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ViewPoint

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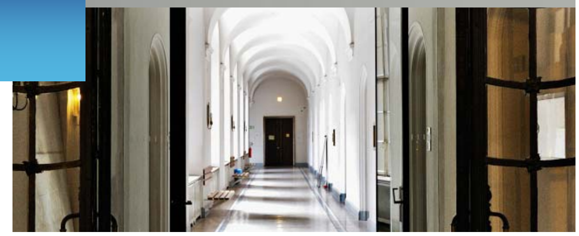
Money Market Funds: Potential Capital Solutions



The money market fund industry has come under heightened scrutiny in the aftermath of the worst financial crisis in recent history. The events of 2008, including the historic "breaking of the buck" by the Reserve Primary Fund in September of that year, exposed both idiosyncratic (fund-specific) and systemic (industry-wide) risks associated with money market mutual funds, and gave rise to several reform measures designed to mitigate such risks and enhance the overall value and viability of this important investment vehicle. The Securities and Exchange Commission (SEC) Money Market Reform rules, effective in May 2010, outlined more conservative investment parameters related to the credit quality, maturity and liquidity of money market fund portfolios, and prescribed enhanced guidelines around transparency to investors. Shortly after, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) imposed further safeguards that touch nearly every part of the financial industry.

While these efforts have gone a long way toward strengthening the industry and enhancing investor protection, additional proposals related to money market funds (MMFs) remain highly topical today and were aired on May 10, 2011 at the "SEC Roundtable on Money Market Funds and Systemic Risk." In this *ViewPoint*, we review the objectives and constraints surrounding additional structural reform in the MMF industry and focus specifically on the capital solutions that remain topics of conversation today. Ultimately, we believe the goal of the investment community and policymakers is one and the same: to further reduce systemic risk without undermining money market mutual funds' important role as a source of value to investors and funding to the short-term capital markets.

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Background: The Role of Money Market Funds

In 1971, the first MMF in the US was established. Shortly thereafter, several similar products were created and the market grew significantly over the next few decades.

MMFs play a unique role in the economy by providing short-term funding to commercial and municipal borrowers through purchases of commercial paper and other short-term debt. The flexibility to borrow through short-term debt markets is an important alternative to borrowing from banks for many commercial and governmental entities. In many cases, banks are not equipped nor inclined to provide comparable lending. As such, a great part of the appeal of MMFs is their ability to cost effectively match issuers and investors. In addition, MMFs are an important source of funding for banks that regularly issue commercial paper.

The opinions expressed are as of August 2011 and may change as subsequent conditions vary.

MMFs also provide value in the form of liquidity and market-level short-term yields to a broad array of institutional and retail investors. For many investors, this represents a favorable alternative to bank deposits or to the direct purchase of instruments in terms of both liquidity and diversification. In addition, tax-exempt MMFs provide a unique source of funding to municipalities and income to investors that bank deposits cannot replicate.

