DEVELOPMENTS IN THE MUTUAL FUND INDUSTRY –  
MONEY MARKET FUNDS  
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MARTIN LYBECKER: Good afternoon. I’m Martin E. Lybecker of Wilmer Cutler Pickering Hale and Dorr LLP, and it is my honor to moderate one of the four online programs on developments in the mutual fund industry, presented by the Securities and Exchange Commission Historical Society. The SEC Historical Society is a non-profit organization separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org. Today’s program will be preserved in the virtual museum so you can listen to the discussion or read the transcript later.

Today’s program focuses on the development of money market funds. Joining with me today are John McGonigle, Vice-Chairman of Federated Investors; Robert Plaze, Associate Director of the Division of Investment Management, U.S. Securities and Exchange Commission, and David Silver, who is a retired president of the Investment Company Institute. This developments in the mutual fund industry series is made possible in part through the support of the Richard and Elda Phillips Fund. The remarks we make today are solely those of the speakers and are not representative of the Society. Our speakers cannot give investment or legal advice.

We have a series of questions that we’ll discuss from each participant’s perspective. Bob Plaze in particular is a very important player in the development of money market funds starting in late 1980’s and early 1990’s. I will be the SEC representative in essence for the first four or five questions that go back to the amortized cost method of accounting hearings and the very early developments in money market funds.

We thought it would be useful, however, to start with Dave Silver to give the historical perspective -- what the initial developments looked like when money market funds first started in 1973, 1974 -- and what they have achieved, historically.

DAVID SILVER: Thank you, Marty. When you first asked me to be on this panel, I almost asked myself a variant of that famous question of Admiral Stockdale – what are we going to be doing here? But the more I thought about it, the more I realized memory gets dim over time and I did go back and look and think, and I realized that the development of money market funds was a seminal event from the point of view of public investors and for the mutual fund industry. So I thought it might be worth while to cast ourselves back and think in terms of what money market funds meant to the investing public and what money market funds meant to the mutual fund industry.

The first fact, which seems almost unimaginable in these days of 1% interest rates, is that at the end of the decade of the ‘70’s, interest rates, short-term rates, 6-month CDs, had reached almost 17% and inflation had reached almost the same level on an annual basis. Millions of families were losing ground to inflation because the savings and investment media open to them did not permit them to receive a market return. Banks were subject to Regulation Q. That is an antique, if there ever was one. Regulation Q limited banks to 5% interest on passbook accounts. Moreover, on transaction accounts, checking accounts, essentially no interest was permitted. Now money market funds had actually first started in 1974, but by 1980, they had reached only about $60 or $70 billion. However, the spur of the high interest rates was a tremendous push, and in the year 1981 over $100 billion was added to money market funds. So the investing public increasingly turned away from banks as their primary savings media and moved toward money market funds. From an industry point of view, by 1980, mutual funds, equity funds were actually losing ground. Assets in equity funds, which had always been the economic backbone of the mutual fund industry, were stagnant. Equity fund assets were about $40 billion at the end of 1980 and were about the same level at the end of 1970, although bond funds had grown from about $2 billion to about $14 billion. The industry was characterized by its equity funds and the smaller bond funds. There was no safe investment, and I put the word safe in quotations in the mutual fund industry. Bond funds might be safe from the point of view of ultimate protection of capital, but they were subject to the volatility in the secondary markets that long-term instruments saw. Money markets funds were entirely...
different. They did provide a safe substitute, safe as you can be in an investment as compared to a guaranteed savings account for the investing public.

There was a tremendous explosion of money market funds in 1981. At the Investment Company Institute, we did the first shareholder study of money market funds, the five million new shareholders in these funds. What we found was extraordinary. The traditional funds were suffering from an aging shareholder base. Well over half of our investors were over the age of 50, and there was very little growth. On the money market funds, we found that 50% of money market funds shareholders were under 40 years of age, well over half of them had college degrees, 25% of them had graduate degrees, and 2/3 of them had never owned any mutual funds. I did go back and look at my report to the mutual fund industry in 1982, and I’d just like to share several sentences with you: “I suggest to you that these demographics make money market fund shareholders an even more critically important factor in the future of the mutual fund industry than they are at present. These young, intelligent, and increasingly affluent shareholders will be a major source of business for decades to come. They will be responsive to innovation and every effort should be made to serve their changing needs. Thus the legislative environment for money market funds is of paramount importance, not only for our present, but for the future.” This is probably not the place to go into what happened thereafter with the fight in 28 states.

MARTIN LYBECKER: We’ll get there.

DAVID SILVER: But I did particularly want to read these several sentences because, in my long career at the Investment Company Institute, I was wrong a lot of the time, but this time I was right on the money.

MARTIN LYBECKER: As it were. Okay, John, let’s go back to the early 1970’s. Dave put it in historical and economic perspective. In the 1970’s, your company amongst others was very interested in using the amortized cost method of accounting. You requested that the Commission institute an administrative proceeding after a bunch of preliminary sparring, and that’s where the original amortized cost method of accounting was approved as a settlement of that administrative proceeding. Are you happy with your decision to request an administrative proceeding? Was that a good decision? Is that a good forum in which to make these kinds of decisions, or was it a bad one?

