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SEC May Boost Money Funds' Power to Know Their Customers

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The new money market fund rule requires managers to hold enough liquid securities for foreseeable redemptions, but falls short in providing funds with the leverage they need to know who the funds' shareholders are, critics say.

The "Know Your Investor" provision of the new rule grew from the widespread panic that ensued when a money market fund broke the buck in 2008, leading to calls for major regulatory reform. The Securities and Exchange Commission deemed in adopting its new money fund rule last month that the funds "need to develop procedures to identify investors whose redemption requests may pose risks for funds [and] as part of these procedures, funds would need to anticipate the likelihood of large redemptions."

The SEC already has Rule 22c-2, which was enacted after the market-timing scandal and requires that funds enter into contracts with financial intermediaries under which they can demand certain types of information about shareholder identity and transactions. Money market funds are exempt from this rule, yet funds and intermediaries could draw up similar contracts. In addition, the issue of gaining greater investor transparency may be on the SEC's radar; in fact it has already promised further reforms of money market funds this year.

"That could be an issue we address," says Robert Plaze, assistant director of the SEC's Division of Investment Management, referring to fund firms' current difficulties in determining who holds their money funds.

The SEC did emphasize that money market funds must adopt "policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders," according to the rule.

"In other words, fund boards should make sure that the adviser is monitoring and planning for 'hot money,'" the rule reads. "In their consideration of these procedures and in the oversight of their implementation, fund boards should appreciate that, in some cases, fund managers' interests in attracting additional fund assets may be in conflict with their overall duty to manage the fund in a manner consistent with maintaining a stable net asset value."

Prior to adopting the rule, SEC chairman Mary Schapiro had inquired how the "Know Your Investor" provision would interact with the minimum liquidity requirements. Plaze responded that funds may either look through the omnibus accounts or "draw conclusions based upon historical patterns of redemptions that you get through that omnibus account."

The SEC acknowledged in its final rule the concern of some in the industry that suggested the agency "should require greater transparency of investments held through financial intermediaries to allow funds to better monitor client profiles." The SEC also suggested that funds "seek to access this information in contractual arrangements with their financial intermediaries."

Plaze says it's too early to tell if this will be a big issue with the industry. He also adds that funds may opt to refuse to do business with a financial intermediary that does not want to enter into a contract. Money market funds were exempt from Rule 22c-2 because the activities that led to the rule's creation, market timing and late trading, did not occur in money market funds, Plaze says.

But Niels Holch, president of the Coalition of Mutual Fund Investors, would like to see the SEC empower money market funds so that they can demand investor information in omnibus accounts.

"Fast-forward to now and money market funds need to know more about their customers for liquidity issues," says Holch, who maintains that the funds are handicapped in knowing about potential redemption needs if they are not able to look at omnibus accounts. "What the SEC did [with the new money fund regulations] is adopt a requirement that mutual funds had to develop know-your-customer procedures, but [did] not tell them how to do it."

Joan Ohlbaum Swirsky, of counsel at **Stradley Ronon** and author of *The Guide to Rule 2a-7: A Map Through the Maze for the Money Market Professional*, says the idea of money market funds' striking up contractual agreements with their intermediaries would be daunting for both parties.

"You have to communicate with each of your intermediaries, and when you're talking to hundreds of them, it could be a big task," she says. "And the intermediaries may or may not feel equipped to carry out the task for money market funds."

Others also have weighed in with concerns. **BlackRock** suggested "that the Commission consider requiring [that] an adviser receive some minimum level of transparency for portal and omnibus account positions" in its comment letter.

"This should include aggregate data on the number and stratification of the underlying accounts as well as the specific holdings of any clients that represent more than 5% of the total omnibus or portal position in the funds," BlackRock wrote. "This data would further assist the adviser and the fund's board in monitoring each fund's client profile and adjusting portfolio liquidity appropriately."

State Street wrote that "many investors invest in money market [funds] through omnibus accounts, where the adviser does not know the ultimate identity (and therefore characterization) of the investors." It also went further in proposing that "the Commission extend Rule 22c-2 to apply to money market funds with respect to sharing shareholder information."

"We believe that this requirement would permit funds to periodically examine the nature of their shareholder base, even where much of the fund is held through omnibus accounts," the firm wrote.

The Investment Company Institute, in conjunction with many fund industry giants, also suggested that "funds should consider the various risk levels of shareholders that are omnibus accounts" in the ICI Report of the Money Market Working Group issued last year.

"Funds also should look closely at the shareholder's use of portals (especially those portals that do not provide funds with the identities of the underlying users) or other third party distribution methods, because the intentions of the shareholders using the portal may be unclear," the report reads.

Holch notes that although the ICI identified the problem, it did not come up with a specific solution except to encourage funds to develop policies and procedures in this area. The "Know Your Investor" provision originated from the ICI report, and as with other ideas, became part of the final rule.

"The fund industry's 'know your customer' programs only consist of evaluating aggregated trade data that does not include shareholder identification or transaction data at the beneficial owner level," Holch wrote in his comment letter last year. "Without this information, a fund can only speculate about potential redemption demands, instead of conducting a much more precise evaluation of expected liquidity demands through a review of the actual identity and redemption history of all fund investors."