The Crisis

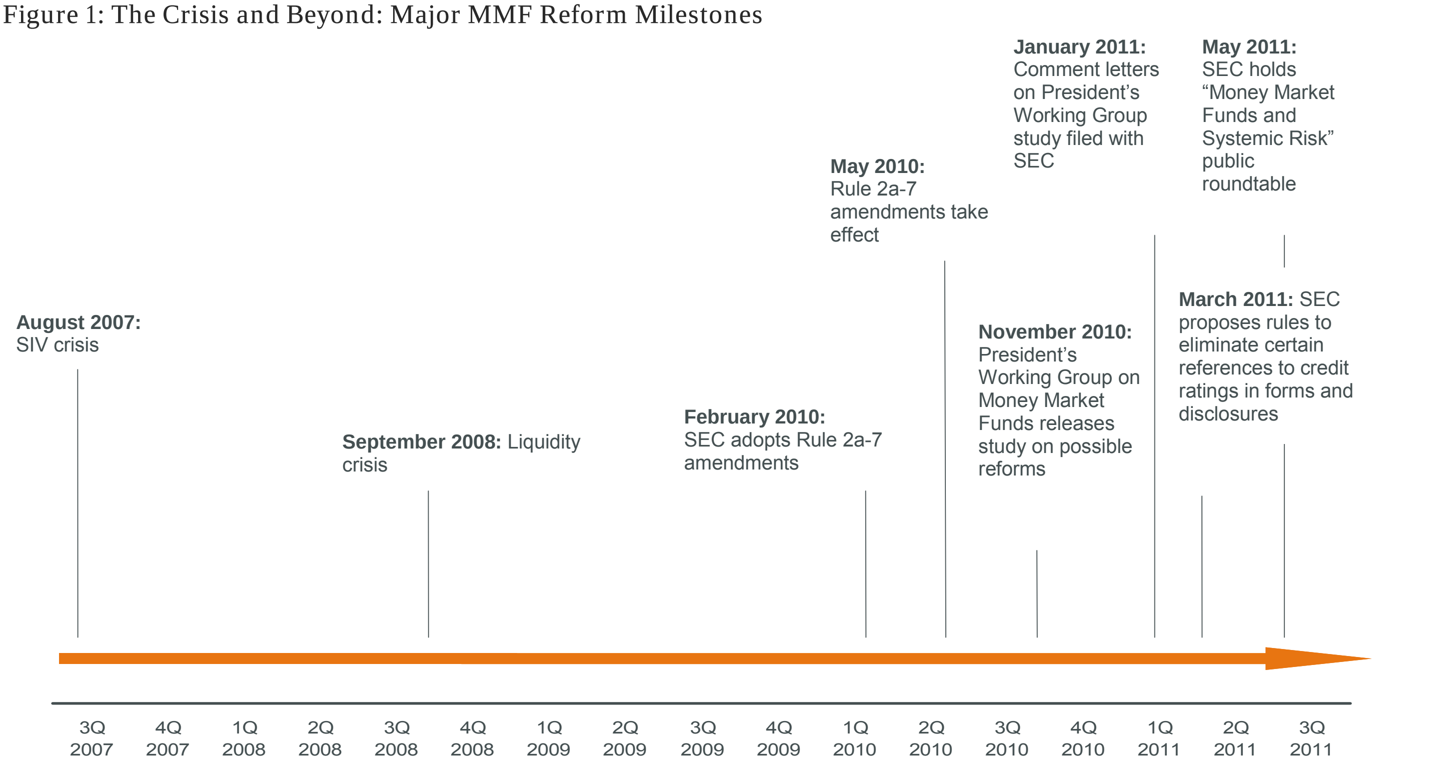
Changing market dynamics in August 2007 created a mini-crisis in the industry. Many MMFs that had reached for higher yields investing in the paper of structured investment vehicles (SIVs) found themselves holding securities whose value was deteriorating. The full-blown crisis came a year later when overall bond market liquidity was very tight and a series of financial firms became insolvent. Lehman Brothers failed, the Reserve Primary Fund broke the buck, and investors redeemed prime MMFs en masse, reflecting their concerns over which firms might fail next. The US government stepped in with a series of programs to stabilize the markets. A program to purchase asset-backed commercial paper (the Federal Reserve's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility) and another to insure MMF balances (the Treasury's Temporary Guarantee Program for Money Market Funds) reinstated liquidity and restored investor confidence. The combination of these and other government programs successfully turned investor sentiment more positive and quickly returned MMFs to normal functioning. Investors returned more than $400 billion to MMFs during the fourth quarter of 2008. Most importantly, short-term credit markets recovered rapidly as MMFs resumed normal operations, and the government programs were wound down without taxpayers incurring any losses.

The Regulatory Response

Prior to the unprecedented credit crisis of 2008, MMFs successfully provided liquidity to the financial markets for nearly 40 years without requiring government intervention. During the height of the credit crisis and in its immediate aftermath, the concerted actions by policymakers were essential in restoring order and confidence to the markets in a time of great uncertainty. Following is a brief review of reforms that have been implemented and those proposals still under consideration.

SEC Rule 2a-7 Enhancements. The changes to SEC Rule 2a-7 under the Investment Company Act of 1940 were adopted in February 2010 and took effect in May 2010. They were strongly endorsed by the industry, including BlackRock, which filed a comment letter with the SEC dated September 4, 2009. The enhancements resulted in more conservative portfolios in terms of credit quality and maturity structure, more liquid portfolios via requirements for minimum daily and weekly liquidity, as well as enhanced transparency, broader Board powers, and provisions for stress testing. Notably, the SEC meeting in February of 2010 ended with a statement that this was "phase one" and that further structural changes could be expected. SEC Chairman Mary Schapiro remarked at the time that, "Our work, however, is not yet complete. We will continue to pursue more fundamental

Figure 1: The Crisis and Beyond: Major MMF Reform Milestones



Source: BlackRock

Figure 2: SEC Enhancements to Rule 2a-7, Effective May 2010

Credit Quality	► Reduced exposure limit for second-tier securities.[1] ► Funds not permitted to acquire second-tier securities with remaining maturities of > 45 days.
Diversification	► More restrictive single-issuer limits. ► More restrictive collateral requirements for repurchase agreements qualifying for "look-through" treatment.
Liquidity	► Reduced exposure limit for illiquid securities.[2] ► At least 10% of total assets in Daily Liquid Assets[3] (not applicable to tax-exempt funds). ► At least 30% of total assets in Weekly Liquid Assets.[4]
Maturity	► Reduced Weighted Average Maturity (WAM) limit. ► Weighted Average Life (WAL) calculated without reference to any provision that would permit a fund to shorten the maturity of an adjustable-rate security by reference to its interest rate reset dates.
Portfolio Stress Testing	► Performance of stress testing (simulated shocks such as interest rate changes, higher redemptions, changes in credit quality of fund) as required by new policies and procedures adopted by the fund Board.
Transparency	► Monthly disclosure of all portfolio holdings on the fund's website. ► Monthly filings of portfolio holdings and additional information ("shadow" NAV) with SEC.
Additional Board Powers	► Fund Board permitted to suspend redemptions and postpone payment of redemption proceeds if a fund will "break the buck" and if the fund will irrevocably liquidate.

