

Note

Treating the Contagion: An Analysis of International Proposals for Regulating Money Market Funds

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I. INTRODUCTION

It is an iconic scene of American cinema, familiar to virtually any American who has spent a lazy Thanksgiving evening flicking channels. The President of the local building and loan institution, played by Jimmy Stewart, is just about to leave on his honeymoon when he sees a crowd gathering in front of his institution. He tells the driver to stop the car and goes to see what all the commotion is about. When he arrives, the doors to the building and loan institution are locked. The crowd is growing more restless by the minute. They want to redeem their deposits, they want their money out and they want it now. The President assures them that they will get their money and unlocks the door, only to find his Uncle, the Vice President of the institution, huddled inside without a dollar to satisfy the demands of the depositors.

As the customers demand to see the money they put into the institution, Jimmy Stewart is forced to give them a basic lesson in how depository institutions function. He calmly explains that their money is not in the vault; it has all been lent back to other homeowners in the area. With no money to be had, the depositors threaten to leave and take \$.50 on the dollar from a rival investor. At that moment, Jimmy Stewart's new wife offers up their honeymoon funds to help the customers make ends meet until the bank reopens the following week. As each depositor comes up to the counter and takes their share, the stack of cash dwindles, but the building and loan closes the day with cash reserves to spare – albeit, only \$2 worth – and survives the sort of bank run that was fairly commonplace in pre-Great Depression America.¹

This Note analyzes the international regulatory response to the latest phenomenon in the world of contagious runs: the run on Money Market Funds (MMFs) that occurred during the 2008 financial crisis. Three major regulatory entities – the U.S. Securities and Exchange Commission (SEC), the European Union's (EU) European Commission, and the Financial Stability Board (FSB) – have all come forward with unique proposals designed to stem the possibility of future runs on MMFs. This Note discusses the strengths and weaknesses of each proposal, concluding that the best regulatory solution to the future threat of

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1. *IT'S A WONDERFUL LIFE* (Liberty Films II 1946); *see also* Charles W. Calomiris, *Runs on Banks and the Lessons of the Great Depression*, 22 REG. 4, 5 (1999) (describing the “unprecedented upheaval felt in the banking sector” around the time of the Depression).

contagious runs on MMFs is the institution of mandatory, risk-weighted capital buffers. Part I explores the background of MMFs, the role that they played in the financial crisis of 2008, and the regulatory proposals put forward. Part II analyzes each of these proposals, while Part III finds that risk-weighted capital buffers provide the best regulatory option for reducing the systemic risk of MMFs and preserving their unique benefits. In a sense, *It's a Wonderful Life* may have taught us the best antidote to the panic which drives contagious runs – have enough capital on hand to redeem the deposits of the most worried investors and weather the storm.

I. The Nature of Money Market Funds, Their Role in the 2008 Crisis, and the Latest Regulatory Proposals

A. The Nature of Money Market Funds

An MMF is a special form of mutual fund – effectively, a pool of money that is deposited in the fund by third parties and then invested by the fund managers in a variety of investment opportunities.² Based on their designation as mutual funds, U.S. MMFs are regulated as a pooled investment fund under the Investment Company Act of 1940³ and European MMFs are regulated under either the Undertakings for Collective Investment in Transferable Securities (“UCITS”) or the Alternative Investment Fund Manager (“AIFM”).⁴ Several factors differentiate MMFs from normal mutual funds, however.⁵ First, the law requires MMFs to invest in presumably “safe” assets.⁶ As a result, MMF portfolios normally consist of government securities, certificates of deposit (CDs), commercial paper, and other investment opportunities that offer low risk and similarly modest returns.⁷

Second, while the Investment Company Act requires all mutual funds to allow shareholders to redeem their investment “on demand,”⁸ many MMFs (and almost all U.S. MMFs) take the concept one step further by maintaining a Net Asset Value (NAV)⁹ of one dollar.¹⁰ MMFs

2. Money Market Funds, SEC.GOV (Jan. 16, 2013) [hereinafter Money Market Funds], <http://www.sec.gov/answers/mfmmkt.htm>; Mark Perlow, *Money Market Funds – Preserving Systemic Benefits, Minimizing Systemic Risks*, 8 BERKELEY BUS. L.J. 74, 76 (2011).

3. Money Market Funds, *supra* note 2; Perlow, *supra* note 2, at 76.

4. *Commission Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds*, COM (2013) 615 final (Sept. 4, 2013) [hereinafter *Commission Proposal*], available at http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-regulation_en.pdf. The majority of European funds (80% of the funds and 60% of the assets) are regulated under UCITS while the remaining funds fall under AIFM.

5. See Hilary J. Allen, *Money Market Fund Reform Viewed Through A Systemic Risk Lens*, 11 J. BUS. & SEC. L. 87, 89–91 (2010) (discussing MMFs’ unique characteristics).

6. *Id.* at 91; Money Market Funds, *supra* note 2.

7. Money Market Funds, *supra* note 2.

8. Technically, investors have to be paid within seven days. *See id.*

9. The per-share NAV of a MMF is calculated by subtracting total liabilities from total assets and dividing the result by the total number of outstanding shares. *See* Net Asset Value, SEC.GOV (July 9, 2013) [hereinafter Net Asset Value], <http://www.sec.gov/answers/nav.htm>.

