Regulators Skip Vote on Money Market Fund Reform

How to Mitigate Shareholder Risk When the SEC Won't

Introduction

Since late 2008, when the $3.5 trillion money fund industry was left reeling in the wake of the Reserve Primary money market fund's failure, a number of regulators have warned against systemic risks that institutional money market funds still pose to the financial system. In September 2008, as the tidal wave of news spread about potential exposures to Lehman Brothers, terrified money market fund investors incited an exodus from prime funds that likely would have led to many more fund failures. The Treasury Department intervened to stop the run with a full guarantee of the $1.00 net asset value of all registered money funds for a period of 12 months. Dodd-Frank makes future rescue efforts more difficult, which amplifies the importance of averting future panics.

SEC Chairwoman Mary Schapiro recognized this and has worked on additional modifications to reduce the risk of shareholder runs for several months, but in late August, as it became clear that Shapiro lacked the necessary votes for passage, a planned vote on her recommendations for additional reform was cancelled. The largest money market fund companies spent at least $16 million in the first half of 2012 to lobby against further reforms[1], and their efforts appear to have worked – the risk that investors could repeat the exodus of September 2008 during a crisis is largely undiminished. The Financial Stability Oversight Council or the Fed may still have something to say on the matter, but in the meantime, there are measures that investors can take on their own to reduce shareholder risk.

Treasury Funds

Some cash investors fled prime money market funds in favor of government funds to reduce risk exposure, and have remained in government funds ever since. It is important to note, however, that the panic in 2008 was not isolated to funds that held Lehman debt; most funds had been avoiding Lehman exposures for some time. The stampede for fund redemptions in 2008 highlighted the inherent unpredictability of shareholder activity – the most conservatively managed prime funds were impacted by the run, as well. Credit quality of fund holdings had little to do with interruptions in access to liquidity; redemptions were halted on all 18 of the Reserve's money market funds in September 2008, *including their government funds*. Many other Treasury money market funds closed their doors to new investors in the wake of the Lehman collapse due to the precipitous drop in

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Treasury Bill yields. In 1994, long before the Reserve failure, the Community Bankers U.S. Government money market fund broke the $1.00 NAV. Unfortunately, it's clear that shifting to a fund with a more conservative credit profile does not eliminate shareholder risk.

Separately Managed Accounts

Until a regulatory body confronts the potential for shareholder runs in a meaningful way, investors are on their own to monitor shareholder risk. Individual shareholders can't hope to control the collective behavior of a fund's investors, but an investor can reduce total shareholder risk through direct security purchases. Investments in a segregated, bankruptcy-remote custody account in the investor's name do not share liquidity with other investors, access to accounts can't be interrupted by other investors' behavior and the custodian's creditors can't access the account in the event of a bankruptcy.

The chart below gives us a current snapshot of Treasury note yields maturing within 13 months, the maturity limit that the SEC's Rule 2a-7 imposes on investments held in a registered money market fund:

30 days	0.10%
60 days	0.10%
90 days	0.12%
120 days	0.13%
150 days	0.15%
180 days	0.15%
210 days	0.16%
240 days	0.17%
270 days	0.18%
300 days	0.19%
330 days	0.19%
360 days	0.21%
390 days	0.22%
Average:	0.16%

Source: Bloomberg, as of 8/27/12

Under current 2a-7 requirements, money market funds must maintain weighted average maturities (WAMs) of less than 60 days. In years past, however, average maturities were considerably longer. Until 1991, WAMs were restricted by Rule 2a-7 to 120 days, and, from 1991 to 2010, WAMs were limited to 90 days. Since 2010, the SEC has further limited WAMs to 60 days in an effort to limit the effects of shareholder runs.

Direct purchases of the same Treasury bills and notes that are commonly held in a comingled fund would obviate the risk of a run, as there is just one shareholder in control. With this in mind, a portfolio comprised of direct investments in Treasury bills and notes maturing within 13 months could maintain a longer WAM than the current 60-day maximum and still fit the spirit of the SEC's money market fund rules, as the 60-day maximum was enacted specifically to help minimize the impact of shareholder runs.

Average portfolio yields of an evenly-laddered Treasury portfolio with a WAM between 90 and 180 days are likely to average 12 to 15 basis points (as of 8/27/12):

Average Yield:	0.12%	
WAM:	**90 Days**	
U.S. Treasury Note, maturing	9/30/2012	0.10%
U.S. Treasury Note, maturing	10/31/2012	0.10%
U.S. Treasury Note, maturing	11/30/2012	0.12%
U.S. Treasury Note, maturing	12/31/2012	0.13%
U.S. Treasury Note, maturing	1/31/2013	0.15%

Average Yield:	0.15%	
WAM:	**180 Days**	
U.S. Treasury Note, maturing	9/30/2012	0.10%
U.S. Treasury Note, maturing	10/31/2012	0.10%
U.S. Treasury Note, maturing	11/30/2012	0.12%
U.S. Treasury Note, maturing	12/31/2012	0.13%
U.S. Treasury Note, maturing	1/31/2013	0.15%
U.S. Treasury Note, maturing	2/28/2013	0.15%
U.S. Treasury Note, maturing	3/31/2013	0.16%
U.S. Treasury Note, maturing	4/30/2013	0.17%
U.S. Treasury Note, maturing	5/31/2013	0.18%
U.S. Treasury Note, maturing	6/30/2013	0.19%
U.S. Treasury Note, maturing	7/31/2013	0.19%

Source: Bloomberg, as of 8/27/12

As of July 31, the 15 largest institutional government money market funds had weighted average maturities that averaged 46 days and yielded an average of 0.01%. The average expense ratio of the 15 largest institutional government money market funds was 0.16% as of July 31, 2012.[2]

If fees for segregated bank custody accounts and investment management are measurably less than money market expense ratios – and, in CAG's experience, they typically are – allocations to appropriate direct Treasury investments are likely to outperform government money market funds.[3] The larger variety of credit exposures in prime money market funds would make a comparison of prime money funds to comparable direct purchases more tedious than an all-Treasury example, but reductions in shareholder risk and potential for increased returns still would apply.

Conclusion

In an August 24 television interview, former SEC Chairman Arthur Levitt referred to the SEC's failure to support Shapiro's reforms as a "national disgrace."

While last week's cancelled SEC vote failed to temper risks of a future run, we shouldn't forget that comingled investments in registered money market funds maintain a tremendously useful role in the arsenal of the corporate treasurer. Still, irrational and unpredictable investor behavior is almost omnipresent in today's unsettled global economy, preserving a constant challenge in assessing the risk of shareholder runs. We believe that with vigilance and diversification in direct holdings of appropriate securities, the impact of any future shareholder runs may be diminished.

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[1] Bloomberg News, 8/24/12
[2] www.cranedata.com
[3] As of 7/31/12, CAG fees for investment management averaged less than expense ratios for the 15 largest institutional government money market funds.