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Correcting the Record: Investor Protections in the SEC's 2010 Money Market Fund Reforms

We've said it before, and we'll say it again: One of the most puzzling aspects of regulators' campaign for changes to money market funds is their ability to ignore the dramatic improvements in these funds resulting from the regulatory reforms that the Securities and Exchange Commission (SEC) enacted in 2010. Six months before Congress passed the Dodd Frank Act, the SEC became the first agency to address any of the financial products hit by the crisis, passing a package of sweeping changes to tighten regulation and make money market funds more resilient. For more than a year, those reforms have been tested by the ongoing European debt crisis, the standoff over the U.S. debt ceiling, and the historic downgrade of the U.S. credit rating—and money market funds have emerged strong.

To her credit, SEC Chairman Mary Schapiro acknowledges that "the 2010 reforms were extremely positive." But at the same time, her public statements—including her latest testimony before the Senate Banking Committee—frequently downplay and undercut those very reforms. Take today's example:

Misstatement: "I don't think [the 2010 SEC amendments] address the unfair results that can occur when a sophisticated institutional investor gets out quickly and losses are concentrated with retail investors, or retail investors are left in a frozen fund and can't access their liquidity."

Actually, the SEC's 2010 amendments address exactly this situation.

First, the healthy liquidity that the amendments require money market funds to hold sharply reduces the odds that a fund will become "frozen." As we've noted, liquid assets held by prime money market funds today are twice as great as the outflow from such funds in the week that Lehman Brothers failed in September 2008.

Second, these reforms, for the first time, give money market fund boards of directors the power to assure a fair and orderly liquidation of a troubled money market fund, should that be necessary.

In September 2008, the Reserve Primary Fund's board did not have the ability to promptly suspend redemptions—leading to a chaotic response when the fund broke the dollar. Now, the SEC has given money market fund boards a powerful new tool that will, in the SEC's own words, allow for the "orderly liquidation of fund assets" for a troubled fund and "reduce the vulnerability of investors to the harmful effects of a run on the fund, and minimize the potential for disruption to the securities markets."

To use this power, a board must decide to liquidate the fund. Once it does, shareholders are protected, because the board can suspend redemptions to ensure that "sophisticated" investors can't exit first and inflict losses on those remaining behind. The new rule recognizes that a money market fund's share price can decline in value, and provides for an orderly liquidation of the fund's securities in a manner that best serves the fund's shareholders. It would effectively negate any "first mover" advantages and avoid a fire-sale liquidation of the portfolio.

This new rule has yet to be tested—but Chairman Schapiro is already saying that it's not effective. That's odd, because she was head of the SEC when this rule was adopted. Once again, there's no analysis to explain her puzzling reversal.

The SEC has a long history of upholding the importance of mutual fund directors in ensuring fairness and protection for fund investors. The role of directors as "watchdogs for investors" was recognized by the U.S. Supreme Court as recently as its 2010 ruling in Jones v. Harris Associates L.P. But the SEC has gone strangely silent on the importance of money market fund directors since some of the Commission started campaigning for structural changes that will damage the value of money market funds for investors and the economy. In fact, Chairman Schapiro's testimony fails to mention even once the important role of boards in overseeing money market funds.

This is the fourth ICI Viewpoints posting on myths and misstatements about money market funds. The previous entries:

- Correcting the Record: The "Susceptible to Runs" Myth
- Correcting the Record: Regulators' False Narrative of 2008
- Correcting the Record: What Money Market Fund Investors Know

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