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Money Market Insight™

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◆ ANOTHER STORY SURFACES ON POSSIBLE FED-MMF STRATEGY

Another report has surfaced indicating that the Federal Reserve is considering using money-market funds as a temporary receptacle for a portion of assets north of $1 trillion held as mortgage-backed securities and U.S. Treasurys.

According to the Oct. 9 report on Bloomberg.com, those who served as sources for the story declined to be identified because no decision has been made. The Bloomberg.com theme echoed a recent *Financial Times* report which also did not identify an official source when citing the Fed's consideration of using reverse- repurchase agreements with money-market funds as among the tools to be implemented to wind down its role in the financial markets. Under the arrangement, the Fed would borrow assets from money-market funds for a limited time using its holdings as collateral.

The story states that the strategy is under consideration because "dealers would face constraints on capital if they were the sole counterparties on all so-called reverse-repurchase transactions while they're still repairing balance sheets after booking losses and write-downs in the aftermath of the worst financial crisis since the Great Depression."

Commenting on the idea, Federated Executive Vice President Debbie Cunningham said, "If we were to get additional supply from the Fed, that just adds to what's been a dearth in supply and would be very much welcome." She added, "The market has shrunk a lot for acceptable securities for purchase in money-market land."

Meanwhile David Glocke, who heads taxable money-funds for the The Vanguard Group, said the idea is "intriguing" because the Fed is "a no-risk counterparty, and such a program could provide support for short-term yields."◆

◆ OMNIBUS ACCOUNTS AND TRANSPARENCY-RELATED ISSUES UNDER DISCUSSION

Among the issues raised in recent months about money-market funds and their vulnerabilities is the omnibus model of doing business.

Under the omnibus model, investors have a direct relationship with an intermediary and not the fund family with whom their money is invested. There are various types of intermediaries who at the end of the day implement one trade with a fund representing thousands of individual clients. The ability to transact with "one wire" saves the mutual fund families the time and expense of setting up individual accounts and transacting individual trades.

Money-market portals, in large part, utilize the omnibus method. This permits the investor to choose among an array of funds without having to set up an account with each company. All trades are transmitted through the portal.

While omnibus has been described as a model with huge operational efficiencies, it also has been criticized for its lack of transparency. This lack of transparency has been raised in relation to liquidity risk.

The Securities and Exchange Commission's July 8 document titled Money-Market Reform: Proposed Rule states: "...We believe a fund should adopt policies and procedures to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders, particularly those that hold their securities through omnibus accounts or access the fund through 'portals' or through other arrangements that provide the fund with little or no transparency with respect to the beneficial shareholder." The SEC then asks whether or not it should be the one to impose such policies and procedures.

With "well over $100 billion" trading on its portal via omnibus money-market fund accounts, BNY Mellon's Kirk Black is not looking to make a change. Serving as vice president and senior relationship manager, Black told *MMI* that the above-mentioned concerns were raised at his institution "long before the credit crisis." The answer to those concerns lies with knowing your customer, he said. At BNY Mellon, each client has a person dedicated to the account. According to Black, it is that type of individual attention which is responsible for a "history of success with omnibus accounts." Black said generally there is notification by the clients if a large redemption is planned. He also said of BNY Mellon, "We work with the fund families as partners."

Fewer than 10 percent of BNY Mellon's portal accounts utilize the full-disclosure method which allows for a direct relationship between investor and fund company. The fact that it generates paperwork at the fund company level to open each account and, in turn, transmit individual trades is viewed as a burden on those companies; a burden lifted through the omnibus model.

Black feels that some changes are in the offing when it comes to tracking clients within the omnibus structure. He is unsure what they will be and says BNY Mellon will meet the challenge whatever the outcome.

Niels Holch, executive director of the Coalition of Mutual Fund Investors, takes a markedly different tack when it comes to omnibus trading accounts. He is opposed to the current practice of intermediaries not sharing underlying shareholder information with funds. While CMFI deals with the entire spectrum of omnibus accounts, which include equities, he also believes they present a problem for money-market funds.

In discussing the SEC's suggested liquidity levels for retail and institutional clients, Holch told *MMI*, "What I would rather see is just transparency through the shareholder base so you can really evaluate with some precision what your anticipated needs are based on redemption history and taking a look at the data to see what's going on at the underlying beneficial-owner level." Holch sees this as the most "sensible way for a fund to manage its liquidity risk."

Asked about the likelihood of the SEC stepping in and mandating fund-level transparency, Holch said it is possible but didn't say it is likely. He pointed to the recent enactment of Rule 22c-2, which provides for transparency down to the shareholder level, which does not apply to money-market funds.

Following the rule's adoption, systems were put in place via the National Securities Clearing Corp., and Holch believes there would not be a huge cost to adapt the site for money-market fund disclosure. Admittedly he said money-market funds are "on a very thin margin right now because rates are so low."

In his view, the full transparency he seeks may be realized via a link on the NSCC Web site called "networking." It is described as "a standard format that uniformly reports account positions, activity and dividend information, as well as registration updates between fund companies, or their transfer agents, and intermediary firms."

