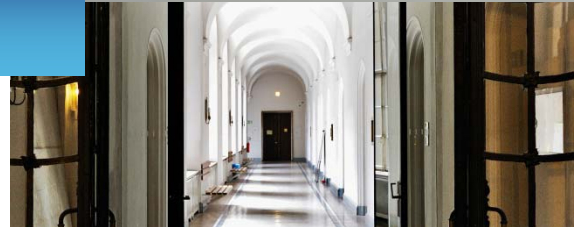


Money Market Funds: A Path Forward



Introduction

Policymakers globally continue to grapple with the regulation of Money Market Funds (“MMFs”) in the wake of the 2007/2008 financial crisis. A seemingly simple product has challenged some of the best regulatory, industry and academic minds, and consensus on a proposal for additional MMF reforms still appears to be elusive. We at BlackRock have been deeply engaged in these discussions and – like others – have worked on numerous proposals for reform based on the lessons learned in 2008. In this *ViewPoint*, we propose a path forward that takes into account the various concerns and objections that have been raised in past discussions. We make three basic proposals that address the concerns of those who believe that MMFs are a systemic risk while preserving the benefits of the product for investors and the short-term funding markets. Importantly, these proposals can be applied to MMFs that are subject to regulation in various jurisdictions globally.



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Summary

We believe that any further change to global MMF regulation must satisfy a two-part test:

1. Preserve the benefits of the product for investors and preserve the functioning of the short-term funding markets; and
2. Provide a mechanism for managing mass client redemptions, or “runs”.

We propose the following regulatory changes which satisfy the two-part test above:

1. **Asset Standards:** establish minimum requirements for asset quality, duration and liquidity similar to those adopted by the SEC for Rule 2a-7 in 2010;
2. **Disclosure:** establish consistent and robust standards for disclosure of investment strategies and accounting treatment of holdings; and
3. **Circuit Breakers:** Require MMFs to have Standby Liquidity Fees (SLFs). Triggered by objective standards, these fees would benefit the remaining investors, thereby discouraging redemptions and reversing the negative spiral of a run.

A two-part test: (1) preserve the benefits of the product for investors and the short-term funding markets and (2) provide a mechanism for managing “runs”

We believe that any proposed further regulation of MMFs must pass two basic tests. First, it must preserve the core benefits of the product. The benefits to investors in MMFs are well known: diversification, ease of operation and accounting, and market competitive returns. But what is often overlooked are the benefits to borrowers in the capital markets (e.g., issuers of commercial paper, certificates of deposit and sovereign and supranational securities). Looking at MMFs solely as “shadow banks” misses this point; MMFs are better considered as a form of market finance¹.

Market finance produces important benefits for lenders. For example, in times of market stress, banks are quick to reduce lending, especially interbank, and outside of national borders. MMFs can provide a more stable, cross-border source of funding that is able to respond rapidly and in a market-based manner to the needs of borrowers (for example, through reverse enquiries for financing). In sum, both banks and MMFs are key components of the short-term funding markets. To rely solely on the banking system in this area would both increase risk for investors and raise funding costs for issuers.

The second test for further regulation of MMFs is that it must address the issue of “runs”. There is no question that in 2008 – for the first time in history – “Prime MMFs” (US MMFs that are not limited to holding only exposure to US Agencies/Treasuries) experienced unprecedented redemption demands, coupled with a complete failure of market liquidity as investors fled any exposure to banks and mortgage securities. The events of September 2008 created a significant contraction of credit and were part of the broader global financial crisis. As a result, any successful MMF reform must address this scenario – massive client redemptions.

Most ideas on the table today fail the two-part test

The recent SEC proposals. The proposals recently considered by the SEC were to add continuous redemption holdbacks and capital requirements to MMFs. Under those proposals, redeemers from MMFs would leave behind a fixed percentage of their deposit, which would only be returned after a delay. This would be in force even during times of normal functioning in the markets. These ideas fail both parts of our test. First, the proposals would have destroyed the MMF industry. In our discussions with our US MMF clients, they uniformly told us that they would abandon the product if the SEC proposals were implemented. Many current managers of MMFs and their service providers would not have undertaken the expensive operational work required to deliver the product because it was unclear that an industry would exist afterward.