JOHN MCGONIGLE: No, it was absolutely the right one because we had two dramatically opposing views at that time. The Commission had, at one point in the issue, stated that it felt the only method for valuing money market instruments was to use market values and our position was that there were not real market values out there. People bought these securities and held them to maturity; therefore, they didn’t buy and sell them, and the Commission release agreed with that conclusion. One of the major turning points for us was in the mid-’70’s when money market fund yields fell below the passbook rates, and we found that individual investors started to move back into banks and savings and loans. The one group of people who didn’t leave our funds at that time was bank trust departments at that time. We then divided the country up into segments and each of the senior officers of our company took a territory, and we went out and visited every bank - 14,000 of them over a period of a couple of years. What we found is that those bank trust officers who were very sophisticated investors did not have a methodology for investing in money market instruments because they had a variety of accounts with small balances, medium-sized balances and large balances. They would have to trot these balances down to the local S&L and get passbooks for each one of them. Strange as that may seem, that’s the way it worked. Or they would put the money in checking accounts in the bank at no interest. So those were their options.

When the money market funds came along, we had computer systems that would accumulate all those balances and transfer them into the funds. One of the things trust officer were adamant about is that this thing called mark-to-market was not what they wanted. They wanted “dollar in, dollar out” and they wanted the yield on that portfolio daily as it moved forward. They were very sophisticated and knew there weren’t market prices for the securities. Under the Principal and Income Act as it existed at that time, they had to keep separate accounts for principal and income, so that if you took theoretical movements in the market and added them to the interest or the income of the fund, as was suggested at one point, it was transferring principal to income and violated the Principal and Income Act. If you had a fluctuating asset value based on a market that didn’t exist, then you were subjecting the principal of the account to risk to
benefit the income beneficiary. Now you have to put yourself back 30 years ago, and in that environment, they wanted “dollar in, dollar out.” And so we were issued the first temporary exemptive order, and it was based on the 120-day average portfolio maturity, 1-year maturity per instrument, with high-quality instruments, no trading of the portfolio, and the investor had to have at least $50,000 in the fund. So we started off with this exemptive order that resulted from the demands of sophisticated investors. Then in the course of the hearings, people from the industry came in and testified that, although the traditional method was to use mark-to-market, retail investors would also like to have dollar-in, dollar-out. But it started with the institutions – the most sophisticated investors - making that demand to use money market funds in the most sophisticated investors.

MARTIN LYBECKER: Well, I was the one who inherited the administrative proceeding that John’s company requested, and he’s absolutely correct. The Commission did issue a temporary exemptive order and then we the SEC staff found ourselves in the very difficult and unusual situation of having other mutual fund advisers in perfectly good faith ask for their own temporary order, too, and we ended up in the temporary exemptive order business while at the same time rolling every single one of new applicants who got a temporary order into the administrative proceeding. I looked up and kept thinking we’re going to have this never-ending group of people who’d been applicants, all of whom would have procedural rights in the hearing as a “party,” but they’d never get their turn at the hearing to present their arguments in an orderly manner. So, of course, what we did was first try to bargain out all the applicants that were willing to mark-to-market and use a dollar net asset value per share, and then finally ended up having an administrative proceeding with the hard core of applicants that were demanded the amortized cost method of accounting. That hearing was resolved in a settlement before the administrative law judge that I then presented to the Commission after the adverse parties waived the ex parte rule. Personally, I found it a very difficult way to make public policy. We got to the right result, but it’s very uncomfortable for a SEC staff person to talk to an administrative law judge about public policy responsibilities, as distinct from an adversarial enforcement proceeding, while the SEC staff is prevented by the ex parte rules from talking to the five Commissioners to whom you have a lot of responsibility and, as John just said, had given us instructions in setting the matter down for a hearing to stick with mark-to-market pricing and not to agree to the amortized cost method of accounting, so it was difficult. But that was sort of the first legal round.

The second legal round was hearings on Capitol Hill in which the banking industry attempted to get various people in the Senate and the House to question money market funds, and I ended up being called upon regularly to testify for the Commission. I’m pointing at Dave, you also did something in which we, the SEC staff, didn’t play a role. The state developments that you had just started to talk about was very aggressive attempt by the banking industry to regulate money market funds and in which you had a deep personal involvement.

DAVID SILVER: Yes, Marty, I think before passing over the Congressional hearings which were critical, and they were critical because those hearings established without any legislation, but the hearings themselves established what you might call the legitimacy of money market funds. And I think that the investing public, certainly the mutual fund industry, owes a major debt of gratitude to the Commission and particularly Irv Pollock, a Commissioner who at that time was the Commission witness at the major hearings in which he talked about the fact that money market funds would continue to be adequately regulated and second, and this is of critical importance in what followed, that money market funds were not banks. They did not fit the definition of banks in the banking laws, that the money market funds issued securities and not bank deposits because what the hearings were about were the attempts of the banks to have the Congress one way or another recognize or label money market funds as banks, in which case for a whole variety of reasons, money market funds would cease to exist under the Glass-Steagall Act and other provisions.