10. Money Market Funds, *supra* note 2; Perlow, *supra* note 2, at 76.

achieve this Constant Net Asset Value (CNAV) largely due to regulatory exceptions that allow MMFs to employ accounting techniques that normal mutual funds are not allowed to use.¹¹ Namely, MMFs are not required to revalue their assets every day based on the market price of those assets.¹² Instead, MMFs report asset value at their “amortized cost,” which is defined as the purchase price of the asset adjusted for any discount amortized and any premium accreted daily from the date of purchase to the date of maturity.¹³ Additionally, if the NAV remains between \$0.995 per share and \$1.005 per share, an MMF is allowed to round its NAV to \$1.00.¹⁴ MMFs are only required to revalue their assets at market or fair value when an asset goes into default or suffers a credit event.¹⁵ These accounting provisions allow MMFs to avoid daily fluctuations in their NAV, effectively giving them a CNAV.¹⁶ This feature causes MMFs to appear very stable and makes them appealing to investors looking for safe cash management options that provide a greater return than traditional savings accounts.¹⁷

Finally, MMFs differ from traditional mutual funds in how they interact with and are used by investors.¹⁸ The fact that many MMFs allow their investors to redeem investments through check writing illustrates this.¹⁹ This particular practice allows an investor’s MMF interest to essentially function no differently than a checking account at the investor’s local bank.²⁰ Investors traditionally receive a higher rate of return on their investments in MMFs than on deposits at their local bank, while suffering no liquidity disadvantage and appearing to take on little to no risk due to the stability of MMFs.²¹ There is, of course, one glaring difference between an MMF account and a traditional bank account at a U.S. bank – Federal Deposit Insurance Corporation (FDIC) deposit insurance.²² While this distinction is fundamental and incredibly meaningful, it had little to no practical impact on the MMF industry for years prior to the 2008 crisis.²³

B. The Role of MMFs in the Global Financial System

MMFs serve a key role in the U.S. and global financial system.²⁴

11. Perlow, *supra* note 2, at 76; William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WIS. L. REV. 1155, 1175 (2010).

12. Perlow, *supra* note 2, at 76.

13. *Id.*; Birdthistle, *supra* note 11, at 1175.

14. Perlow, *supra* note 2, at 76; Allen, *supra* note 5, at 90–91.

15. Perlow, *supra* note 2, at 76.

16. *Id.* at 76–77.

17. Birdthistle, *supra* note 11, at 1175.

18. *See id.* (comparing MMFs to banks in terms of investors interaction with them).

19. *Id.*; Perlow, *supra* note 2, at 79.

20. Birdthistle, *supra* note 11, at 1175; Perlow, *supra* note 2, at 79.

21. Perlow, *supra* note 2, at 79.

22. *Id.* at 86. The single greatest advantage that modern bank accounts in the United States possess is the near absolute certainty that you will never lose your money for any reason short of a complete apocalypse. While MMFs have long been viewed as secure, even completely safe, you could always, theoretically at least, lose your money.

23. *See id.* (discussing the FDIC and guarantees put into place by the U.S. government following the 2008 crisis).

24. *See* Birdthistle, *supra* note 11, at 1157 (“Dysfunction in money market funds

U.S. MMFs manage nearly \$2.7 trillion in assets while European MMFs manage roughly \$1 trillion in assets.²⁵ While dwarfed by the overall “shadow banking” sector^{26,27} MMFs still comprise a sizeable amount of capital. The impact of MMFs on the overall financial system, however, has more to do with the types of investments that MMFs typically make.²⁸ Because the funds are required to invest exclusively in what are traditionally considered “safe” investments, MMFs concentrate the majority of their assets in three distinct investment classes: (1) national government securities; (2) commercial paper; (3) state, local, and municipal government securities.²⁹

Although the market for national government securities, particularly U.S. securities, is large enough to not become reliant on MMFs, the same cannot necessarily be said of the commercial paper and local government bond markets.³⁰ The commercial paper market, for instance, was worth approximately \$2.1 trillion at its peak, prior to the financial crisis, and is now worth just over \$1 trillion.³¹ MMFs play a crucial role in the commercial paper market.³² Functionally, MMFs help provide corporations with an alternative way to fund their day-to-day operations and debt needs, serving a role traditionally reserved for banks.³³ The intertwined nature of commercial paper and MMFs is both intriguing and incredibly important because a downturn in the MMF market can have a serious impact on the availability of corporate financing.³⁴ MMFs role in the short-term debt market for state and local governments is even more pronounced.³⁵ In the U.S., for example, MMFs hold the majority of such

cascaded into credit markets . . .”).

25. *Release: Money Market Mutual Fund Assets*, INVESTMENT COMPANY INSTITUTE (Oct. 2, 2013), <http://www.ici.org/research/stats/mmf> (open the “release;” click on the link for the “weekly money market assets”); *Commission Proposal*, *supra* note 4.

26. Shadow banking is best understood as the grey area of the financial system in which non-bank entities perform bank like functions – such as credit intermediation – without the regulatory oversight to which regular banks are subjected. *See* Daniel Meade et al., *Shadow Banking: The Growing Sector of Non-Bank Credit Activity*, BUS. L. TODAY, Oct. 2012, at 1.

27. The shadow banking industry as a whole is worth approximately \$60 trillion. Reuters, *Shadow Banks Must Comply with First Global Rules by 2015*, CNBC.COM (Aug. 29, 2013), <http://www.cnbc.com/id/100997262>.

28. *See* Perlow, *supra* note 2, at 78 (“Money market funds generally invest their assets in a variety of money market instruments, which are debt instruments with short term maturities.”).

29. *Id.* at 78; *see also* Money Market Funds, *supra* note 2 (“Money market funds typically invest in government securities, certificates of deposit, commercial paper of companies, or other highly liquid and low-risk securities.”).

