans were often paid down in 60. Given the appetite of money market funds, however, corporations were allowed to continually extend and "roll over" their commercial paper. To further meet the insatiable demand of the funds, banks and other investment firms put together structured asset-backed deals called securitized investment vehicles (SIV). Finally, banking companies also began to tap the commercial paper market for funding; almost 92% of all commercial paper was issued by the financial industry including U.S. subsidiaries of foreign banks (Kacperczyk and Schnabl*).

When the crisis occurred, money market firms owned over 38% of all commercial paper outstanding *(Anderson and Gascon).* In 2007, for every $1 in outstanding U.S. Treasury Bills there was $2 of outstanding commercial paper for a total amount of over $2 trillion dollars *(Kacperczyk and Schnabl).* The explosion in paper outstanding also produced a decline in the quality of the issuers.

TOO MUCH "REACHING FOR YIELD" LED TO A FALL.

In the summer of 2007, two Bear Stearns subprime hedge funds went belly up and three BNP Paribas money market funds suspended withdrawals to figure out how to value what the funds actually held. This was a wake-up call to



Source: FRED, Board of Governors of the Federal Reserve System, from the Federal Reserve Bank of St. Louis: Money market mutual funds; total financial assets, Level; http://research.stlouisfed.org/fred2/graph/?g=HA9; accessed August 22, 2014

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some, but it wasn't until Lehman declared bankruptcy in 2008 that investors understood that the firms backstopping the commercial paper did not have a backstop themselves. The lights dimmed on the commercial paper market and investors realized pooling investments with other investors to earn a slightly higher rate did not come without consequences. As part of the regulatory review in the aftermath of the Financial Crisis of 2008, the SEC has been studying money market funds.

THE END OF THE MONEY MARKET FUND AS IT EXISTS TODAY.

On July 23, 2014, the Securities and Exchange Commission adopted money market reform rules to, "provide structural and operational reform to address run risk in money market funds." *(SEC press release July 23, 2014).* The amendments will be implemented following a two year transition period and are currently only targeted towards prime and tax-exempt money market funds.

First, money market funds will have to post a daily floating net asset value. Securities will no longer be valued by the "amortized cost" method and now must be valued based on the market price of the underlying securities. Additionally, prime and tax-exempt funds have to round their NAVs to the nearest basis point. Instead of showing a price of $1.00, these funds will now have to price as $1.000, further highlighting their actual NAV.

To prevent a run on a fund, the new rules give money market funds' boards the authority to impose one or two percent withdrawal fees and in distressed market situations, halt all fund withdrawals for up to ten days. The liquidity restrictions are based on a fund's weekly liquid assets (cash, U.S. Treasury securities that mature within 60 days, and any security that matures in under one week). Money market funds can impose a one percent liquidity fee if weekly liquid assets levels fall below 10% of the fund's total value. If a fund experiences a 30% drop in weekly assets, the fee can increase to 2%, and the fund can prohibit all withdrawals for up to 10 days. An investor can witness a money market fund's value fall 30% and be completely gated from withdrawing funds for up to ten days.

Ironically, the rule changes are simply a reversal of the amendments the SEC put in place in 1983. Then, the goal was to shield investors from knowing the true NAV of money market funds to give them pricing stability and the appearance similar to bank savings accounts. Today, the goal is to highlight a fund's true market NAV and restrict liquidity in times of crisis. **Investors in money market funds will see increased volatility and decreased liquidity for the same underlying investments.**

* Citations at end of paper

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