

IMMFA's *Industry Guide to*
Understanding Institutional
Money Market Funds

www.immfa.org

January 2005

IMMFA
Institutional Money Market Funds Association

This industry guide was written by VriesPort Consulting LLC in conjunction with IMMFA. The conclusions were a result of a study, commissioned by IMMFA, to review the policies and procedures of service providers to institutional money market funds.

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Foreword

The global acceptance of institutional money market funds has been one of the great success stories of the last ten years. As assets under management have soared, the potential risks implicit in these funds have come under close scrutiny. The asset management groups and service providers involved in this industry recognised early on the need to address industry issues with one common voice. As a result, the Institutional Money Market Funds Association (IMMFA) was formed as the trade body representing the triple-A rated money market fund industry. As of December 31st 2004, IMMFA represented 32 fund management groups and service providers, with total assets in members' funds exceeding US \$232 billion.

Outside the US, money market fund providers do not operate in a regulatory regime that addresses the special risk monitoring that is needed for funds where capital security is of paramount importance. In the US, failings in the risk monitoring process led to special SEC regulation designed to force the industry to address capital security issues. Amendment 2a-7 to the 1940 Investment Act still remains the most comprehensive money market fund legislation in the world.

In 2002, IMMFA members adopted a code of practice, loosely based on rule 2a-7. The purpose of IMMFA's Code of Practice is to promote best practice in the management of triple-A rated money market funds. All IMMFA members have agreed to abide by the Code.

In 2004, IMMFA initiated a business review of the evolution of the triple-A rated institutional money market fund industry. In particular the review examined how the service providers were performing in light of the requirements of the IMMFA Code of Practice and changes in the UCITS requirements for professionals involved in the management of money market funds. VriesPort Consulting was given the mandate to undertake this review. In particular, VriesPort was asked to highlight issues that concern everyone involved in the money market fund industry, including directors of money market funds whose level of responsibility has recently changed under the new European directive.

This guide contains VriesPort's conclusions. It should be studied by all those charged with policing the industry. In particular: directors, auditors, investment managers, risk managers, administrators, custodians, trustees, credit/governance committees, rating agencies and regulators.

It is not an amendment to IMMFA's Code of Practice; it is an educational aid, a user manual for professionals involved in the management, servicing or policing of triple-A rated institutional money market funds.

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This guide has been produced for general guidance only and does not constitute advice on the set-up, administration, management or investment strategies of institutional money market funds or the control of risks associated with these funds.

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Executive Summary

The executive summary provides a bullet point synopsis of the key risks and controls referred to in this guide. Within this publication, key risks and controls are presented in a question and answer format, with explanatory commentary both within the responses to each question and within the text. A glossary of terms is presented at the end of the text for additional reference.

Setting up a fund

- Money market funds are often perceived to be the same as bank deposits by investors – as such, they have a very different risk profile from other mutual funds. Fund providers should have a sound business plan in place prior to launching a fund. The provider should have a clear picture of the potential investors in the fund, projected size of the fund and the nature of money that will be invested in the portfolio. **Questions 1 & 4**
- The risks associated with managing a money market fund are quite different from managing a treasury desk. Fund asset managers should have previous experience in managing constant net asset value (CNAV) money market funds. **Question 2**
- The principal risk facing a money market fund provider is losing the CNAV of the fund, or “breaking the buck.” To ensure that management, trustees and the board are aware of this risk, it is vital that escalation procedures be established. In addition, there should be a clear plan established should a change in the fund’s net asset value (NAV) reach an escalation point. **Questions 3 & 4**

The Role of Investor Activity

- Large redemptions by individual investors could force a fund manager to sell securities at a gain or a loss, thereby affecting the yield and possibly the NAV of the fund. Providers should seek diversity in their investor base to minimize excessive subscriptions and redemptions due to cyclical cash flow patterns. **Question 5**
- One of the fund manager’s largest challenges is to balance the need for liquidity versus the maximising of yield. Pre-set warning levels should be set to notify the fund manager of large trades that could cause a significant movement in the fund’s net assets. The fund manager should receive a summary cash availability report shortly after the trading cut-off time. **Questions 6 & 7**
- Recently, the topic of the acceptance of late trades has been a particularly sensitive area. Trades received after the trading cut-off time should not be accepted into the fund. **Question 8**

