Money Market Fund Regulatory Changes Post Financial Crisis

2011 Money Market Funds Summit
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Historical Development of Rule 2a-7

- Rule 2a-7 was adopted by the SEC in 1983, providing exemptive relief to allow money market funds to maintain a stable net asset value or price per share.
- The rule was amended in 1986 to facilitate the development of tax-exempt money market funds and was substantially amended in 1991 and 1996 to require all money market funds to comply with a more robust set of conditions to rely on the exemptive relief provided.

Historical Development of Rule 2a-7

- As amended in 1991 and 1996, Rule 2a-7 required money market funds to comply with strict conditions relating to the quality and maturity of investments and to the diversification of investments among issuers.
- **Quality.** All investments were required to be rated in the top two rating categories by an NRSRO or unrated securities of comparable quality. Second tier securities were limited to 5% of a taxable fund's total assets.
- **Maturity.** No investment could have a remaining maturity in excess of 13 months. Average portfolio maturity was limited to no more than 90 days.
- **Diversification.** Taxable and national tax-free funds were limited to no more than 5% exposure per issuer. For single state tax-free funds, this 5% limit only applied to 75% of the fund's total assets. Additional limits applied to demand features and guarantees.

Post Crisis Regulatory Changes - Overview

- In November 2008, ICI formed the Money Market Working Group, which was charged with conducting a wide-ranging study of the money markets, money market funds and recent market events and with making recommendations in response to potential weaknesses in money market fund regulation that were revealed by the 2008 market crisis.
- In March 2009, the ICI Working Group published its Report, making a series of recommendations designed to make money market funds more resilient in the face of extreme market conditions.
- In June 2009, the SEC proposed comprehensive amendments to Rule 2a-7 and other rules governing money market funds. After a comment period in which approximately 120 comments were received, the SEC adopted the amendments in February 2010.
- The amendments were designed to increase the resiliency of money market funds in the face of short-term market risks and to protect investors in a money market fund that breaks the dollar share price.

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Overview of Changes to SEC Rules

- The Amendments to Rule 2a-7 and other rules governing money market funds were both comprehensive and broad-reaching and included changes designed to:
  - Enhance money market fund portfolio liquidity;
  - Shorten the average portfolio maturity of money market funds;
  - Enhance the credit quality of money market fund portfolios;
  - Enhance disclosures to investors; and
  - Otherwise enhance the protection of shareholders, including:
    - Enhancing the ability of sponsors to support money market funds; and
    - Permitting fund directors to wind up money market funds in an orderly manner.

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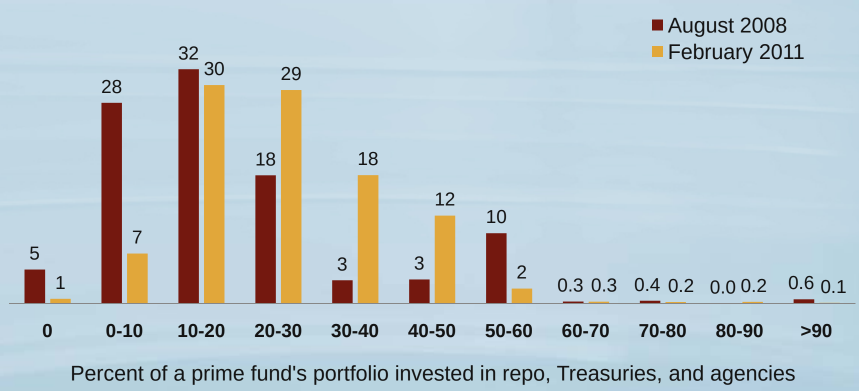
SEC Rule Amendments – Portfolio Liquidity

- **General Requirement.** All money market funds are required to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions.
- **Daily Liquidity.** Taxable money market funds must hold at least 10% of total assets in cash, U.S. Treasury securities, and securities that mature within one day.
- **Weekly Liquidity.** All money market funds must hold at least 30% of total assets in cash, U.S. Treasury securities, certain other government securities that mature in 60 days or less, and other securities maturing within one week.
- **Purchases of Illiquid Securities.** All money market funds are prohibited from purchasing illiquid securities if those securities would exceed 5% of the fund's portfolio (prior law permitted up to 10% in such investments).

