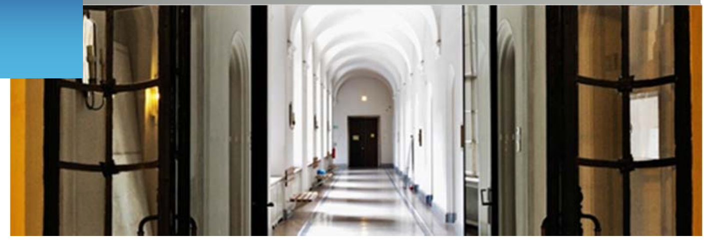
The New Regulatory Regime for Money Market Funds

A Window into the Mark-to-Market NAV



Introduction

Since the inception of money market funds several decades ago, a stable net asset value per share (NAV) has been a defining feature of this investment vehicle. Shareholders of money market funds managed in accordance with Rule 2a-7 under the Investment Company Act of 1940 subscribe and redeem shares at a net asset value of $1.00 per share. While money market funds seek to achieve a stable net asset value of $1.00 per share, there is no guarantee that it will be maintained.

In the wake of the market events of 2008, the U.S. Securities and Exchange Commission (SEC) approved changes to Rule 2a-7, added new disclosure requirements and took other actions in 2010 intended to strengthen the regulatory framework governing money market funds. Broad in scope, these changes imposed tighter restrictions on money market funds' portfolio maturity, credit quality and liquidity guidelines, expanded portfolio disclosure requirements and increased transparency to investors. A key element in increasing transparency was the requirement that money market funds file the mark-to-market--or "shadow"— NAV of their portfolios with the SEC on a monthly rather than semi-annual basis. The SEC will make this information public on a time-lagged basis.

In this paper, we review some of the factors that influence the mark-to-market NAV and its characteristic daily fluctuations. Ultimately, we believe that the new regulatory regime will prove beneficial to investors by supplying them with more detailed information on fund managers' investment philosophies and approaches to risk management.

Background: Money Market Funds and their Regulatory Framework

Money market funds are open-end investment companies that are registered with and regulated by the SEC under the Investment Company Act of 1940. Under Rule 2a-7, money market funds are able to use a stable NAV, typically $1.00 per share. To accomplish this, these funds can value portfolio securities at their acquisition cost adjusted for amortization of premium or accretion of discount. This is known as amortized cost accounting.

The SEC permits money market funds to use this valuation method due to the short-dated, diversified, high quality and liquid nature of their underlying investments. In addition, money market funds that use the amortized cost method are required to calculate a separate NAV—often called the "mark-to-market" or "shadow" NAV—which is based on available market quotations for the funds' portfolio securities plus undistributed realized gains and losses. There are typically very small daily market price movements experienced by the securities in a money market fund's portfolio. So long as the mark-to-market NAV is within one-half of one cent per share (between $0.995 and $1.005) of the NAV calculated using the amortized cost method, a money market fund is permitted to continue using amortized cost accounting and to conduct purchases and redemptions of its shares at $1.00 per share. In the event that the mark-to-market NAV deviates from the money market fund's amortized cost price per share by more than one-half of one cent per share (commonly referred to as "breaking the buck"), the fund is required to promptly consider what action should be taken, which may include suspending the use of amortized cost accounting. Under the new regulatory requirements, a fund's mark-to-market NAV must now be filed monthly with the SEC on Form N-MFP, the contents of which the SEC will make available to the public starting in early February 2011.

We support efforts by the SEC to provide investors with more detailed information and believe that the additional disclosure will provide shareholders with more insight into the workings of money market funds.

What Makes the Mark-to-Market NAV Fluctuate?

A money market fund's mark-to-market NAV can fluctuate for a number of reasons. One major factor is monetary policy. Monetary policy is the process by which a central bank regulates the control of money and interest rates in an economy. Within the U.S., this is carried out by the Federal Reserve Board (FRB), which sets short-term interest rates (longer-term rates are set by the capital markets). Because money market funds hold short-duration securities, the values of their portfolio securities are affected when the FRB moves short-term interest rates. When interest rates move up or down, the value of fixed-income securities held by money market funds moves as well--typically in the opposite direction of interest rates. As a result, rising rates will tend to move security prices and the mark-to-market NAV downwards, while conversely, falling rates will cause security prices to rise. Because the instruments involved are comparatively short in duration, these movements in the mark-to-market NAV tend to be small.

