Industry, Others Continue to Disagree Over Contents, Need for SEC Money Fund Rule

NEW YORK—Financial market participants and observers espouse differing views on the necessity of an eagerly anticipated Securities and Exchange Commission proposed rule affecting money market mutual funds, but see the agency pushing ahead with its plan to complete the rule, practitioners and others told Bloomberg BNA.

Sources knowledgeable about the rulemaking outlined the rule's probable contents, which essentially would force money market fund sponsors to abandon their current practice of using a fixed net asset value (NAV) unless they adopt capital buffers and redemption limitations. The rule probably will be issued during the latter part of March, they predicted.

Industry groups and others have expressed concern over the anticipated rule, claiming its envisioned changes could impair the product's attractiveness to investors, cripple corporate flexibility to borrow, and even drive fund sponsors out of the industry.

Critics of the anticipated rule also claim the government has not given SEC regulations approved in January 2010, which made material changes to the structure of money market funds, enough time to effectuate change within the sector.

But proponents of the anticipated rule assert changes introduced by the 2010 rule do not go far enough to adequately protect investors; the funds, they contend, currently pose systemic risk to the U.S. financial system.

Envisioned Proposal.

In a Nov. 7 speech, SEC Chairman Mary L. Schapiro said her agency will “pursue further structural reform” of the money market fund industry. The reform's aim will be to improve market resiliency by reducing the funds' “susceptibility to runs and providing for a greater cushion in the case of a poor credit decision or decrease in short-term liquidity,” the chairman said.

While the proposed rule has not yet been issued, sources said the proposal probably will require money market funds either to adopt a floating NAV or continue structuring funds with a fixed NAV, provided a fund adopts two new provisions.

First, funds wanting to keep a fixed NAV will have to impose redemption restrictions limiting or even prohibiting investors from pulling all of their money out of a fund daily.

Second, fixed NAV funds under the proposal will have to incorporate into their structure a capital buffer, which might be calculated as a percentage of a fund's total assets. Some assets considered very safe—U.S. Treasuries, for example—might be exempt from a fund's capital requirement calculation, the sources said.

While those concepts have their opponents, they also have drawn support. A two-tier system, under which some money funds would possess a floating NAV and others a stable NAV, provided they submit themselves to capital and supervisory requirements, was recommended to the SEC by former Federal Reserve Chairman Paul A. Volcker in a Feb. 11 letter.

Money market mutual funds, also known as money market funds, are mutual funds that typically invest in conservative debt securities such as government bonds, certificates of deposits, and corporate debt. A total of 632 taxable and nontaxable money market funds held $2.69 trillion in assets as of Dec. 31, according to Investment Company Institute data.

Redemption Requirement.

While some industry officials said the capital buffer concept may be acceptable, the redemption concept was far less popular.

The limitation on withdrawing funds could take the form of a hold-back provision that would dissuade or even prohibit investors from withdrawing all of their money on a daily basis.

One way this could be effected in the final rule is to allow investors requesting a redemption to withdraw a certain percentage of their total investment immediately, with the rest available for withdrawal only after a specified period.

The overarching concept of such a hold-back provision would be to try to avoid possible runs on the money market fund asset class by removing the “first mover” advantage.

But introducing a redemption limitation would make the product unappealing to investors, Todd Cipperman, an investment management specialist at law firm Cipperman & Co., told Bloomberg BNA Feb. 17.

The SEC's push for additional regulation on money market funds is a “complete overreaction” to concerns about money fund safety and soundness, Cipperman said.

Capital Buffer.

While the Securities Industry and Financial Markets Association opposes a requirement that funds adopt a floating net asset value, SIFMA members “are prepared to explore the possibility of a capital buffer if it's done so in a way that allows the funds to function on a cost effective basis,” SIFMA Executive Vice President Randy Snook told reporters in January.

Investment Company Institute General Counsel Karrie McMillan told Bloomberg BNA her organization does not have an opinion on the capital buffer requirement because the anticipated rule has not been issued yet, but “we would be opposed to anything that would make the product meaningfully less attractive to shareholders such that they would reject it or that it would be so expensive that it would cause consolidation in the industry.”

The idea of introducing a capital buffer could be complex, SIFMA Executive Vice President (public policy and advocacy) Kenneth E. Bentsen told reporters in January. A capital buffer could introduce material tax consequences for individual investors, he said.

And in certain circumstances a capital buffer requirement could “almost create a bank-like capital structure which would really be detrimental” to money market funds, he said.

“So, it's not as simple as it might sound,” Bentsen said.

Support for Capital Buffer.

A capital buffer requirement would also effectively drive yields on money market funds down, others said.

However, a capital buffer requirement for money market funds was supported by others, including Columbia University Law School professor Jeffrey N. Gordon, who told Bloomberg BNA instituting such a buffer would materially enhance the product's safety and soundness.

Without added protections such as a capital buffer, stability of the funds rests on an “implicit promise” of assistance from fund sponsors, Gordon said.

Indeed, absent additional SEC regulation, money market funds will continue to be “a major source of systemic risk” to the U.S. financial system, Gordon said.

Are Changes Needed?