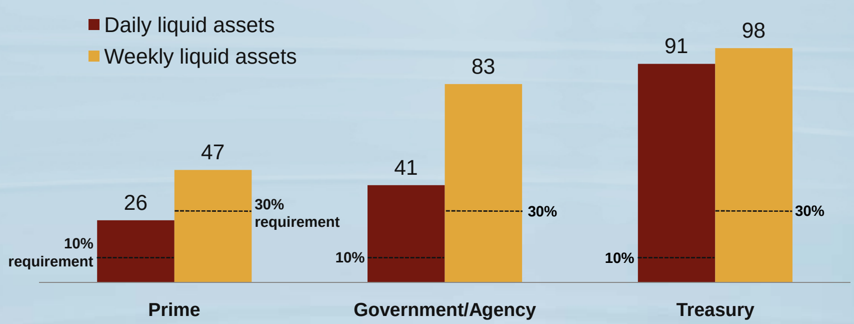
Concentration of Prime Money Market Funds' Assets by Holdings of Repo, Treasury, and Agency Securities



Source: Investment Company Institute

Liquid Assets for Taxable Money Market Funds

Percent of total assets, December 2010



Note: Calculations for daily liquid assets do not include securities subject to a demand feature that is exercisable within 1 business day. Weekly liquid assets do not include securities subject to a demand feature that is exercisable within 5 business days. Weekly liquid assets include all agency securities with remaining maturities of 60 days or less, regardless of whether those securities were initially issued at a discount.
Source: ICI tabulation of Form N-MFP data

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SEC Rule Amendments – Portfolio Liquidity

"Know Your Customer" Procedures.

- To comply with the new portfolio liquidity requirements, money market funds are required to implement procedures designed to identify and monitor the risk characteristics of fund shareholders.
- These procedures must be reasonably designed to ensure that the fund has sufficient portfolio liquidity to meet anticipated redemptions.

Stress Testing.

- Money market fund boards must also adopt procedures requiring periodic "stress testing" of the fund's ability to maintain a stable $1.00 NAV per share upon the occurrence of certain hypothetical events, such as changes in short-term interest rates, increased shareholder redemptions, and downgrades or defaults of portfolio securities.
- Stress testing results are reported to the board at its next meeting (sooner if issues arise) and must include the adviser's assessment of the fund's ability to withstand events that are reasonably likely to occur in the upcoming year.

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SEC Rule Amendments – Portfolio Maturity

- **Weighted Average Maturity ("WAM").** The maximum dollar-weighted average maturity of a money market fund's portfolio was reduced from 90 days to 60 days.
- **Weighted Average Life ("WAL").** Money market funds must now also limit the "average weighted life" of the fund's investments to 120 days. This calculation is made by reference to the fund's right to receive the principal amount of the investment and is measured without regard to the interest rate reset dates of variable or floating rate securities.

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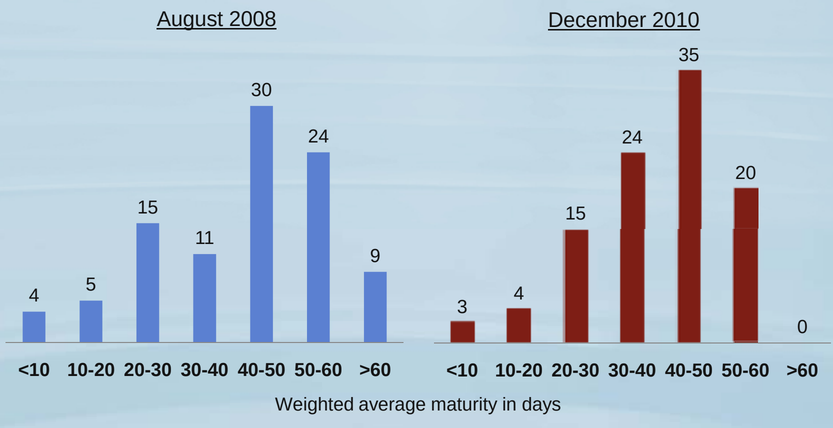
WAMs for Taxable Money Market Funds