1 A second-tier security is defined as a security rated in the second-highest short-term rating category by rating agencies.

2 An illiquid security is defined as one that cannot be sold or disposed of within 7 days at approximately the value ascribed to it by the fund.

3 Daily liquid assets include cash, US Treasury securities, and securities readily convertible to cash within 1 business day.

4 Weekly liquid assets include daily liquid assets (convertible to cash within 5 business days rather than 1) as well as US government agency discount notes with remaining maturities of 60 days or less.

changes to the structure of money market funds to further protect them from the risk of runs." After outlining possible additional reform measures, Chairman Schapiro went on to say, "While each of these ideas is under serious and active consideration, they represent substantial revisions to the money market fund landscape and, therefore, require further review and study." In hindsight, this represented an early testament to the SEC's commitment to thoughtful and thorough structural reform — an effort that continues today.

President's Working Group (PWG) Report. The President's Working Group on Financial Markets outlined a series of additional proposals related to MMFs in a report titled "Money Market Fund Reform Options," released in November 2010. The PWG tagged the Financial Stability Oversight Council (FSOC), an organization established by the Dodd-Frank Act, with investigating the options more fully. The proposals include the idea of floating MMFs' net asset value (NAV), establishing private emergency liquidity facilities, a requirement for mandatory in-kind redemptions, insurance programs for MMFs, a two-tier system for MMFs incorporating retail and institutional fund solutions, regulating MMFs as special purpose banks, and enhancing constraints on "unregulated MMF substitutes." Each of these proposals is discussed in detail in a separate BlackRock *ViewPoint* paper published in January 2011 and titled "Money Market Fund Reform: Discussion of Reform Proposals."

SEC Public Roundtable. In May 2011, the SEC assembled a panel to address "Money Market Funds and Systemic Risk." SEC Chairman Schapiro and Commissioners Casey, Walter, Aguilar and Paredes were in attendance, as were six representatives from the FSOC and a wide array of interested parties that included corporate Treasurers, institutional investors, academics, industry group representatives and regulators.

Figure 3: PWG Proposals on MMFs

- Floating net asset value (NAV) structure for MMFs
- Creation of private emergency liquidity facilities
- Imposition of mandatory redemptions-in-kind
- Insurance for MMFs
- Two-tier system with enhanced protection for stable-NAV funds
- Two-tier system with stable-NAV funds reserved for retail investors
- Regulating stable-NAV MMFs as special purpose banks
- Enhanced constraints on "unregulated MMF substitutes"

During the roundtable, Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System, along with other bank regulators, emphasized the floating NAV as a key means for limiting MMF-related systemic risk. Institutional investors and industry participants presented the opposing view, with CVS Caremark Senior Vice President and Treasurer Carol A. DeNale noting the need for and diversification benefits of stable-NAV MMFs. If faced with a floating-NAV structure, Ms. DeNale remarked, “We will not do it. We will pull out of money market funds,” adding that MMFs are unique in their objective and provide an avenue for portfolio diversification. “I do not expect to be picking up different yield (from) my money market. We’re looking for diversification for my portfolio.”

While floating the NAV was a central topic, other views were presented, including the idea of sponsor capital introduced by Seth Bernstein, Global Head of Fixed Income for JP Morgan Asset Management, and the concept of supplemental shareholder capital presented by Bob Brown, President of the Money Market Group for Fidelity Management & Research Company.

In the President’s Working Group Report, the ball was passed to the FSOC as the interagency group to take forward structural reforms to MMFs. The 2011 FSOC Annual Report published in July states, “To increase stability, market discipline, and investor confidence in the MMF market by improving the market’s functioning and resilience, the Council should examine, and the SEC should continue to pursue, further reform alternatives to reduce MMFs’ susceptibility to runs, with a particular emphasis on (1) a mandatory floating NAV, (2) capital buffers to absorb fund losses to sustain a stable NAV, and (3) deterrents to redemption, paired with capital buffers, to mitigate investor runs.” Needless to say, regulators are focused on structural reforms for money market funds.

Industry and academic responses and new ideas. Issuers of commercial paper, fund managers and MMF investors have universally expressed concerns about the floating-NAV structure for a vehicle that for decades has been differentiated and prized for its stable-NAV feature. In response to the PWG report, and based on subsequent dialogue, a number of new ideas have been proposed. These include: an NAV buffer within each MMF portfolio, a trust structure or other special purpose entity (SPE) outside the individual MMF, a subordinated share class and/or the imposition of redemption fees. In this paper, we examine the pros and cons of each of these approaches.

Advancing Structural Change: Objectives and Constraints

Before additional change can be made in the MMF industry, it is important that all interested parties agree on exactly what the problem is that requires solving and, to that end, which tools are available and which are off limits. Importantly, the solutions must work for all constituencies, including regulators, MMF sponsors, investors and commercial paper issuers.

