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Financial Crisis – Law Firms

A Status Report On Money Market Funds And Other Investment Vehicles

The Editor interviews ***Diana McCarthy,*** *Partner in the Investment Management Group of Drinker Biddle & Reath LLP.*

Editor: Please describe your practice area.

McCarthy: We represent, among other things, people in the investment management industry, including both registered and unregistered funds as well as commodity pool operators and trading advisors, and registered and unregistered investment advisers – generally all aspects of the investment management industry.

Editor: Money market funds were heavily impacted by the sub-prime crisis, including one fund so far that has "broken the buck." Why?

McCarthy: There are a couple of reasons why money market funds were so heavily impacted by the sub-prime crisis. Some money market funds had invested in what has come to be known as "toxic assets," that is to say, derivative instruments that were collateralized by credit default swaps and other problematic derivatives, and some had invested in Lehman paper before it went bankrupt. Second, almost every money market fund has been affected all year by a lack of liquidity and an inability to sell even highly rated securities because the market froze. So, part of it was a liquidity issue and part of it was directly related to the toxic assets they owned.

Editor: Had some of the funds been more disciplined in their approach?

McCarthy: There is no question that the last year and a half has shown that some money market funds were managed very differently from others. There were some that took a very conservative posture very early in the subprime crisis. Those are the funds that did the best. The ones that went farther out, the ones that held a lot of structured investment vehicles, which had some of these toxic assets in them – those are the funds that have had some problems. There is no question that in this environment, there were some money market funds that took on more risk than they thought they were taking on, because there was a lack of transparency in the derivatives market.

Diana McCarthy

In particular, there was a complete lack of transparency about some types of derivative investments known as the structured investment vehicles. These are relatively new securities, and they've not been tested in extreme market conditions. Investment advisers and rating agencies were all using historical assumptions about things like default rates which didn't prove to be accurate with a new derivative security, which is in large part what got the funds into trouble.

Editor: The Treasury Department has made several programs available to money market funds. Can you describe the programs and their purpose?

McCarthy: There are two programs that will impact money market funds the most. The Treasury Department has an insurance program called the Treasury Guarantee Program. The program basically makes shareholders whole for losses that they may sustain in the event of fund liquidation. But the program is only designed to protect people who were in those funds as of September 19. For the last 60 days we've been counseling investment advisers on whether certain investors will be covered in the event of liquidation.

The other major program is actually a Federal Reserve program, the Money Market Investor Funding Facility, designed to provide more liquidity to money market funds. If a money market fund buys highly rated commercial paper and then cannot sell it because the market is illiquid, this program allows them to sell it back to the federal government. This and some other programs that the Fed has offered are designed to provide liquidity and enable funds to sell assets more easily in an illiquid market. They are not aimed at buying any toxic assets from money market funds.

Editor: Is there a chance more money market funds will break the buck, given the availability of these governmental programs?

McCarthy: There is still a possibility that some funds could break the buck. These are funds that are under real stress because they still hold toxic assets, although they are usually backed by guarantees from their advisers.

Editor: Don't funds have to issue prospectuses and updates of the prospectus?

McCarthy: They absolutely do have to issue prospectuses and they have to keep their disclosure up to date. When we've

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had these very unusual kinds of market conditions, funds have to pay special care to their disclosures to ensure that they properly reflect their investment strategies and risks. If a fund has a defaulted security, it has to ensure that the default is appropriately disclosed in its financial statements.

Editor: There have also been heavy losses reported in bank-operated, private, "money-market-like" funds, and many lawsuits have been filed in connection with these losses. Can you talk about the legal claims in these lawsuits and whether these suits are likely to succeed?

McCarthy: There have been quite a number of lawsuits filed by ERISA plans, among others, and large financial institutions in connection with private funds. These private funds are not registered money market funds, but money market-like funds in the sense that the institutions run them more or less like a registered money market fund. Like their registered counterparts, these funds have had liquidity problems, and some hold defaulted securities. The allegations, for the most part, deal with a lack of disclosure and a lack of information provided by the investment adviser to the plan fiduciaries – basically allegations of fraud and a lack of disclosure.