Developing the Portfolio

- Duration risk is typically controlled through the weighted average maturity (WAM) of the portfolio. The desired WAM can be obtained by structuring the portfolio in various ways. To control variability of the WAM and stay within rating agency guidelines, a number of risk factors should be considered. **Question 9**
- Non-traditional money market securities introduce various levels of risk to the portfolio. To control these risks, it is important that each security type be analysed and approved by the investment committee; and that policies regarding security concentrations, interest rate reset mechanisms and structural credit risk be addressed. **Questions 10, 11, 12 & 14**
- A strong credit culture is recommended to reduce risk in the portfolio. Credit procedures should be established independently of the asset manager or other departments in the organisation where a conflict of interest might arise. **Questions 13 & 14**

Primary Back-office Controls

- Historically, the highest number of yield adjustments is due to incorrect income accruals on floating rate notes (FRNs). Although recalculating the rate each time a FRN is purchased and every time the interest rate resets is the best control, there are other less time consuming measures that can be taken to protect the investor. **Question 15**
- The accuracy of the fund's NAV is dependent upon sound pricing policies. Money market instruments should be priced using a pricing matrix provided by an independent third party. Non-money market and non-traditional securities should be priced using issue specific prices. In addition, an escalation policy should be established to report pricing differences between marked-to-market and amortised cost prices on individual securities. **Questions 16 & 17**
- When a security is sold for either a gain or loss, most funds "smooth" the net realised gain/loss into the fund's yield over a period of time. To ensure consistency among all IMMFA member's funds and to ensure that all investors in the fund receive fair treatment, the policies recommended by IMMFA's Code of Practice should be adhered to. **Question 18**

The IMMFA Industry Guide

IMMFA's Executive and Technical Committees have agreed on certain policies and procedures relating to the operation of money market funds through IMMFA's Code of Practice. These policies and procedures are the foundation for the guidelines and commentary included in this guide, which is designed as an aid to understanding risks in this asset class. As such, it is primarily addressed to money market fund directors, auditors, investment managers, risk managers, custodians, trustees, credit/governance committees, ratings agencies and regulators.

Taking a look at the Big Picture

After a slow start in the mid-nineties, the development of European CNAV money market funds has been rapid. It has introduced a new asset class to institutional investors and also attracted new fund providers into the market. It is important that anyone entering the market ensures that they have a proper infrastructure, and more importantly, that they understand the risks associated with this unique asset class. As such, the questions to be asked of a fund provider are:

1

Q. Why establish a CNAV money market fund?

A. Fund providers should have a sound business plan in place prior to launching a fund. A well developed infrastructure of credit, fund management, sales, administration and controls should be in place before a fund is launched.

The provider should have a clear picture of the types of potential investors in the fund, projected size of the fund and the nature of money that will be invested in the portfolio. Without a clear business plan for fund development, risks to the investor as well as the provider are accentuated.

In a typical mutual fund, the share price of the fund fluctuates up and down. Since a CNAV fund states that its objective is to have a stable price, the provider has now created a product that *looks like a deposit – and, as such, the perception that its price can never change.*

2

Q. What background and experience does the asset management team have in running a CNAV money market fund?

A. A fund provider should either have a background in money market asset management or hire people who do. Running a money market fund is significantly different from running a treasury desk. Although yield is an important component of successful fund management, preservation of capital should be the fund manager's primary objective.

It is important that the asset management team understands the pricing, operational and accounting risks associated with the product it manages.

The principal risk facing a money market fund provider is losing the CNAV of the fund – this is commonly called “breaking the buck”. Technically, this happens when a CNAV fund’s market value price strays 50 basis points (bp) or more off from the constant \$1, €1, or £1. If the price of the fund increases, it is a good problem; the fund can just distribute more income or capital gains. However, if the price of the fund falls, it’s a little more difficult. There should be controls in place as early warning signals to ensure that action, if needed, can be taken as soon as possible.

3 Q. What escalation procedures are in place to measure and report variations between a fund’s amortised cost NAV and its marked-to-market NAV?