Defining the Objectives

We would identify two key and universally accepted objectives of structural change: (i) to maintain MMFs as a viable cash vehicle, and (ii) to strengthen Rule 2a-7 to enable MMFs to better withstand risks. We believe particular attention should be paid to fund-specific risks, including factors related to a fund’s credit quality and liquidity, and its ability to withstand acute risks in the event of a systemic situation.

Acknowledging the Constraints

There are a number of meaningful obstacles to MMF reform that must be factored into the development of an acceptable solution. Among them:

The status quo is not acceptable to regulators. The May 2011 SEC Roundtable highlighted the Commission’s view that Rule 2a-7 enhancements are important and positive developments, but in themselves, are not enough. The FSOC reiterated this view in its first annual report issued in late July. Regulators are seeking to establish an additional cushion to protect MMFs in the event of a credit issue or an acute liquidity issue. In short, maintaining the status quo is not an option.

A floating NAV is not acceptable to investors, and the demise of MMFs as we now know them is likely to cause unintended consequences. Institutional and retail investors strongly prefer a stable NAV. If a stable NAV is not available in MMFs, investors are likely to look elsewhere for a comparable vehicle, in either bank deposits or non-registered investment vehicles. The end of MMFs is likely to cause a flight of assets into banks, resulting in an undesirable consolidation of assets that only exacerbates existing concerns regarding “too-big-to-fail” and increases the pressure on deposit insurance. The demise of MMFs would also raise questions regarding funding sources for municipalities and corporations that regularly access commercial paper markets. If banks are not lending, where will these entities turn for a source of working capital?

Access to the Federal Reserve discount window is not available. The Federal Reserve and other regulators oppose a structural solution that includes access to the discount window. This effectively eliminates a proposal from the Investment Company Institute (ICI) that called for the establishment of a Liquidity Exchange Bank as well as other solutions that would rely on access to the window.

Socialized or shared capital could result in idiosyncratic risk. Socialization of capital is seen as potentially encouraging undesirable risk-taking by individual plan sponsors. This effectively eliminates industry-wide insurance as well as government insurance as potential solutions.

Segregating retail and institutional investors does not solve the MMF problem. Much like institutional investors, individual (or retail) investors also have been known to redeem MMF assets when trouble arises. Amid the crisis in 2007 and 2008, one well-known retail enhanced cash fund experienced major redemptions, which forced the fund to sell assets in a severely depressed market and, in turn, exacerbated the problem for remaining shareholders. After settling a class-action lawsuit, the retail fund now faces liquidation.

Importantly, it is also difficult to differentiate between institutional and retail investors. Defined contribution plans and other aggregators are examples of gray areas. In addition, many fund sponsors offer funds with both institutional and retail share classes. This approach provides better diversification and spreads expenses over a larger pool, benefiting retail investors. Segregating retail investors would negate this benefit.

Capital Solutions: An Overview

Capital solutions to the MMF debate can include multiple structures (or *forms* of capital) and multiple sources of capital. Figure 4 highlights the full spectrum of possibilities. Assuming that both the first and final options in this continuum (maintaining the status quo and floating the NAV) are unacceptable — for the reasons noted above — the following discussion focuses on various forms of capital solutions as well as the possibilities around redemption fees.

Figure 4: Wide Spectrum of Possible Capital Solutions*

Status Quo: Rule 2a-7 enhancements are sufficient

Redemption Fees: Institute an economic incentive to discourage runs

NAV Buffer: Establish an NAV buffer (or cushion) within individual MMF portfolios

Subordinated Share Class: Create a new share class to co-exist with common shares

Trust/Special Purpose Entity: House a buffer outside the individual portfolio(s)

Hybrid Approach: Employ some combination of the prior three options

Floating NAV: Eliminate stable NAV and find new market equilibrium

* Capital to be derived from sponsors, shareholders, third parties and/or some combination thereof.

NAV Buffer

What Is It?

Under this scenario, a "buffer" would be established within each MMF by siphoning a small amount of income from the portfolio to be set aside as an NAV cushion. The assumption is that a uniform "fee" would be set by regulators (e.g., 4 basis points). The buffer capital is regarded as an asset of the portfolio and, as such, is calculated into the NAV and results in a higher NAV for the MMF. The siphon would be turned on and off depending on the size of the buffer relative to the pre-determined minimum capital requirement. In other words, the portfolio would stop retaining income when the target buffer is reached. Shareholders of the MMF would "own" the buffer. Although this option appears to be embraced by many industry participants, regulators have signaled that this may be insufficient based on the challenges outlined below.

Key Benefits

Ease of implementation. The NAV buffer concept would be relatively simple to implement.