Second, it was not clear that the proposals would have reduced the risk of mass redemptions. Clients in our research told us that the punitive nature of the holdback would make them more likely to redeem, if they invested at all, and they would do so sooner in order to secure their investment before market stresses took hold. In short, the SEC proposals were fundamentally flawed and failed to win Commission and industry support. They would have caused a major contraction in short-term funding without solving the core issue of mass redemptions.

Converting from Constant Net Asset Value (CNAV) to Variable Net Asset Value (VNAV). Another idea often discussed is to do away with CNAV accounting for MMFs. Our research suggests that this would change but would not destroy the industry; indeed, both CNAV and VNAV products are offered and are successful in Europe. If CNAV funds were eliminated, we believe the industry would contract significantly but would survive in reduced form. However, this idea fails the second of our two tests – it will not solve the problem of mass redemptions. Both CNAV and VNAV funds experienced substantial redemptions during the 2007/2008 financial crisis. The safety of MMFs is driven fundamentally by three things: the quality of the assets in the funds, the duration of those assets and the amount of available liquidity held in the funds. CNAV versus VNAV merely relates to the accounting treatment of the calculation of the NAV of the fund. Economists speculate about the potential first mover advantage of CNAV versus VNAV, but in our experience, clients decide to leave the fund based on their assessment of the quality of assets, duration of assets and liquidity levels and whether those are deteriorating in an unusually dramatic way. The “run” on prime MMFs in 2008 did not represent fears of investors regarding the pricing structure of one type of MMF, but rather their concern regarding the creditworthiness (that is, solvency) of financial institutions in which the MMFs had invested. Even in a pure floating VNAV fund, clients will run for the exits if they believe that those NAVs will be substantially (and perhaps irreparably) worse in the future.

The CNAV/VNAV debate is further confused by the fact that the terms are used in an imprecise manner. We believe there are actually three types of funds:

- ▶ CNAV funds maintain a constant NAV based on accounting treatment that permits them to round the value of fund holdings to the closest full value, i.e., (in the case of US funds) to \$1. The validity of this rounding is tested regularly by marking all the assets to market. Clients in a number of jurisdictions, including the US, UK, continental European countries (such as Germany, the Netherlands, and Switzerland) as well as Asia, find this extremely attractive. This is not because they falsely believe it carries some form of guarantee. They find it attractive for transactional reasons in that it eliminates taxable gains and losses on each trade (for those clients subject to such treatment) and facilitates sweeps and other transactions.

¹ We use the term “market finance” to refer to the broader set of activities often included in the “shadow banking” discussion such as MMFs, securities lending, repo, ABCP and hedge funds. The terms “bank finance” and “market finance” reinforce the complementary roles of both in financing the real economy.

- ▶ Floating NAV funds sell and redeem their shares at the true mark-to-market value every day. These funds would inconvenience those clients who are subject to tax-lot accounting². They do not eliminate the risk of a run because the NAV of these funds generally oscillates in a tight range of +/- 10 bps around par for 99.9% of the time. When a market crisis that tests the solvency of banks hits, the funds' NAV can fall out of this "normal" range, leading to significant redemptions. Clients will redeem from floating NAV funds whenever they believe the NAV is declining in an unusual manner and will likely be worse in the future. We believe that if the US had floating NAV funds in 2008, the run would have spread faster to a broader set of clients.
- ▶ A third type of fund is used in a number of European countries and is the prevalent form of MMF in France. These hybrid VNAV funds principally use a combination of mark-to-market accounting, model-based accounting and/or amortized cost accounting to determine the value of assets. Such hybrid VNAV funds reflect in part the paucity of market pricing in short maturity Euro instruments, such as CP and CD under 1 year, making pure floating VNAV funds difficult to manage. Hybrid VNAV funds offer accumulating shares. Interest earned is added to the value of shares as this is the most tax efficient approach in some countries, although retention of earnings is not permitted in many other markets. The result is shares that are indeed variable, but they are almost always rising. These funds are susceptible to runs if their shares begin to behave in an unusual way (e.g., by ceasing to accumulate).

While it is tempting to believe that a simple change in accounting treatment is all that is needed to provide run-protection for this industry, none of these types of funds is insulated from runs. Each type has its pros and cons but none passes the second of our two tests, the need to be more resilient to significant client redemptions. As discussed above, a major regulatory change focused on VNAV will be expensive, time consuming, and ultimately will not achieve the goal of reducing systemic risk.

