Emad A. Zikry, President and Chief Executive Officer

Bore you into a Sound Night's Sleep?

On January 27, 2010, the US Securities and Exchange Commission approved amendments to Rule 2a-7. The amendments impose new requirements on money market funds covering: 1) credit quality; 2) portfolio maturity; 3) portfolio liquidity; 4) disclosure of portfolio holdings; 5) shareholder concentration; 6) periodic stress tests; 7) transactions at prices other than $1.00 per share; 8) purchases by affiliates; and 9) Fund liquidation / suspension of redemptions. While the goal of these adopted rules is to prevent future disruptions in the money market fund industry, similar to what we saw in the fall of 2008, most industry experts believe that these changes will do little in preventing a run on a fund. Some analysts actually believe that these amendments will increase the likelihood of another money market fund collapse. The goal of this paper is to review the amendments to Rule 2a-7 and their likely effects and to provide an outlook for money market funds.

Credit Quality

Revised SEC Rule:

Money market funds are restricted to investing no more than 3% of their total assets in Tier II securities, down from 5% under the current Rule. No more than 0.5% (down from 1%) of a fund's total assets in Tier II may be invested in securities of a single issuer. Funds are prohibited from acquiring any Tier II security that, at the time of acquisition, has a remaining maturity greater than 45 days. For Tier II Securities that are subject to guarantees and demand features, the fund is prohibited from having more than 2.5 percent of its total assets in securities issued by, or subject to demand features or guarantees from, the provider of the demand feature or guarantee (down from 5 percent under the current Rule).

The Effect:

The change to limitations to Tier II securities will have almost no impact because historically most institutional prime funds have stayed away from Tier II securities altogether. On paper this rule change appears substantive however its impact is negligible.

Portfolio Maturity

Revised SEC Rule:

The maximum weighted average maturity (WAM) of a fund has been reduced to 60 days from 90 days. The SEC also introduced the maximum weighted average life (WAL) of a money market fund to 120 days. For purposes of calculating WAM and WAL, cash is deemed to have a maturity of 1 day, and extendable notes that are extendable at the option of the issuer must use the stated final maturity date.

The Effect:

Reducing the WAM on all funds to 60 days will not increase the likelihood of a money market fund being able to maintain a stable $1 NAV during interest rate movements or market shocks. Many industry experts believe that the effect of this amendment will reduce the yield by over 5 basis points.

<u>Portfolio Liquidity</u>

Revised SEC Rule:

Taxable money market funds must have a minimum of 10% of their assets in cash, US Treasury securities, or securities that convert into cash within one day. All funds must have at least 30% of their assets in cash, US Treasury securities, specific US instrumentalities with remaining maturities of 60 days or less, or securities that convert into cash within one week. The SEC also amended Rule 2a-7 to prevent a fund from investing more than 5% (down from 10%) of the portfolio in illiquid securities.

The Effect:

Many industry analysts believe that the daily and weekly liquidity requirements will not be sufficient in times of duress and/or volatility. For example, The Reserve Primary Fund had $62 billion in assets on September 16, 2008. By Friday, September 19, the Fund received roughly $60 billion in redemption requests (approximately 97% of the total portfolio). Obviously the magnitude of the run would have exceeded any additional liquidity requirement. Forcing funds to have 30% of their portfolio mature within one week could result in portfolio managers emphasizing a barbell strategy. This could lead to greater risks associated with interest rate movements and liquidity.

<u>Disclosure of Portfolio Securities</u>

Revised SEC Rule:

By no later than the fifth business day of each month, the fund must post on its web site a detailed schedule of investments, as of the last day of the prior month. Also, by no later than the fifth business day of each month the fund must file Form N-MFP with the SEC, as of the last business day of the prior month. Results from this report will produce a "shadow" NAV calculation (mark to market) that will be disclosed by the SEC to the public with a 60 day lag.

The Effect:

The shadow price is comparing the amortized cost net asset value to the mark-to-market net asset value of the portfolio. Very rarely will a money market fund have an actual pricing of a $1 NAV. By posting a "shadow" NAV, some industry experts believe that this can lead to confusion and unintended consequences. People who are responsible for managing cash might have to explain why they are in violation of their investment policy (as the NAV of the fund will most likely not be $1 per share) which could possibly lead to investors redeeming their position. Also, by posting the "shadow" NAV on a 60 day

lag, it does not provide investors with an accurate barometer of the current value of the securities within the money market fund.

Monitor Shareholder Concentration

Revised SEC Rule:

"Know Your Investor" protection. Money funds are required to monitor and identify large shareholders whose activity may pose liquidity problems for the fund.

The Effect:

One of the fundamental problems with money market funds is that it there are pooled investment vehicles in which one shareholder can adversely affect all the other shareholders in the fund. Unexpected redemptions from a large shareholder can have a serious impact to not only the performance of the fund but liquidity as well. If you get a few large shareholders who want to redeem at the same time, it could have a potential devastating impact on the overall fund itself. Identifying large shareholders alone will not protect the integrity of the fund.

Periodic Stress Test

Revised SEC Rule:

Money funds are required to test the fund's ability to maintain a stable NAV under certain hypothetical events, such as increases in short-term interest rates, an increases in shareholder redemptions, downgrades or defaults of portfolio securities, or widening or narrowing of spreads between yields on appropriate benchmarks selected by the Fund for overnight interest rates and commercial paper, and other types of securities held by the Fund.