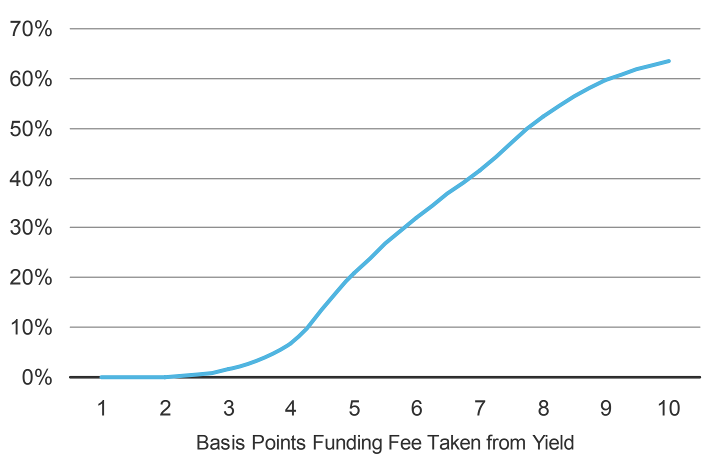
No favoritism. It affords no advantage or disadvantage for large or small fund families; however, it would create a barrier to entry for new fund sponsors, as existing funds would already have established a buffer.

Removes incentive to redeem. For shareholders who are worried about the NAV breaking the buck, the buffer affords a higher NAV that removes part of their incentive to redeem. In the event of a run, assuming the fund's NAV is above $1 per share, the NAV accretes, providing further disincentive for shareholders to redeem and again putting a brake on the run.

Key Challenges and Options for Addressing Them

Length of time to accumulate. The yield differential between prime and government funds limits the size of the "fee" that can be siphoned from a prime portfolio. We estimate a breakeven of less than 5 basis points (bps). As illustrated in Figure 5, with a fee of 5 bps, the average prime fund yielded less than the average government fund 24% of the time, whereas a fee of 4 bps results in a yield crossover less than 10% of the time. Depending on the target minimum capital, this approach could take a long time to accumulate sufficient capital. As a potential remedy, the sponsor could deposit an initial amount as a loan to be repaid over time.

Figure 5: Percent of Time Prime Lags Government Yield



Source: BlackRock

Amortized cost valuation. In order to retain amortized cost to value its investments, a MMF must not have a difference of greater than 0.5% (i.e., ½ of 1%) between the amounts obtained valuing its investments at amortized cost and fair value. As a result, this model can hold no more than approximately 40 bps of capital without “breaking the buck” to the upside. Perhaps a rule change could be constructed to allow for holding more than 40 bps of capital. Such a provision does not exist under current rules.

Tax inefficiency. Current tax rules would require taxation of income that is set aside for the NAV buffer. Also, registered investment company (RIC) rules do not allow retention of significant income within a fund. A possible solution is to consider tax deferral (not tax exemption) of retained income to accelerate the timeframe for accumulating the buffer. In addition, RIC rules might be adjusted to allow for the retention of income in a MMF in cases where it is specifically used to create and maintain a buffer. Of course, at more normal interest rate levels, the 4 to 5 bp fee would be under 2% and would not trigger an excise tax issue.

Sponsor has no skin in the game. Assuming the buffer represents the sole solution, the capital would come entirely from shareholders, meaning the MMF sponsor has no financial skin in the game (unless the sponsor had made a deposit to initiate the buffer).

Subordinated Share Class

What Is It?

Under this approach, each MMF would have two share classes: senior and subordinated. The senior class would act much like current MMF shares, with investment income and dividends based on the underlying portfolio less an amount allocated to the subordinated share class. The subordinated share class would have a variable payout based on a fee charged to the total portfolio and distributed to the subordinated shareholders. As noted earlier under the discussion of the NAV buffer concept, the relative yield differential between prime and government funds will limit the amount of income that can be siphoned. Given the nature of this new security, we assume the market will demand a yield similar to a low investment grade or a strong high yield issue. For example, if the portfolio can support a fee of 5 bps and the market requires a yield of 4% to 6% above MMF yields for a subordinated share class, this approach could support capital levels of approximately 70 to 125 bps. As noted in Figure 6, higher or lower market yields will dictate the amount of subordinated capital that can be supported by a fund.

The subordinated share class would have a term. In order to reduce liquidity pressure on a single date, we recommend a laddered approach with five one-year increments (i.e., 20% matures each year; each maturity year would then need to be refinanced).

The subordinated share class would be subject to one-year extensions up to a 10-year term. If the NAV falls below a threshold (e.g., 0.999), then the subordinated share class would extend for one year. If, at the end of five extensions, the NAV still is not above the threshold, the fund would be liquidated with all subordinated shareholders receiving a pro rata redemption amount (something less than $1) regardless of which maturity series they hold.

Given that MMFs have large inflows and outflows, the fund sponsor would need to be able to issue additional subordinated shares and/or redeem subordinated shares to right-size the subordinated share class relative to the overall size of the fund. In the event a fund diminished in size without an NAV decline, the subordinated share class would be subject to a tender (optional redemption) feature.

Key Benefits

Discipline imposed by the market. This approach sets a market price for the level of risk involved. Assuming efficient markets, poor risk managers will be disciplined by the market in that higher returns will be demanded of them for their inherently higher level of risk.

Risk tailored to investor type. Subordinated shareholders are clearly buying a subordinated interest and assuming that risk. In essence, this places each form of risk in a MMF with investors who understand and want to take that risk.