Capital Requirements. BlackRock was one of the first firms to seriously consider the value of adding a capital requirement to MMFs. We continue to support the idea that sponsors should be able to set aside some reserves in a tax-efficient manner for a "rainy day" to be used in support of their funds. We also considered in depth the proposal of academic economists for the use of subordinated capital in MMFs, although in the end this idea proved impractical. While capital might make MMFs

marginally safer, it will not solve the core issue regulators are trying to address: runs. One of the problems with capital in MMFs is that in almost all conceivable scenarios, it will either be unnecessary or insufficient. For idiosyncratic events, most sponsors have historically had sufficient access to capital to protect their funds. For true systemic market failures, the amount of capital necessary to fully protect the funds would be so large as to destroy the commercial viability of the product.

A Path Forward

Having now spent considerable time engaged in the debate on MMF regulatory reform, we have identified three regulatory steps that pass our two-part test of preserving the benefits of the product and answering the challenge of "runs". Upon reflection, we realize that the term "shadow banking" may have diverted attention from the real issues. It implied that MMFs are best understood as a kind of bank and therefore bank-like solutions should work³. But when we focused on MMFs as a form of market finance, this led us to consider ideas that have helped to ensure the robustness and safety of markets: *asset standards*; *disclosure*; and *circuit breakers*.

Based on this concept, we recommend the following steps be taken by global regulators with appropriate tailoring to local markets:

1. **Consistent Standards for Asset Quality, Duration and Liquidity.** Regulators should set clear standards that would apply to all funds that are sold to the public, whether institutional or retail investors, and whose primary goal is preservation of capital. A good test is whether the fund receives cash equivalent accounting treatment in the local jurisdiction. The SEC's update of Rule 2a-7 in 2010 provides a useful model. Regulators should make those or similar standards global, with appropriate allowances for local customs and accounting practices. These standards should work whether the funds are set up with CNAV, floating NAV or hybrid VNAV accounting conventions.
2. **Enhanced Disclosure.** Require all MMFs to be very clear about the standards to which they are managed and the accounting treatment they deploy. Ideally regulators would agree on a common vocabulary (similar to food labeling) by which all clients could really understand a) what standards guide the assets, b) how the accounting treatment works, and c) how the circuit breakers described below could be implemented in a crisis.

² "Enhanced MMFs" in Europe were a further form of floating VNAV funds. Many invested substantially in long dated ABS and MBS (asset-backed and mortgage-backed securities) and experienced significant redemptions starting in August 2007. Following the issuance in May 2010 of the ESMA Money Market Fund Guidelines, such funds may no longer bear the label 'MMF'. BlackRock discussed these issues in greater detail in a ViewPoint issued in July 2010.

³ In a BlackRock ViewPoint issued in January 2011 we proposed treating MMFs as special purpose banks that would hold capital and have access to the Fed's discount window. Regulators rejected the idea that MMFs should have access to the discount window. Unfortunately, solutions that would regulate MMFs as banks but not allow the same access to the Fed window are not workable.

Figure 1: SEC Enhancements to Rule 2a-7

The SEC published regulations for money market funds in 1983 to define and standardize the asset class. The regulations are known as Rule 2a-7 and were enhanced in May 2010. Those changes can be summarized as follows:

Credit Quality	<ul style="list-style-type: none"> ▶ Reduced exposure limit for second-tier securities.^a ▶ Funds not permitted to acquire second-tier securities with remaining maturities of > 45 days.
Diversification	<ul style="list-style-type: none"> ▶ More restrictive single-issuer limits. ▶ More restrictive collateral requirements for repurchase agreements qualifying for “look-through” treatment.
Liquidity	<ul style="list-style-type: none"> ▶ Reduced exposure limit for illiquid securities.^b ▶ At least 10% of total assets in Daily Liquid Assets^c (not applicable to tax-exempt funds). ▶ At least 30% of total assets in Weekly Liquid Assets.^d
Maturity	<ul style="list-style-type: none"> ▶ Reduced Weighted Average Maturity (WAM) limit. ▶ Weighted Average Life (WAL) calculated without reference to any provision that would permit a fund to shorten the maturity of an adjustable-rate security by reference to its interest rate reset dates.
Portfolio Stress Testing	<ul style="list-style-type: none"> ▶ Performance of stress testing (simulated shocks such as interest rate changes, higher redemptions, changes in credit quality of fund) as required by new policies and procedures adopted by the fund Board.
Transparency	<ul style="list-style-type: none"> ▶ Monthly disclosure of all portfolio holdings on the fund’s website. ▶ Monthly filings of portfolio holdings and additional information (“shadow” NAV) with SEC.
Additional Board Powers	<ul style="list-style-type: none"> ▶ Fund Board permitted to suspend redemptions and postpone payment of redemption proceeds if a fund will “break the buck” and if the fund will irrevocably liquidate.