MARTIN LYBECKER: Including the imposition of reserve requirements.

DAVID SILVER: Yes, the whole thing, and the SEC would drop out of the picture and essentially regulation would pass to the bank regulatory agencies. I have to say though that, at those hearings, the Fed took a position favorable to money market funds. Governor, then Governor Charles
Partee testified that consistently with the testimony offered by Irv Pollock for the Commission. This was of critical importance from a legislative-lobbying point of view because of the banks’ insistence on trying to label money market funds as banks and indeed submitting a letter to the Criminal Division of the Justice Department asking for criminal prosecution of the money market funds for violation of the Glass-Steagall Act. That was rebuffed by the then-Chief of the Criminal Division Phil Heymann, who I think is now a professor at Harvard Law School who wrote a very long and very strong letter pointing out the fact that money market funds did not fit the functional or legal definition of banks. Those hearings, as I say, served to establish the legitimacy of money market funds. Thereafter, the banks turned to the states and we have to recognize in the practicality of things the bank lobby in each state and the S&L lobby, savings and loan lobby in each state were usually number one and two as far as lobbying capacity was concerned at state level. Usually the S&L’s and the banks spent a lot of time fighting with each other over looking for competitive advantage, one against the other. This was one of the few times where the banks and S&L lobbies joined together against what they conceived to be a common enemy. Time does not permit to go through the battles that occurred in 28 states; suffice it to say that we won in the trenches in 27 states. In the 28th, we won on a “Hail Mary” pass at the very end because the bill did pass outlawing money market funds, but the governor vetoed it, and that was in the state of Rhode Island.

**JOHN MCGONIGLE:** Marty, there is one point that I would like to make here. The winners in this battle were the investors. The banks were fighting money market funds because, at this time, in 1982, money market funds were the three times the size of equity and bond funds and were 20% of the deposit in MMDA’s and bank deposits - which from a standing start of some ten years earlier was a rather phenomenal change. The investors were getting rates that they were blocked from getting by federal law which dictated that passbooks could not pay more than approximately 4 or 5% during that period of time. So investors in money market funds were getting rates of 17% as opposed to a locked-in rate of 5%. They were the winners in the whole issue, because they were getting those kind of yields.

**DAVID SILVER:** No doubt, John, that it was the investors who turned the trick in the states. There was no lobbying capacity by mutual funds on the state level, and it really was a David and Goliath situation in each of those states, and what we did was go directly to the public. We did something which is commonplace today, but was very innovative for those times. We went on radio, heavy, heavy advertising campaigns on radio, and when these brushfires would start and become a forest fire in a particular state, we had our scripts ready. Just one very quick anecdote – most of the small radio stations in the Midwest and other places in the country were “cash and carry.” They wouldn’t accept advertising except with a certified check or perhaps an American Express card, so what I had to do for the Institute was to divide our staff into teams and we would start one person in one part of the state, another person from another part of the state. The Midwest states which are mainly rectangles were easy because we started in the four corners of the states and had them drive across the states dropping off the scripts and the American Express charge at each radio station. Again, John, we did benefit tremendously from the fact that we managed to convey to the public exactly what was at stake, and I’ll never forget the statement of Senator Garn when he saw at the Congressional hearings. Senator Garn, then-Chairman of the Senate Banking Committee who was originally sympathetic to punitive legislation against money market funds, at the end, not metaphorically, but really threw up his hands and said “even Jake Garn knows the difference between 5% and 15%.”

**ROBERT PLAZE:** And it was a loss for the banks. The banking industry lost this huge source of very cheap money and deposits, and at the same time with the growth of the commercial paper market which responded to the growth of money market funds lost prime lending client/customers. And one wonders to what extent, and Marty you’d have a better insight than I did, did that contribute to the eventual problems the banks had later in the decade.

**MARTIN LYBECKER:** There were the changes that the Reagan administration made to real estate lending that really was the death knell. But we need to move to our sub-topic. As has happened in any number of circumstances, once a particular kind of exemptive application becomes commonplace and the number of them granted, normally the SEC will propose and adopt a rule, and that happened in this instance. So, the first question for John and Dave is whether it was a good idea to adopt a rule, and then
the subpart would be: Rule 2a-7 could have been lots of things. It could have been a rule like the original exemptive applications that just stated principles and left the details alone. As it is, it’s become a very detailed rule where as a number of the provisions relate to very specific interpretive questions, less has been left to the industry for them to interpret. Was it a good idea for the Commission to move from exemptive applications to a rule? Is a rule the right way to go about doing the daily tasks of detailed regulation? You can be first, John.