30. *See* Perlow, *supra* note 2, at 78 (providing the percentage holdings money markets possess in each area).

31. *Id.* at 78; Board of Governors of the Federal Reserve System, *Volume Statistics for Commercial Paper Issuance*, COMMERCIAL PAPER: VOLUME STATISTICS (Jan. 29, 2014), <http://www.federalreserve.gov/releases/cp/volumestats.htm#fn1>.

32. Perlow, *supra* note 2, at 78.

33. Birdthistle, *supra* note 11, at 1178 n.145; *see also* Perlow, *supra* note 2, at 78–79 (explaining that money market funds proved more attractive to savers than bank deposits).

34. Birdthistle, *supra* note 11, at 1178 n.145; *see also* Perlow, *supra* note 2, at 78–79 (describing the relationship between commercial paper and MMFs).

35. *See* Perlow, *supra* note 2, at 79 (explaining the “crucial role” MMFs play in state

debt.³⁶

Finally, MMFs provide corporations with an important source of liquidity management.³⁷ Corporations use MMFs as a piece of their cash-management strategy by leveraging MMFs' ability to provide better returns than traditional bank accounts and maintaining a high level of liquidity through their "on demand" redemption structure.³⁸ As a result, MMFs not only provide liquidity and funding to corporations through MMF purchases of commercial paper and corporate debt, but also serve as a safe and lucrative destination for excess corporate cash reserves.³⁹

C. The Role of MMFs in the 2008 Crisis

In 2008, Lehman Brothers declared Chapter 11 bankruptcy, kicking off what would become the financial crisis of 2008.⁴⁰ The announcement was particularly jarring for the Reserve Primary Fund, a large MMF holding approximately \$62 billion in assets.⁴¹ The Reserve Primary Fund held \$785 million in Lehman Brothers' commercial paper.⁴² Due to the accounting exceptions provided to MMFs, the Reserve Primary Fund had continued to report its Lehman Brothers holdings at approximately face value until the bankruptcy announcement. The announcement constituted a credit event that triggered a mandatory revaluation of those assets.⁴³ Instantly, the Reserve Primary Fund was forced to write down its \$785 million worth of Lehman commercial paper to its true market value – \$0.⁴⁴

Unfortunately, the fund could not absorb the financial hit and maintain a NAV of \$1 per share.⁴⁵ The next day, the Reserve Primary Fund "broke the buck" by valuing its shares at \$.97⁴⁶, becoming only the second MMF and by far the largest to ever do so.⁴⁷ There was an instant

and local governments).

36. *Id.* at 79.

37. *See id.* (explaining how the ability to write checks from an MMF allows for "daily liquidity").

38. *See id.* (describing the benefit of high interest rates and ability "to redeem shares through check-writing" that MMFs offer).

39. *See id.* at 76–79 (providing an overview of the role MMFs play in the U.S. as well as their benefits).

40. *See* Andrew Ross Sorkin, *Merrill is Sold: Failing to Find Buyer, Lehman Set to File Bankruptcy*, N.Y. TIMES, Sept. 15, 2008, at A1 (reporting on the declaration of bankruptcy by Lehman Brothers); *see also* Press Release, Lehman Brothers, Lehman Brothers Holding Inc. Announces it Intends to File Chapter 11 Bankr. Petition; No Other Lehman Brothers' U.S. Subsidiaries or Affiliates, Including Its Broker-Dealer and Investment Mgmt. Subsidiaries, are Included in the Filing (Sept. 15, 2008), *available at* http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf.

41. Perlow, *supra* note 2, at 80.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. Birdthistle, *supra* note 11, at 1178. This may seem like a relatively small loss to the casual observer. However, to large institutional investors with millions of dollars in MMFs, this drop represented the sudden evaporation of millions of dollars that the investors believed to be as safe as bank deposits. In the mind of investors, the size of the loss was quite possibly subordinated to the mere fact that a loss had been incurred. *Id.*

47. Perlow, *supra* note 2, at 82. The only other fund to ever break the buck was a small fund marketed to community bankers, not consumers and corporate investors.

run on the Reserve Primary Fund as investors attempted to redeem their shares at as close to a \$1 par as possible to prevent further losses.⁴⁸ Finally, the high demand for redemptions forced the fund to appeal to the Federal Reserve for a waiver to allow the fund to suspend redemptions and dispense the fund's assets in an orderly manner.⁴⁹ In order to prevent the fund from paying out the investments of large, institutional investors, a group of smaller investors sued the fund to force it to liquidate the funds assets and pay all of the investors on a pro rata basis, ensuring equal treatment of all shareholders, regardless of size.⁵⁰

The real problem with MMFs became apparent when the bank-run-like activity that destroyed the Reserve Primary Fund began to impact other funds.⁵¹ Shortly after Lehman Brothers announced its bankruptcy and the Reserve Primary Fund broke the buck, investors attempted to redeem nearly \$300 billion worth of shares from other primary funds.⁵² The results were devastating.⁵³ Fund managers stopped investing in order to maximize their cash reserves and satisfy the redemption orders of panicking investors.⁵⁴ The credit markets dried up almost overnight, leaving many of the largest companies in the world without access to the loans that they used to finance their daily operations.⁵⁵ The continuous wave of redemption orders forced funds to sell off their assets in order to

However, this statistic is somewhat deceptive because, prior to 2008, as many as 136 funds needed an injection of capital from the funds' sponsors in order to avoid breaking the buck in the past. The year 2008 showed that sponsors were justified in their fear that breaking the buck would lead to far greater losses than what would have been incurred through a short-term support commitment. *Id.*

48. *See id.* (describing the "cycle of redemptions and asset sales" that occurred following the drop); *see also* Birdthistle, *supra* note 11, at 1178 ("[t]he loss triggered a run on the fund that threatened to impose far greater losses . . .").