Editor: Apart from money market-type funds, what issues are other types of funds experiencing?

McCarthy: Fixed income funds are continuing to experience issues similar to money market funds in terms of pricing of assets in an illiquid market since many of these assets are thinly traded. Advisers have been working to ensure that the people who are doing the pricing evaluations have the appropriate skill set in order to verify prices. Pricing has become much more of a verification process – you cannot necessarily rely on a broker-dealer's pricing nor on that of a pricing service. We are seeing investment advisers beefing up their credit departments and pricing functions with increased resources in order to be able to verify prices. The next big concern for fixed income funds is asset-backed securities, specifically credit-card-backed securities, since people are starting to default on those cards as they lose their jobs.

Editor: Boards of directors are ultimately responsible for the valuation of assets held by these funds. Are you counseling boards differently during this current crisis and, if so, how?

McCarthy: We are not counseling them differently, but we are counseling them more often. In particular, boards of money market funds have been required to meet more often to make decisions regarding downgraded and defaulted securities. We're also delving deeper into counterparties with which the funds trade to understand the investment advisers' processes and controls for evaluating these counterparties. There is heightened scrutiny on all of the investment advisers' internal controls and processes for counterparty risk and the credit research processes. Boards want to make sure they understand them and that they seem reasonable.

Editor: Are portfolio managers and credit research groups within investment advisors managing money and approaching investment differently than before the current crisis?

McCarthy: People are managing portfolios much more conservatively. I cannot remember a time in my 15 years of practice when funds were carrying such a high level of cash in their portfolios. Also, today there is much greater focus on credit research and counter-party evaluations than ever before.

Editor: Do you expect that risk management will play a bigger role in the investment management industry in the future?

McCarthy: To date it has not played a very significant role in the investment management industry. We are behind our European counterparts who have been practicing more risk management for a longer period of time. As a result of this crisis, those financial companies with the best risk management systems are the ones who have faired the best thus far. Taking note of that, the industry is likely to move to place more emphasis on risk management as a best practice. There probably will be a greater effort to understand what risk management means within the context of the investment management industry. There will be more stress testing – by that I mean, trying to understand how a particular instrument will do when it is placed under stress in a very illiquid or volatile market.

Editor: Do you think there is a role for hedge funds in the future?

McCarthy: I do. While some hedge funds have tanked over the last 60 days or so, there will always be a role for hedge funds. In fact, they may even play a greater role in financing transactions now that there are fewer investment banks. Remember also that a fair number of hedge funds did pretty well over the last year or so because they had adopted strategies that had nothing whatsoever to do with the sub-prime meltdown. Of course, if they play a larger role in our economy in the future, they may have to live with more regulation.

Editor: What types of future regulation would work best for the investment management industry?

McCarthy: I believe that you will see more direct communication – by that I mean talking on the telephone or by e-mail with regulators. The SEC has been moving in that direction with money market funds over the past couple of months. The larger funds have been having to report their holdings, their redemption levels and other metrics around their operation to the SEC on a weekly basis. I expect there to be more of an effort to cause more transparency in terms of the types of assets that these funds buy. There will be more regulation over derivatives, especially where leverage is involved such as with credit default swaps.

My guess is that the credit-rating agencies will continue to play a major role with money market funds but under heavier regulation. Money market funds rely heavily on credit-rating agencies to help evaluate the types of securities that they can buy. The industry generally wants to keep the credit-rating agencies in place with greater regulation requiring, for example, disclosure of their assumptions and requiring codes of conduct to mitigate conflicts of interest between the agencies and the issuers of securities they rate.

Generally speaking, I also expect there to be more regulation of the financial services industry. There are so many different overlapping agencies – some companies have multiple regulators that don't necessarily communicate with each other in terms of the information they have. I expect greater efforts to streamline regulation so that there is more information sharing and more efficiency.