A. To ensure that management, trustees and the board are aware of any potential risk of “breaking the buck”, it is vital that escalation procedures be established. These procedures set thresholds where the fund manager, senior investment management, the trustee and board of directors are notified of potential pricing issues in the fund. Often both the fund provider and the fund’s administrator have their own escalation policies. *It is imperative that the administrator’s policies be in line with, or more conservative than, the fund provider’s policies.*

Certain regulatory jurisdictions have provided guidance to their administrators that an appropriate policy is to notify the trustee/board of directors at 50bp. Clearly this is too late as the fund has already “broken the buck”. Fund providers should ascertain that their administrator’s escalation policies are in line with their own and that the board of directors, who have ultimate responsibility for the fund, be notified well before the 50bp differential is reached. A recommended escalation policy would have the fund administrator notifying the fund manager at 10bp, senior management of the investment company at 20bp and the trustee/board of directors at 30bp.

Money Market Funds – two pricing methods

Money market funds use a pricing methodology called amortised cost. If a security is purchased at a premium or a discount, one day's accretion or amortisation is taken into income, and the price of the security is adjusted. At the security's maturity date, the price of the security is par. By utilising this pricing methodology, a fund's NAV per share can stay at a CNAV (i.e. \$1, £1 or €1) per share.

Amortised cost is meant as a proxy for actual market value. As such, fund administrators should mark-to-market securities and the fund's NAV on a weekly basis and compare them to the results derived by using amortised cost. Due to credit events or interest rate movements, the true market value of a security, and thus the NAV per share of the fund, may no longer reflect amortised cost.

What happens if the worst case scenario threatens? Although the mantra of money market fund management is safety and soundness, there have been cases where the fund provider has stepped in to protect the integrity of a fund's CNAV. Therefore:

4 Q. To what extent would the fund provider support its money market fund in a time of turmoil?

A. Legally, a fund provider is not required to support a mutual fund's NAV, if the volatility in the fund's price is due to market conditions. There have been numerous incidents in the history of money market funds where a fund provider has stepped in to purchase a security from its fund at par, has injected capital, or has become a shareholder in the fund to provide instant liquidity. However, there is no guarantee that the fund provider will, and there is certainly no obligation to do so.

The fund provider should have a clear plan that identifies the various options available to stabilise the NAV should the fund threaten to "break the buck". Ultimately, of course, the action the fund provider takes will depend on the particular circumstances.

Investor activity can play a large role in money market fund risk

When most people define risk factors in money market funds, they tend to focus on interest rate, spread or credit risk. It is true that these are the fundamental risks that can cause problems in a fund. However, the influence of these factors on the fund can be magnified by the actions of the fund's investors. As fund assets decrease, the magnitude of any specific problem increases, as it then becomes a larger percentage of the fund as a whole. As such, knowledge of the fund's shareholder base is very important. Therefore:

How Investors' Redemptions can affect a fund's NAV

The table below reflects a fund with a 60 day WAM – the maximum WAM allowed by the rating agencies in a triple-A rated CNAV money market fund. The far left column reflects a one day increase in interest rates of 100, 200 and 300bp, respectively. The bottom row shows one day redemptions in the fund. For example, if one day interest rates rose 200bp, and the fund lost 10% of its assets to redemptions, the per share NAV of the fund would fall to .9963. If the fund's NAV per share falls below .995, the fund's price would have to be rounded down to .990. At this point it has effectively "broken the buck."

With no shareholder redemptions, a fund could absorb a one day 300bp rate increase and still maintain its rounded NAV of 1.00. Combining interest rate increases with redemptions drives the fund price even lower. As such, when developing a portfolio, it is necessary that the fund manager not only considers potential interest rate movements, but also projects the investors' sensitivity to interest rate changes.

BP Increase	Net Asset Value per Share			
100	.9984	.9982	.9979	.9977
200	.9967	.9963	.9959	.9953
300	.9951	.9945	.9938	.9930
Fund Redemptions	0%	10%	20%	30%

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Q. How are shareholders' investment flows monitored and controlled?

A. It is imperative that the fund provider and transfer agent, as well as the investment manager, understand who is investing in their fund. Large redemptions by individual investors could force a fund manager to sell securities at a gain or a loss, thereby affecting the yield and possibly the NAV of the fund. In addition, certain types of shareholders may have cyclical cash flow patterns in their business that causes them to invest or redeem shares *en masse* at various times during the year.

Providers should seek diversity in their investor base to minimise excessive subscriptions and redemptions due to cyclical cash flow patterns. Fund providers should work with their transfer agents to establish maximum shareholder concentrations for each fund, broken down by single investor, top 10 investors and type of investor. Shareholder activity should then be monitored, not only for concentration levels but also to measure hot money – those investors that invest then redeem shares over very short periods of time. These investors are often in the fund to arbitrage and the fund provider should ensure that an appropriate policy is in place to avoid significant fluctuations in the daily yield.

