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Geithner Reactivates Push for Money Market Fund Reform

Securities and Exchange (SEC) Chair Mary Shapiro's decision in August not to proceed on money market fund (MMF) reform was considered a win by the industry. However, last Thursday, Treasury Secretary Timothy Geithner made it clear that this issue is far from dead, sending a letter to the Financial Services Oversight Council (FSOC) urging them to use the authority granted by Dodd- Frank to press the SEC to move forward. His call for the FSOC to take action echoed Shapiro's comments after her proposal was rebuffed by three SEC commissioners, when she urged other financial regulators to move forward where she could not. If the FSOC decides to exercise this authority, the SEC would be forced to adopt the recommended standards or explain to the FSOC in writing why it has failed to act.

In his letter, Geithner wrote, "Further reforms to the MMF industry are essential for financial stability. MMFs are a significant source of short-term funding for businesses, financial institutions, and governments. The funds provide an important cash-management vehicle for both institutional and retail investors. However, the financial crisis of 2007–2008 demonstrated that MMFs are susceptible to runs and can be a source of financial instability with serious implications for broader financial markets and the economy."

Geithner indicated the FSOC staff is already preparing a proposal for consideration at an FSOC meeting in November. Their draft will include " the two reform alternatives put forward by Chairman Shapiro, request comment on a third option as outlined below, and seek input on other alternatives that might be as effective in addressing MMFs' structural vulnerabilities.

"*Option one* would entail floating the net asset values (NAVs) of MMFs by removing the special exemption that allows them to utilize amortized-cost accounting and rounding to maintain stable NAVs. Instead, MMFs would be required to use mark-to-market valuation to set share prices, like other mutual funds. This would allow the value of investors' shares to track more closely the values of the underlying instruments held by MMFs and eliminate the significance of share price variation in the future.

"*Option two* would require MMFs to hold a capital buffer of adequate size (likely less than 1 percent) to absorb fluctuations in the value of their holdings that are currently addressed by rounding of the NAV. The buffer could be coupled with a “minimum balance at risk” requirement, whereby each shareholder would have a minimum account balance of at least 3 percent of that shareholder’s maximum balance over the previous 30 days. Redemptions of the minimum balance would be delayed for 30 days, and amounts held back would be the first to absorb any losses by the fund in excess of its capital buffer. This would complement the capital buffer by adding loss-absorption capacity and directly counteract the first-mover advantage that exacerbates the current structure’s vulnerability to runs.

“*Option three* would entail imposing capital and enhanced liquidity standards, potentially coupled with liquidity fees or temporary “gates” on redemptions that may be imposed as an alternative to a minimum balance at risk requirement. “

While Geithner’s first recommendation is for the FSOC to use its authority under Dodd-Frank to formally recommend that the SEC implement money market fund reforms, he also outlined other ways to address the issue. “The SEC,” he wrote, “by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risks that MMFs present to the economy. However, while we pursue this path, the Council and its members should, in parallel, take active steps in the event the SEC is unwilling to act in a timely and effective manner.

“Under Title I of the Dodd-Frank Act, the Council has the authority and the duty to designate any nonbank financial company that could pose a threat to U.S. financial stability. The Council should closely evaluate the MMF industry to identify firms that meet this standard. Designating MMFs or their sponsors or investment advisers would subject those firms to supervision by the Federal Reserve and would give the Federal Reserve broad authority to impose enhanced prudential standards…Alternatively, the Council’s authority to designate systemically important payment, clearing, or settlement activities under Title VIII of the Dodd-Frank Act could enable the application of heightened risk-management standards on an industry-wide basis.”