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Statement No. 325

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Statement of the Shadow Financial Regulatory Committee on

Regulation of Money Market Funds and Systemic Risk

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According to recent press reports, the Securities and Exchange Commission (SEC) is considering releasing a controversial proposal to impose additional capital and liquidity regulations on the $2.7 trillion money market fund industry (MMMFs) and to replace the fixed $1 net-asset value ("par value") rule now used by all MMMFs to redeem customer funds with a mark-to-market (NAV) requirement. The motivation underlying this regulatory change is to make MMMFs less susceptible to the kind of destabilizing "run" they experienced after the collapse of Lehman in September 2008, which triggered the liquidation of Reserve Primary Fund (an institutional MMMF) and ultimately led to the federal government intervening to guarantee the safety of all MMMF investments in order to prevent a possible systemic effect on financial markets generally as well as the collapse of the commercial paper market and its associated liquidity fallout.

In the words of SEC Chairman Mary Schapiro, "Money market funds remain susceptible to runs and to a sudden deterioration in quality of holdings, and we need to move forward with some concrete ideas for proposals to address these structural risks."

The Shadow Financial Regulatory Committee (SFRC) also has expressed its concern about this issue. In its February 14, 2011 Statement (Statement No. 309) the Committee proposed that the SEC shift "to the floating NAV model for institutional MMMF products. The relative sophistication of wholesale investors ….and their heightened tendency to run, as reflected in the 2008 crisis, would be greatly moderated. In fact, adhering to the semi-guaranteed par asset value arguably suggests that MMMFs should be regulated as banks. It may also be time to rethink our regulatory approach to retail MMMFs."

The SFRC is now persuaded that its previous proposal should be expanded to encompass four additional aspects:

1. Apply the proposed floating NAV model to retail as well as institutional MMMFs;

2. Permit MMMFs to be exempt from this floating NAV model if they are sponsored by fund companies that provide an explicit contractual guarantee to investors in these funds that their MMMF investments will be redeemed upon demand and at par value (a fixed $1 net-asset value model);

3. Impose capital and liquidity requirements on fund companies that sponsor "guaranteed" MMMFs (similar to what the SEC is contemplating); and

4. Mandate that all MMMFs publicly disclose sufficient information to assure that all MMMF investors are aware of and understand the differences between "sponsor-guaranteed" MMMFs, MMMFs that operate under the floating NAV model, and FDIC insured bank deposits.

The SFRC believes that this regulatory structure will greatly moderate the systemic risk associated with the present structure of the MMMF industry while still enabling the industry to provide a variety of MMMF products and investors to benefit from the competition and financial innovation MMMFs provide.