MEMORANDUM

December 23, 2012

To: File

From: Anil K. Abraham
Office of Commissioner Daniel M. Gallagher

Re: Money Market Fund Regulation and Special Study on Money Market Funds

Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Division of Risk, Strategy, and Financial Innovation, November 30, 2012)

On December 19, 2012, Commissioner Daniel M. Gallagher and Anil K. Abraham, Counsel to the Commissioner, met with the following representatives of BlackRock: Barbara Novick (Vice Chairman), Richard Hoerner, CFA (Managing Director), Kathryn Fulton (Managing Director), and Peter D. Rich (Principal, Rich Feuer Anderson).

The participants discussed: (1) money market fund regulation; (2) the November 30, 2012 special study on money market funds prepared by the Division of Risk, Strategy, and Financial Innovation; and (3) BlackRock's comment letter[1] regarding the November 2012 money market funds proposal issued by the Financial Stability Oversight Council.

Attachment: PowerPoint presentation provided by BlackRock at this meeting.

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[1] Available at http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0012.

Structural Reform for Prime Money Market Funds

December 19, 2012

The opinions expressed are as of December 18, 2012 and may change as subsequent conditions vary.

Executive Summary

Structural reforms should be undertaken if they satisfy a two-part test:

1. Preserve the benefits of money market funds ("MMFs") as a liquidity management tool for investors and preserve the functioning of the short term funding markets
2. Provide a mechanism for managing mass client redemptions (or "runs) and minimize the risk of a run on a single fund triggering a systemic run

BlackRock's Constant Net Asset Value with Standby Liquidity Fees Proposal presented in comment letter to FSOC

- Approach builds on regulatory foundation of registered mutual funds and the 2010 Rule 2a-7 reforms ("2010 MMF Reforms")
- Maintains integrity of MMF product for investors and issuers
- Changes manager behavior
- Protects investors from the behavior of others
- Provides incentives to stay invested rather than to run
- Gives all investors access to their cash

The ultimate goal is to make MMFs even safer while avoiding unintended consequences to financial markets

Comparison of MMF Reform Proposals

Proposal	Impact on MMF Product and Short-Term Markets	Impact on Run Risk	Other Benefits or Challenges
Constant NAV with Standby-Liquidity Fee	• Preserves MMFs as attractive cash investment product	• Features to discourage run behavior plus gates to stop a run if one starts	• Should work for all sponsors • Shorter transition period • Protects investors from the behavior of other investors
Floating NAV	• Investors will migrate to constant net asset value ("CNAV") or floating net asset value ("FNAV") given specific needs • Expect Prime MMF shrinkage	• Does not address run risk	• Highlights NAV fluctuates • Reinforces "not guaranteed" message • Assets move to remaining CNAV funds
NAV Buffer (1%) plus Minimum Balance at Risk (MBR)	• Eliminates MMFs given investor objections	• Likely to act as accelerant	• Capital available to address idiosyncratic risks • Operationally challenging • Assets move to banks
NAV Buffer (3%) plus Other Measures	• Eliminates MMFs given sponsor economics		• Capital available to address idiosyncratic risks • Assets move to banks

Differentiating between MMFs and Banks

Banks

- Rely on government guaranteed deposits as source of funding
- Have access to Federal Reserve discount window
- Assets reflect wide range of lending practices
  - A typical bank holds commercial and individual loans ranging from commercial real estate loans, unsecured credit card, receivables, home mortgages, etc.
- Employ leverage which can amplify positive and negative aspects of portfolio
- Hold "loan loss reserves" to cover the expected losses on portfolio which reflect the range of credit quality of their loans
- Boards of Directors focused on shareholders of the banks and not directly on the depositors.
- Assets are generally opaque to investors and customers

- Shareholder's can redeem shares from a MMF and depositors can demand deposits from a bank

MMFs

- Not government guaranteed and investors understand that they bear the risk of investment results
- Portfolio subject to minimum liquidity and diversification requirements, dollar weighted-average maturity ("WAM") and dollar-weighted average life ("WAL") limits, and restrictions on credit quality
- Boards of Directors charged with overseeing management and operations on behalf of the fund's shareholders
- Assets publicly disclosed on regular basis
- Subject to specific daily and weekly liquidity requirements

Differences in regulation of banks and MMFs reflect differences between the products