JOHN MCGONIGLE: Originally, I think the rule was a very good idea. The industry was growing quite rapidly at that time. We were getting tremendous numbers of entrants into the business. Money market funds were flourishing, and the major players were the larger firms, but we were getting new entrants into the business. A lot of people were creating money market funds, and we in the industry had concerns about whether these new people really understood the rule or the orders well enough and were going to comply with them. I’m sure the Commission had those very same concerns. And so I think the rule in its basic form with the 120-day average and the 1-year maturity basically set the rules and set the parameters. We in the industry watched all the new entrants into the business quite carefully as did the ICI, and we reviewed everybody’s annual reports and semi-annual reports. We were also creating all kinds of new instruments which were coming online at that time, and we were going from a point where commercial paper was $20 to $30 billion in the early 1990’s to where it’s a over a trillion dollars today, and every kind of instrument that’s out there has been sliced and diced and put into money market funds in various forms. So it required a lot of sophistication to know what the risks of those various kinds of securities were, and I think the rule put the stake in the ground and required everybody to operate from the same page. It also gave the Commission the basis for going forward on a more systematic basis at its own pace, as opposed to getting an application every day and having to make decisions on it.

ROBERT PLAZE: Processing the applications was extremely resource intensive. And the question is always when someone comes up with a new idea, do you modify the application and then do you go back and redo all the other applications for the modification because you don’t have the resources to modify all the others. You don’t, and the rule alleviated those issues.

MARTIN LYBECKER: And some money market fund issuers foolishly put in their prospectuses the very restrictions in the rule or the exemptive application that they had at the time as a way of advertising and describing their fund, and when there’d be a development, they’d literally have to amend their prospectus to explain what they were changing to comply with Rule 2a-7. It was difficult. Anything that’s going to evolve is going to be hard to track in prospectuses. What was the industry perspective on Rule 2a-7?

DAVID SILVER: Well, I did again go back through my files and I’m not nearly as well-organized as the files John McGonigle showed me before we started today. Mine are sort of loose-leaf you might say.

MARTIN LYBECKER: John has a bigger staff.

DAVID SILVER: And I did come up with something, a draft called Rule 2a-4(d), and this was an industry effort which we submitted informally to the Commission staff, unfortunately it’s undated, probably the late ‘70’s or around 1980, and when, Marty when you asked me to be on this panel and one of the questions you had that we’ll talk about later, was the complexity of Rule 2a-7. I haven’t been there in some time and I pulled out my Investment Company Act rules and I was shocked at what I found. And all I can say is I’m glad I’m retired from the active practice of law at this time.

ROBERT PLAZE: But what’s really startling, Dave, is that 30 years from now, this will be the simple days.

DAVID SILVER: Going back to what I have, and I’ll give it to the SEC Historical Society, is this 12 line rule, three sentences long which does contain the essence of Rule 2a-7. It follows the pattern of Rule 2a-7 in that it defines money market fund and restricts the usage of the term money market fund to funds that comply with the rule and the 120-day average maturity not to exceed 120 days, 1 year is there, but it has the advantage of only being 12 lines long.

MARTIN LYBECKER: Yes, well, then it wouldn’t have picked up inverse floaters with 150 basis points discounts from the London LIBOR measured against the 13th District Federal Home Loan
Bank, but that’s actually an amusing way to get to Bob. We got through the 1980’s without much in the way of, I don’t want to use the word “scandals,” events. Early 1990’s, you really pick up the story, and of course there’s a series of “events.” Probably the most spectacular being the Orange County bankruptcy. Tell us what effect all of that had on Rule 2a-7, the philosophy behind how you were going to administer Rule 2a-7, and in particular Orange County with respect to money market funds.

ROBERT PLAZE: Well, where David left it, Rule 2a-7 rule is fairly simple when it was adopted in 1983, not a long, detailed rule, and the question was well why do we have to go and mess it up, I guess, is one way of putting it. Was it abused? Was it misused? And I think the answer when we came to look at it in the late ‘80’s, early ‘90’s was “no.” It wasn’t abused, but it was outmoded in some extent. It was very informal. This was a segment, a growing segment of the financial service industry, up to now about $450 billion of assets, relying essentially on a footnote in a release indicating what “high-quality” meant. I’m not sure the authors of that footnote fully appreciated the weight that that footnote would bear on holding the dollar share value for a $450 billion industry.

And so that was a problem, we felt. And, secondly, a number of money market funds had developed the practice of relying exclusively on the credit rating of the rating agencies and weren’t doing, as the rule required, independent credit analysis. And I did an examination once in around 1990 of a money market fund that was part of a large insurance company where the portfolio manager had been promoted from the clerical staff and has been given a list of appropriate securities in which to invest. There was no credit analysis being done in that organization. It was strictly on the rating and I think those are the informality of the management of administration of money market funds in light of the growth of the industry and the significance. I think it was 10% of the industry at that time. I think that it just simply seemed inadequate.