Percent of funds



Source: Investment Company Institute

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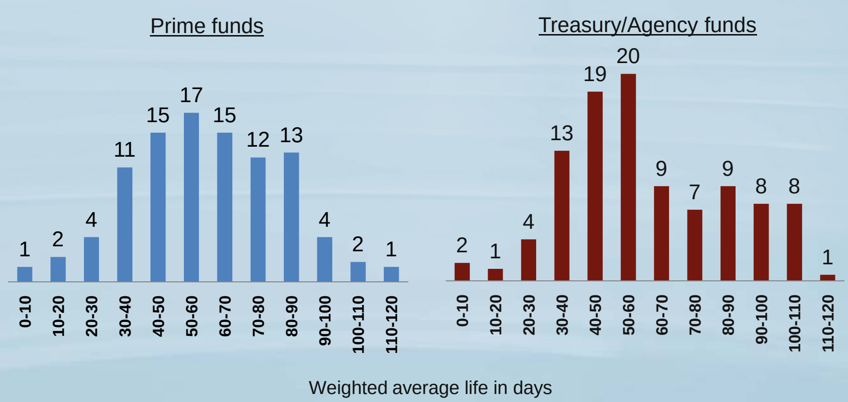
WALs for Taxable Money Market Funds

Percent of funds, December 2010



Note: Excludes money market funds that invest primarily in other money market funds (e.g., master/feeder structure).
Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website

SEC Rule Amendments – Credit Quality

<u>Second Tier Securities</u>.

- A money market fund's ability to invest in second tier securities was further restricted by:
  - Reducing from 5% to 3% the maximum percentage of a money market fund's total assets that can be invested in second tier securities;
  - Reducing to ½ of 1% (from the greater of 1% or $1 million) the maximum percentage of a money market fund's total assets that can be invested in second tier securities of a single issuer; and
  - Reducing from 397 days to 45 days the maximum remaining maturity of second tier securities in which a fund can invest.

SEC Rule Amendments – Credit Quality

- The 2010 amendments also required money market funds to designate four NRSROs on whose ratings the fund would rely to determine which securities were eligible for investment.
- In July 2010, Congress enacted The Dodd-Frank Wall Street Reform and Consumer Protection Act, which required the SEC to remove references to NRSROs from its rules. In light of this, the NRSRO amendments have not become effective.
- The SEC recently proposed further amendments to Rule 2a-7 that would remove all references to NRSROs from the rule.
- The proposed amendments would require a fund's board (or its delegate) to determine that an issuer has the highest capacity to meet its short-term financial obligations (in the case of a first tier security). A security would be a second tier security if a fund's board determines it presents minimal credit risks but is not a first tier security.

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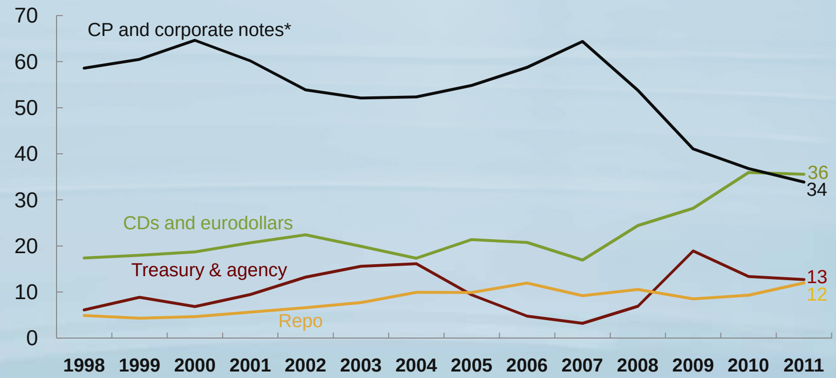
Prime Money Market Fund Holdings