49. Perlow, *supra* note 2, at 80.

50. Birdthistle, *supra* note 11, at 1178–79.

51. *See id.* at 1179 ("[T]he failure of the Primary Fund dramatically illustrated the interdependence between money market funds and the capital markets.").

52. *Id.* at 1180; *see also* Samuel G. Hanson et al., An Evaluation of Money Market Fund Reform Proposals 1 (Dec. 20, 2012) (unnumbered working paper, Harvard Bus. Sch.), available at http://www.people.hbs.edu/dscharfstein/MMF_Reform_12-20-12.pdf (outlining the effect Lehman Brothers had on other MMFs after breaking the buck); *see also* Marcin Kacperczyk & Philipp Schnabl, *How Safe are Money Market Funds?*, 128 (3) Q.J. OF ECON. 1073, 1073 (2013) ("This run quickly spread to other funds, triggering investors' redemptions of more than \$300 billion . . ."); *see also* Jeffrey N. Gordon & Christopher M. Gandia, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?* 2 (Columbia Law Sch., Working Paper No. 426, 2013) ("Immediately thereafter, investors . . . began to withdraw from other 'prime' money market funds."); *see also* Latoya Brown, Article, *The Regulation of U.S. Money Market Funds: Lessons from Europe*, 9 BYU INT'L L. & MGMT. REV. 201, 202 (2013) ("In just a few days, more than 309 billion USD was withdrawn from funds . . ."); *see also* Jonathan Macey, *Reducing Systemic Risk: The Role of Money Market Mutual Funds As Substitutes for Federally Insured Bank Deposits*, 17 STAN. J.L. BUS. & FIN. 131, 132 (2011) ("[T]here was a 'run' on certain MMFs when, after was a 'run' on certain MMFs when, after the collapse of Lehman Brothers, many investors rushed to redeem their shares.").

53. *See* Macey, *supra* note 52, at 132 (referring to the national financial downturn following the announcement by Lehman Brothers").

54. Birdthistle, *supra* note 11, at 1180.

55. *Id.*

pay off investors.⁵⁶ In the end, fund sponsors⁵⁷ were forced to intervene and injected approximately \$12 billion into various MMFs in order to prevent more funds from breaking the buck.⁵⁸

Four days after Lehman Brothers filed for bankruptcy and sent the MMF market into a panic, the Treasury Department initiated an optional program that guaranteed investors deposits in MMFs.⁵⁹ The program promised investors that if the NAV of their MMF fell too far below \$1, the fund would be liquidated and the Treasury Department would insure that every share was redeemed on a \$1 per share basis.⁶⁰ In order to qualify for the program, MMFs had to pay a premium to the Treasury Department. Virtually every MMF did so happily.⁶¹ In effect, the Treasury created an ad hoc form of FDIC insurance for MMFs.⁶² The new program worked. With the assurance of the U.S. Treasury that their funds would be safe, investors no longer felt the need to run on MMFs and the system stabilized.⁶³ The Treasury's program remained in place for nearly a year and the Treasury Department suffered no losses – in fact, it made approximately \$1.2 billion off of the premiums that funds paid to participate in the program.⁶⁴

D. New Regulatory Proposals

In the aftermath of the 2008 crisis, there was a push for more stringent regulation of MMFs. In 2010, the SEC released new regulations that purported to make the MMF market more stable and less prone to the sort of catastrophic freezes witnessed in 2008.⁶⁵ The SEC's 2010 regulatory changes primarily revolved around making MMFs' asset portfolios safer. The regulations restricted the kinds of assets that MMFs could invest in, reduced the proportion of a fund's portfolio that could be composed of higher risk assets, required higher levels of liquidity in MMF portfolios, and increased regulatory oversight.⁶⁶ The industry endorsed these changes and largely tracked the proposals of the Investment Company Institute, the leading lobbying organization for

56. *See id.* at 1179 (describing the sale of portfolio holdings as a means of satisfying redemptions).

57. Fund sponsors are typically larger financial institutions or fund complexes that manage a variety of MMFs and sometimes other funds. *See* Kacperczyk & Schnabl, *supra* note 52, at 1081–83 (describing the role of fund sponsors).

58. Perlow, *supra* note 2, at 80–81.

59. *See id.* at 81 (outlining the governmental programs that were established specifically to support money markets.); *see also* Press Release, U.S. Dept. of the Treasury, Treasury Announces Temporary Guarantee Program for Money Market Funds (Sept. 29, 2008), <http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx> (announcing the opening of the Temporary Guarantee Program for Money Market Funds).

60. Allen, *supra* note 5, at 98–99.

61. Perlow, *supra* note 2, at 81.

62. *See* Birdthistle, *supra* note 11, at 1198–99.

63. Perlow, *supra* note 2, at 81.

64. Emily Brandon, *Treasury's Money Market Guarantee Program Ends*, *Money, Retirement, U.S. NEWS & WORLD REPORT* (Sept. 18, 2009), <http://money.usnews.com/money/blogs/planning-to-retire/2009/09/18/treasurys-money-market-guarantee-program-ends>; Perlow, *supra* note 2, at 81 n.55.