The Effect:

Most money funds had already been performing stress tests as a normal course of business and they have proven to be useless. What we have learned over the past 20 years is that nothing more than a rising interest rate environment and a little bit of volatility has lead to many money market funds needing support from their sponsor to keep the fund at a constant $1 NAV.

Processing Transactions

Revised SEC Rule:

Money market funds and/or their transfer agent must be able to have the ability to process transactions at a price based on the fund's current net asset value, not just $1 per share.

The Effect:

There is a significant cost for money market fund providers to adhere to this requirement which could lead to even more money market providers closing their funds.

Purchases by Affiliates

Revised SEC Rule:

The amendment will expand the ability of affiliates of money market funds to purchase distressed assets from the funds in order to protect them from losses.

The Effect:

There is no binding contract that states an affiliate will support a fund. The benefits of this rule are far from certain.

Fund Liquidation / Suspension of Redemptions

Revised SEC Rule:

The fund's Board of Directors will be able to suspend redemptions or liquidate the fund without SEC approval. It is not necessary for the fund to actually "break the buck" before the Board decides to suspend redemptions.

The Effect:

The SEC's intention is to reduce the devastating effects of a run on a fund and minimize the potential disruption to the overall financial markets. But in reality, investors losing access to liquidity in a specific Fund could lead to a downward spiral trend that will possibly have negative consequences on the overall financial markets (just like what we saw in September 2008). Investors, whether they are retail or institutional will not have access to their funds and companies that depend on money market funds to fund themselves would not be able to raise capital. On top of that, one of the primary reasons why investors use money market funds is because of the liquidity they offer. If funds now have the ability to halt redemptions without advance notice, institutional investors will lose their appetite for using money market funds as a cash management tool and move to alternative vehicles.

Conclusion to Amendments to Rule 2a-7

The amendments to Rule 2a-7 will not make money market funds "safer" and less susceptible from to a run. The issue that money funds need to address to make them "safer" and less susceptible to a run is the mismatch of assets and liabilities (meaning money funds have assets that go out 13 months, 24 months for floating rate product, while providing daily liquidity) and the utilization of a stable NAV (in times of duress, securities in the fund could be below amortized cost which would lead to the Fund breaking the buck). The end result to the amendments to Rule 2a-7 will only lead to greater costs and additional risks for money fund sponsors. Those increased costs and risks, along with additional regulatory uncertainties, will lead many sponsors to exit the space which will result in further concentration in an already highly concentrated business (as of 12/31/2009, the top 20 money fund firms managed 94% of all institutional

money market assets). So in the long term, the amendments to Rule 2a-7 which were originally approved to calm investors' fears, could actually result in the demise of the $3 trillion industry.

One Solution to Money Market Funds

The idea of utilizing Separately Managed Accounts (SMAs) as a component of one's cash and liquidity management strategy has grown significantly over the past couple of years. It is important to note that money market funds and SMAs are similar in one specific aspect: investors hire professional investment managers to manage their portfolio.

The most significant distinction between a SMA and a money market fund is ***ownership***. While this may sound trivial, it offers investors many benefits that are not possible with a money market fund. Plus, it addresses many of the key concerns the SEC has with money market funds. With a money market fund, investors own shares of a pool of securities with many other investors. The fund is managed based on the investment objectives and guidelines stated in the prospectus. The performance and liquidity of the fund can be adversely affected by other investors in the fund. With a SMA, investors actually own the underlying securities that make up that specific portfolio. The portfolio is managed based upon the unique objectives and guidelines of each individual investor. Plus, the performance and liquidity of your portfolio will not be compromised by any other investor.

One key benefit of a SMA is that it offers investors with complete ***customization***. Portfolios are constructed based on investors own specific guidelines that can address various metrics: duration, maturities, types of securities, liquidity requirements, minimum ratings etc. With a money market fund, it is impossible to have the portfolio manager manage the fund based on the specific guidelines for each investor. This gives investors greater control on how they want their money managed.

Another advantage of a SMA is ***transparency***. Investors have the ability to monitor their portfolio on demand. As all investment managers know, transparency is the foundation of making informed investment decisions. SMAs allow investors to make timely investment decisions should there be an issue in the marketplace. With money market funds, lack of transparency has been a major issue. To address that, one of the amendments to rule 2a-7 states that money market funds must publish holdings on a monthly basis. While having holdings available on a monthly basis is an improvement, it is still nearly impossible for investors to address any type of credit issue in a timely manner.

SMAs also provide investors with customized ***reporting***. Reporting can be unique to each investor based on their specific needs and requirements. Those reports can be sent out on demand. Money market funds cannot offer unique reporting for specific investors.

Finally, one of the other key advantages is ***performance***. SMAs have the potential of significantly outperforming money market funds. The investment guidelines of money market funds are limited to SEC rule 2a-7. SMAs are not constrained by rule 2a-7. This allows for greater flexibility from security selection, yield curve positioning, duration limitation, etc. which all lead to the potential for much greater returns over a money market fund.

Separately Managed Accounts are a great compliment to any institution's cash management strategy. The process of creating a SMA can take up time and resources but the end result is worth it. A unique portfolio is created based on one's specific goals and objectives that cannot be adversely affected by any other investor. This provides for greater control, greater transparency, better reporting and the ability to enhance the overall performance of any portfolio.

Vanderbilt Research Team