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Opinion

Transparency the Cure For Money Funds' Liquidity Ills

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The Securities and Exchange Commission is about to embark on a second round of rulemaking for money market funds. Front and center in this process will be an evaluation of a new SEC rule requiring each money market fund to continually evaluate the liquidity needs of its shareholders. This is crucial to the fund's efforts to be sufficiently liquid so it can fulfill expected redemption requests. But accomplishing these goals can be quite complicated when funds cannot identify many of their shareholders, particularly those who access money funds via omnibus accounts held at brokerages or retirement plan recordkeepers. That's why the Coalition of Mutual Fund Investors believe the next round of SEC rulemaking needs to prioritize transparency, with an emphasis on identifying investors who access money funds through omnibus accounts.

A review of the SEC's recent regulatory overhaul of money funds shows that while progress has been made, we are still not making enough strides in the area of transparency. In January 2010, the SEC finalized new regulations to help money market funds improve their ability to avoid breaking the buck in a market crisis. Among other provisions, these rules require money market funds to maintain daily and weekly liquidity positions, and to reduce credit risks and interest rate risks, while conducting periodic "stress tests."

As an additional step, the SEC wants money market funds to monitor and plan for "hot money" investors, in order to mitigate the risks involved in liquidity runs on individual funds. In response, the SEC imposed a general liquidity rule that requires each fund to evaluate — on an ongoing basis — the characteristics of its investors and their likely redemption needs.

However, a big obstacle to implementing any type of "know your shareholder" process is the fact that most money market funds receive purchase and redemption orders using omnibus accounting. In an omnibus accounts structure, the institution placing the fund orders is the shareholder of record, such as a brokerage, and does not typically provide investor-level identity or transaction information to individual funds.

Since the SEC's new money market rules were finalized, several industry commenters — including the Coalition of Mutual Fund Investors — have argued in favor of greater transparency within these omnibus

accounts. The belief is that such reform can help funds monitor underlying investor activity in a more robust manner and adjust portfolio liquidity as needed.

The easiest way to improve transparency within omnibus accounts is to extend SEC Rule 22c-2 to money market funds. Rule 22c-2 was promulgated in 2005, after the market-timing problems encountered by the fund industry. The rule requires financial intermediaries to share investor-level identity and transaction information within an omnibus account, when requested by a fund. Money market funds are currently exempted from this information-sharing procedure, although many funds would clearly benefit from a standardized approach to receiving this information. It's obvious that this additional information can help funds evaluate the actual liquidity needs of their underlying shareholders.

Access to investor-level data will permit fund advisors to develop more accurate and sophisticated evaluative processes regarding the liquidity patterns of their investors. And these evaluations will include all of the distribution channels where transactions are occurring within an individual fund's shares.

The liquidity risks of money market funds remain a concern for the SEC and all investors. Support for mandating more transparency in money market funds is building within the industry and among the SEC staff. And an expansion of Rule 22c-2 is a more preferable regulatory option than converting money market funds into special-purpose banks or creating a special class of floating NAV funds.

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