But the one that added a lot of the meat to the bones of the original Rule 2a-7 was developed in response to specific events occurring in 1989 and 1990. There were defaults on money market instruments by two companies, Mortgage Realty and Trust, and Integrated Resources. I think that Mortgage Realty and Trust had the bigger impact. These were A2/P2 issuers that defaulted soon after their commercial paper was downgraded. Now remember that footnote in the original release, adopting release in 1983, said it could be high-quality for the first two ratings in the money market funds by NRSROs. These were second-tier A2/P2 issuers and what was startling to the Commission staff at that time is that the issuers lost their rating and they defaulted. There was no opportunity for investors to make an orderly exit from that market. We looked around, and we saw a number of money market funds had high proportions in their portfolio in A2/P2 paper, and the concern was that if that is the characteristic of the A2/P2 market, or that was the developing characteristic, money market funds weren’t as safe as we thought they were in 1983.

Now what’s important to this story is to understand who was running things at the Commission at the time. Richard Breeden was chairman, and he had just come over from the White House staff in the first Bush administration, and his responsibility at the White House staff was shepherding through the thrift bailout legislation and he was focused on that during his time there. Coming over to the SEC, the last thing he wanted to see on his watch was the money market fund industry having a similar problem and having to preside over another bailout. Now a number of money market funds owned those two securities, the Integrated Resources and the Mortgage Realty and Trust. The advisors bailed out those money market funds. They took the security off the funds’ books at par value. Breeden was very concerned about presiding over another meltdown. Secondly, he was concerned about investors reaction should funds start “breaking the dollar” because his concern was they were going to take their money out of money market funds which had grown very large, and put them in banks, putting further pressure on the depository insurance system. So he had two reasons. He met with the staff of the Division and said “I want recommendations on how to tighten Rule 2a-7 to diminish the likelihood that money market funds would ‘break a dollar.’” There was an assumption built up over the intervening years that had been introduced that, if money market funds started “breaking the dollar,” that is pricing their shares below a dollar, that investors would flee money market funds and they would go back to bank instruments. And what’s interesting about the conclusions that Chairman Breeden at the time reached and the conclusions
the staff of the Commission reached is that I think the members of the industry, David you were president of the ICI at the time, had reached a similar conclusion. We were all concerned that one or more funds “breaking the buck” could have a ripple effect over larger parts of the industry.

**DAVID SILVER:** There was always that concern from the very beginning of money market funds. As a matter of fact, just to get back to your comment about Chairman Breeden at the beginning, later on, one of the last things I did as president of the ICI, I think it was 1989 or 1990, there was a concerted effort by second level industrial companies to broaden the rule to permit A2/P2 paper. The charge was headed I think by Chrysler and some other large fallen angels in the marketplace and I had a meeting with Chairman Breeden and we both agreed that if in fact the story being told by Chrysler and the others that A2/P2 paper was just as safe as A1/P1 paper that it was just some extra yield, there was no inhibition against anybody starting something they might call an “ultra short” fund, just not call it a money market fund, and if what the representations being made were true, the ultra short funds would drive the conventional money market funds from the field with superior yield. Well that never happened.

**ROBERT PLAZE:** But I did track Chrysler commercial paper values for a while after that and funds would have been very, very sad to have continued to hold that paper.

**MARTIN LYBECKER:** All of those changes were very beneficial ones. By the late 1980’s, it was pretty clear to everybody who was close to the money market fund industry that there were those who were buying A2 paper just before they thought they’d become A3/P3, solely for the yield “bump” they could get, and many of those funds were broker sold so they had very high fees, so you could understand the competitive pressure on portfolio managers to do that. One of the very nice aspects of the changes that you all put in place in 1991 was that the focus now had to be on quality and on the credits, and the yields were going to be, I wouldn’t want to call them homogenous, but they were going to be much more within the same band of range. There weren’t going to have wild disparities between yields. I know it meant that Gene Gohlke had less fun looking up the Donohue’s report every Monday and trying to figure out who the outliers were who held various strange things.

**ROBERT PLAZE:** The maximum average maturity was 120 days, we brought that down to 90 days. Very few mainstream money market accounts went past 90 into the 120, but people would take a flyer every now and then to take a play on the yield curve, and if you won on the yield curve, you won. If you lost, you lost.

**JOHN MCGONIGLE:** I think one of the good points that Bob makes here is that you don’t put the emphasis on the A1/P1; you put it on the quality of the issuer. That’s the purpose of the credit files. The ratings set the parameters, but it’s incumbent on the portfolio manager to have a file that justifies why they went into that particular security, not the rating which as you say, some people were using, but it was the quality of the instrument that needed to be looked at.

**ROBERT PLAZE:** Yes, particularly because of the risk of ratings failure. In the late 1980s we had such a failure with the Mortgage Realty Trust whose paper was held by several funds. One rating agency continuing to rate this A2/P2 while the others had concluded that it was not a good credit and as a result, when that, there was funds holding on to that credit despite the fact that there had been a consensus among the rating agencies that there was serious risk here. We called it the “last rating agency asleep at the switch” problem. The 1991 rules dealt with that problem by requiring funds to do their own credit analysis, and by requiring them to look at all the ratings. If there are more than one rating agency that has rated the security, you’ve got to look at the consensus of the rating agencies. There’s got to be rating agencies concluding that it is an eligible security.