65. Allen, *supra* note 5, at 96.

66. *Id.*

mutual funds.⁶⁷ In the aftermath of Dodd-Frank, the SEC has also been working to eliminate the regulation's reliance on credit ratings.⁶⁸

While the industry viewed the 2010 SEC changes as sufficient, regulators indicated that they want to go farther. Recently, three new regulatory proposals have emerged on the international scene. First, in June of 2013, the SEC announced a proposed update to its regulations.⁶⁹ The SEC proposal contained two alternatives, although the agency has indicated that it may combine elements of both ideas in the final regulation.⁷⁰ The first proposal by the SEC eliminates the special accounting provisions that MMFs are allowed to take advantage of in the current system.⁷¹ The proposal is limited to funds that invest in commercial paper, exempting those that invest exclusively in government backed securities, and would mean the end of CNAV primary funds in the United States.⁷² Unless a fund invested exclusively in government securities, the proposal requires the fund to move to a VNAV system and function much more like a regular mutual fund, revaluing their assets on a daily basis according to market value.⁷³ The second SEC proposal would allow funds to keep their CNAV status and would grant large discretionary powers to fund managers to impose fees on investors that redeem their shares or to suspend redemptions altogether in times of crisis. This "fees/gate" proposal purports to solve the problem of runs by allowing a fund manager to either penalize redemptions by charging a fee or simply halt the redemption of shares from the fund until the fund has an opportunity to re-organize or liquidate in order to pay investors.⁷⁴

Second, in September of 2013, the European Commission proposed a new regulation for European Union MMFs. The EU proposal first lays out portfolio controls and liquidity requirements similar to the ones imposed by the SEC in 2010.⁷⁵ Additionally, the EU proposal will require funds to either switch to a VNAV model – revaluing their assets at market value on a daily basis – or maintain a capital buffer equal to 3% of the fund's assets.⁷⁶ The idea behind the EU proposal is to either remove the incentive for runs by forcing funds into a VNAV operating environment, or at least ensure that funds are adequately capitalized to

67. Perlow, *supra* note 2, at 90.

68. *Id.* at 77.

69. Press Release, SEC, SEC Proposes Money Market Fund Reforms (June 5, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575248#.UlbfInNet6M>; Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 118, 36833 (proposed June 19, 2013) (to be codified at 17 C.F.R. pts. 210, 230, 239, 270, 274, 279).

70. SEC, *supra* note 69; Money Market Fund Reform, 78 Fed. Reg. at 36834.

71. SEC, *supra* note 69; Money Market Fund Reform, 78 Fed. Reg. at 36834.

72. Money Market Fund Reform, 78 Fed. Reg. *passim*.

73. *Id.*

74. *Id.*

75. *Commission Proposal*, *supra* note 4, at 1–4; Gabriele Steinhauser & Kristen Grind, *EU Proposes Tough Rules for Money-Market Funds*, WALL STREET JOURNAL (Sept. 4, 2013), <http://online.wsj.com/news/articles/SB1000142412788732412300457905458003391339>.

76. *Commission Proposal*, *supra* note 4, at 8.

satisfy most investor runs without having to sell off their portfolios at a discount rate.⁷⁷

Finally, the same week the European Commission released its proposal, the Financial Stability Board⁷⁸ also released a proposal for the regulation of “shadow banking entities.”⁷⁹ The FSB classifies MMFs as “shadow banking entities”. MMFs, thus, will fall under this new regulatory proposal.⁸⁰ The FSB proposal would require CNAV funds to shift to a VNAV operating scheme “where workable.”⁸¹ Where a shift to VNAV would not be practical, the FSB would institute liquidity requirements in order to make funds more resilient when faced with run scenarios.⁸² The International Organization of Securities Commissions (IOSCO) is currently evaluating the practicality of implementing the FSB’s proposals. A final report and proposal will be ready sometime in 2014.⁸³

II. Analysis

The proposals advanced by the SEC, EU, and FSB each deserve consideration as the global community decides the regulatory future of MMFs. This section will first analyze the two alternative proposals put forward by the SEC in July 2013. Next, the EU’s two-pronged reform proposal will be discussed, with special attention given to the capital buffers option. Finally, the Note will include an analysis of some of the preliminary ideas advanced by the FSB and the IOSCO.

A. The SEC’s Proposals: destroying the benefit of MMFs or living with the dangers

As outlined above, the SEC recently put forward two potential reform options.⁸⁴ The first SEC proposal involves the elimination of the special accounting privileges afforded to MMFs which allow MMFs to maintain a stable NAV.⁸⁵ The second proposal by the SEC would empower fund managers to impose a fee on redemptions from the fund during a time of crisis or, potentially, suspend redemptions altogether in order to stabilize the fund’s value.⁸⁶ This section will first evaluate the

77. *See id.*

78. The FSB has received a mandate from the G-20 to construct a standardized baseline for global financial regulation. *Strengthening Oversight and Regulation of Shadow Banking: An Overview of Policy Recommendations*, FINANCIAL STABILITY BOARD (Aug. 29, 2013) [hereinafter FSB], http://www.financialstabilityboard.org/publications/r_130829a.pdf.

79. *Id.*

80. *Id.* at iv.

81. *Id.* at 3.

82. *Id.*

83. *Id.* at ii.

84. SEC, *supra* note 69; Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 118, 36833 (proposed June 19, 2013) (to be codified at 17 C.F.R. pts. 210, 230, 239, 270, 274, 279).

85. SEC, *supra* note 69; Money Market Fund Reform, 18 Fed. Reg. at 36833.

86. SEC, *supra* note 69; Money Market Fund Reform, 18 Fed. Reg. at 36833. While the SEC has hinted that we could see a fusion of these two proposals, this Note will analyze them as alternatives. It is unclear what a combination of a VNAV proposal and a fees and gates proposal would look like in a practical sense, other than simply granting fund managers the power to impose fees and gates in addition to forcing funds to move to

VNAV proposal by the SEC, and then turn to the fees and gates proposal.

