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RESEARCH SUMMARY

# OPENING THE GATE TO MONEY MARKET FUND REFORM


For decades investors have viewed money market funds (MMFs) as safe, low-risk investments. But the 2007–2009 financial crisis—during which several MMFs experienced large-scale redemptions—challenged that perception. The destabilization in short-term lending markets precipitated by these redemptions and the subsequent government bailout of MMFs prompted regulators to study potential MMF reforms.

Following the adoption of an initial set of MMF regulatory changes in 2010, the Securities and Exchange Commission (SEC) considered additional, more far-reaching reforms. After a lively debate among representatives of industry, regulators, MMF investors, and academics, the SEC adopted a second set of reforms in the summer of 2014. Those reforms remain controversial, as some believe they went too far and others contend they did not go far enough.

In a study conducted for the Mercatus Center at George Mason University, authors Hester Peirce and Robert Greene find that the SEC's approach and similar reforms would threaten the core of the industry and do little to stabilize MMFs and short-term financing markets in the event of large-scale redemptions. The study offers an alternative market-based regulatory proposal that builds on the existing role of MMF boards of directors in making decisions on behalf of their funds.


To read the study in its entirety, see "Opening the Gate to Money Market Fund Reform."

## WHAT ARE MMFs, AND WHAT HAPPENED TO THEM DURING THE CRISIS?

MMFs are mutual funds that typically invest in low-risk securities, such as high-grade commercial paper, government securities, and certificates of deposit. They are a vital source of short-term funding for banks, municipalities, and corporations and a safe, convenient investment vehicle.

The roughly \$2.7 trillion MMF industry is regulated by the SEC under the Investment Company Act of 1940. SEC Rule 2a-7 allows MMFs to calculate share price in a manner that facilitates the maintenance of a stable net asset value (NAV)—the one-dollar share price that is a fundamental feature of most MMFs.


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If the actual value of a share in a MMF drops below 99.5 cents, the fund "breaks the buck," and its shares may no longer be traded at $1. One MMF—the Reserve Primary Fund—notoriously broke the buck during the 2008 financial crisis, a virtually unprecedented event in the stable world of MMFs. A run on certain MMFs ensued, specifically on those funds that had invested in risky assets and thus had higher yields leading up to the crisis. The government then set up a number of programs to prop up MMFs and the entities that rely on them for funding.

## KEY FINDINGS

### The SEC's Reforms Will Not Improve MMF Stability

The SEC adopted a floating net asset value for certain MMFs and allowed fund boards to impose liquidity fees or suspend redemptions if liquidity reaches trigger levels. These reforms raise a number of concerns.

- *Floating the net asset value.* MMF investors would buy and sell fund shares at a price that reflects the market value, rather than at a stable $1 price. Evidence shows that a floating NAV wouldn't solve the core problems that lead to runs—the liquidity, solvency, and risk of underlying investments. A floating NAV would reduce the utility of MMFs to their investors and impose costly new tax and accounting requirements.

- *Triggered liquidity fees and gating.* Tying redemption suspensions and liquidity fees to a predetermined trigger risks precipitating destabilizing, anticipatory redemptions as MMFs approach the arbitrary trigger level.

### Other Suggested Reforms Would Not Improve MMF Stability

The paper also looks at a number of other reforms suggestions made by regulators and others. It finds that these suggested reforms, which include capital buffers and minimum balance at risk, would not be effective at preventing runs and preserving the MMF's important role in the US financial system.

## RECOMMENDATIONS AND CONCLUSIONS

MMF boards, not regulators, should make critical decisions on behalf of the fund during times of crisis. Specifically, MMF boards of directors should be permitted to suspend (or "gate") redemptions at the board's sole discretion for any length of time with an affirmative board vote. Placing this key strategic decision in the hands of the board of directors builds naturally on the many responsibilities Congress and the SEC already have entrusted to fund boards.

This ability would give MMF advisers, boards, and investors an incentive to limit MMF risk-taking in order to safeguard ready redeemability. It would also reduce the likelihood and the severity of runs while maintaining most of the desirable features of MMFs, including the stable NAV.

The liquidity risk associated with gating would cause investors and managers alike to think twice about risky yield-chasing and would serve as a stark reminder to MMF investors that MMFs are not equivalent to bank accounts.

Possessing real-time, fund-specific knowledge, MMF boards are better able than regulators to determine whether, when, and how their funds are vulnerable to redemptions driven by crises. With open-ended gating authority, boards could shield their funds from damaging asset fire sales in times of crisis. In contrast to other MMF reforms, this approach offers a viable solution to increase the resilience of MMFs without undermining their utility in the financial system.