Figure 6: Fee Dictated by Yield Differentials, Thereby Dictating Capital Levels

		Amount of Capital That Results					
Yield on Subordinated Share Class Above Money Markets	10%	0.20%	0.30%	0.40%	0.50%	0.60%	0.70%
	8%	0.25%	0.38%	0.50%	0.63%	0.75%	0.88%
	6%	0.33%	0.50%	0.67%	0.83%	1.00%	1.17%
	4%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
	2%	1.00%	1.50%	2.00%	2.50%	3.00%	3.50%
		2	3	4	5	6	7
	Basis Points Capital Charge Taken From Yield						

= Potential marketable area (highlighted cells: 0.67%, 0.83%, 1.00%, 1.25%)

Source: BlackRock

Sponsor accountability. Regulators can require sponsors to hold a minimum amount of the subordinated share class to ensure financial skin in the game.

Key Challenges and Options for Addressing Them

Complicated structure. The subordinated security is a new type of security that is quite complex, entailing variable interest as well as extension features. Investor appetite for this security will depend on the ability to obtain a rating and on the development of a liquid secondary market.

We estimate that the most likely purchasers of the subordinated share class are insurance companies. While interest is likely to be strong for an instrument with an investment-grade rating, obtaining an investment-grade rating may be difficult and may require changes to the structure.

Complexity and cost of implementation. The ability to initially issue and to dynamically administer/adjust the amount of the subordinated share class will require significant infrastructure and expense. The expense of this structure will create a drag on the yield of the portfolio. Scale players will be favored in that these costs can be more readily absorbed by larger funds. The secondary market, if any develops, will not only favor strong risk managers, but will also favor brand names and larger issues that are perceived to have greater liquidity.

Sponsor financial statements would be more complex. The fund likely would be consolidated by the fund sponsor if the sponsor owns more than a majority of the subordinated class. Consolidation would inflate the sponsor's financial statements.

Conflicts between senior and subordinated shareholders. We could envision various scenarios in which an investment decision would favor one set of shareholders over another. This could cause issues between classes of shareholders. If the fund sponsor/investment manager holds a portion of the subordinated class, there could be additional accusations of self-interest.

The example in Figure 7 highlights a situation where the investment manager can sell the shortest-maturity securities or the longest-maturity securities to meet redemption requests. Subordinated shareholders would prefer the manager sell the shortest maturities, whereas senior (or common) shareholders would benefit from the sale of the longest maturities since the

Figure 7: Example of Potential Conflict in the Two-Share-Class Approach

Start with portfolio below, then interest rates rise 50 bps (parallel shift in yield curve) and redemptions equal to 30% of the fund

Question: How does the manager raise liquidity beyond the 10% maturing overnight

Allocation		DTM	Yield	Market Yield	Unrealized Gain/Loss
10%	10,000,000	1	2.50%	2.50%	-
20%	20,000,000	7	2.05%	2.55%	(1,944)
45%	45,000,000	30	2.10%	2.60%	(18,750)
20%	20,000,000	90	2.15%	2.65%	(25,000)
5%	5,000,000	180	2.20%	2.70%	(12,500)
100%	100,000,000	42	2.15%	2.60%	(58,194)

Option 1- Sell shortest maturities

- Realize loss of $1,944*
- Weighted average maturity extends to 58 days
- Yield over next 180 days if rates are unchanged is 2.39%
- Yield if rates rise another 50 bps 30 days from now is 2.73%

Subordinated shareholders would prefer Option 1

- Minimize realized loss and potential for permanent impairment of NAV. Unrealized losses related to interest rate moves will likely recover.
- Impact on NAV of subordinated shares far exceeds benefit of higher yield

Allocation		DTM	Yield	Market Yield	Unrealized Realized Gain(Loss)
0%	-	1	2.50%	2.50%	-
0%	-	7	2.05%	2.55%	-
64%	45,000,000	30	2.10%	2.60%	(18,750)
29%	20,000,000	90	2.15%	2.65%	(25,000)
7%	5,000,000	180	2.20%	2.70%	(12,500)
100%	70,000,000	58	2.12%	2.62%	(56,250)

Option 2- Sell longest maturities

- Realize loss of $31,250*
- Weighted average maturity shortens to 28 days
- Yield over next 180 days if rates are unchanged is 2.44%
- Yield if rates rise another 50 bps 30 days from now is 2.84%

Common shareholders would prefer Option 2

- Higher yield over 180-day horizon, especially if there are further rate increases
- Subordinated shareholders absorb realized losses
- Subsequent realized gains could offset realized losses however gains may not be available to take. If they are it poses another conflict between share classes since realizing gains usually entails giving up yield.

Allocation		DTM	Yield	Market Yield	Unrealized Realized Gain(Loss)
0%	-	1	2.50%	2.50%	-
29%	20,000,000	7	2.05%	2.55%	(1,944)
64%	45,000,000	30	2.10%	2.60%	(18,750)
7%	5,000,000	90	2.15%	2.65%	(6,250)
0%	-	180	2.20%	2.70%	-
100%	70,000,000	28	2.09%	2.59%	(26,944)

* The 10% of the portfolio allocated to overnight assets would reduce the requisite amount of money raised from sales to 20% of the portfolio.