Motivation of Investors to Run

The adoption and continued use of MMFs by investors are driven fundamentally by three factors:

i. Quality of assets

ii. Duration of those assets

iii. Amount of available liquidity held in fund

Investors run when they are concerned about the above three factors

We believe first mover advantage exists whether the NAV of a fund is floating or constant[1]

- Because MMFs will sell their most liquid assets first to support redemptions, the remaining investors will be left with a riskier, less liquid portfolio

Over the 40-year history of U.S. MMFs, while mark-to-market NAVs have fluctuated regularly, investors have not run en masse, except in 2008.[2]

FNAV funds (such as Variable NAV funds in Europe[3] as well as enhanced cash funds in the US)[4] also experienced significant withdrawals in 2007-2008.

1 David W. Blackwell, Ph.D., Kenneth R. Troske, Ph.D. & Drew B. Winters, Ph.D., *Money Markets Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk* (Center for Capital Markets Competitiveness Report, Fall 2012) at 36 ("a floating NAV does not change investors' incentives to remove their money quickly when they believe there has been a change in the riskiness of the fund. In other words, MMFs reporting floating NAVs can still experience runs.").
2 *See, e.g.*, Center for Capital Markets Competitiveness Report, *supra* note 10, at 39 ("First, since retail investors were largely spared any losses and disruptions in the 2008 run, and since as far as we are aware, there has never been a run on retail money market funds, any additional regulation of MMFs designed to reduce the probability of a run will impose additional costs on retail investors without providing any meaningful additional benefits to them."); ICI Research Report, Pricing of U.S. Money Market Funds (January 2011) at 3 ("Between 1996 and 2010, investor net redemptions from taxable money market funds in a single week exceeded 20 percent of a fund's assets in fewer than 1 percent of instances. Over four-week periods during those years, redemptions exceeded 20 percent of assets in fewer than 2.5 percent of instances.").
3 *See*, Comment Letter of the Investment Company Institute; Comment Letter on the President's Working Group Report on Money Market Fund Reform Options (Rule No.4-619) (Jan. 10, 2011) at 51 ("French floating NAV dynamic funds lost about 40 percent of their assets over a three-month time span from July 2007 to September 2007").
4 Over the course of the financial crisis between 2007 and 2008, asset deterioration and investor withdrawals led to a rapid decline in assets in the Schwab YieldPlus Fund—from $13.5 billion at its peak to $1.8 billion.

Perception of MMF Guarantee

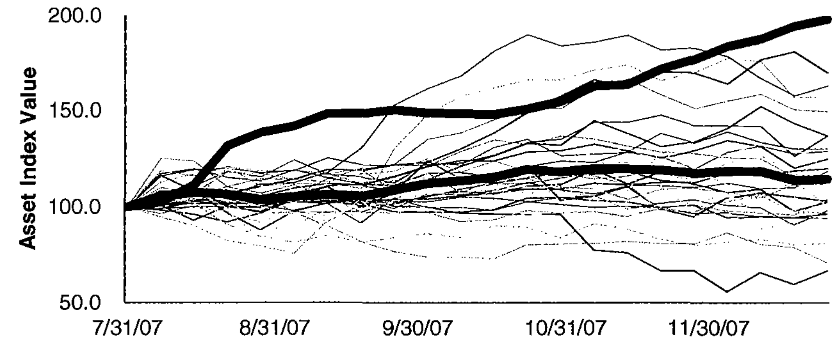
Though some have expressed concern that investors believe MMFs are guaranteed, investor behavior does not support this theory

- In 2007, institutional investors moved from weaker prime MMFs to stronger prime MMFs[5] and government MMFs in response to the SIV crisis (Figure 1).
- "[d]uring the peak of the financial crisis, in September 2008, investors redeemed assets from prime money market funds and, to a great extent, reinvested those assets into Treasury money market funds with the same structural features as prime money market funds"[6] (Figures 2 and 3).

5 *See,* SEC Staff Report by the Division of Risk, Strategy, and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher,* (Nov. 30, 2012) ("SEC Staff Report"), at 7 (prime money funds lost assets as a whole during the 2008 crisis, but certain prime money funds gained assets during that period).
6 SEC Staff Report, at 6.