^a A second-tier security is defined as a security rated in the second-highest short-term rating category by rating agencies.

^b An illiquid security is defined as one that cannot be sold or disposed of in the ordinary course of business within 7 calendar days at approximately the value ascribed to it by the fund.

^c Daily liquid assets include cash, US Treasury securities, and securities readily convertible to cash within 1 business day.

^d Weekly liquid assets include daily liquid assets (convertible to cash within 5 business days rather than 1) as well as US government agency discount notes with remaining maturities of 60 days or less.

3. Circuit Breakers. Build in circuit breakers to all MMFs to limit runs in the time of a crisis. We believe these should take the form of stand-by liquidity fees (SLFs). We recommend these have the following features:

- a) Objective triggers. The SLFs would not be active during times of normal market functioning. They would be triggered when a fund has fallen to half the requirement for NAV rounding or to one quarter the required liquidity levels based on the standards set above. In the case of US Rule 2a-7 MMFs, this means that the SLFs would be triggered when the fund fell below a mark-to-market NAV of 99.75 or when its 1-week liquidity fell below 7.5%.
- b) The amount of the fee is a simple calculation. We recommend the amount of the fee charged when the SLFs are in force to be twice (2x) the difference between the mark-to-market NAV and \$1. As an example, if the mark-to-market NAV fell to 99.70%, the fee would be 60 basis points (30 bps x 2). The rationale for this fee is to create a positive cycle as clients redeem in place of a negative cycle. As each client redeems and leaves behind twice the deficit, the NAV for the remaining shareholders is strengthened. In a run today, redeeming shareholders can weaken the fund as they leave and the NAV begins to spiral downward further accelerating the run. With SLFs in place, the NAV would improve as people who leave are charged a fee, which would create a natural brake on a run, and investors remaining in the fund would be protected from the behavior of those who redeemed.

- c) Let clients choose. The SLF model gives clients a choice in a crisis, based on straight-forward economic incentives. Clients that truly need liquidity (e.g., to meet the payment of salaries and pensions) can get it, but they must pay a price for it. If a client can wait for their liquidity, they can attempt to preserve the value of their shares by staying put and redeeming once the SLFs are lifted. This is a model similar to the one BlackRock employed in working with the State of Florida on a government cash pool that was experiencing mass redemptions in 2007.
- d) Closure to redemptions. Fund boards should have the right to close funds to redemptions in extreme circumstances, as they currently do in the US. Fund Boards should also be given the discretion to end the SLFs after an appropriate recovery of the fund, and after a determination that it is in the shareholders’ interests to do so.
- e) Payment to clients that stayed. Any amount of liquidity fees gathered by the fund would be retained in the fund to restore the NAV to \$1 (or par). If there were an excess liquidity fee in the fund, it would be paid to all shareholders of record on the last day in which the SLFs were in force. This way, those shareholders that stayed with the fund in the difficult time, as well as those who invested or reinvested and thereby helped “boost” the fund, would receive a benefit for the risk they took.

Conclusion

Finding a solution to money market fund reform has been elusive. We continue to search for a workable solution that meets the needs of investors, issuers, policy makers, and MMF sponsors.

The three steps outlined above would pass our two-part test for the regulation of MMFs. While many clients may initially object to the idea of SLFs, and the industry will initially contract (perhaps substantially at first), we believe clients will adjust. Those that simply cannot tolerate any form of liquidity limits will favor government MMFs. Others may choose to use government MMFs for some portion of their assets and Prime

MMFs subject to liquidity fees for their longer term cash. The SLFs will also encourage fund managers to deal with potential problems sooner, to avoid tripping a SLF trigger. Borrowers from MMFs (e.g., issuers of commercial paper) will continue to use MMFs but will limit their reliance to ensure other sources of funding.

The changes proposed in this paper will preserve the industry in providing its important function in the short-term capital markets. And, this approach will create an effective brake on a run by introducing a mechanism that requires runners to pay for the cost of their liquidity plus an increment to protect clients that do not redeem.

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