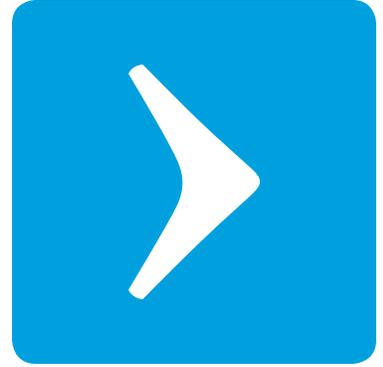


## Money Market Reforms: The Next Chapter Unfolds

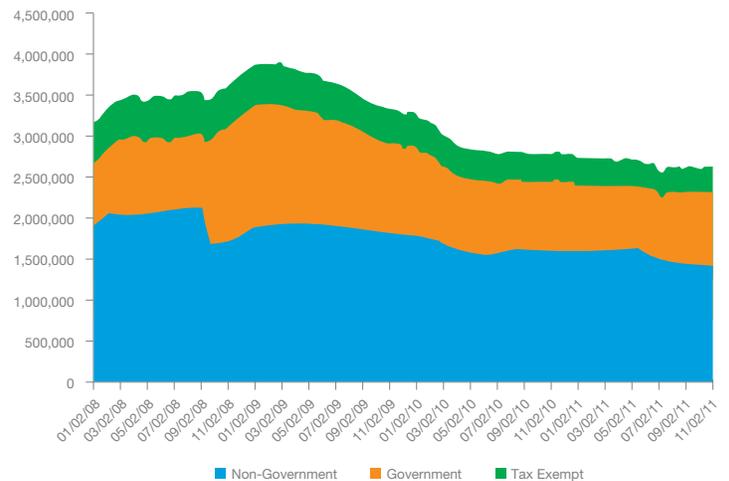


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The money market fund (MMF) industry remains a systemically important industry that addresses the liquidity needs of investors. MMFs have been in existence for nearly four decades with few challenges to liquidity or principal. Today, industry assets under management stand at just under \$2.7 trillion, down significantly from the “panic peak” of \$4 trillion in 2009.

Not only do these funds serve as important investment vehicles, but they also function as major sources of liquidity for businesses, financial institutions and governments. Until recent years, many viewed all cash investments as low return, low risk options. Today, we have a high degree of regulatory activity in the money market fund space with regard to the operation of these funds subsequent to the wide ranging regulatory changes in 2010. The regulatory changes instituted in 2010 made the MMF industry a safer space in which to invest. Further regulatory action designed to increase the safety of the industry is likely to come into play in 2012, but the devil is in the details. Significant thought and deliberation is necessary to ensure that the MMF industry continues to thrive.

Money Market Funds AUM



## Chapter One Implemented

In early 2010, the SEC introduced significant changes to Rule 2a-7 designed primarily to further strengthen the resiliency of MMFs. Key changes included more restrictive maturity limits, establishment of new daily and weekly liquidity requirements, higher credit quality standards and additional reporting that provides more transparency to investors. Many of these reforms have been in effect for over a year now and most MMFs operate well within the new boundaries.

One unfortunate side effect of these changes is a more homogenized asset class, which could actually increase the systemic risks to the overall markets. MMFs are now less differentiated due to the restrictions imposed on them. The limited supply of short-term high quality investments — a side effect of the economic downturn — is exacerbating the problem today. As a result, MMF portfolios look increasingly similar from fund to fund with little room for variance in portfolio holdings due to the tight restrictions.

	New Regulation	Previous Regulation	Primary Rationale	Compliance Deadline
<b>Maturity Limits</b>	60-day maximum weighted average maturity (WAM)	90-day maximum WAM	Limits funds' exposure to interest rate risk	6/30/2010
	120-day weighted average life (WAL)	No requirement	Limits investments in long-term floating rate securities	6/30/2010
<b>Liquidity</b>	10% of assets must meet daily liquidity standard	No requirement	Ensures sufficient liquidity available to meet redemptions	5/28/2010
	30% of assets must meet weekly liquidity standard	No requirement	Ensures sufficient liquidity available to meet redemptions	5/28/2010
	"Illiquid" securities limited to 5% of portfolio	10% limit	Ensures sufficient liquidity available to meet redemptions	5/28/2010
<b>Credit Quality</b>	Limits purchase of second tier securities* to 3% of fund's assets	Limits purchase of second tier securities to 5% of fund's assets	Lowers exposure to less credit worthy securities	5/28/2010
	Limits exposure to any single second tier security to 0.5% of fund's assets	Limits exposure to any single second tier security to 1% of fund's assets or \$1 million	Lowers exposure to less credit worthy securities	5/28/2010
	Limits maximum maturity of second tier securities to 45 days	Maximum maturity of second tier securities is 397 days	Lowers exposure to less credit worthy securities	5/28/2010
<b>Disclosure</b>	Monthly website postings of portfolio holdings information	No requirement	Provides greater transparency to investors	10/7/2010
	Monthly detailed portfolio schedules including "shadow" NAV reporting to SEC, available to public on a 60-day delay	Semi-annual shadow NAV (the mark-to-market value of the fund's net assets reporting to SEC)	Provides greater transparency to investors	12/7/2010