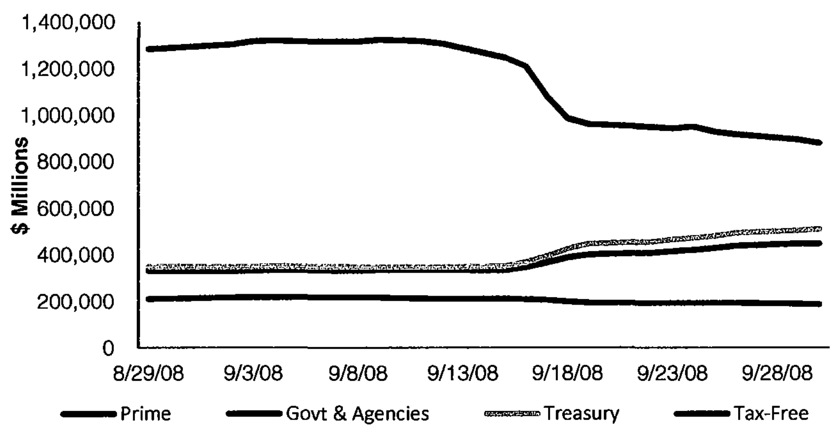
Figure 1: Prime MMF Assets During 2007 ABCP / SIV Turmoil

Colored lines represent 33 representative prime institutional funds. Heavy black line represents total of the 33 funds. Heavy red line represents total government institutional funds. Assets indexed to 100 on 7/31/07.



Source: iMoneyNet

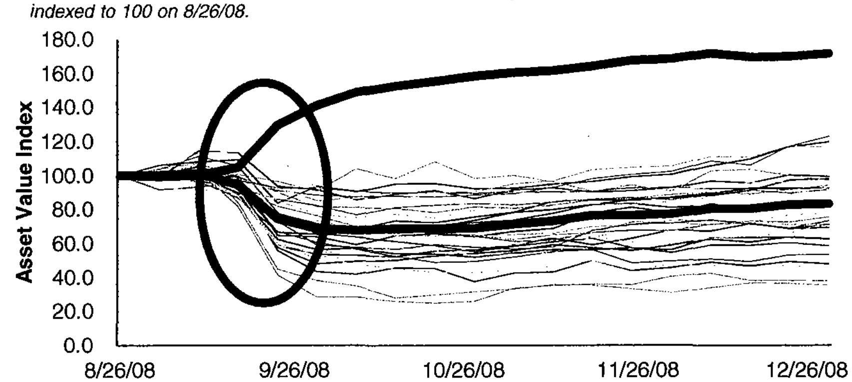
Figure 2: Institutional MMF Assets



Source: iMoneyNet

Figure 3: Prime MMF Assets During the 2008 Crisis

Colored lines represent 31 representative prime institutional funds. Black heavy line represents total of the 31 funds. Heavy red line represents total of all government institutional funds. Assets indexed to 100 on 8/26/08.



Source: iMoneyNet

Constant NAV with Standby Liquidity Fees Proposal – Basic Features

Objective Triggers	• SLFs not active during times of normal market functioning. • SLFs triggered when a fund has fallen to one half of the required weekly liquidity levels under Rule 2a-7. • Using the current Rule 2a-7 guidelines requiring that a MMF have 30% weekly liquidity, this translates into one-week liquidity of 15%. This rate has been chosen to ensure that the fund still has some liquidity if triggered, and yet the trigger is remote enough that it is unlikely to be reached during times of normal market functioning.
Enhanced Transparency	• Requirement of a weekly public disclosure with a 5-business day delay of the mark-to-market NAV and daily disclosure of Weekly Liquid Asset Levels based on the prior day's close.
Gates	• Once the objective liquidity trigger is met, a mandatory gate would come down. • Gate would prevent additional investor withdrawals until the fund could be reopened with a SLF. This closing is anticipated to be brief, i.e., by the next business day, to provide enough time to address any operational concerns in imposing the SLF. • Mandatory closing removes questions of conflicts of interest or hesitancy to take action. • As soon as a fund is closed, the Board will be expected to reopen the fund with a SLF.
Standby Liquidity Fee ("SLF")	• A fee of 1% would be imposed on withdrawals occurring after the gate has been put in place. This rate has been chosen to create incentives for investors not to run. • SLF rate is likely to be in excess of the cost of selling securities to raise cash to meet redemptions, and the excess would remain in the fund and accrue to the benefit of the remaining shareholders. • For those who "want" but don't "need" their money, this would act as a disincentive to redeem. • With SLFs in place, the NAV of a fund would improve as investors 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.
Removal of SLF and Special Distribution	• Any SLFs gathered by the fund would be retained in the fund to restore the NAV. • Once NAV reached $1.00, SLF would be removed and fund would return to functioning normally. • If the fund had built up any excess, this would be paid as a special distribution to shareholders of record on the last day in which the SLFs were in force. In this scenario, shareholders that remained in the fund or made new investments in the fund during this period of stress would be rewarded for their behavior. • We recommend placing a 30-day limit on the period a fund can operate with a SLF in place.

