Money Market Funds

The impact of the financial crisis

By George Hagerman
Founder and CEO, Cachematrix Holdings, LLC

Money Market Funds: Impact of the Financial Crisis

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The global financial crisis of 2007–2008 has wreaked havoc on financial markets, forever altered Wall Street, and spurred unprecedented government intervention in private enterprise. This paper discusses the impact of the events of September 2008 and their aftermath on money market funds.

Introduction

Money market funds are registered investment companies that seek to maintain a stable net asset value of $1.00 per share. They are heavily regulated by the Securities and Exchange Commission (Commission) under Rule 2a-7 of the Investment Company Act of 1940. Rule 2a-7 imposes strict diversification, credit quality and maturity standards on money market funds. Money market funds are viewed as conservative investment vehicles and historically have been viewed as being as safe as cash. Money market funds are a critical source of short-term financing in the United States. Just prior to the events of the week beginning September 15, 2008, money market assets represented $3.5 trillion and had experienced only a single incident of "breaking the buck."[1] Additionally, market participants have come to expect advisers or sponsors of money market funds to support those funds.[2]

The events of September 2008 resulted in a registered money market fund "breaking the buck" for only the second time in the history of money market funds, which precipitated a run on money market funds and "freezing" of the money markets. Another large fund closed its doors and liquidated, and many fund sponsors sought relief to provide various types of support agreements to funds.

As government and industry groups continue to assess what happened, it is clear that one of the consequences of the recent financial crisis will be greater scrutiny and heightened regulation of money markets funds. Based on industry proposals and developments to date, including the recent Report of the Money Market Working Group of the Investment Company Institute,[3] it appears that regulatory developments and best practices will likely

[1] A fund "breaks the buck" when its net asset value drops below $1.00 per share. In 1994, increases in interest rates caused the value of many adjustable rate securities to fall below par. As a result, approximately twenty-five (25) advisers or their related persons purchased those securities from money market funds at amortized cost to avoid shareholder losses. The US Government Money Market Fund, a series of Community Bankers Mutual Fund Inc., however, broke a buck in 1994 and ultimately paid investors 96 cents per share due to such holdings.

[2] For example, in December 1994, Orange County, California, declared bankruptcy and approximately thirty-eight (38) advisers or their related persons purchased Orange County notes from, or entered into credit agreements with, their municipal money market funds in order to maintain a stable net asset value of $1.00.

[3] See *Report of the Money Market Working Group of the Investment Company Institute* (March 17, 2009) (the "ICI Money Market Report").

include greater reporting requirements for money market funds, an emphasis on transparency of portfolio holdings, and potentially "know your client" obligations. Adoption of any or all of these requirements will require money market funds and their service providers to assess their systems for gathering, analyzing and reporting portfolio information and shareholder information.

Market Events – September 2008

The causes of the current financial crisis have been attributed to many factors, none of which were caused by money market funds. Nevertheless, money market funds found themselves in the "eye of the storm" on September 15, 2008 and were deeply impacted by a rapid succession of events in the financial markets over the next few days.

These events included the sale of Merrill Lynch to Bank of America on September 13th and 14th in a hastily arranged deal, the bankruptcy filing of Lehman Brothers Holdings, Inc. (Lehman Brothers) on September 15, 2008 and the Federal Reserve bailout of American International Group, Inc. (AIG) on September 16, 2008. On September 16, 2008, the Reserve Primary Fund, one of the oldest money market funds in the U.S., announced that it "broke the buck" due to a write off to zero of debt issued by Lehman Brothers.[4] Several other advisers or their related persons entered into support agreements due to holdings of Lehman Brothers and other distressed issuers in order to maintain a stable net asset value. In the days that followed, other financial institutions failed or were acquired by competitors at "fire sale" prices. Two large investment banks, Morgan Stanley and Goldman Sachs also came under pressure due to their exposure to mortgage-backed securities or related credit derivatives, and applied for and were granted status as bank holding companies.[5]

The credit turmoil in general, and the rapid succession of these extraordinary events, resulted in panicked markets, extreme volatility in the equity markets, plunging prices across most asset classes, and essentially frozen credit and securitization markets. Money market funds were subject to intense redemption pressures and on September 18, 2008, Putnam Investments' Prime Money Market Fund, a $15 billion institutional fund, announced that it was liquidating due to those pressures. Industry participants were deeply concerned that the industry could not sustain a "run" on money funds and that the ripple effects of such a run would be devastating.

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[4] On the same day, BNY Institutional Cash Reserves (which is not a money market fund but rather an unregistered securities lending fund run by BNY (cont'd)

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Mellon) also broke the buck when its shares fell to 99 cents due to Lehman Brothers holdings.

[5] Such status subjects these entities to the full regulatory regime of bank holding companies, but also provides them with access to borrowing facilities otherwise limited to banks and bank holding companies.

