



# Investment Perspective

Cash Management

First Quarter 2011

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## The Shifting Regulatory Landscape for Money Market Funds

### Continued regulatory proposals

There have been various amendments undertaken over the last year that have enhanced the credit and liquidity risk profiles of money market funds with several regulatory proposals still on the horizon. Recognizing the importance of money market funds, these new proposals aim to reduce the risk posed by money market fund runs to the broader economy.

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#### Money market liquidity facility and capital requirements

The Investment Company Institute, the national association of the U.S. investment companies, proposed creating a private emergency liquidity facility (LF) to support prime money market funds during periods of unusual market stress.<sup>1</sup> The LF would require participation by all prime funds and would be formed as a state-chartered bank or trust company. The bank would be capitalized through an initial contribution based on a fund's asset under management and then increased from ongoing fees of three basis points per annum from funds of the LF member. During times of unusual market stress, the LF would buy high-quality short-term securities from member prime money market funds at amortized cost<sup>2</sup> thus enabling funds to meet redemptions and avoid selling securities into an illiquid market. The use of the LF would be permitted only after a substantial portion of the fund's liquidity positions are depleted and the LF would not provide credit support by buying distressed securities. It is unlikely that the LF would have prevented the Reserve Fund from "Breaking the Buck",<sup>3</sup> but it would have limited the after shocks of the market dislocations for the remaining prime money market funds in the industry.

Another proposal that is gaining some momentum recommends that each money market fund create and maintain a capital reserve.<sup>4</sup> To fund the capital reserve, a money market fund would retain a portion of its income over time, for example, five basis points per year for eight years for a total 40 basis points. At the end of the eighth year, the reserve would be fully funded and the money market fund would stop charging the fee. This would effectively reduce the fund's yield and would shift the cost of the capital reserve to the investor, in contrast to the LF's cost which would be initially backed by fund advisors.

Both proposals have draw backs and complexities to their design and many questions remain. Which proposal is better? Would investors be willing to accept lower yields in order to benefit from increased liquidity? Would a combination of both proposals work? Would these proposals force some advisors to exit the market? These are difficult questions to answer and it will take time to evaluate and implement either of these proposals.

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1 Investment Company Institute, ICI Comment Letter on President's Working Group on Money Market Fund Reform, Jan. 10, 2011.

2 Amortized cost is the valuation of a security based on the acquisition cost as adjusted for amortization of premium or accretion of discount rather than the value based on current market factors

3 'Breaking the Buck' is when the net asset value (NAV) of a money market fund falls below \$1.

4 Investment News, SEC pitches plan to prevent 'Breaking the Buck', April 3, 2011

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## **SEC proposal to remove credit rating references from SEC Rule 2a-7**

The SEC is implementing provisions of the Dodd-Frank Act that was signed into law in July 2010 by proposing to remove references to credit rating agency ratings in Rule 2a-7 under the Investment Company Act of 1940, which governs the operations of money market funds.<sup>5</sup> This proposal which aims to eliminate any over-reliance on credit ratings and to encourage an independent assessment of creditworthiness by investors, would affect the following five elements of the rule:

- Eliminate the requirement that a security be rated by a Nationally Recognized Statistical Rating Organization (NRSRO). The current rule requires that money market funds invest at least 97% of fund assets in securities that are deemed “first tier”, meaning they have received the highest short-term credit rating and no more than 3% of fund assets in “second tier” securities, meaning they have received the agency’s second highest rating.
- By removing the credit agency reference, the fund’s board of directors or its delegate would have to assess the credit quality of the security and determine that each security held presents minimal credit risk as well as classify each as a “first tier” or “second tier” security within the existing percentage limits.
- Remove the credit rating requirement from any security with a conditional demand feature, a common feature of variable rate demand obligations typically issued by municipalities. This proposal would require the fund’s board or its delegate to determine that the underlying security is of high quality and subject to minimal low credit risk.
- Eliminate the use of credit ratings in the rule’s downgrade and default provisions in regards to monitoring minimal credit risks.
- Eliminate the reference to portfolio securities’ downgrades in the stress-testing provisions.

Public comments on the proposed rule amendments were sought by the SEC through April 25, 2011. In managing credit risk, Invesco draws on an experienced credit research team and conduct thorough fundamental credit analysis independent of rating agencies. Despite the challenging external environment, we remained steadfast in our commitment to maintain minimal credit risk in our portfolios and continue to avoid issuers with higher probabilities of event and headline risk for our clients.

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## **Moody’s new money market fund rating methodology**

In Sept. 2010, Moody’s proposed a new methodology to better measure the credit quality of money market funds due to multiple funds that either suspended redemptions or required support from their sponsors to maintain a stable net asset value (NAV) in the fall of 2008.<sup>6</sup> The proposal focused on introducing a new money fund rating scale, elevating the importance of sponsor support of money market funds (MMF) and quantifying specific factors to evaluate a fund’s liquidity profile, concentration risks and NAV stress. The proposal was widely criticized by fund sponsors upon release. In March 2011, Moody’s subsequently released an updated methodology taking into consideration the substantial feedback received from market participants.<sup>7</sup> Moody’s maintained their current MMF rating symbols but appended them with an “mf” modifier to highlight the money market fund rating. Additionally, the role of sponsor support in measuring the credit quality of MMFs have been limited considerably from the scope initially proposed by Moody’s. Finally, the new methodology is based on two distinct analytical assessments of the portfolio, Credit Profile (based on credit quality of the fund’s assets) and a Stability Profile (including market and liquidity risks) in combination with an analysis of the sponsor quality and manager attributes to determine the final fund rating. This new rating framework goes into effective on May 20, 2011.

We believe that because of the Rule 2a-7 enhancements, the industry is arguably better positioned today to protect investors during periods of market stress than at any time previously. We are encouraged that policymakers recognize the vital economic role that money market funds play as a source of short-term credit as well as serving as an important investment vehicle for investors. We will continue to actively work with both policymakers and our industry peers to enhance industry standards and practices.

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<sup>5</sup> Securities and Exchange Commission, Speech by SEC Chairman: Opening Statement Regarding Proposal to Remove Credit Rating References from Investment Company Act Rules and Forms, Securities and Exchange Commission, March 2, 2011

<sup>6</sup> Moody’s Investor Service, Moody’s Proposes New Money Market Fund Rating Methodology and Symbols, Sep. 7, 2010

<sup>7</sup> Moody’s Investors Service, Moody’s finalizes new methodology for money market funds, March 10, 2011

**An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in such a Fund.**

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