Building on '40 Act and 2010 2a-7 Reforms...

Gates

If a truly systemic run were underway and every fund experienced a dramatic run combined with reduced market liquidity, gates would come down quickly and protect investors.

- All investors would have access to their funds
- A standby liquidity fee (SLF) would be imposed on shares being redeemed
- SLFs would accrue to the benefit of the fund and the remaining investors

Liquidity Trigger

Liquidity triggers may change sponsor behavior

- A fund manager will focus on assets and liabilities to avoid triggering a gate
- A fund manager will be incented to know the underlying clients and model their behavior
- A fund manager will be incented to address potential problems early

Enhanced Portfolio Transparency

Investors run when they are concerned about underlying assets...

- In 2007 institutional investors moved from weaker prime funds to stronger prime funds and government funds. In 2008 they moved from all prime funds to government funds.
- Given increased transparency, an idiosyncratic problem should not translate into a systemic run.
- In the event a single fund closes for any reason, increased transparency should allay investors' concerns about other funds. Those fund sponsors will over-communicate with their investors.
- Investors will have no incentive to leave a fund that does not have underlying asset or liquidity issues

2010 2a-7 Reforms

2010 reforms fundamentally changed the management of 2a-7 funds...

- WAM and WAL limits reduce the ability of an individual manager to take significant risk
- Portfolio transparency enables investors to identify problematic holdings in a fund
- Daily and weekly liquidity requirements ensure cushion to address immediate cash needs
- Board has power to close a fund and commence its liquidation
- Mandatory portfolio stress testing

Investment Company Act of 1940

The Investment Company Act provides a sound framework for MMFs...

- Independent Board oversight of a registered investment advisor and its portfolio management activities
- Rules based approach to portfolio construction and management of potential conflicts
- Extensive disclosures to investors, including risk factors
- Subjects funds and managers to SEC examination and potential enforcement

Constant NAV with Standby Liquidity Fees Proposal – Benefits Over Other Proposals

1. CNAV with SLFs preserve many of the benefits of MMFs for both investors and borrowers, therefore, there should be minimal impact on the utility of MMFs.
2. Investors would be able to continue to enjoy the benefits of a diversified portfolio rather than be forced into concentrated investments or investments that are not cash equivalents.
3. For borrowers, this means continued access to MMFs as a source of funding which translates into important benefits in their liability structure and helps preserve the functioning of the short-term funding markets.
4. The gates are "standby", not "continuous", so that investors can transact normally except in abnormal circumstances. Based on interviews with clients, this construct is considered more acceptable, especially as it affords them protection from the behavior of others by removing first-mover advantage for redeeming investors.
5. Client choice is also an important element. In the event an investor needs or wants cash, they have access to it (albeit at a cost).
6. Concerns about systemic runs would also be allayed. Fund managers will have clear incentives to avoid triggering the gates, and in the tail event situation that a gate is triggered, the SLF will stop a run rather than allowing it to snowball. MMF boards will be mandatorily required to use gates if the objective triggers are met, which removes any questions about conflicts of interest or discretionary decisions. This will create a level playing field for all SEC-regulated MMFs, with all such MMFs subject to the Rule's requirements.
7. SLFs are a solution that works for all sponsors of and investors in MMFs. This approach does not favor large firms versus small firms, public companies versus private or mutual companies, bank-owned versus independent fund managers, or institutional versus retail investors. This proposal has several benefits when compared with other options, including: (a) regulators are not put in the position of picking "winners", (b) there is no regulatory pressure for industry consolidation, and (c) once operational issues are addressed, this solution can be implemented quickly requiring little or no transition period.
8. The only issue not addressed in this proposal is the lack of a cushion to deal with idiosyncratic risk in a specific fund. This returns to the question of whether investors understand that MMFs are not guaranteed. Actual behavior of investors in 2007, 2008, and again in 2011, suggest that they definitely understand that their investment is not guaranteed, making it unnecessary to provide this cushion. We discuss capital in more detail below under "NAV Buffer and Other Measures".

