Opinion

Money Fund Reform Faces Omnibus Account Dilemma

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Some form of redemption restrictions is the best way to protect money market funds from a liquidity crisis and restore investor and regulator confidence in money funds.

Any potential reform cannot ignore how thousands of money fund investors keep their savings inside non-transparent omnibus accounts sponsored by financial intermediaries.

Specifically, the Securities and Exchange Commission needs to extend Rule 22c-2 to money market funds. That would ensure that fund firms can overcome omnibus account–related operational challenges if the proposed redemption restrictions for money funds are approved.

We cannot allow a situation where one set of money fund investors, those in omnibus accounts, are treated differently than shareholders who invest directly in 2a-7 funds.

Now is an ideal time for the industry to take a deeper look into the omnibus account component of money fund reform.

Federal regulators appear ready to engage in another round of rulemaking to address the capacity of money market funds to honor redemption requests in a severe credit market crisis.

The biggest fear of both the industry and its investors — and rightfully so — is the proposal to require a floating NAV for money fund shares. That structural reform would significantly reduce the attractiveness of these funds as a cash management vehicle for investors.

Several industry organizations have proposed that fund boards be authorized to impose certain types of redemption restrictions in a liquidity crisis.

This compromise position, if adopted, would clearly improve the durability of money market funds in a crisis, while maintaining the fixed NAV that is the hallmark of the money fund product.

One of these proposed restrictions, called a redemption gate, is used in the hedge fund industry. An aggregate redemption maximum is established and a fund is permitted to reduce redemption requests on a pro rata basis until the gate limit is reached.

Any unfilled or outstanding redemption requests are carried over until the next redemption period.

Another proposal would permit fund boards to temporarily impose a redemption fee to deter institutional investors from cashing out their money fund accounts at the first sign of a problem.

A money market fund attempting to apply a redemption gate or fee to its entire shareholder base will be unable to apply either of these restrictions uniformly, with so many investors holding shares inside non-transparent omnibus accounts used by financial intermediaries.

An omnibus account comprises the individual accounts and share orders of the customers of a financial intermediary, such as a broker-dealer or investment advisor.

The intermediary serves as the shareholder of record, instead of the underlying investors, on a money fund's books. Under this accounting structure, a fund does not have access to any identity or transaction information at the investor-account level.

Since purchase and redemption orders offset each other within the omnibus structure, investors holding shares through intermediaries are able to evade any type of redemption restriction that may be imposed in a liquidity crisis.

The netting of investor-level transactions at the same financial intermediary causes these transactions to be executed before an aggregated order is placed with a fund.

Therefore, a redemption restriction imposed by a fund would not apply to these underlying transactions. Redeeming shareholders would be able to execute transactions outside of the purview of the firm managing the money market fund.

The inability to impose redemption restrictions within omnibus accounts was a problem that the SEC tackled in the aftermath of the market-timing scandals that plagued the industry a decade ago.

In order to help a fund impose a redemption restriction for excessively frequent trading by an investor, the SEC brought out Rule 22c-2, which permits mutual funds to obtain investor-level identity and transaction information from any intermediary using the omnibus account structure.

The original purpose of the rule was to address market timing, and that was not a problem with money market funds, as a fixed NAV means that there is no risk of arbitrage trading that exploits inefficient pricing.

An extension of SEC Rule 22c-2 to money market funds would provide funds with the needed transparency down to the shareholder level, permitting a more uniform application of any redemption restriction that a fund may impose in a liquidity crisis.

Since the middle of a crisis is no time to be requesting a mountain of underlying shareholder information, Rule 22c-2 information sharing should be standardized for the industry and used as a tool on a daily basis.

Funds should be able to monitor underlying investor activity in real time. They should have the ability to develop analytic processes that can anticipate the liquidity needs of all their shareholders, with more precision than is the case today.

When the next liquidity crisis occurs, money market funds with full transparency into the activities of their underlying shareholders will be better prepared to honor redemption requests.

And a fund with real-time transparency into its shareholder base will be able to make effective use of temporary redemption restrictions, if necessary, in a non-discriminatory manner.

If federal regulators agree that redemption restrictions can be an effective tool for money market funds in a crisis, then the durability of these funds will be improved for investors and the industry will avoid the devastating effects of a floating NAV.

This would create a desirable outcome for both the fund industry and its investors.