Source: BlackRock

subordinated shareholders would absorb any realized losses that occur.

In order to reduce conflicts, regulators will need to spell out a clear hierarchy of fiduciary interest to ensure sponsors know what actions are appropriate in what circumstances.

Trust (or Special Purpose Entity) Structure

An alternative approach is a trust or special purpose entity (SPE) structure that would house the money market mutual fund. In many ways, the trust structure is similar to the subordinated share class, however, there are several key differences. While BlackRock initially considered the idea of one SPE per fund sponsor and potentially multiple funds supported by a single SPE, we have concluded that it would be much simpler (and pose fewer conflicts) if each MMF portfolio had its own SPE.

What Is It?

The SPE would be created to hold capital for the benefit of the MMF. The SPE would, in effect, provide a guarantee to the MMF to top up the NAV to $1 whenever the fund's fair value drops below 0.995. This mechanism would work like a capital support agreement.

The capital for the SPE could come from (i) the fund sponsor, (ii) a fee imposed on the portfolio, (iii) third parties, or (iv) from some combination of the prior three sources. Ideally, the SPE would issue both common and preferred stock. It is expected that the sponsor would hold the common stock of the SPE. The sponsor could choose to issue preferred stock for purchase by third parties to reduce the sponsors' total exposure.

As with the NAV buffer, a fee could be set by regulators and applied uniformly to all funds industry-wide. Unlike the NAV buffer, the capital in this structure would be owned by the SPE, and in the event of a liquidation, the remainder would be returned to the holders of shares in the SPE.

As mentioned earlier, the SPE shares many of the features of the subordinated share class. This approach lends itself to combining sponsor and third party capital. In addition, the fee from the portfolio ensures investors are contributing to the cost of a stable value product. As with the subordinated share class, the SPE would need to issue staggered maturities and work out the redemption and extension features to reflect the underlying value of the MMF portfolio.

Unlike the subordinated share class, however, these securities would be outside the MMF itself, and they would clearly be "equity" in the SPE rather than "debt" of the MMF. The SPE could issue multiple share classes (i.e., common and preferred) with different rights, enabling the preferred to be more protected and thus should require a lower yield.

Key Benefits

Ease of implementation. The SPE structure can be set up quickly. This approach does not require significant changes to MMF documents. In addition, this approach uses existing financial technology. Both capital support agreements and preferred stock are familiar instruments to financial market participants. There is an existing mechanism for using CSAs to support MMFs. Likewise, there is an established market for preferred stock.

Flexibility and speed of funding. This approach provides flexibility as to the source of funding. A sponsor would contribute capital to the SPE immediately. Sponsors desiring to lay off some of the risk could sell interests in the equity of the SPE to third parties in a transaction that would essentially result in reinsurance for MMFs. In addition, a uniform fee could be imposed on the MMF to add to or replenish capital over time.

Sponsor accountability. If the sponsor holds the common stock, it would have direct financial skin in the game. In this approach, regulators could specify a minimum amount of capital they want the sponsor to retain to ensure continued financial accountability and commensurate conservative behavior.

Risk tailored to investor type. The interests sold to third parties may be common stock or preferred stock in the trust. The pricing of the shares would reflect the level of risk being taken by investors. It is anticipated that buyers would be sophisticated investors who understand the risk being taken.

No capital limits. Unlike the NAV buffer described earlier, an SPE could accumulate higher levels of capital to support the MMF and it could be replenished rapidly. The SPE's capital will become a fund asset only if the fund's fair value falls below 0.995 of its amortized cost valuation.

Key Challenges and Options for Addressing Them

Complicated structure. The preferred stock is complex and will raise a number of issues similar to the subordinated share class. The presence of common stock that is more junior may mitigate some of the rating issues or concerns about the redemption value of the preferred.

Complexity and cost of implementation. Again, the SPE approach has many similarities to the subordinated share class.

No benefit to NAV; limited redemption safeguard. Because the capital is an asset of the SPE and not the MMF, it would not be factored into the fund's NAV (except as noted above). As a result, there is no clear disincentive to shareholders to redeem (i.e., shareholders will not be leaving any capital buffer above $1 on the table if they were to redeem). Investor concerns about the extent of available support from the SPE can be addressed by publishing the fair value of the SPE and the amount of remaining support available from the SPE.

Governance guidelines would be required. To implement this approach, the MMF Board would need to establish guidelines for governance of the SPE.

Sponsor financial statements would be more complex. The SPE and the MMF likely would be consolidated by the fund sponsor. As with the subordinated shares, consolidation would inflate the sponsor's financial statements.

Redemption Fees

Redemption fees could be established to create economic disincentives to redeem. The redemption fee would need to be applied using a clear set of rules. These rules could include a provision for di minimis withdrawals, and could provide for a notice period after which the fee would not apply. Any fees collected from redemptions would be retained within the MMF for the benefit of remaining shareholders. This type of "circuit breaker" would further protect a fund from excessive redemptions. While not eliminating the need for capital, the presence of redemption fee features should mitigate the amount of capital required. Some institutional investors may be resistant to products with redemption fees and the triggering mechanism will be important to their analysis.