Market conditions and investor expectations also influence a fund's mark-to-market NAV. When market liquidity changes--or borrowing becomes cheaper or more expensive--the prices of securities held within a portfolio can fluctuate. Changes in market conditions can impact both the broader markets and individual securities and sectors in those markets. Such changes will also influence money market funds' daily mark-to-market NAVs. Investor subscriptions and redemptions also have an impact day to day. This is because funds buy and sell portfolio securities based on shareholder subscriptions and redemptions. If different funds are buying or selling at different points in the interest-rate cycle, this could contribute to differences in the mark-to-market NAVs between those funds.

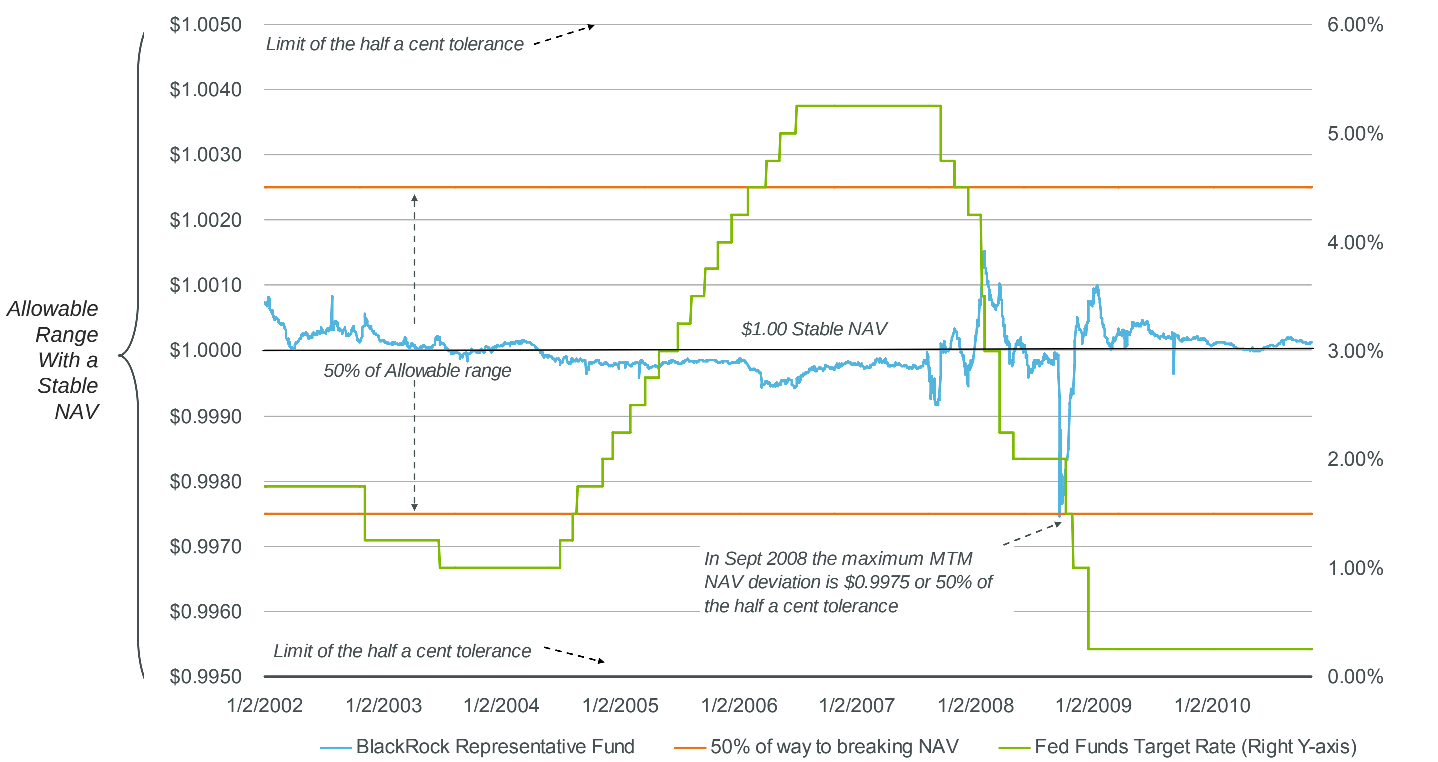
Overall, mark-to-market NAVs of money market funds have generally performed counter to the business cycle: historically, they tend to track above $1.00 during slowing economic periods, when interest rates are typically lowered to kick-start the economy, and tend to track slightly below $1.00 in periods of economic expansion, when rates typically rise.