**DAVID SILVER:** I think a point that John made inferentially and Bob referred to it, is the growth of professionalism within the money market fund industry of those who are responsible for managing those portfolios. I was smiling, Bob, when you talked about the fact that anybody at the beginning might turn out to be the portfolio manager. The reason for that was that it was a carryover from the days that all equity funds would always have some uninvested cash. And if you go back to the old days, and I’m talking about now the ‘50’s, the ‘60’s, etc. that uninvested cash was never looked upon as being an investable asset. It was just to be held somewhere and if you can get a return, that would be nice, so it would be anybody who might be taking care of it. It could be the CFO or the investment advisor. It
could the chief cook and bottle washer. It was not looked upon really as investment management to take care of the cash. You called your investment banker and he told you what CDs to buy or what commercial paper to buy, and that was essentially it. So a number of organizations, when money market funds first got started, they simply carried over whatever mechanism they had for investing cash in their equity funds, but during the ‘80’s as the funds grew, it became clear for the very reasons we’ve been talking about that this was as professional a job as portfolio management on the equity side, you had a real growth of expertise in the industry.

ROBERT PLAIZE: Most of the changes in ’91 were based upon concepts embedded in the ’40 Act that were already reflected in Rule 2a-7, diversification, quality and maturity restrictions, but one was brand new. Remember 2a-7 was primarily an exemptive rule dealing with the use of the amortized cost method of share valuation. The rule was transformed in 1991 away from that. Some money market funds were not using amortized cost and were therefore not subject to the rule’s conditions. They were investing in riskier securities, were using longer maturities, but they were holding themselves out to be money market funds, nonetheless, and so a new provision went into 2a-7 saying if a fund that held itself out to be a money market fund, you must comply with the risk limiting conditions of the rule. There had been such a brand name “money market fund” successfully created, and we were really concerned that investors thought they were getting something that they weren’t in some of these cases. In some cases the net asset values of underlying money market funds of insurance products floated, and they really didn’t use the risk limiting conditions of the rules. That was I think a significant change, and I think it reflected the success and the importance of money market funds in retail finance.

MARTIN LYBECKER: The early 1990’s were a watershed in lots of ways. One of the ways that I think is pretty obvious is that Wall Street reacted to the changes that were made to Rule 2a-7 and created new instruments for money market funds that were designed solely to meet the conditions of Rule 2a-7. In the tax-exempt area, it was the creation of variable rate demand notes, an absolutely brand new concept with a maturity much longer than a year or two years, a significantly longer maturity, but an interest rate reset feature that would keep the interest rate basically trapped at the very low end of the yield spectrum and features that would make it behave as if it was a very short term maturity instrument.

ROBERT PLAIZE: Without which, tax-exempt money market funds would be a fraction of the size because of the shortage of supply.

MARTIN LYBECKER: Of course, I’m fond of pointing out on that very one point that it’s a huge wealth transfer. Dave, with all of his millions earned as the president of the Investment Company Institute, wanted tax-exempt income. He also didn’t want to take a principal risk, exactly the point you made, John, when we started this discussion. He didn’t want to lose any of the principal, so he was willing to take a much lower interest rate in order to have no risk of principal. The flip side of that is that every county that wanted to finance a bus or a new school wasn’t paying the five-year or eight-year interest rate, they were paying the 30 to 90 day interest rate, so it was really a wealth transfer from the wealthy who wanted a tax-exempt interest rate, and the features of a tax-exempt money market fund, to all of those of us who pay taxes in counties and on our homes. John, your firm was very involved in a number of new instruments that were created in the early 1990’s. Anything else come specifically to mind?

JOHN MCGONIGLE: Well, yes, it’s one of the worries about the rule is that it may get too complex. In the municipal area for instance, we were able to go to banks - remember when municipalities went to the bank for their loans and most of them never hit the street - and say look, we can take all those municipals off your hands as a package, get the see through income on them and you’re going to put the demand feature on them, and we can get our money back in a week. And they puzzled over that. First it was a little confusing to them, then it started to make sense to them because they could keep the relationship with the customer, turn the securities over to us to the point that we controlled them, and give us the demand feature with it. As a result of the cash flow coming into the funds, we didn’t have to exercise the demand feature and so for the municipalities and for the banks, it gave them a nice constant flow. Then when the municipalities realized what was happening, they also realized that there were other
ways of doing this and that they could create their own instruments and significantly lower their costs, and out of that came the asset-backed market that exploded, the variable rate market.

ROBERT PLAZE: That’s perhaps the newest and most important of the new instruments that have been created in the last 10 or 15 years. A tremendous percentage of money market fund assets today are asset-backed commercial paper and it’s protected the money market funds from the credit ratings of some of the issuers of the underlying assets.