Percent of prime funds' total net assets, annual, March 1998–March 2011



*Includes corporate notes and bank notes.
Source: Investment Company Institute

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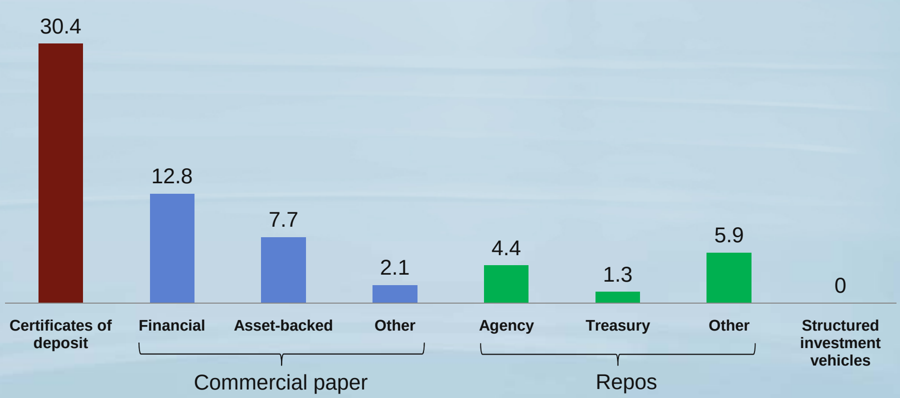
Selected Prime Fund Holdings, by Type

Percent of prime funds' total net assets, December 2010



Source: ICI tabulation of Form N-MFP data collected from SEC website

SEC Rule Amendments – Disclosure Reporting to the SEC

- Money market funds provide new, detailed portfolio information to SEC monthly with 5 day lag
- SEC releases it to public with 60 day lag
- Started with November 2010 data
- Data provide vast new information on shadow prices, WALs, capital support agreements, securities holdings, repo collateral
- Data intended to allow regulators, media, academics, others to analyze and assess money market funds

Shadow Prices of Prime Money Market Funds

Weekly, 2000–2010

Note: Data is shown as a simple average.
Source: Investment Company Institute; sample of prime money market funds

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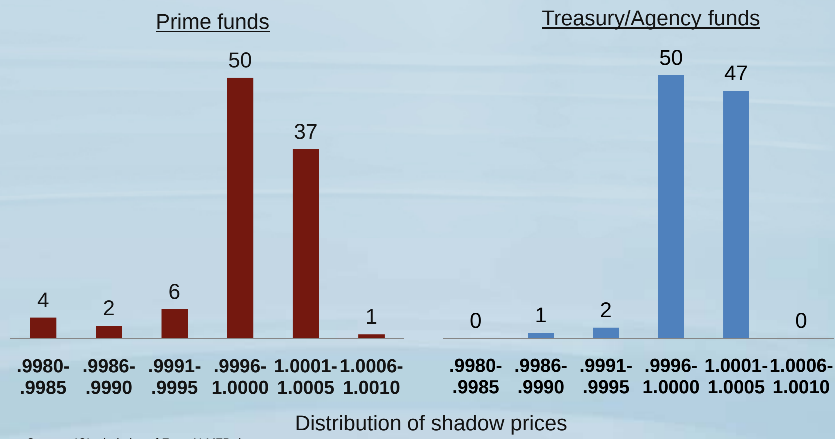
Shadow Prices for Taxable Money Market Funds

Percent of total net assets, December 2010



Source: ICI tabulation of Form N-MFP data.