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Asset Management ADVocate

# Money Market Funds and Re-Proposed Rule 18f-4

This post continues my consideration of why certain "unfunded commitment agreements" should be carved out of the valuation at risk limitations of re-proposed Rule 18f-4. My previous post explained why two of the justifications offered for this carve out do not bear scrutiny. My current view is that the scope of the carve out depends on the third proposed justification: that some commitments may not have "leveraging effects." This requires an understanding of the leveraging effects regulated by Section 18 of the Investment Company Act. I will use the example of money market funds to explore "leveraging effects" because (a) it allows me to answer a question raised in the proposing release and (b) it illustrates another means of limiting leverage.

## Money Market Funds Engage in Firm Commitments

The second request for comment in the proposing release is:

> Do money market funds currently engage in any transactions that might qualify as derivatives transactions under the rule or any of the other transactions permitted by the rule?"

The answer is yes: money market funds regularly enter into firm commitments, which the release explicitly includes in derivatives transactions. I am frequently asked why Rule 2a-7 limits the maturity of eligible securities to 397 days. The SEC chose this number:

> in order to accommodate funds purchasing annual tender bonds, and securities on a when-issued or delayed delivery basis. These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them."

In a leap year, an "annual tender bond" has a term of 366 days; a commitment to purchase them one month in advance would be 31 days, and the sum is 397 days. This "commitment to purchase" an annual tender bond is a firm commitment, as the interest rate on the bond is fixed at the time of the commitment.

## Why Firm Commitments Have a "Leveraging Effect"

The staff of the SEC once defined "indebtedness leverage" as:

> an obligation, or indebtedness, to someone other than the fund's shareholders [that] enable[s] the fund to participate in gains and losses on an amount that exceeds its initial investment …."

This will be my working definition of "leverage" going forward. A money market fund is not required to pay anything at the time it commits to purchase an annual tender bond. The fund is nevertheless exposed to changes in the market value of the bond prior to settlement, so the commitment has a leveraging effect until the fund pays the purchase price. Readers should refer to Release 10666 for a more complete explanation of the leveraging effects of firm commitments.

## How Rule 2a-7 Limits Leverage

One objective of Section 18 is to prevent investment companies from "increas[ing] unduly the speculative

character of their" shares. Rule 2a-7 goes further by requiring money market funds to seek to minimize fluctuations in their share price, avoiding any "speculative character" altogether. To this end, Rule 2a-7 requires "a money market fund [to] maintain a dollar-weighted average portfolio maturity ["WAM"] appropriate to its investment objective," which cannot exceed 60 days. A money market fund must include a security in the calculation of its WAM on the date it commits to purchase the security for a set price or yield, and the maturity must be measured from the commitment date until the date on which the principal is due. This means that, if a money market fund commits to purchase an annual tender bond one month before the bond is issued, the firm commitment will add up to 397 days, weighted by the purchase price, towards the fund's WAM. If we think of the 60-day limit on WAM as a money market fund's "risk budget" for interest rate duration, this type of firm commitment requires a substantial risk expenditure. For example, if the rest of the portfolio had a WAM of 30 days, a fund would have to invest less than 9% of its net assets in a 397-day firm commitment to keep its WAM under 60 days. Thus, the limitation of a fund's WAM also limits the extent of its firm commitments.

# Conclusion

By requiring money market funds to minimize their volatility, Rule 2a-7 controls the "speculative character" of their shares, and leveraging effects of their firm commitments, more directly than Section 18. My next post will explore some implications of this for proposed Rule 18f-4.

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