Options Proposed by FSOC

Floating Net Asset Value Proposal

While a Floating NAV ("FNAV") MMF may provide some investor protection, <u>FNAV does not address systemic runs</u>

- Experience of Schwab YieldPlus Fund and French VNAV funds during 2007-2008 crisis support this

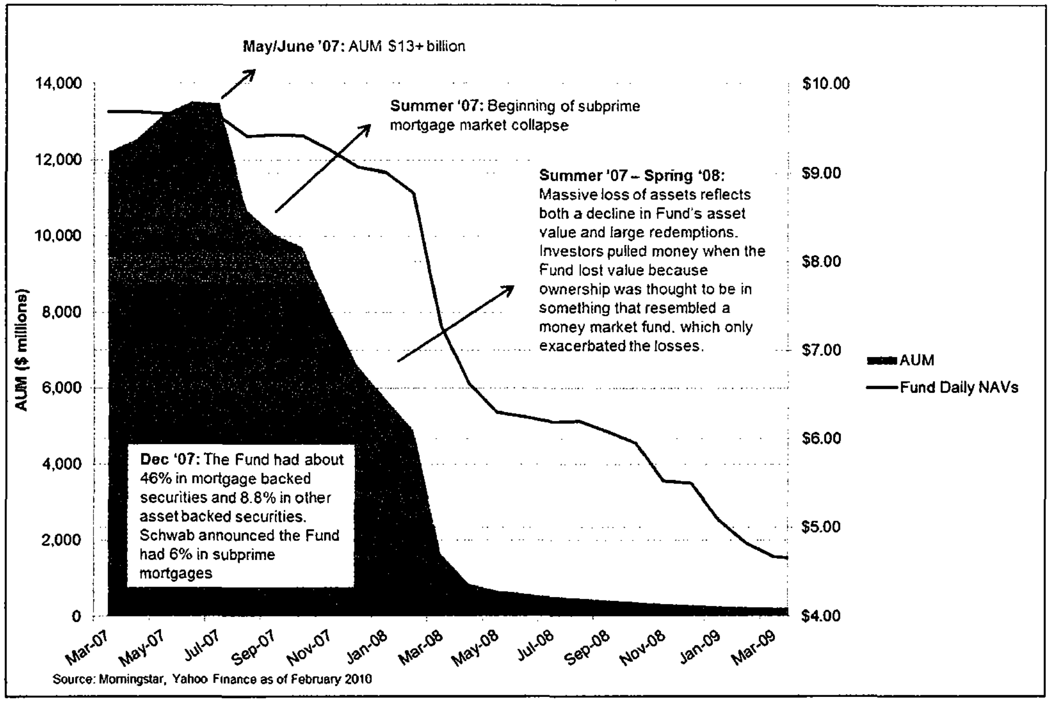
Many operational issues would need to be addressed

- Timing of NAV determination
- FNAV MMFs may not be able to accommodate late purchases and redemptions unless Fed wire system stayed open later
  - Inability to stay open late would hurt investors who use MMFs as sweep vehicles
  - Fed wire system would have to accommodate large amounts of redemptions at end of day

If policymakers pursue FNAV for MMFs, we recommend the following features:

1. Limit scope to Prime MMFs only
2. Require all funds that use the name "money market fund" to abide by Rule 2a-7 requirements
3. IRS tax relief for de minimis gains and losses on FNAV MMFs
4. Mutual fund accounting rules that allow assets with fewer than 60 days remaining to maturity to use amortized cost accounting should apply to MMFs and be extended to MMF securities with fewer than 90 days to maturity
5. $10.00 initial NAV for FNAV MMFs

Schwab YieldPlus Fund 2007-2008 Crisis



Source: Morningstar; Yahoo Finance as of February 2010

NAV Buffer and Minimum Balance at Risk Proposal

We do not believe that the minimum balance at risk approach will work for 3 reasons:

i. Clients will not invest in MMFs with these redemption restrictions, especially when holdback is subordinated

ii. May increase the likelihood of a run

iii. Extremely complex and costly to implement operationally

Requiring holdbacks to be in a "first loss" position punishes investors who are redeeming for normal operating cash even when there is no crisis

Many investors <u>cannot</u> use this product given requirements to have access to 100% of their capital