JOHN MCGONIGLE: If you just go back to the early 1970’s, a repo was an exotic, esoteric instrument. Today, repos are a $5-trillion marketplace that dominates the capital market desks. There are days when we’ll put $50 billion out on an overnight basis in repos, so money market funds have become a financing mechanism for a lot of capital markets to a significant degree, and it has increased the variety of short-term instruments that are available out there exponentially because there is a whole new market. Often, the people can come directly to us, including major corporations of the country, to do a variable-rate demand note knowing that that note will sit there in our portfolio and it will constantly be getting us the right yield in so long as they’re of the right quality. That security may be there for the long-term, so it gives us what we want and it gives us what they want. They don’t have to come back to the market on a regular basis and saves a lot of administrative costs along the way.

ROBERT PLAZE: Marty, you mentioned the complexity of Rule 2a-7, and this is where I’m supposed to get a little defensive here on this.

MARTIN LYBECKER: Wait until we get to questioning you about the Commission’s statutory authority to adopt Rule 2a-7.

ROBERT PLAZE: Oh, okay. But in fact what I think we’ve discovered is that the portfolio managers that I speak to understand the music in 2a-7 pretty well, even if they don’t always understand all of the words, and the portfolio managers that I speak to understand, even if they don’t know the provision, they understand the logic of the rule, they get to the right answer almost all the time. It’s the lawyers that complain about 2a-7 that get asked a question once every six months and who don’t live with the rules. In fact I think what’s happened is that money managers, the portfolio managers live within the norms of 2a-7, but they don’t on a day-to-day basis explore the outer edges of the provision. That has been left to the investment bankers creating the instruments and then obtaining opinions from law firms and the banks; they’re the ones that explore those issues because those are the people for whom I get most of the questions from. I don’t get questions from portfolio managers that much.

DAVID SILVER: I would pick up, Bob, and say that until now, the Commission and the industry have done very well in separating what you might call the wheat from the chaff. There are very creative types on Wall Street as we know, and one of the dangers of complex regulation is that there are, I’ll call them geniuses, whether they’re on the dark side or the light side, who are quite expert in crafting financial instruments which may literally comply with every word of a complicated rule, and yet have hidden risks which would be unacceptable.

ROBERT PLAZE: Well that takes us back to the “COFI floaters,” which because they were government instruments, were not adequately addressed by rule 2a-7. They’re floating instruments because they were issued by a GSE. The rule assumed that they floated at par. In fact, embedded within those instruments were surprises, and when interest rates went up in the early ’90’s, the provisions lagged the interest rates, and there were losses, and I think that’s a perfect example and something the Commission woke up to, and in the releases dealing with the tax-exempt instruments, although these occurred in taxable and tax-exempts, one of the things that the Commission said is that not only do you need to do credit risk, you need to put the instrument through its paces. If you had taken those COFI floaters and you had simply mapped out how they would behave in a variety of interest rate scenarios which are not too terribly unusual, you would have seen that these instruments would have been underwater. So what the Commission made clear to the fund industry is that you’ve got to look at structures as well as credit risks.

MARTIN LYBECKER: It was called “stress testing,” and the point was that the investment adviser couldn’t buy the instrument based just on where interest rates were now or where they were
expected to be two weeks from now, but the adviser had to stress test out beyond the edges of where interest rates currently were.

**ROBERT PLAZE:** And the importance of 2a-7 in terms of structural risk and credit risk is that there is the underlying responsibility for the portfolio manager to determine that it is appropriate for a money market fund, and that catch-all provision is of critical importance.

**DAVID SILVER:** When in the ‘90’s the industry decided to create an insurance program for money market funds, we got into these kinds of issues in the course of underwriting the money market funds, and I have to say that I’m of a suspicious nature, but when the experts we retained looked at many of these arcane instruments, we found that the industry by and large had done a very good job I think separating the wheat from the chaff, we had very, very few money market funds that were ever questioned or rejected for insurance.

**ROBERT PLAZE:** The way the process works is that the investment bankers create these instruments and sell them initially to the large players in the market - Federated or Fidelity – that will have legal and analytic staff, and can bring a lot of talent to bear on these instruments and then the rest of the players in the industry get comfortable once they see them in the large players’ portfolios, so there’s the vetting process that seems to have worked itself out, albeit informally.

**JOHN MCGONIGLE:** Yes, there is and it started not with Wall Street creating the instruments for us, but Wall Street watching what these money market funds were doing and being creative and coming up with these demand instruments, and then paying some attention and realizing that they had control of many of the instruments because people were coming to the market through them. Now as that change started to take place, then we were in constant contact with Wall Street, because we were one of the major players, and consequently, they would bring us all sorts of instruments together with their legal opinions. We would vet them and stress test them, because obviously an inverse floater is not the same as a principal-only security and reacts totally different when rates change. When we would stress test those securities, that would shake the tree a little bit. Occasionally you’d see one that we wouldn’t favor because we didn’t feel it was appropriate. We always talked to Dave at the ICI at that point and say look, there might be one of these securities out there on the street. We aren’t touching it. We know the major players aren’t touching it. Yet, it’s out there in the street, so we tried to keep the information flow going back and forth, including the Commission, about the kind of instruments that were out there because in a sense, we were on the cutting edge, and without running it through a severe stress test, you don’t know what you have. And if you are uncomfortable, there were plenty of securities out there. We didn’t have to deal with securities we felt uncomfortable about. At the end of the day, we would get the requisite legal opinion, the requisite stress testing of the instrument and then we would buy in small quantities and we would again stress test them, and then when we were satisfied we would move out from there. That’s how we ended with the market for asset-backed or variable-rate instruments and even repo because as we can recall, some Texas municipalities bought repos and failed to perform the critical action – take control of the underlying securities. And then in a bankruptcy proceeding, it turned out that those municipalities which bought directly from the dealer didn’t have the securities and therefore lost their preference in bankruptcy.

