Blogs
March 17, 2016
Asset Management ADVocate

What Does Liquidity Have to Do with Diversification?

In my recent article on money market fund reforms, I observed:

> The minimal credit risk determination for ABS [an Asset-Backed Security] should identify every entity on whose financial strength the fund will rely; the illiquid security determination should identify to whom the fund might sell the ABS in seven days. A fund may exclude any entity not so identified from further consideration as a potential guarantor of the ABS.

Wait a minute, writes a credit analyst:

> I thought an illiquid security determination was outside of and separate from diversification. Are we looking to see who is providing liquidity or whether the security is illiquid? Aren't these 2 different things?

Diversification and liquidity are indeed two different things. But the addition of ABS sponsors to Rule 2a-7's definition of guarantee have conflated these things. The new paragraph of the definition requires a money market fund to treat a sponsor as guaranteeing the full amount of its ABS:

> unless the money market fund's board of directors has determined that the fund is not relying on the sponsor's financial strength or its ability or willingness to provide liquidity, credit or other support to determine the quality (pursuant to paragraph (d)(2)) or **liquidity** (pursuant to paragraph (d)(4)) of the asset-backed security . . . .

Paragraph (d)(4)(i) prohibits a fund from acquiring -

> any illiquid security if, immediately after the acquisition, the money market fund would have invested more than five percent of its total assets in illiquid securities.

And, for purposes of Rule 2a-7:

> *Illiquid security* means a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.

So, if the fund relies on the sponsor's "ability or willingness to" buy an ABS "in the ordinary course of business within seven calendar days" for purposes of determining that the ABS is not an illiquid security, the fund must treat the sponsor as having guaranteed the ABS, even if the fund "is not relying on the sponsor's financial strength . . . to determine [its] quality." Paragraph (d)(4) also requires funds to hold daily and weekly liquid assets, so if a fund relies on the sponsor's demand feature to treat an ABS as having a daily or weekly maturity, it would also have to treat the sponsor as a guarantor of the ABS. Demand features and guarantees are subject to the same diversification limits, however, so this should not affect the total exposure 2a-7 would permit the fund to have to the sponsor. The conflation of diversification and liquidity should be limited to this circumstance.
So far as Rule 2a-7 is concerned, a dealer may be the exclusive market maker for any other security issued by a non-affiliated company without being treated as the issuer or guarantor of the security for purposes of diversification. Of course, if the dealer's commitment to purchase the security rises to the level of a demand feature, the demand features and guarantee diversification limits would apply.

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