Historical Mark-to-Market Fluctuations – 2002 to 2010

To show how different economic conditions can influence a money market fund's daily mark-to-market NAV, we compiled data from January 2002 to October 2010 for a representative BlackRock institutional fund to construct the chart below (this period includes the financial crisis that began in 2007-2008). The fund is a taxable "Prime" money market fund that invests in a wide variety of money market instruments, including certificates of deposit, time deposits, commercial paper, and treasury and agency obligations. As such, it provides a useful example for this discussion.

In the chart, the fund's stable NAV of $1.00 per share is the horizontal line shown in the center, while the mark-to-market NAV is the fluctuating line moving above and below the $1.00 line. We have also added horizontal lines at $1.0025 and $0.9975, or one-quarter of one cent above and below $1.00, to show the historical limited range of fluctuation that the representative fund's mark-to-market NAV experienced during this period. Lastly, to show the effect prevailing interest rates can have on the mark-to-market NAV, we have overlaid an additional line spanning the period that plots changes in the Federal Funds Target Rate which is set by the FRB.

Figure 1: Impact of Interest Rate Changes and Market Events: 2002 to 2010



Note: The data shown above is one example, and is not a guarantee of future results. Money market funds are not guaranteed to maintain a $1.00 net asset value and shares of a fund are not insured by the Federal Deposit Insurance Corporation or any bank or government agency.

Source: BlackRock

Using the chart we can summarize how the fund's mark-to-market NAV can fluctuate under differing interest rate environments and economic conditions:

1) January 2002 to June 2004 – As the U.S. economy emerged from the recession of the early 2000s and the FRB progressively lowered interest rates, the prices of fixed-income securities rose and money market funds' mark-to-market NAVs generally exceeded the $1.00 stable NAV.

2) June 2004 to August 2007 – In this period, interest rates rose steadily and then stabilized; the impact of these rate hikes can be seen in the chart, where the Fund's mark-to-market NAV remained slightly below the stable $1.00 NAV.

3) August 2007 to January 2010 – The credit crisis that began in mid-2007 was a time of unprecedented stress in the credit markets. The systemic events that followed in late 2008 caused short-term debt instruments to experience a massive loss of liquidity. This caused money market funds' mark-to-market NAVs to exhibit far more volatility than normal. As shown in the chart above, during the period from early 2008 to early 2009, the representative fund's mark-to-market NAVs showed unusual price movements relative to historical experience.

In analyzing historical NAVs such as those plotted in the chart above, it is important to note that even during the great credit crisis that began in mid-2007, the representative fund's mark-to-market NAV did not exceed 50% of the one-half of one cent threshold needed for the fund to break the buck. At its lowest point in September 2008, the mark-to-market NAV of the fund was $0.9975; however, for the great majority of the period covered by the chart, the representative fund's mark-to-market NAV remained comfortably within one-tenth of one cent above or below the stable NAV of $1.00.

Conclusion

BlackRock has welcomed the SEC's changes to Rule 2a-7, including the new rules requiring more frequent disclosure of mark-to-market NAVs. We believe that transparency is critical for investor confidence and that an increased understanding of how money market funds have worked in practice should help reinforce investors' understanding of these products and the regulatory framework critical to maintaining the integrity of the product.

We encourage investors to review published mark-to-market NAV data with the understanding that different money market funds' mark-to-market NAVs will naturally differ from each other. Each money market fund has different dynamics in terms of its portfolio composition and shareholder base. In the vast majority of cases the Rule 2a-7 structure has historically allowed money market funds to keep a stable $1.00 NAV in place despite these differences. Accordingly, we maintain our belief that money market funds continue to provide shareholders with an important source of short-term liquidity and investment diversification.

We recommend investors keep the following key points in mind:

- Changes in the mark-to-market NAV are normal and to be expected;
- The mark-to-market NAV typically fluctuates in a tight range around the $1.00 stable NAV and is almost never precisely $1.00;
- The mark-to-market NAV can be slightly above or below $1.00 for sustained periods of time--sometimes for years;
- Mark-to-market NAV movements are typically caused by changes in interest rates, prevailing economic conditions and investor purchase and redemption activity.

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