Partly as a reaction to the 2008 financial crisis, during which the Reserve Primary Fund money market fund “broke the buck” when its NAV fell below $1 per share, the SEC Jan. 27, 2010, approved changes to its Rule2a-7 and other rules governing money market funds under the Investment Company Act of 1940.

The rule was designed to make money market funds more resilient to market risks while providing investors with greater protections when investing in the funds.

Most specialists interviewed for this report said the 2010 SEC rule enhanced the money market fund regulatory regime. But some said the SEC should allow those rules more time to influence the market before adopting a new rule to regulate the same industry.

“We would very much like to see the regulators take a close look at how well the reforms they've already adopted have played out. … Those reforms have not been given the credit … that they are due,” McMillan said.

Others agreed. According to Bentsen, the 2010 rule “should be allowed to take hold before we start to tinker around with what is a very widely used and beneficial product for investors.”

Support for Rule.

While industry groups largely oppose at least parts of the anticipated rule, others argued more regulatory action regarding the funds is needed to safeguard investors and the U.S. financial system.

Despite improvements introduced by the 2010 rule, “the money market mutual funds that are stable value funds are still vulnerable to runs, and we don't want a situation in the future where in the event of a financial crisis taxpayers are called upon to guarantee the system,” University of Michigan Law School professor Michael S. Barr told Bloomberg BNA Feb. 16.

“There are plausible scenarios … in which money market funds, which are essential to the funding of many financial institutions, suffer a run when the financial sector as a whole comes under strain,” said Barr, a former Treasury Department assistant secretary and special adviser to former Treasury Secretary Robert E. Rubin.

Barr characterized the 2010 final rules “a good step, but insufficient.” He also said the SEC should approve the anticipated rule in the near term, “before people forget the lessons of the [2008] financial crisis.”

Earlier Rule Components.

The SEC should orchestrate money market fund rule changes with the adoption of rules implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203) so financial markets “will have certainty about the broad range of changes that were effectuated by the post-crisis reforms. So I think it is important to do it now,” Barr said.

The January 2010 rule limited the types of securities money market funds may invest in, shortened the maturity of funds' portfolios to 60 days from 90 days, and adopted a 120-day limit on the weighted average life of money market funds' portfolios.

The 2010 rule also required all money market funds to maintain sufficient liquidity so they could meet reasonably foreseeable redemption requests while reducing the likelihood a fund would have to meet redemptions by selling portfolio assets into a declining market.

Fund managers must also stress test their portfolios against potential economic shocks.

Opposition to Floating NAV.

Financial industry groups generally oppose the use of a floating NAV. A floating NAV would fundamentally change the characteristics of the instrument, they argue, and would make money market funds less attractive to investors.

Also, if companies invest in funds with floating NAVs, every time they buy or sell into or out of a fund they would have to record capital gains or losses. “That just causes a lot of accounting complications,” Alice Joe, senior director of the U.S. Chamber of Commerce's Center for Capital Markets, told Bloomberg BNA Feb. 16.

Also, some firms disallow investments in instruments lacking a fixed net asset value, Joe said.

“Shareholders have told us that is not a product they can or would use, and so you would find a lot of money migrating out of the registered and regulated products into other types of stable NAV products,” McMillan said.

SIFMA members are “very concerned” about eliminating a fixed NAV and replacing it with a floating NAV, Snook added.

Impact on Corporate Borrowing.

Opponents of changes to the current regulatory system for the funds also claim the anticipated rule would negatively affect broader U.S. financial markets.

For instance, money market funds are a chief purchaser of corporate debt, known as commercial paper, which is issued by companies to meet short-term cash needs.

Fewer investors in money market funds would mean less cash in the funds, which in turn would reduce the money funds have to purchase commercial paper. Companies issue CP because it is a relatively cheap and fast way—corporate debt issuances can occur in a day—to borrow cash.

Volcker Proposal.

In his Feb. 11 letter, Volcker said money market funds can inject risk into the U.S. financial system in scenarios under which large banks affiliated with funds would have to inject large amounts of capital into them in order for the funds to maintain a fixed NAV. Such actions would deplete the bank's capital buffer, Volcker wrote.

The former Fed chairman proposed to remedy this scenario by establishing two money fund models: money market funds with stable NAVs that may present themselves as funds offering redemptions at par, and all other money market funds.

So-called stable NAV funds would be required to submit themselves to capital and supervisory requirements plus possess Federal Deposit Insurance Corp.-type insurance. All other funds, which would have a floating NAV, could present themselves to the public as a conservative, low risk, liquid investment product, the letter said.

Commission Vote.

Any SEC proposed rule would have to attract three votes from the five-member commission in order to be approved. Sources said Schapiro and fellow commissioner Elisse B. Walter probably would support a money market fund reform proposal and Republican commissioners Troy A. Paredes and Daniel M. Gallagher might oppose it.

That means the fifth commissioner, Democratic appointee Luis A. Aguilar, may be in a position to decide the issue.

It is unlikely Schapiro would put a proposed rule to a vote unless she secured the votes to ensure its passage.

An SEC spokeswoman did not respond to a request for comment on the anticipated rule's contents or when the rule might be issued.