**ROBERT PLAZE:** That’s another story and we probably don’t have time for it, but the changes in bankruptcy laws dealing with repos in the last several years are very important, well, ten years or so, very important to the money market funds also and they’re reflected now in the repo rules for money market funds.

**MARTIN LYBECKER:** We’ve only got three or four minutes. I’d like all of you to be philosophical here. Money market funds now have, starting with you, Dave, from your opening remarks, started out with an itty bitty share of the market; now they’ve got a gigantic amount of money under management. There’s always pressure on investment advisers to obtain yields notwithstanding the pressure to do right by the credit. Why haven’t there been more scandals, more frauds, more enforcement cases? Why is this group of funds, I would have said, gotten away relatively squeaky clean? Your thoughts.
DAVID SILVER: Well, I think as John has said before, there is a tremendous amount of self-policing by the industry, albeit of an informal nature. John’s group I’m sure recognizes that they’re not the only people who would call the ICI or somebody on the Commission staff and say “hey, you ought to take a look at this.” In other words, the responsible and respectable players recognized that the industry was vulnerable to some machinations of some outlier who could do tremendous damage to the industry, so there has always been vigilance on the part of the industry, and that was not only by the members of the Institute, but the Institute itself. I think that there always was and still is today a tremendous amount of informal contact where the industry and the Commission staff were on the same page as to, you might say, who the usual suspects are and like matters.

MARTIN LYBECKER: John?

JOHN MCGONIGLE: I wholeheartedly agree with Dave. The “dollar in, dollar out” concept is absolutely critical to the money market industry, and the money market industry critical to the mutual fund industry. So we need to deliver the “dollar in, dollar out,” and the ultimate mandate is that you’ve got to know what’s in the portfolio because that’s where the “dollar in, dollar out” comes from. We have to worry not only about ourselves, but we have to worry about what other people are doing and that’s why a lot of communication with the Commission, a lot of communication with other members of the ICI, through the ICI and directly about these kinds of instruments is absolutely critical to the health of our business.

ROBERT PLAZE: Interestingly enough, regulation by the SEC of the 2a-7 structure commoditized in large part money market funds, and surprise, surprise, that’s exactly what investors wanted, a commodity that they could use and it’s good for the industry also. The pressure, the discipline however, comes from people writing checks to prevent their money market funds from breaking a dollar. And I suspect in every organization, no one wants to talk to their affiliate, their parent company about the need to bail out and I think that’s created incredible discipline over the last several years and I think you’ve had a fewer number of funds acting irresponsibly or allowing portfolio managers to act in ways that weren’t responsible.

MARTIN LYBECKER: Any comments on the very last point that Bob raised about the bailouts? That has been the way in which people have dealt with credit problems is to have the adviser use its resources to bail out the fund. Any thoughts?

DAVID SILVER: I think that will probably continue, but as I think Bob has pointed out, the pressures to stay within the parameters are so great that I don’t think that except for very unexpected circumstances, that you’re going to have even the occasional failures of portfolio instruments that you had in the ’80’s.

ROBERT PLAZE: And bailouts that I’ve seen in the last several years - although the event has been unfortunate – they have not arisen in circumstances that could raise eyebrows about the decision to purchase the security.

MARTIN LYBECKER: And there’s really only the one enforcement case from 1998. If you look for cites on money market fund enforcement cases, you can look a long time between cites. There just aren’t much. Well, this gets us down to our last minute and I need to do the commercials.

First I need to thank John McGonigle, Bob Plaze and David Silver, each of you sincerely for your participation in this discussion on money market funds. As Dave said at the beginning, when Matt Fink and I were developing this format and the topics we’d cover, this was first on both of our lists because the creation of money market funds really was a seminal event in which everyone here participated meaningfully.

As a reminder to our audience, today’s program is now archived in the Society’s virtual museum. You can listen to that discussion again at any time or read the transcript later on. Our four-part series on developments in the mutual fund industry will conclude next month with a discussion on recent developments in the mutual fund industry. They should have taken a page out of your book, Bob, and called it recent “events.” They didn’t like the word “scandals” either. This program which was originally scheduled to take place on March 1st will be broadcast on Wednesday April 27th at 11 am Eastern Daylight Time. Matt Fink will moderate a discussion with Kathie McGrath at Crowell and Moring,
Robert Pozen at MFS Investment Management, and James Riepe at T. Rowe Price. Thank you all for being with us today.