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Money Market Fund Rules Unchanged, For Now

Earlier this year, we reviewed the new rules and regulations for money market funds being considered by the Securities and Exchange Commission. This Letter is an update of our February 2012 report. With some $2.6 trillion in assets, money market funds are a key link in the global financial system. They provide short-term credit to businesses, municipal governments and financial institutions and, with their highly liquid investments and normally attractive yields, help individual and institutional investors manage their cash efficiently.

Since the financial crisis, the SEC has been concerned about the susceptibility of money market funds to investor runs and the potential impact on the financial system. In 2008, a large institutional money market fund, the Reserve Primary Fund, had substantial holdings of Lehman Brothers' debt. When Lehman Brothers filed for bankruptcy, the Reserve Primary Fund "broke the buck," meaning that investors trying to withdraw funds received less than a dollar for every dollar put in. This triggered a widespread run on money market funds that did not subside until the Federal government intervened and guaranteed them.

Under the Financial Reform Act of 2010, a number of new regulations were implemented to make the industry more resilient. Money market funds now have tighter credit standards on the types of securities in which they may invest and are required to keep enough cash on hand to meet "reasonably forseeable redemption requests." These reforms appear to be working as over the last few years the industry has weathered the European debt crisis, as well as our own debt downgrade and budget stand-off, without a crisis of its own.

The SEC consists of five Commissioners who are appointed by the President with the advice and consent of the Senate. Some of the Commissioners believe that even with the reforms of 2010, the money market fund industry remains at risk and a moderate financial shock could turn into a destabilizing run. In the words of Mary Schapiro, Chairman of the SEC, this would leave policymakers with "two unacceptable choices: a bailout or a crisis."

One option would be a "floating" net asset value for money market funds. That is, instead of an apparent stable net asset value of $1 (or a dollar received for every dollar put in), money market funds would be required to value their shares each day based on the fluctuating value of the assets in the fund.

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A second option would be a regulated capital buffer that funds would be required to maintain. The buffer would be stricter than the current cash on hand rule and designed to absorb any small losses occurring on a day-to-day basis. As could be expected, the money market fund industry was opposed to these proposals, particularly the "floating" net asset value. A primary concern was how investors using funds as part of their cash management strategy would deal with the capital gains and losses from the fluctuating asset values that would be realized each time a check was written or monies were transferred in or out.

The Commission was scheduled to vote at the end of August but just a few days before, Ms. Schapiro made a surprise announcement that a majority three of the five Commissioners would not support the proposal and that the SEC therefore would shelve its efforts.

Of the three dissenting Commissioners, two stated that the proposed changes were not supported by the accompanying data and analysis, were unlikely to be effective in achieving their purpose and would impose significant costs on both issuers of debt purchased by funds and on investors in money market funds. They also believe that the proposed changes would introduce new risks into the financial system.

The other Commissioner, who was formerly an executive with a money market fund company, pointed out that money market funds are only one part of a large cash management industry and that many parts of the industry are exempt from SEC oversight and regulation. The entire cash management industry should be considered before one segment is altered in a fundamental way. Also, the reforms enacted in 2010 should be studied and assessed before additional changes are made.

The financial crisis highlighted a number of weaknesses within the financial system which the SEC took steps to address. The good news is that the 2010 reforms, which addressed the critical issues of quality and liquidity, seem to have been effective. The bad news is that in the current environment, the need for regulatory reform tends to be viewed through either the blue- or red-colored lens of politics.

With the SEC abandoning its efforts, some observers think that the Financial Stability Oversight Council, also created in 2010, may reopen the issue. The Council, composed of the nation's top regulators, includes Ms. Schapiro, Treasury Secretary Timothy Geithner and Federal Reserve Chairman Ben Bernanke. But if the Council decides that the entire industry is systemically important, this would send the issue right back to the SEC. On the other hand, if only certain money market funds are deemed systemically important, regulatory oversight would then be shifted to the Federal Reserve. The Treasury Department has announced that it also is considering which steps should be taken next.

Whatever the eventual outcome, we continue to recommend that investors select high-quality money market funds that are offered by large, established firms. With the possibility of new rules or changes in regulatory oversight, larger firms should be better able to cope with the shifting landscape. Until the financial crisis -- with its regulatory and political ripple effects -- is well behind us, investors should, as always, focus first and foremost on quality.