*\*Second tier securities are eligible securities that, if rated, have received a rating other than the highest short-term debt rating from the requisite NRSROs or, if unrated, have been determined by the fund's board to be of comparable quality*

## Chapter Two – What’s Next?

The SEC has been working with the Financial Stability Oversight Council to evaluate options to address the next reform for MMFs now that the first set of reforms has been announced. The Financial Stability Oversight Council (FSOC) created under the Dodd-Frank Act, is a collaborative body chaired by the Secretary of the Treasury and consist of various federal financial regulators, state regulators and an insurance expert with the mandate to identify risks and respond to emerging threats to financial stability. A range of feedback has been put forth by various industry participants on proposed changes and the next wave of reform proposals will be announced fairly soon.

The next announcement has been long-awaited since the SEC’s last request for comments on President’s Working Group Report on MMF Reform in January 2011. SEC Chairman Mary Schapiro, in her remarks during the Securities Industry and Financial Markets Association Annual Meeting in early November 2011, indicated that the SEC would share a MMF reform proposal soon.

### Floating NAV – Investors Experience Market Movements

A strong contender for one of the many reforms has emerged recently from the SEC. Floating the Net Asset Value (NAV) was a previously unthinkable proposal given challenges such as the record-keeping, legal and operational burden it creates. In fact, 67 percent of treasury managers in the JP Morgan Asset Management Global Liquidity Investment Survey 2011 indicated that they would not invest in floating NAV funds if stable NAV MMFs are no longer available due to regulatory changes. However, as regulators focus more on systemic risk such as possible fund runs, these challenges are being outweighed by a desire to ensure the stability of the fund industry. The question now is how extensive the floating NAV proposal will be.

Imposition of the Floating NAV standard would result in investors having to account for the NAV of the MMFs based on real-time mark-to-market levels, instead of the current stable NAV method where the funds account for the value of fund investments based on an amortized cost basis.

The SEC argues that a floating NAV would reinforce the perception of ownership of shares of an investment that are not a guaranteed product and are subject to credit and market risk. However, the SEC appears to be sympathetic to the fact that the floating NAV potentially would deprive investors of access to a stable “cash” investment that has met many of their needs. As such, the SEC would favor an orderly transition from stable NAV to floating NAV.

We believe that it is unlikely that the floating NAV standard would be imposed across the board due to the dissimilarities between each sub-class of MMF. Should it be imposed, it is likely that the standard would be combined with other enhancements such as the establishment of capital solutions.

### Capital Buffer – “Cash” Investors Retain Stable NAV

Under the capital buffer proposal, the fund sponsor would create a subordinated class in the fund structure as a loss absorption cushion. In the event of market disruption or credit event, investors could take comfort that the first loss would be absorbed by the capital buffer prior to impacting the “senior” MMF investors. A capital buffer would further constrain yield, depending on the level of buffer required. It may be economically challenging for the fund sponsors to continue to manage a fund that requires a capital buffer, especially in the current historic low or “no yield” environment.

One potential scenario is for fund complexes to create a subordinated floating NAV capital class in the funds that would absorb losses, allowing the senior tranche to retain a stable NAV. The subordinated capital class may be either subscribed to by the fund managers or sold to external investors. Funds that opt out of the capital solution may be required to adopt the floating NAV standard. There is also the possibility that such proposals may only be limited to “prime” or corporate MMFs.

## Redemption Restrictions Minimize the Risk of Disorderly Run

Another proposal on the table is the combination of capital buffers together with redemption restrictions. Redemption restrictions could be placed once capital buffers are breached to minimize the risk of a disorderly run on the MMFs and to emphasize to investors that money market funds do not guarantee bank-like liquidity. Of course, imposing redemption restrictions works against the second primary objective of cash investors: liquidity.

Other proposals such as back-up liquidity, insurance fund and mandatory redemptions-in-kind appear to be out of favor due to much debate over the difficulty or ineffectiveness of implementing such proposals.

## 2012 Will Conclude the Next Chapter

No matter how the dust settles, we believe regulators would allow fund sponsors and, more importantly investors, time to adjust to any new regulations. Further deliberations, which typically include requests for comments and roundtable discussions, are likely to be held prior to the determination of new regulations.

We at SVB remain highly confident in the safety of the money fund industry and, in particular, of the funds we offer to our clients. In addition, our commitment to keep you informed and provide appropriate advice regarding your investment choices is unwavering.

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