The Challenge of Nominee and Omnibus Accounts

Quite often it is difficult to measure concentration of investors in a fund due to the fact that the fund's transfer agent registry may only reflect a nominee name or omnibus account. Nominee and omnibus accounts are those where someone other than the transfer agent of the fund maintains detailed accounts of the ultimate investors in the fund – for example a bank may invest in a money market fund, however, the ultimate investors in that fund consist of a mixture of that institution's securities lending money, excess escrow cash and money from numerous other sources.

Prior to accepting these investors into a money market fund, the fund provider should perform an extensive analysis of cash flow histories to determine both the stability and cash flow patterns associated with omnibus/nominee investors. This analysis should be ongoing in nature to ensure both the fund and the other investors in the fund are not adversely affected by highly fluctuating cash flows.

On a day to day basis, one of the investment manager's largest challenges is to balance the need for liquidity with the maximisation of yield. The unknown factor in this picture is shareholder investment flows. The investment manager must have a good line of communication with both fund accounting and the transfer agent to ensure that the fund's cash flows are reported as quickly and as accurately as possible. There are certain standard procedures that should be put in place to mitigate this risk;

6

Q. What procedures are in place to warn the fund manager of large trades?

A. Depending upon the size of the fund, a pre-set warning level should be set to identify large trades that could cause a significant movement in the fund's net assets. The transfer agent should establish early warning notifications at frequent intervals to allow the fund manager to plan an investment strategy prior to receiving the final cash availability report. To protect the fund during periods of market instability, it is recommended that the investment manager has the option to reject subscriptions into the fund that are over a pre-determined size.

7

Q. What procedures are in place to report investable cash to the fund manager?

A. Each day a fund manager must know exactly how much cash there is to spend or how much money is needed to meet redemption requests. Reporting should take the form of an investable cash statement that identifies incoming cash from security maturities, interest payments and shareholder subscriptions and outgoing cash due to security settlements, expense and dividend payments, and shareholder redemptions. As the information included in this report is a function of both fund accounting and transfer agent activities, it is important that these two departments work together to provide accurate data to the fund manager.

The fund manager should receive a preliminary cash availability report early in the day that identifies overnight shareholder activity and projections from fund accounting. Preferably within 20 minutes of shareholder trading cut-off, the fund manager should receive a report that shows net cash availability from both transfer agent and fund accounting activities. To minimise the risk of error, *only one report should be sent to the fund manager*. In addition, although many fund managers prepare their own cash availability reports, *the administrators should always provide a report to which the fund managers should reconcile*.

On the topic of shareholder transactions, a particularly sensitive area is the acceptance of late trades. Over the past year, this subject has come under a great deal of scrutiny throughout the world, prompted by problems in the US. Both the transfer agent and the fund provider, if the provider has a client relationship desk, should have detailed written procedures regarding trading cut-off times.

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Q. What are the fund's policies for accepting late trades?

A. Shareholder transactions can be transmitted via various forms of communication – some more efficient than others. In some cases, the transfer agent of the fund only receives omnibus information and the fund provider, or a sub-transfer agent, keeps the detailed registration records.

In any situation, *a trade received after the trading deadline should not be accepted into the fund unless proven that it was executed prior to the trading deadline.* Although less sensitive than the equity and bond markets, where the fund's NAV will reflect market quotes, late trading in a money market fund could be a sign of interest rate arbitrage by the investor. It could also be viewed as giving preferential treatment to certain customers.

Trading policies should be well documented and any exceptions to the policies should be reported to both the fund's trustee and the board of directors.

Understanding the Investment Manager's portfolio

Developing an investment strategy involves a number of different factors. These factors include: understanding the day-to-day liquidity needs of the fund; establishing a duration profile based upon expectations of short-term interest rates, defining portfolio concentration risks and establishing credit quality parameters. In addition, creating a timely communication system between front and back office is essential for strong risk management.

These issues can be broken into three areas; assessing the market and the investors in the fund, looking at the security selection process and, finally, the influence of credit analysis in the decision making process.

9

Q. What are the factors considered in establishing the duration and maturity structure of the money market fund?

A. There are three factors that should be considered when determining the duration and maturity structure of a fund. First, expectations of market yields play a critical role in establishing target duration. However, there are many ways to structure a fund to obtain a specified duration – the most common are laddered portfolios and bar-belled portfolios.