1. VNAV Accounting

The first SEC proposal eliminates the special accounting privileges that MMFs have been given under the Investment Company Act.⁸⁷ This proposal is very unpopular among industry insiders, who claim that removing the CNAV status of MMFs would effectively destroy the entire industry.⁸⁸ There seem to be two reasons that industry so strongly opposes a shift to VNAV accounting. First, VNAV accounting would impose significant accounting costs on the large institutional clients that MMFs rely on to supply significant portions of fund capital.⁸⁹ These costs would make MMFs less appealing and would destroy one of MMFs strongest points of comparative advantage when compared to other financial instruments.⁹⁰ Second, industry claims that that a variable, and thus somewhat unstable, NAV would have a significant psychological impact on investors, leading many investors to shun MMFs altogether.⁹¹ Some question the validity of this concern, especially given the sophisticated nature of many MMF investors, but there could be at least some investors that would avoid MMFs due to the perceived instability associated with VNAV accounting.⁹² Overall, the MMF industry argues that VNAV accounting will make MMFs significantly less attractive to investors and drive capital into other, less regulated financial instruments.⁹³

Regulators, on the other hand, believe that VNAV reform removes much of the incentive for runs.⁹⁴ There are two main arguments in support of VNAV accounting. First, proponents argue that the CNAV system provides the incentive for runs in the first place.⁹⁵ Because funds still redeem shares at \$1.00 per share, even when their actual NAV may be less than \$1.00 per share, investors have an incentive to “run” on the fund early, before the fund officially breaks the buck and begins to redeem shares at a lower value.⁹⁶ Second, proponents argue that moving to a VNAV system will have significant psychological benefits.⁹⁷ They argue that a shift to a VNAV system will eliminate investors’ misconception of MMFs as risk-free investments and therefore reduce panic-induced runs when a fund “breaks the buck.”⁹⁸⁹⁹

a VNAV accounting system. In that scenario, the two ideas would still operate largely independently of one another and the analysis would likely not be significantly different.

87. SEC, *supra* note 69; Money Market Fund Reform, 18 Fed. Reg. at 36834.

88. See Macey, *supra* note 52, at 171–73.

89. See *id.*

90. See *id.*

91. *Id.*

92. See *id.*

93. *Id.*

94. See Brown, *supra* note 52, at 222–23; Hanson et al., *supra* note 52, at 21.

95. See Brown, *supra* note 52, at 222–23; Hanson et al., *supra* note 52, at 21.

96. See Brown, *supra* note 52, at 222–23; Hanson et al., *supra* note 52, at 21–22.

97. See Brown, *supra* note 52, at 222–23; Hanson et al., *supra* note 52, at 22.

98. A fund breaks the buck when its NAV falls outside the specified range and can no longer be listed at \$1.00. When this happens, shares are no longer redeemable for \$1.00 each, as the investor is expecting. See Perlow, *supra* note 2, at 74.

Despite the common sense appeal of a VNAV system, however, there are serious flaws surrounding such a proposal. The most significant flaw is that a VNAV reform would not actually enhance the financial stability of the MMF market.¹⁰⁰ The highly illiquid nature of many of the assets that MMFs hold, such as commercial paper and CDs, means that even under a VNAV system, MMFs would still report the value of a large number of their assets based on modeling or accounting, rather than reliable market prices.¹⁰¹ In this way, the portfolios of MMFs closely resemble banks in that the reported value may not accurately reflect the market value of the portfolio.¹⁰² As a result, investors would still have an incentive to run if they believed that the reported value of their shares is still higher than the actual value of the assets that are backing those shares.¹⁰³ While slightly more nuanced, this incentive for runs could prove just as strong during a time of economic turmoil.¹⁰⁴

In fact, the inability of a VNAV system to prevent a systemic run was observed in Europe during the 2008 crisis.¹⁰⁵ A large portion of European MMFs use a VNAV accounting system, yet VNAV MMFs in Europe were subject to the same sort of run-like behavior as CNAV funds in other countries.¹⁰⁶ Clearly, VNAV accounting does not completely eliminate the incentives for runs. The fact that a change to VNAV accounting would have little to no practical impact on most MMFs only reinforces this.¹⁰⁷ In fact, a quirk in the SEC's current accounting rules would allow MMFs to continue to use amortized cost accounting on up to 80% of their assets.¹⁰⁸ Additionally, an analysis of MMFs during normal economic times reveals that the share price of an MMF would likely fluctuate within a range of 10 basis points of \$1.00 per share.¹⁰⁹ It is unlikely, therefore, that a shift to VNAV accounting will do much to reduce investor perceptions of MMFs as "safe" investments. Finally, the primary investors in MMFs are large, institutional investors who were presumably aware of the risk of MMFs before the 2008 crisis and chose to invest despite those risks because they believed that the benefits outweighed the risk.¹¹⁰ It does not seem particularly likely that VNAV accounting would change the calculus of these investors.¹¹¹ Consequently, the psychological impact of VNAV accounting on panic-based runs seems substantially smaller than it may have been initially portrayed.¹¹²

99. See Brown, *supra* note 52, at 222–23; Hanson et al., *supra* note 52, at 21–24.

100. Hanson et al., *supra* note 52, at 22.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. See Brown, *supra* note 52, at 223.