Holch doesn't see a half-way solution to the transparency question. He says, "Unless you go all the way, you are just going to be working with aggregated data." And, in turn, "You cannot evaluate liquidity risk."

Sally Hart, vice president of SunGard's Wealth Management Business, agrees. SunGard is one of the few money-market portals which operate exclusively on a full-disclosure basis. Hart echoed Holch's comments, telling *MMI* that "fully-disclosed, non-omnibus trading eliminates the concerns surrounding transparency. It is worth the additional work involved in opening up individual accounts for every fund or investment a firm makes. When an investor trades directly with a fund company, and the fund company knows the investor, both parties' risk is minimized and full transparency is achieved."

Federated Executive Vice President Debbie Cunningham said only a small portion of Federated clients operate via omnibus accounts and there is no problem. She attributes the smooth sailing to understanding the type of client who is invested. Cunningham told *MMI,* "I think using the term omnibus as a generic term that describes all types of undisclosed accounts is really inappropriate. I think there are good ones and bad ones." For instance, some accounts consist of "shareholders which, for the most part, may look at what they are doing annually or semiannually, but certainly are not day-to-day moving around." The other side of the equation is someone who is rate shopping via a portal and in that instance, "you would have to be very wary."

"I think there have been undisclosed accounts for decades that for the most part have not caused any real problems from a fund-industry perspective. There are a few incidences last year that are being reckoned with ...the damage was done. Lessons have been learned and we will move on from here. We don't want lessons learned to be forgotten, but I think to a large degree it's behind us."

Summing up, Cunningham said, "I really feel we are on the path to normalcy again. To some degree, the fact that we have been in recession for over a year makes the market seem less than normal because we were used to growth for so long. The fact that we are still experiencing shrinkage, or at least a flat line from a market perspective on a volume basis, has some people spooked, but I think that's a lagging indicator. I really feel from a normalcy perspective we're a good way there in the commercial paper money-markets, at least."◆

◆ ICI COMMENT LETTER REINFORCES WORKING GROUP'S AGENDA

The Investment Company Institute's submission of a comment letter on Sept. 8 to the Securities and Exchange Commission on proposed Rule 2a-7 changes provided the organization an opportunity to reinforce conclusions raised earlier in its Report of the Money Market Working Group.

A news release summed up ICI's major positions in relation to the future of MMFs. At the forefront is ICI's unwavering opposition to the idea of a floating net asset value. The statement laid out what ICI sees as "potential negative consequences to the economy of moving to a floating NAV, including: an increase of systemic risk to the financial system as institutional investors seek investment opportunities in alternative investments that are not similarly regulated; a significant reduction in the supply of short-term credit to corporate America; and loss of an important source of funding for municipalities in the short-term markets."

ICI President and Chief Executive Officer Paul Schott Stevens said stable NAVs "provide enormous benefits to money-market fund investors. In our view, forcing funds to adopt a floating NAV would introduce new and significant risks to the financial system without any offsetting gains."

Following the floating-NAV comment, subject areas were divided into three sections: risk-limiting conditions, disclosure of portfolio securities and money-market fund operations.

With regard to risk-limiting conditions, the ICI diverges from the SEC in supporting a minimum 5 percent daily liquidity requirement and 20 percent weekly requirement for all money-market funds. For retail funds, the SEC proposes a 5 percent daily liquidity requirement and a 15 percent weekly requirement. For institutional funds, the SEC proposes a 10 percent daily liquidity requirement and 30 percent weekly requirement.

ICI also opposes an SEC proposal that would prohibit money-market funds from holding illiquid securities. "The Institute concurs with the SEC's assessment of the importance of money-market fund liquidity. The SEC seems to suggest, however, that the liquidity determination is always straightforward and binary -- securities are either liquid or illiquid. In reality, this determination can sometimes be gray and can change quickly depending on asset type and market conditions, as recent experience aptly demonstrated." Another reason cited for this stance is the ICI view that it would serve as a deterrent to innovation and competition by disallowing untested instruments from participating in the marketplace.

ICI supports the continued use of credit-rating agencies. It recommends "requiring fund advisers to designate and disclose three or more nationally recognized statistical ratings organizations that funds would look to for all purposes under Rule 2a-7."

When it comes to limiting money-market fund purchases to first tier securities, ICI and the SEC almost see eye to eye. ICI favors a provision allowing a fund to retain a security if it is downgraded following its purchase.

ICI would like to see a 75-day weighted average maturity as opposed to the recommended 60-day WAM. It does agree with the SEC on the weighted average life recommendation of 120 days.

The disclosure of money-fund holdings passed muster with ICI which states support for "requiring money-market funds to publicly disclose certain portfolio holdings information monthly." Logistically speaking, the ICI and many other respondents feel that displaying the information seven to 10 days following the end of the month would be a more workable arrangement than the second business day of the month, as recommended by the SEC.

ICI discusses operations in the third and final section. It supports permitting funds to suspend redemptions to "facilitate an orderly liquidation (not just in the event that a fund is unable to maintain a stable NAV) to ensure all investors are treated fairly, and temporarily under the other exigent circumstances other than liquidation."