Secondly, the liquidity needs of the investors in the fund must be understood. Funds that have high concentrations of shareholders or a highly unstable shareholder base should carry more liquidity to compensate for these risks. In this case, utilising a bar-bell approach could give the fund a highly volatile WAM. Assuming short-term securities were used to provide liquidity for redemptions, a fund could experience a significant spike in its WAM on high redemption days. This could affect its credit rating.

A fund's WAM is an important factor considered by the rating agencies when assigning a rating. For a triple-A rating, for example, a fund must maintain a WAM of 60 days or less. Having a highly volatile WAM, could lead to a possible downgrade of the fund.

10

Q. What are the fund's policies with regards to security diversification?

A. Specific written policies addressing both security and industry concentration levels for a fund should be established. UCITS regulations do not permit more than 10% of the funds assets to be invested in a single security. This concentration level, however, is significantly higher than industry standards, which are traditionally set a maximum 5% concentration level. With larger funds, this could be reduced to as low as 2% of net assets to reduce risk of loss. It should be noted that a CNAV money market fund defaults or "breaks the buck" at 50bp - clearly the greater the diversification in a fund, the less chance there is that a single security could cause a problem.

Although most money market instruments are quite straight forward, there is an ever increasing offering of more sophisticated products that can add an additional dimension of risk to a portfolio. Therefore, it is important to know;

11 Q. What types of securities does the fund invest in?

A. Although money market funds traditionally operate on the key fundamentals of safety, soundness and security, not all money market funds are alike. Some funds invest in long-term FRN's or asset/mortgaged backed securities, while others invest in even more non-traditional securities such as structured deposits, secured liquidity notes or extended commercial notes.

These securities generally provide some additional yield, but have different risk factors from traditional money market instruments such as certificates of deposit (CD) or commercial paper (CP). If a fund invests in these types of securities, the investment manager should have detailed studies examining the risks these types of securities could present. This should include tolerance "what if" analyses. *At a minimum, the investment committee should approve investment in non-traditional money market instruments and set up concentration levels for each asset type.*

Equally important is *that every player in the fund's communication chain can identify the type of security being purchased and understands the risks associated with that security.* Portfolio and trading systems often only use generic terms such as CP for commercial paper or FRN for floating rate notes. These generic terms are not specific enough to identify securities like extendible CP, structured deposits or asset backed securities. To properly price non-traditional securities, the administrator must first be able to identify them. Reporting should be sufficiently detailed to allow the individuals pricing the fund and those checking compliance of the fund to be able to do their jobs effectively.

12 Q. What are the fund's policies with regards to the reset mechanism of FRNs?

A. FRNs are often purchased by money market funds as a way of improving fund performance. Due to the long-term maturity of these securities, they typically carry greater spread risk than short-term money market instruments.

To reduce interest rate, or duration risk, these securities have interest rate resets at least annually. To be effective, *the base for the interest rate reset must be tied to a money market rate, such as LIBOR or LIBID.* Using non-money market reset rates could cause a significant loss in the market value of a security if movement between long- and short-term rates is out of balance.

One of the key points of a sound investment policy is the establishment of clear credit guidelines for the investment manager to follow. Key items to examine are:

13 Q. What procedures are in place to establish and monitor the credit quality of securities purchased by the fund?

A. Investment management companies should have an *independent* credit review process for establishing and monitoring the credit quality of investments held in the fund and those securities that could be purchased by the fund manager. The credit assessment process should be independent of the asset management process and in the case of bank sponsored funds, the securities sales desk of the bank. Both fund managers and security salesmen are compensated based upon performance, which can raise inherent conflicts of interest if they also control the credit function.

Fund managers should be provided with an approved list of individual securities (for asset- or mortgaged-backed securities) or corporate issuers (for CP, short-bonds, CDs and deposits). Ideally, an approved list should include concentration limits by issuer and industry as well as a maximum final maturity. In addition, credit research should be performed independently of the rating agencies. This adds an additional level of control as well as a level of accountability for the analyst.

Approved lists should be monitored on an ongoing basis. Specific procedures should be in place to handle situations when a fund manager would like to purchase a security that is not on the approved list or a new security type. In addition, procedures should be in place to address downgrades by the rating agencies and to remove credits from the approved list.