106. See *id.*

107. See Hanson et al., *supra* note 52, at 22–23.

108. See *id.* at 23.

109. See *id.*

110. See *id.* at 24.

111. See *id.*

112. See *id.* at 22–24.

Most significantly, however, VNAV accounting may actually spark additional runs and increase the systemic risk of runs on MMFs.¹¹³ If a fund was thought to be unstable by its investors, those investors would still have an incentive to redeem their shares as soon as possible in order to generate the greatest return possible.¹¹⁴ In order to satisfy these redemption requests, the fund could be forced into a “fire sale” of its remaining assets.¹¹⁵ Given the relatively illiquid nature of some of the assets on the balance sheets of MMFs, a fund that faced a large wave of redemptions would likely have to sell many of their assets at a severe discount.¹¹⁶ Because VNAV accounting would rely heavily on market prices, these distressed prices would cause the fund to write down other identical assets on its balance sheet, further decreasing the value of the fund and spurring more redemption requests.¹¹⁷

A spiral of ever-decreasing value and write-downs would be bad enough if it could be contained within a single MMF. However, the composition of fund assets makes it highly probable that this problem would spread throughout the industry. Because they face stringent portfolio restrictions, various MMFs generally hold many of the same assets.¹¹⁸ In fact, the interconnectedness of the holdings of the MMF industry has been recognized by some as an enormous systemic risk and particularly dangerous in a run scenario.¹¹⁹ As soon as investors see one fund in trouble, they are more likely to withdraw their capital from other funds because the similar asset portfolios of the funds signals that a downturn in one fund could be an indicator of a broader problem.¹²⁰

VNAV accounting significantly exacerbates this problem.¹²¹ As soon as one fund is forced to sell some of its assets at a discount price, other funds would be forced to write down their holdings of that same asset to the new market price, reducing the value of their shares and triggering investor redemptions.¹²² Once confronted with extra redemption demands, the new funds would also be forced to sell some of their assets at a reduced price, which would depress the overall market value of those assets for the rest of the funds that hold them, increasing the breadth of the crisis.¹²³ Consequently, the added market sensitivity that VNAV accounting forces onto the MMF industry would not stabilize MMFs in a time of crisis; it would actually manufacture broad runs on MMFs where none might have existed.

In the end, while VNAV accounting may seem like a logical solution for the problem of runs in the MMF industry, it is not likely to

113. *See id.* at 22.

114. *See id.*

115. *See id.*

116. *See id.*

117. *See id.*

118. *See Gordon & Gandia, supra* note 52, at 7–8.

119. *Id.* at 9.

120. *Id.* at 7–8.

121. *See Hanson et al., supra* note 52, at 22.

122. *Id.*

123. *See id.*

be a successful policy. Current SEC accounting rules and the nature of the assets that MMFs typically hold will allow most MMFs to continue with business as usual, leading to very little change in public perception of the stability of MMF investments. Simultaneously, the accounting costs associated with a switch to VNAV accounting would be significant and might drive capital out of the MMF market altogether. Most importantly, however, VNAV accounting would do little to actually stabilize the MMF sector in times of economic turmoil. As with European VNAV funds which were subjected to run-like behavior, VNAV accounting may actually lead to significantly broader and more severe runs.

2. Fees and Gates

The second proposal put forward by the SEC would entrust fund managers with the power to impose liquidity fees on shareholder redemptions during times of crisis.¹²⁴ Additionally, the proposal would potentially enable fund managers to suspend redemptions all together if the crisis became serious enough.¹²⁵ Again, on its face, this SEC proposal appears to be a workable solution. Advocates stress that, given the stability of MMFs, a liquidity fee of even a couple of percentage points would remove most of the financial incentive for a run in all but the worst of economic environments.¹²⁶ They further argue that allowing fund managers to suspend redemptions would give the fund enough time to reorganize or liquidate its assets and preserve most of the value of the fund without setting off a fire sale of assets.¹²⁷ In contrast to the VNAV proposal, industry generally supports the idea of fees and gates, assuming that some reform action must be taken.¹²⁸

Despite this support and the appeal of stopping runs by simply changing the decision-making calculus of investors deciding whether or not to redeem their shares, fees and gates are also unlikely to significantly increase the stability of MMFs and may actually increase the likelihood of a run. There are four reasons why fees and gates will be ineffective and may actually increase the instability of the MMF market. First, the fees and gates proposal is purely voluntary.¹²⁹ While the proposal includes a mandatory cut-line at which a fund must impose a gate on redemptions, the board of the fund can override this provision and continue with business as usual if the board feels that it is in the best interest of the fund.¹³⁰ While leaving the ultimate decision of when to impose a fee or a gate to the fund managers makes some sense, they do not necessarily have the right incentives. Funds – and by extension, their

124. SEC, *supra* note 69; Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36833, 36878 (proposed June 19, 2013) (to be codified at 17 C.F.R. pts. 210, 230, 239, 270, 274, 279).

125. SEC, *supra* note 69; Money Market Fund Reform, 78 Fed. Reg. 36878.

126. See *Temporary Liquidity Gates, Fees Concept Only Viable FSOC Option for Prime Money Market Funds*, INVESTMENT COMPANY INSTITUTE (Jan. 24, 2013), http://www.ici.org/pressroom/news/13_news_fsoc_response.

