More haste…

MARK STOCKLEY EXAMINES THE GLOBAL REGULATORY CHANGES AFFECTING THE MONEY MARKET FUND INDUSTRY.

In recent years, financial regulators across the world have introduced amendments to legislation that have affected virtually every area of the markets. These changes have had a major impact on the work of treasury practitioners in both domestic and multinational corporations.

One area that has been particularly affected is the practice of investing a corporation's cash in triple-A rated stable or constant net asset value money market funds (CNAV funds). Globally, CNAV funds have been subject to regulatory or industry-led amendments that we believe have strengthened the product model and reinforced its relevance to corporate investors as a source of diversification, credit quality and daily liquidity. At the same time, CNAV funds have maintained their contribution to economic growth by bringing together institutional borrowers (issuers of short-term debt) and lenders (investors in money market funds).

While regulators will undoubtedly continue to pay close attention to CNAV funds, we believe the changes made so far are adequate to preserve their importance to the cash investing community and the wider economy. Therefore, we suggest that regulators pause to adequately assess the impact of changes made so far. We also encourage corporate treasurers who are comfortable with money market funds to express their views to their local regulators to help mitigate further change that may be unnecessary and detrimental.

Money market funds following the CNAV model play a critical role in the US and international markets, bringing together issuers of and investors in short-term financial instruments. These funds are attractive to investors specifically because they provide a stable NAV and daily access to funds while also offering a competitive yield relative to bank deposits and direct investments. From the early 1970s until the 2008 financial crisis, money market funds successfully provided this service to the markets.

MORE PROPOSALS CONSIDERED In the US, the Money Market Fund Reform rules adopted by the US Securities and Exchange Commission (SEC), effective May 2010, have gone a long way in addressing concerns about money market funds. However, the SEC continues to assess additional proposals, including floating the NAV, introducing a two-tier system for retail and institutional investors, requiring insurance and creating a private liquidity bank for the industry.

In Europe, the term money market fund has been applied to stable NAV funds and a wide range of fluctuating NAV funds. In May 2010, the Committee of European Securities Regulators (CESR) – the predecessor of the European Securities and Markets Authority (ESMA) – limited the type of funds able to call themselves money market funds and created new categories: "short-term money market

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funds (stable and fluctuating)" and "money market funds (fluctuating only)". This was designed to increase transparency, making it easier for investors to distinguish between fund types and identify suitable funds in terms of liquidity and preservation of capital.

In addition to the steps taken by CESR, similar changes to those made by the SEC were brought in by the Institutional Money Market Funds Association (IMMFA) for internationally domiciled CNAV funds. IMMFA has a voluntary code of practice similar to the Investment Company Act's Rule 2a-7 for US-registered money market funds.

RISK MITIGATION The unprecedented events of the credit crisis, including the historic "breaking of the buck" by the Reserve Primary Fund in the US, exposed both idiosyncratic (fund-specific) and systemic (industry-wide) risks associated with money market funds, and gave rise to several reform measures designed to mitigate such risks. The changes enacted to Rule 2a-7 include more conservative investment parameters related to credit quality, maturity and liquidity, as well as enhanced guidelines on transparency to investors.

Focusing on arguably the most impactful measure that regulators may introduce, proponents argue that a floating NAV would reflect a fund's true market value, allowing investors to see regular fluctuations in their investment and providing a clearer idea of the risks associated with a particular fund. Essentially, these industry members claim that floating the NAV would reduce the likelihood of a run on a fund because, in a crisis, likely declines in the value of the fund's investments would cause the fund to honour shareholder redemptions at less than $1.00 per share, thereby reducing the incentive to flee and protecting remaining shareholders from additional NAV declines exacerbated by a potential run.

Opponents of a floating NAV argue that, for many investors, it would negate the value of the product. A floating NAV fund generates taxable gains and losses with each subscription and redemption, creating a tax and accounting burden for individual investors and for institutions that use these funds on a daily basis for their working capital. Perhaps most importantly, opponents argue that floating the NAV does not solve the underlying issue of investors fleeing the funds and disrupting the cash markets and the broader financial system.

In our view, it is critical to preserve the stable value feature of money market funds, recognising their importance to financing companies, financial institutions and local governments, and, by extension, the contribution of stable value money market funds to the health of the broader financial system. We believe that sweeping reforms that would alter the nature of this product would be counterproductive and result in unintended consequences for the funding of corporations and municipalities.

For a more detailed analysis, see BlackRock's ViewPoint paper, Money Market Mutual Funds: The Case Against Floating the Net Asset Value.

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