14 Q. What credit review procedures are in place for asset/mortgage-backed securities?

A. Some money market funds allow the purchase of asset or mortgage-backed securities. These securities are floating rate instruments, but have different risk elements from traditional corporate or government issued FRNs. As the securities are backed by mortgages, bank loans or receivables, the payment of the debt is determined by the speed at which the mortgage or loan is repaid. As such, the actual maturity of the security may occur sooner or later than the stated final maturity date. The expected yield from these securities can fluctuate based upon payment speeds.

Credit analysis of mortgage and asset-backed securities is very different from corporate credit analysis. The issuer of the security is normally a trust or similar type of special purpose entity. As such, the analysis of these securities is much more tied into legal and probability risk rather than fundamental credit analysis. If a money market fund invests in these types of securities, the fund provider should have an experienced structured finance credit analyst within its independent credit group to evaluate the securities' risks.

A well controlled back office ensures smooth day-to-day operations

While the fund manager is responsible for purchasing quality securities for the portfolio, the back office is responsible for correctly valuing the securities and ultimately the fund itself. It is the first line of defence to identify potential problems in a fund. As such, it plays a primary role in the protection of the CNAV. There are a number of key points that should be reviewed with an administrator to ensure that issues either do not arise or at least are identified early. They include:

15 Q. What are the primary controls to ensure the interest rate resets on FRNs are accounted for on a timely and accurate basis?

A. The largest number of adjustments made over the past few years in IMMFA members' funds has been due to income accrual adjustments on FRNs. There are some primary controls that can be put in place to minimise the risk of incorrect accruals. Those controls are to:

- Recalculate the interest rate based upon the security's LIBOR formula – both when a security is first bought into the fund and at reset date;
- Have an automated report which identifies interest reset days;
- Confirm rate changes with the fund manager;
- Perform periodic rate and interest accrual reconciliations with a pricing vendor.

Clearly, the best control is to recalculate the rate, both when the security is purchased and when the reset takes place. However, this can be extremely time consuming and may not be the most efficient use of time. It is most efficient to set periodic interest rate reconciliations between the fund's accounting records and pricing vendors (such as Bloomberg or Reuters). Although this is an 'after the event control', it will generally mean that any yield adjustments will be relatively minor.

16 Q. What are the fund's marked-to-market security pricing procedures?

A. Marked-to-market prices for securities held by money market funds should be provided by a pricing source that is independent of the asset manager and administrator. For money market securities, priced using a matrix approach, it is imperative that the third party pricing source reflects all market factors that could affect the price of the security – security type, maturity, credit quality and coupon rate.

The industry should strive to find pricing sources that meet the criteria noted above. This will ensure consistency of pricing not only within funds using the same administrator, but for all funds regardless of their administrator.

For non-money market securities or non-traditional securities, issue-specific prices should be obtained from an independent pricing source. If this is not possible, prices should be obtained by the administrator from market making brokers. On a periodic basis, these prices should be audited against quotes from multiple brokers.

17 Q. What escalation procedures are in place for individual securities where the marked-to-market price differs from amortised price?

A. In Question 3, escalation procedures related to the variance between a fund's mark-to-market and amortised cost NAV were examined. It is also important for escalation procedures to be in place for individual securities. A situation could arise where individual securities in a portfolio counter each other to have a net effect of zero on the fund. Should either of these securities be sold, however, the fund could experience stress on the CNAV.

Fund administrators should establish escalation guidelines, significantly lower than fund escalation reporting points, for individual securities. Securities that exceed the escalation threshold should be reported to the fund manager on at least a weekly basis.

18 Q. What are the fund's policies regarding the treatment of realised capital gains or losses from the sale of securities?

A. Rather than reflecting the entirety of a net capital gain or loss from the sale of a security in the fund's daily yield, many funds smooth the gain or loss into their yield over a period of time. This eliminates spikes in the yield and provides performance consistency for investors.

Certain funds follow their US counterparts and do not include realised gains or losses in their distribution rate. The US distribution policy is not driven by money market regulation (Rule 2a-7) but by tax regulations and Regulated Investment Company rules (RIC) on US mutual funds. As such, the policy not to distribute gains or losses has nothing to do with controlling risk.