Regulatory Response

These events spurred a number of short-term emergency measures designed to "unfreeze" the money markets and credit markets, and are likely to result in long-term reforms focusing on systemic risk management, increased reporting, and greater "transparency" (i.e., access to information in the marketplace and by regulators) with respect to portfolio information and shareholder information.

Emergency Measures. On Friday, September 19, 2008, the U.S. Department of the Treasury announced a temporary guarantee program for money market funds that was designed to guarantee the $1.00 per share value to shareholders holding shares as of September 19, 2008 in participating money market funds at $1.00 per share. The program was designed principally to mitigate fears of additional funds "breaking a buck" and stabilize redemption flows from funds. Substantially all money market funds participated in the program. The program had an initial termination date of April 30, 2009, which was subsequently extended to September 18, 2009. The program, by its terms, is not subject to further extension.

In addition, the Federal Reserve established the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility in September, as well as the Commercial Paper Funding Facility and the Money Market Investor Funding Facility in October. These programs were designed to help money market funds meet redemption demands by facilitating the sale of asset-backed commercial paper to approved third parties.

The staff of the Commission issued more than twenty-five (25) no-action letters between September 16, 2008 and October 24, 2008, providing emergency relief to money market funds to allow the adviser or its related persons to acquire securities from, or enter into various capital support agreements with, affiliated mutual funds in order to maintain a stable net asset value. These requests generally arose from holdings of Lehman Brothers, AIG, SIVs and other troubled issuers. For the first time, the no-action relief permitted the acquisition of securities by the adviser or its related persons solely for liquidity purposes (i.e., to facilitate redemption requests of the fund). Certain advisers and their related persons were themselves subject to tremendous financial stresses as a result of the credit and market turmoil, and the expectation of support further exacerbated these stresses.

Long-Term Reforms. Financial crises of this magnitude usually spur significant regulatory reform. Money market funds and their sponsors will be affected by many of the broad regulatory reforms under discussion, as well as by proposals directed specifically at money market funds. Although a wide range of proposals are being considered and debated, some broad themes have emerged.

First, regulatory reform will likely focus on risk management practices and systemic risk. The President's Working Group on Financial Markets concluded that investors failed to conduct comprehensive risk assessments of instruments that were complex, and relied too heavily on credit ratings.[6] The group also noted inadequate stress testing procedures and failure to adequately identify vulnerability to system-wide shocks to markets and market participants. The Group's report contains a number of recommendations to mitigate systemic risk. The report recommends the establishment of a systemic risk regulator and a centralized capital markets regulator. Industry recommendations, discussed below, also focus on risk management and include a number of recommendations designed to enhance risk management practices, including mandatory stress testing requirements. Regulatory reforms may include additional reporting requirements designed to allow regulators to monitor systemic risk, as well as requirements designed to enhance risk management at individual firms.

A second major theme of regulatory reform is transparency. Several groups have proposed more frequent reporting by money market funds of portfolio holdings and other key information to a designated regulator on a more frequent basis.[7] This information could include portfolio holdings, yield, shadow pricing and other information. Such groups recommended that such reports would be filed electronically in a non-public forum. The ICI's Money Market Report also recommends greater transparency with respect to a money market fund's client base and proposes that funds be required to adopt "know your client" policies, disclose certain information regarding concentration of clients on their websites, and disclose the risks associated with concentration of clients.

Other reforms specific to money market funds have included requiring money market funds to float their net asset values, requiring money market funds to become special purpose banks that are insured and are subject to capital requirements, or requiring advisers to maintain specified capital levels.[8] Commission Chairman Mary Shapiro stated in remarks before the Senate Banking Committee in March the agency will "quickly …. strengthen the regulation of money market funds." Members of the staff of the Commission have said that "Rule 2a-7 is broken" and have indicated that changes to Rule 2a-7 will be forthcoming, and will likely include certain

[6] See *Policy Statement on Financial Market Developments*, President's Working Group on Financial Markets, March 2008.

[7] See, e.g., ICI Money Market Report; see also Fund Democracy/Consumer Federation of America Letter to Mary Shapiro dated June 8, 2009 and petition to the Commission submitted in January 2008 (recommending more frequent reporting of portfolio information on a non-public basis).

[8] See Group of Thirty, *Financial Reform: A Framework for Financial Stability* (2009). The Investment Company Institute strongly opposes any proposal to float the net asset value of money market funds.

of the recommendations contained in the Money Market Report.[9]

Industry Response

The Investment Company Institute (ICI), a leading industry trade group, has published a discussion paper on regulatory reform generally, as well as a comprehensive paper on money market reform.[10] In its first report, the ICI Reform Report, the ICI supported the designation of a new or existing agency as a systemic risk regulator, and the creation of a single "capital market regulator" that combines the functions of the Securities and Exchange Commission with the Commodities Futures Trading Commission. Such capital markets regulator would have jurisdiction over money market funds.[11] With respect to a systemic risk regulator, the ICI Reform Report emphasized greater transparency in general and specifically with respect to risk management practices.