> BlackRock supports financial regulatory reform that increases transparency, protects investors and facilitates responsible growth of capital markets, while preserving customer choice and assessing benefits versus implementation costs.

Hybrid Solutions

Notably, the proposals outlined above need not constitute an all-or-nothing proposition. A hybrid approach that uses some facet of the aforementioned models could be a desirable solution. Rather than being overly prescriptive, regulators could allow for some market innovation — specifying the minimum amount of capital and timeframe for capital to be in place, and then allowing each plan sponsor to address the problem in a way that best meets its needs. However, the benefits of flexibility need to be weighed against the cost of complexity. Ultimately, a hybrid approach may introduce too much complexity.

Example: Assume a hybrid solution that uses an NAV buffer and the SPE structure. In this combination, shareholders and sponsors share the risks and the benefits of MMFs. The presence of the buffer within the MMF strengthens the NAV and obviates the incentive to run. In addition, some capital can be put in place through sponsor contributions more quickly than would be possible using the buffer-only solution. In addition, a mechanism could be designed to enable a sponsor to pre-fund and then recoup its investment over time using income from the portfolio once the buffer is fully funded.

Conclusion

When considering MMF reform, it is important to reflect on the role MMFs play in the overall short-term financing markets for corporations and municipalities and, by extension, the tremendous impact they have on the functioning of our economy. As additional structural change is considered, care must be taken to ensure that the reforms, both individually and collectively, achieve the objective of protecting MMFs and the shareholders who invest in them without inadvertently destabilizing financial markets.

BlackRock has advocated "capital solutions" from the outset of the MMF reform discussions (see February 2010 *ViewPoint* titled "A Proposal for a Capitalized Special Purpose Entity"), and we are not surprised that many of these solutions remain under consideration today. We welcome the opportunity to continue to engage in finding the optimal solution that would both maintain MMFs as a viable cash vehicle and strengthen Rule 2a-7 to enable MMFs to better withstand risks.

Following are several important considerations:

Amount of capital. The amount of capital required by MMFs to ensure a sufficient cushion is a critical discussion and one that is important regardless of the source of capital. We believe the amount of capital should reflect the level of risk in a given portfolio. As such, prime funds would require more capital than government funds or tax-exempt funds. The May 2010 enhancements to Rule 2a-7 require prime funds to hold at least 10% overnight liquidity and at least 30% weekly liquidity, significantly altering the landscape in terms of risk of a liquidity run. The SEC can further modify Rule 2a-7 to reduce liquidity risk even more through a requirement that MMFs limit concentration by not permitting any shareholder to purchase shares if, after such purchase, the shareholder would own more than 5% of the MMF's outstanding shares (as suggested in a BlackRock comment letter on the PWG Report to the SEC dated January 10, 2011). As discussed earlier, the inclusion of redemption fees in Rule 2a-7 could further protect a fund from a run and reduce the amount of capital required. Based on the capital guidelines that ultimately are established, some plan sponsors may decide that the amount is achievable, whereas others may choose to exit the MMF business.

One-size-fits-all is an unlikely solution. It is important to recognize that fund sponsors will have different perspectives based on their organizational structure and other considerations specific to their circumstances. These considerations include ownership structure (public, private or mutual ownership), affiliations (independent versus bank-affiliated), size (large versus small) and asset mix (retail versus institutional). These variables will significantly influence each fund sponsor's preferred solution. Access to capital is a critical issue in this analysis.

Standardization provides benefits. While some flexibility and choice is desirable and may encourage innovation over time, standardization offers simplicity and consistency, which may outweigh the benefits of flexibility.

The importance of an established fee. Whatever form capital takes, regulators should establish a clear and uniform fee structure to provide complete transparency for investors and to ensure that MMF sponsors are adequately compensated for the capital they are providing. Neglecting to establish an appropriate fee structure could inadvertently cause a contraction in the industry, which would be detrimental to all interested parties – MMF investors and sponsors, businesses, municipalities, and corporations.

Accounting rules. Absent a guarantee, current accounting rules do not allow managers to establish reserves on their balance sheet for possible future losses of a MMF that may be borne by the sponsor. However, managers are required to record the liability associated with guarantees provided to a managed fund and may be required to consolidate funds under certain conditions. Any solution must be accompanied by appropriate SEC accounting rule changes.

Tax rules. Each of these structures has different tax implications. In considering the choices, regulators must determine whether changes to current tax rules are warranted as part of an overall solution.

MMF participants must focus on refining the remaining options. Setting out clear objectives and constraints will help all interested parties (investors, CP issuers, plan sponsors, regulators, trade associations) focus their efforts and energy on finding the best possible solution. Each of the remaining options has unresolved issues; however, an intense collaborative effort will be important in addressing these issues and strengthening and enhancing the MMF industry.

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