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A price to pay for new SEC rule

Control to money market managers rather than institutions

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Recent amendments to SEC Rule 2a-7 for money-market fund management might be designed to protect investors, but the jury is likely to be out for quite some time as to whether the Securities and Exchange Commission's moves will be as effective for institutional investors as they were intended.

The changes, which became effective May 5, are designed to strengthen money-market funds and better protect investors by increasing liquidity, reporting and operational requirements. But for many institutional investors and the entities that manage their assets, these new rules might not go far enough to ensure that security and transparency of this liquidity segment will be maintained or effectively strengthened.

These changes are important because a lot of institutional dollars are out there. Institutional money-market funds had about \$1.81 trillion in assets as of mid-June, according to the Investment Company Institute.

New research by Suresh Sundaresan, Chase Manhattan Bank professor economics and finance, Columbia University, and John Dial, chief risk officer, Capula Investment Management LLC, calls unencumbered cash "the most important risk tool at the disposal of a hedge fund" because the cash is much more transparent, relatively model-independent and easy to verify. These factors make unencumbered cash a better risk management measure than value at risk, or a fund's leverage ratio, because those tools are dependent on models and assumptions.

Compliance dates for the 2a-7 changes are being phased in throughout 2010 and could be further refined by the President's Working Group on Financial Markets later this year. At this point, though, institutional investors who use money-market funds should look at these rule changes with wariness. While designed to improve transparency and offer more safeguards for cash, these amendments still fall short of providing what hedge fund and managed futures fund managers require in a cash management solution. They still require an increased measure of liquidity and control in addition to added transparency.

Increased liquidity will come at a price. The new requirements for money-market funds call for an increase in securities that can quickly be converted to cash. All funds will be required to keep at least 30% of their cash assets in Treasury securities or other government securities maturing in 60 days or less. As a result, margins that are already tight will be squeezed even further and the yields seen by institutional clients will shrink even more.

Other operational changes could also cut into investor returns. Although an estimated 94% of institutional money-market funds waived fees in December 2009, to dissuade redemptions, investors need to think what will happen when these funds inevitably reinstate fees when the current low-interest-rate environment adjusts upward.

With an estimated 70% of all cash in money-market funds from institutional clients, there could be another time bomb embedded in money-market funds. Because institutions can make quick moves into and out of investment vehicles to extract some extra yield, the demands upon ready liquidity can be intensified. Because money-market funds commingle client assets, a “herd mentality” move to the exits can be disastrous for investors unwilling — or unable — to withdraw their money as quickly as others.

The new “shadow net asset value” won't mean much for institutional investors, but it could mask problems if the portfolio's infrastructure investments run into trouble. The new rules call for money-market funds to report mark-to-market net asset value each month rather than twice a year. While this increased frequency of reporting might seem like an improvement, reports will still be issued on a 60-day lagged basis. This two-month delay essentially eliminates any reaction time an investor might need to cover redemptions or repricing efforts that might occur in the interim. As a result, institutional investors could easily be lulled into a false sense of security on where a fund stands when the NAV report is finally issued.

Control has been given to money-market fund managers, rather than their institutional clients. The 2a-7 changes give money-market fund managers increased authority to freeze shareholder redemptions if the fund is close to “breaking the buck.” This rule change enables money-market fund managers to suspend redemptions on their own, without seeking permission from the SEC, as they previously had to do. While designed to enable portfolios to be liquidated in an orderly fashion, this rule change increases the power money managers have over the disposition of their fund assets. A rash decision on the money-market fund's portfolio could have disastrous consequences for the fund's institutional investors, for whom cash represents trading capital, the lifeblood of these firms.

Despite these new rules, institutional investors in money-market funds remain vulnerable to catastrophic events. When the Reserve Primary Fund “broke the buck” in 2008, it triggered a massive wave of investor withdrawals. Because the fund didn't have sufficient liquidity to keep pace with redemption requests, billions of dollars of client assets were frozen. Unable to retrieve these monies, some of these institutional investors had to shutter their operations. When the last of the Reserve Primary Fund's assets were finally released to investors, more than 15 months had passed and the net retrieved amount was just 98 cents on each dollar. As well intentioned as the 2a-7 amendments are, they cannot preclude the possibility of another break-the-buck scenario.

Separately managed accounts may be a better solution for hedge funds and other institutional investors to avoid these potential hazards with money-market funds — even with the new 2a-7 rules. Because client funds are segregated from other investors' cash, there's a reduced risk of contagion or liquidity crises. Most importantly, separately managed accounts offer daily transparency, rather than a report of holdings issued 60 days after the fact, adding to the control that institutional investors should look for in light of the rule changes.

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