SEC money fund reform won't placate everyone

Question remains which funds will escape the agency's float proposal

By **Trevor Hunnicutt**, InvestmentNews
Mar 28, 2014 @ 10:33 am (Updated 2:33 pm) EST

Players in the $2.7 trillion money market fund industry are cautioning that even if the SEC moves ahead on its money market reform plan, not everyone will be satisfied. One big sticking point is a proposal that could leave in limbo the opaque accounts used by brokerage firms and retirement plans with retail clients.

“The devil's in the details on that issue,” said David T. Bellaire, executive vice president and general counsel for the **Financial Services Institute Inc.**, a lobbying group for independent broker-dealers.

The **Securities and Exchange Commission** this year is expected to act on reforms of money market mutual funds, with the possibility of imposing a proposal that requires fluctuating share prices, or net asset values, for institutional share classes. Industry representatives, however, expect the regulator to leave largely intact a legal regime that allows retail customers to rely on the consistent pricing of the products at $1 per share — a hallmark of money market funds.

At stake is the definition of what exactly qualifies as an institutional fund, including the status of an unknown number of accounts processed internally by firms such as broker-dealers, rather than fund companies, according to several observers of fund industry regulation.

Many funds have a half dozen share classes in the gray area between institutional and retail, according to Peter G. Crane, founder of research firm Crane Data.

“Everything in between possibly could come under an intermediary that may be eligible for look-through treatment,” Mr. Crane said. “The real question is going to be: How are those details written, and how liberal are they, and how easily could brokerages or intermediaries take advantage of those loopholes?”

The retail-fund industry has argued that retail investors have been less likely than their institutional counterparts to withdraw assets quickly when markets are stressed, as was the case in 2008 when there was a run on money market funds. And in its latest reform effort, the SEC has suggested leaving retail accounts largely untouched by a potential “floating-NAV proposal.”

The structure of that proposal, which would require funds to impose a $1 million daily redemption limit to qualify as retail, drew criticism from large fund companies that administer retail money market funds. In letters to the agency, fund companies argued the redemption limit was either too low or presented practical challenges to operating the funds, in part because of the difficulty of closely scrutinizing trading activity in “omnibus” accounts.

Precise data are impossible to obtain about the so-called omnibus accounts, even for the fund sponsors that supply them. But a 2008 survey by financial services consultancy KDS Partners found that about half of U.S. investor accounts are “processed” using omnibus accounting.

In a move that doesn't surprise several close observers of regulatory action on this issue, the SEC is reportedly favoring an industry proposal to define retail funds by the identifying characteristics of their users, such as a Social Security number, instead of by a redemption limit.

The Wall Street Journal reported last Wednesday that the SEC is “preparing” to adopt the change. The report, which was followed the next day by a similar report by Bloomberg, could not be independently verified, and cited “people familiar with the agency's discussions.”

“That seems to be not a very controversial issue at the SEC,” said Alice Joe, executive director for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce, a business lobby.

SEC spokeswoman Judith Burns declined to comment.

But even using Social Security numbers or other identifying information, regulators and fund companies could face difficulty in enforcing the regulation, according to some observers.

“What would happen if the intermediary did not comply?” said Joan Ohlbaum Swirsky, a lawyer at Stradley Ronon Stevens & Young, which has worked with fund companies.

Last fall, in a joint letter that proposed the “natural persons” definition now reportedly under consideration, nine fund companies also suggested a requirement that omnibus accounts be enforced through “contractual arrangements that require” broker-dealers and other intermediaries “to abide by all fund policies.”

That system would be unlikely to guarantee compliance, according to some advocacy groups.

“I still think you have a need for transparency through omnibus accounts,” said Niels Holch, executive director of the Coalition of Mutual Fund Investors, a shareholder advocacy group. “The biggest issue in my opinion is the transparency problem. Mutual funds are sold with a prospectus, and in that prospectus are a number of promises and representations, and with most mutual funds now transacted through omnibus accounts, it's difficult, if not impossible, for a fund compliance function to work inside these accounts.”

Several fund companies did not make executives available to discuss this article.

Industry consultants said accounting procedures have developed to support the massive fund industry and their distributors to process and settle client orders efficiently and cheaply.

A number of reform watchers also expressed concern that the loss of institutions in the market for fixed-NAV funds could increase costs for investors.

“That could be a logical result because a lot of the cost in the funds are divided among the shareholders,” said J. Christopher Donahue, president and chief executive of Federated Investors Inc., a major sponsor of money market funds.

Mr. Donahue supports a new proposal being pitched by Michael Piwowar, a Republican member of the SEC, that would allow investors to determine how they were regulated. Funds and complexes would offer some vehicles that included a floating NAV and others that used the SEC's other proposed mechanism, which would impose liquidity fees and let funds refuse to allow redemptions in times of market stress. Investors could then decide which to utilize.

“I'm working my hardest to try to get the commission and staff on board,” Mr. Piwowar said.

Money market funds, which are often used by investors to hold cash on a low-risk basis, were hit by billions in withdrawals in 2008 after the collapse of Lehman Brothers Holdings Inc., a supplier of a debt instrument underpinning a fund that “broke the buck,” meaning its net asset value sunk below $1. The run on money market funds was stanched only when the government stepped in.