Reforming the regulation of money market funds

20/06/2013

Financial Services analysis: The Securities and Exchange Commission (SEC) has proposed wide-ranging reforms to the regulation of money market funds (MMFs). But do they go far enough and will they revive investor confidence? Jay G Baris, partner and chair of the investment management practice at Morrison Foerster, New York, considers the implications for the industry.

Original news

Money market funds set for reform

Financial Times, 6 June 2013: A number of proposals have been put forward by the SEC for reforming the structure of MMFs. Regulators have been looking at methods to limit the risk posed by the $2.9 trillion money fund industry, since an avalanche of withdrawals helped to freeze bank and corporate funding markets during the financial crisis almost five years ago.

In summary, what changes are proposed?

The SEC has put forward numerous reforms of the regulation of money market funds, but essentially there are two main stand-alone proposals, which mean the SEC could adopt either one individually, or in tandem with each other.

A floating net asset value (NAV)

Under this proposal an institutional prime MMF would no longer be able to round up an NAV to the nearest dollar. Rather, the investors in a fund would have to purchase and sell their shares at whatever the value of the NAV is at the point of sale; it wouldn't be fixed at $1. The proposals do not apply to government or retail funds. This means that they define a retail fund as one that restricts redemptions by any one shareholder to no more than $1 million a day.

Liquidity fees and 'gates'

- Fees: If the weekly liquidity of the MMF falls below 15% of the fund's total assets, then the fund must impost a 2% redemption fee unless the fund's board of directors determines that a redemption fee is not in the best interest of the fund, or that a lower fee would be in the fund's best interest. This proposal wouldn't apply to government MMFs, although they could apply the fee voluntarily.

- 'Gates': If the weekly liquid assets of the MMF fall below 15%, the fund's board may temporarily suspend redemptions. This would be a completely new approach. The redemptions 'gate' cannot remain closed for more than 30 days at a time in any one given 90-day period. If the weekly liquidity rate rises back above 30% of total fund assets then the gates would automatically open. This doesn't apply to government MMFs but they can apply gates voluntarily.

There are other proposals relating to disclosure enhancements: funds would have to disclose the periods in which they impose fees and/or gates or disclose the reason for the decision why the board of directors decides not to impose them. Diversification requirements will also be tightened up.

What are the industry implications of such changes?

Most notably, compliance costs would go up. MMFs would have to rewrite their operating systems--this would filter down through to broker dealers who sell money market shares through omnibus accounts or retirement accounts, for example. So, take an omnibus account that may have to redeem more than $1 million, but its customers might be all retail. In that case, there would have to be a rewriting of systems to ensure that the fund can process shares.

There may also be an impact on corporate treasurers who invest money in MMFs because there can be tax implications if the floating NAV is adopted, as investors would be liable for taxes on gains and losses.

Could there be any unintended side effects?

There are widely divergent views on whether the rules, if adopted, will increase or decrease investor confidence in MMFs. The great fear is that investors will take their money elsewhere. At the moment, nobody really knows what will happen. It will be interesting to see if these proposals are adopted, only for another MMF to fail: what then?

Will the changes have ramifications on the MMF industry globally?

Yes, in that if institutional investors decide they want to go elsewhere, they could take their money offshore to the UK, the EU or anywhere else.

How does this fit with global efforts to introduce tighter regulation to the shadowing banking industry?

I would say that it's a misnomer to suggest that MMFs operate as 'shadow banks'; MMFs are neither banks nor do they operate in the shadows. This is simply how they are commonly understood to run in the EU. MMFs offer much transparency, and they are not banks because every investor is an equity owner of the fund.

Certainly, these SEC proposals fall short of the measures put forward by FSOC (and measures that the EC is rumoured to advocate), which go further in imposing a requirement of a floating NAV on all MMFs, and in requiring MMFs to maintain capital buffers. FSOC may take the view that these rules don't go far enough and ask for further action from the SEC. There could be a move by Congress or elsewhere to turn MMFs into banks, which in my opinion wouldn't be a particularly good idea.

The proposals are now open for 90 days' public consultation, so we can only wait to see what happens.

Interviewed by Duncan Wood.

The views expressed by our legal analysis interviewees are not necessarily those of the proprietor.