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October 22, 2010

President's Working Group Report On Money Market Fund Reform Options

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TO: ACCOUNTING/TREASURERS MEMBERS No. 34-10
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 41-10
BROKER/DEALER ADVISORY COMMITTEE No. 48-10
FIXED-INCOME ADVISORY COMMITTEE No. 23-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 54-10
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 41-10
OPERATIONS COMMITTEE No. 33-10
SEC RULES MEMBERS No. 108-10
SMALL FUNDS MEMBERS No. 63-10
TRANSFER AGENT ADVISORY COMMITTEE No. 68-10 RE: PRESIDENT'S WORKING GROUP REPORT ON MONEY MARKET FUND REFORM OPTIONS

As you may recall, the Treasury Department's June 2009 white paper outlining the Obama Administration's plan for financial services regulatory reform briefly addressed the regulation of money market funds (MMFs). [1] In particular, the paper recommended that the Securities and Exchange Commission (SEC) move forward with plans to strengthen the MMF regulatory framework and suggested specific changes the SEC should consider. The paper further proposed that the President's Working Group on Financial Markets (PWG) prepare a report considering fundamental changes to address systemic risk more directly. It stated that those changes could include, for example, eliminating the ability of a MMF to use a stable net asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities. [2]

The PWG has released its report, entitled Money Market Fund Reform Options. [3] The report does not make specific reform recommendations. Rather, in the report's Executive Summary, the PWG requests that the newly-established Financial Stability Oversight Council consider the options presented in the report and identify and pursue those "most likely to materially reduce MMFs' susceptibility to runs." The report indicates that the SEC (as the regulator of MMFs) will publish a notice and request for comment in the near future.

[4] The report is briefly summarized below.

Introduction and Background. The report provides basic information about the role of MMFs, how they are regulated, how they operate, the nature of their investors, and types of products that compete with MMFs. The report describes five features of MMFs, their sponsors, and their investors that, according to the report, increase MMFs' susceptibility to runs (especially through interaction with one another). [5] It then discusses the experience of MMFs in the recent financial crisis, including the effects of market turmoil in 2007 and 2008, the aftermath of the bankruptcy of Lehman Brothers and the Reserve Primary Fund's "breaking the buck," and the government programs adopted in September 2008 to help stabilize MMFs and provide liquidity to short-term funding markets.

SEC Changes to MMF Regulation. The report examines the SEC's MMF rule changes to improve the safety and resilience of MMFs. It states that the SEC's reforms are designed primarily to meet the SEC's statutory obligations to protect investors and promote capital formation. It further indicates that these rule changes "should mitigate (although not eliminate) systemic risks by reducing the susceptibility of MMFs to runs, both by lessening the likelihood that an individual fund will break the buck and by containing the damage should one break the buck." The report also discusses the need for further reforms to reduce MMFs' structural vulnerability to runs. It emphasizes, however, that "[n]otwithstanding the need for reform, the significance of MMFs in the U.S. financial system suggests that changes must be considered carefully."

Policy Options. The report discusses seven policy options for further reducing the risk of MMF runs, outlining potential pros and cons of each option. [6] These options are: (1) floating NAVs; (2) private emergency liquidity facilities for MMFs; (3) mandatory redemptions in kind; (4) insurance for MMFs; (5) a two-tier system of MMFs, with enhanced protections for stable NAV MMFs; (6) a two-tier system of MMFs, with stable NAV MMFs reserved for retail investors; and (7) regulating stable NAV MMFs as Special Purpose Banks. As the report notes, the SEC requested comment on some of these options in connection with its MMF reform proposal; others would go beyond the SEC's current regulatory authority, requiring legislation or action by multiple government agencies and the MMF industry. [7]

ICI will continue to engage with regulators on these issues.

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endnotes

[1] See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[2] The paper also advised the SEC and PWG to "carefully consider ways to mitigate any potential adverse effects of such a stronger regulatory framework for [money market funds], such as investor flight from [money market funds] into unregulated or less regulated money market investment vehicles or reductions in the term of money market liabilities issued by major financial and non-financial firms."

[3] The report is available at
http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf.

[4] In addition, following the comment period there will be a series of meetings in Washington, DC with various stakeholders, interested persons, experts, and regulators.

[5] These features are: (1) maturity transformation with limited liquidity resources; (2) net asset values (NAVs) rounded to $1; (3) portfolios exposed to credit and interest rate risks; (4) discretionary sponsor capital support; and (5) investors' low risk tolerance and expectations.

[6] The report acknowledges that new restrictions on MMFs to help diminish systemic risk could reduce their appeal to some investors and might cause some (primarily institutional) investors to move their assets to less regulated alternative investments, which themselves would be vulnerable to runs. The report suggests that "effective mitigation of MMFs' susceptibility to runs may require policy reforms beyond those directed at registered MMFs to address risks posed by funds that compete with MMFs."

[7] Some of the options also were discussed in the Report of the Money Market Working Group (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.