The Money Market Report includes a broad discussion of the causes of the financial crisis. The Report also analyzed how the crisis impacted different types of money market funds, noting differences between retail and institutional funds as well as differences between direct sold funds and funds sold primarily through omnibus arrangements and portals. This analysis contributed to the "know your client" recommendations discussed below.

The ICI Money Market Report contains comprehensive recommendations for money market reform including:

- Imposing daily and weekly minimum liquidity requirements and requiring regular stress testing of money market fund portfolios;
- Decreasing the permitted average weighted maturity of money market portfolios from 90 days to 75 days, and adding a new "spread weighted average maturity" that would limit the use of current maturity shortening techniques;
- Prohibiting investments in second tier securities;
- Requiring advisers to establish new product committees, and encouraging best practices for assessing credit risk;
- Requiring funds to adopt robust "know your client" procedures that assess potential client risks including client concentration risk;
- Requiring greater transparency of portfolio holdings and other metrics to a

[9] Comments of Robert Plaze, Associate Director of Regulation of the Division of Investment Management, ICI Mutual Funds Conference (March 2009).

[10] See Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009) (the " ICI Reform Report").

[11] The Wall Street Journal recently reported that the combination of the agencies appears unlikely. See *Wall Street Journal*, June 8, 2009.

designated regulator on a non-public basis;

- Amending certain rules to allow funds and boards to respond more quickly to potential redemption "runs"; and

- Enhancing disclosure.

Many of the recommendations contained in the Money Market Report will require amendments to Rule 2a-7 or other agency action. The ICI working group recommends that money market funds voluntarily adopt its recommendations by September 18, 2009, which is the expiration date of the voluntary guarantee program. Fund groups with representatives who participated on the working group have said that they intend to adopt the voluntary measures by September 18, 2009.

Compliance and Technology Implications

Money market funds and their service providers should begin to assess their readiness to comply with a significant regulatory overhaul of money market fund regulation and market demands for greater transparency. Regulatory requirements, or market-based demand for, more information on a more frequent basis may require new or enhanced compliance processes and technology solutions.

Funds and their service providers should begin to assess their ability to gather, analyze and report the following types of information:

Portfolio Risk. Funds and their service providers should assess their ability to monitor and track liquidity on a daily basis under the new definitions contained in the Money Market Report, to calculate maturity under the new definition and to quickly identify troubled issuers on a complex-wide basis. Funds should assess their capabilities of meeting potentially more detailed and more frequent reporting of holdings, as well as reporting of other portfolio level information such as shadow pricing information.

Shareholder Concentration Risk. Funds and their service provides should begin to assess their ability to collect information on shareholders, including those who invest through omnibus accounts and portals, and to assess concentration risk. Shareholder concentration risk is the risk that large redemptions by a small number of large shareholders can harm remaining shareholders. Concentration risk may also be present if a fund is sold primarily to similarly situated shareholders who tend to behave similarly. Assessing this risk requires the ability to track underlying balances that make up each omnibus account and to identify funds with risky shareholder concentration levels on a real-time basis.

Active Trading Risk. Active trading risk is the risk that frequent trading in fund shares may be disruptive to remaining shareholders. To assess this risk, funds must be able to track volume of trades by largest shareholders with sorting and search capabilities of historical transactions.

Transparency Risk. Transparency risk is the risk that funds have inadequate information regarding underlying account balances along with complete real-time trade transparency into omnibus positions to allow the fund to monitor concentration risk and active trading risk. Funds and their service providers should assess legal, contractual and technological impediments to obtaining this information.

About Cachematrix

Cachematrix Holdings LLC (Cachematrix) is a premium Software as a Service (SaaS) firm that powers custom money market fund trading solutions for global banks and other financial institutions. Cachematrix offers a total technology solution for many of the world's largest banks and financial institutions. With a combined expertise in software and systems development for financial services, Cachematrix brings an unprecedented level of expertise to the money fund industry.

Cachematrix is a trade facilitator and information source in the institutional money fund space, and is in the unique position of working closely with bank portals and money market mutual funds. With over $2 trillion dollars traded through its proprietary software, we developed a solution that was needed within the industry to provide three levels of transparency for money market funds and their corporate clients. First, the solution needed to provide real time transparency for the underlying money market funds into portal/omnibus transactions. Second, client balances in the omnibus accounts needed to be transparent to the money market funds. Finally, shareholders needed visibility into the securities that comprised each money market fund portfolio.

Cachematrix has invested significant resources into MbOX™ Transaction and MbOX Portfolio Holdings, a revolutionary web-based trading and portfolio holdings transparency tool. MbOX Transaction provides real-time transparency into all money market fund trading activity coming through a fund's transfer agent, third-party money market portals, and all Cachematrix-powered money market trading portals. MbOX Transaction also has the ability to show the underlying account balances that make up each portal or omnibus account.

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887-564-0225
www.cachematrix.com