Liquidity is a key feature of MMFs and an absolute necessity for many investors

- Without full liquidity (at least in normal market environments), investors would not continue to invest in MMFs

Minimum balance at risk will lead to the elimination of MMFs

NAV Buffer and Other Measures Proposal

While capital may cover some idiosyncratic credit losses, <u>capital will not be sufficient to cover a systemic run</u>

Potential sources of capital all present issues

- Sponsors who supply capital would be required to consolidate assets of entire fund onto their balance sheet
- Shareholder capital is complicated and will take significant amount of time to accumulate
- Third party capital is extraordinarily complicated and there is currently insufficient demand from investors for this type of instrument

In light of the concerns related to capital, we return to the question of the purpose of capital in a MMF, and whether it is necessary to require capital from a public policy perspective

Additional Considerations

Scope of coverage of new Rule 2a-7

- We recommend new restrictions only apply to Prime MMFs

Benefits of single or multiple types of Prime MMFs

- While we generally favor choice, asking investors to navigate nuances of various structures may detract from the product without producing clear benefits

Sponsor support

- The decision to provide support (or not) should be a private sector business judgment rather than part of a MMF regulatory rule
- Each sponsor should have discretion to exercise their own judgment regarding the funds they sponsor and whether or not providing support is warranted for their business or even permitted by their regulators

Transition period

- Extremely important to avoid market disruption

Harmonization of rules with other cash products

- Important to harmonize federal and state rules governing short-term investment funds (STIFs)
- Non-US regulators should adopt minimum requirements for asset quality, duration, and liquidity standards similar to 2010 MMF reforms

Transparency to underlying clients

- We recommend strengthening the disclosure rules for portals and other aggregators to enable MMF managers to truly "know-their-customers"

Differentiating between retail and institutional investors

- Very difficult to distinguish as lines often blurred
  - For example, retail shareholders often invest in MMFs through institutional share classes, through broker or bank sweep accounts
- An arbitrary amount such as $100,000 may encourage investors to open multiple accounts to appear smaller than they actually are
- In a world of real-time information, both retail and institutional investors act quickly on information

Appendix

Current Regulatory Framework Governing MMFs

Key Regulatory Features of US MMFs	
Liquidity	• **Daily Portfolio Liquidity of 10%:** Can include cash, US Treasuries and securities that can mature in 1 business day (or are subject to a Demand feature exercisable in 1 business day) [municipal MMFs not subject to the daily limit]. • **Weekly Portfolio Liquidity of 30%:** Can include daily liquid securities, and agency discount notes of 60 days maturity or less and securities that can mature in 5 business days (or are subject to a Demand feature exercisable in 5 business days). • Illiquid securities, securities which cannot be sold in the ordinary course of business within 7 days at approximately the value ascribed to it them on the books of the fund, can only comprise 5% of portfolio, at time of acquisition.
Credit Quality	• Limited to securities which present in the Board's determination "minimal credit risk" • Required to hold securities that have ratings in the top two categories from two nationally recognized statistical rating organizations (NRSROs) • At least 97% of MMF assets, at time of acquisition, must be invested in securities that receive the highest short-term rating or securities of comparable quality ("first tier securities")
Diversification	• Maximum issuer concentration of 5% of portfolio assets (with certain exceptions) • Maximum second tier issuer concentration limit of 3% of portfolio with additional restrictions of 0.5% per single issuer. • Fully collateralized repurchase agreements can only be used for look-through purposes if comprising cash items or government securities
Maturity	• Individual securities can have a maximum maturity of 397 days • WAM cannot exceed 60 days. • WAL or spread WAM cannot exceed 120 days.
Transparency	• Extensive disclosures to investors, including risk factors • **Website Reporting:** Monthly portfolio holdings must be posted to a fund's website within 5 business days after month end. • **SEC Holdings Reporting:** Holdings must be reported to the SEC monthly and in a standardized format. The month-end mark-to-market NAV must be reported to the SE C on a monthly basis and subsequently released to the public on a 60 day lag.
Stress Testing	• Required to periodically test a fund's ability to maintain a stable NAV based on specific hypothetical events, including but not limited to interest rate changes and redemption increases
Board Powers	• Fund Board permitted to suspend redemptions and postpone payment of redemption proceeds if a fund will "break the buck" and if fund will irrevocably liquidate.

Source: BlackRock, ICI. As of 18 December 2012.

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BLK-0549