There are both positives and negatives in maintaining a policy of smoothing realised net capital gains/losses through the yield. On the plus side, smoothing keeps capital gains and losses off the balance sheet. This means that, in a period of rising rates and high redemptions, potential losses can be distributed, thereby reducing the risk of "breaking the buck". On the negative side, the ability of a fund manager to sell for a gain to manipulate yield is something that needs to be controlled by the investment management group.

The level of basis points distributed through the yield on a daily basis is a marketing decision and is far less important than the period of time over which the gain or loss is smoothed. Having no policy is unacceptable. In addition, having a policy of "no limit" could benefit or hurt a potentially large number of shareholders that were not in the fund when the transaction causing a yield change took place. Using the final maturity of the security sold as the period of time over which to smooth in the net gain/loss appears to be logical, but, administratively, it is bulky. If a fund had a significant number of sale transactions, the fund accountant would have multiple distribution adjustments, many of which could be totally immaterial to the fund as a whole – it is an accounting error waiting to happen.

IMMFA's Code of Practice guidelines recommends smoothing in a maximum of 5bp per day over a maximum time period of 60 days.

In Conclusion...

As noted in the foreword to this guide, the lack of European CNAV money market fund specific regulation puts additional pressure on those groups that police these funds. By necessity, regulation has been internalised and it is up to all groups involved in the money market fund life cycle to review, question and identify potential problems before they become an issue.

The success of the US money market industry has been driven by its ability to provide reasonable returns to investors, while maintaining capital preservation. The international market is still relatively small, but is growing rapidly. The key to market growth is preventing capital loss. This guide is intended to raise the level of awareness to key areas where risks can be identified and prevented. More importantly, it is meant to show that there are significant risks for providers of money market funds. Trustees and boards of directors have potential legal liability and rating agencies, mindful of their reputational risk, must protect the “sanctity” of the triple-A rating. Therefore, read this guide, ask questions, and look for issues before they arise.

A Glossary of Terms

Amortised Cost

Money market funds value their securities using an accounting method called amortised cost. When a security is purchased at a premium or discount, one day's amortisation or accretion is "taken into the yield" and the price of the security is changed. The price of the security gets closer to par with each passing day. When a security matures, the entire premium or discount should have been taken into the yield.

Bar-belled and Laddered Portfolios

Two terms related to different maturity structures of a portfolio to obtain the same weighted average maturity (WAM). Bar-belled portfolios balance off very short maturity holdings with very long maturity holdings to obtain a certain WAM. Laddered portfolios spread their maturities evenly to obtain a certain WAM.

Constant Net Asset Value (CNAV) Money Market Fund

A fund that invests in high-quality securities that typically mature in less than one year, such as certificates of deposit (CD) and high-grade commercial paper (CP). The fund distributes net investment income to its shareholders daily to maintain a constant price of \$1, €1 or £1.

Distribution Rate

Also called the mil rate, it is the amount of dividends per share earned by a shareholder. $\text{Net income}/\text{total shares outstanding} = \text{distribution (mil) rate}$.

Dividends

The amount of distributions of money, stock, or other property credited to the account or paid to investors/shareholders by mutual funds or other dividend-paying instruments.

Laddered Portfolios

See Bar-belled and Laddered Portfolios

LIBID

Acronym for the London Interbank Bid Rate which is normally 12.5bp or an eighth less than LIBOR (see LIBOR).

LIBOR

Acronym for London Interbank Offered Rate, the interest rate at which major international banks in London will lend cash to each other, and hence an indicator rate for international lending.

Matrix Pricing

A method of pricing money market securities. An independent third party (the pricing source) collects prices on various money market securities and builds a template driven by asset type, currency, credit quality, coupon rate and maturity of each security. This information is compiled into a matrix that denotes the various criteria noted above (for example, US\$, P-1 rated, CD with an interest rate of 2.5% and that mature in 30-60 days). The prices of all securities meeting each classification level are then averaged and become a representative price.

Net Realised Gain/Loss

The net monetary amount, gain or a loss, realised from selling security shares. Realised gains and losses are often spread into the fund's net income and distributed to the shareholders.

Par

Face value of the security.

7-Day Yield

An annualised historical yield calculated on the date shown based on the preceding seven days' level of income earned by the fund.

Weighted Average Maturity (WAM)

The average number of days to maturity, or interest reset, of the money market fund's portfolio. A fund's WAM can be an indication of its sensitivity to interest rate changes. CNAV funds rated triple-A by the rating agencies must maintain a WAM of 60 days or less.



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