127. *See id.*

128. *See id.*

129. Gordon & Gandia, *supra* note 52, at 26–27.

130. *Id.*

managers –would face enormous reputational pressure not to drop a gate on investors.¹³¹

Second, fees and gates do not solve the problem of runs; they simply incentivize investors to anticipate when a fund may impose a fee or a gate so they will run prior to that time.¹³² In effect, then, a fees and gates regime would actually increase investors' sensitivity and might spark a run sooner and under more favorable conditions than in the current system.¹³³ Because investors typically use MMFs as a cash management tool and fees and gates would essentially lockdown investors' capital in a given fund, investors would have a significant incentive to redeem their shares at the first sign of trouble.¹³⁴

Third, fees and gates focus on the individual fund level, but could have significant impacts on the broader MMF market and the economy at-large.¹³⁵ The imposition of a fee or gate on one fund could trigger a chain reaction and would likely significantly increase the redemption pressure felt by other funds.¹³⁶ This is, again, exacerbated by the interconnectedness of MMF assets, which will lead some investors to believe that a chink in the armor of one fund indicates market-wide problems.¹³⁷ Once again, rather than stabilizing the fund market, this proposal could actually cause systemic runs.

Finally, the fees and gates proposal is unlikely to assist in protecting the MMF market from runs if the current gate provisions available to funds were not effective in 2008.¹³⁸ The SEC's Rule 2-7a, which governs MMFs, already allows a fund to suspend redemptions if the fund breaks the buck.¹³⁹ This provision, combined with a court order to suspend redemptions that were obtained by shareholders, allowed the Reserve Primary Fund to suspend redemptions after it broke the buck in 2008.¹⁴⁰ The ability of the Reserve Primary Fund to suspend redemptions did little, if anything, to stem the broad systemic panic that swept over the MMF industry in the days after the Lehman Brothers collapse.

Ultimately, while the SEC should be applauded for taking early action to reform MMFs in 2010, these new proposals are not well calculated to advance the stability of MMFs while preserving the unique and important role of the industry in the global financial system. In fact, if anything, shifting to VNAV accounting or imposing fees and gates may actually increase the likelihood and severity of runs while providing minimal, if any, benefits.

131. *Id.* We have seen these institutional pressures lead to significant actions by fund sponsors in the past. For instance, reputational pressure drove sponsors to support funds that came close to breaking the buck in order to maintain the appearance of stability.

132. Hanson et al., *supra* note 52, at 28–29; Gordon & Gandia, *supra* note 52, at 27.

133. Hanson et al., *supra* note 52, at 28–29; Gordon & Gandia, *supra* note 52, at 27.

134. Hanson et al., *supra* note 52, at 28–29; Gordon & Gandia, *supra* note 52, at 27.

135. Hanson et al., *supra* note 52, at 28–29; Gordon & Gandia, *supra* note 52, at 27.

136. Hanson et al., *supra* note 52, at 28–29; Gordon & Gandia, *supra* note 52, at 27.

137. Gordon & Gandia, *supra* note 52, at 7–8.

138. Hanson et al., *supra* note 52, at 28.

139. *Id.*

140. Perlow, *supra* note 2, at 80.

B. The EU's Proposal: A better, if imperfect, path forward

In contrast to the SEC, the EU's proposal gives the industry a choice between two alternative regulatory systems.¹⁴¹ The first option would require funds to shift to a VNAV accounting structure, just like the VNAV proposal put forward by the SEC.¹⁴² Alternatively, funds will be allowed to keep their CNAV accounting structure, provided that they maintain a capital buffer of 3%¹⁴³ of NAV in order to satisfy redemption requests.¹⁴⁴ Because the VNAV option in the EU proposal will have essentially the same benefits and disadvantages as the SEC proposal, this section will focus on the capital buffer alternative of the EU proposal.

The EU has recommended that MMFs that maintain a CNAV structure be required to create a capital buffer equal to 3% of their NAV in order to serve as an additional security against runs and increase the ability of a fund to meet redemption requests without breaking the buck.¹⁴⁵ According to the European Commission, a 3% buffer would have been sufficient to prevent funds from breaking the buck without any assistance from sponsors in all but three of 127 cases during the 2008 crisis, including the Reserve Primary Fund.¹⁴⁶ Additionally, researchers estimated that a capital buffer between 3% and 4% would reduce the risk of breaking the buck to .1%, the threshold typically used in evaluating the sufficiency of capital for banks.¹⁴⁷

A capital buffer would add significant protection for investors against loss and thus would remove much of the motivation for a run.¹⁴⁸ By significantly reducing the likelihood that a fund will break the buck, a capital buffer would also significantly decrease the likelihood of another systemic panic.¹⁴⁹ Moreover, by providing investors with additional assurance that they will receive the full value of their shares, a capital buffer will reduce the incentives for investors to redeem their shares at the first sign of trouble.¹⁵⁰ A capital buffer would also allow a fund to honor redemption requests in a time of crisis without having to engage in a fire sale of its assets in a distressed market.¹⁵¹

The most significant objection to the idea of capital buffers is cost.¹⁵² While there is no doubt that maintaining capital buffers would impose some level of costs on funds, it is unlikely that these costs would be exorbitant.¹⁵³ Due to the safe nature of MMFs and their assets, the cost

141. *Commission Proposal*, *supra* note 4, at 8.

142. *Id.*

143. A capital buffer is essentially just a cash reserve that can be used to pay investors who redeem their shares. *See id.* at 38.

144. *Id.*

145. *Id.* at 8.

146. *Id.* at 3.

147. Hanson, *supra* note 52, at 14–20.

148. *Id.*

149. *Id.*

150. *Id.*; Brown, *supra* note 52, at 223.

151. Hanson, *supra* note 52, at 14–20; Brown, *supra* note 52, at 223.

152. Hanson, *supra* note 52, at 14–20; Brown, *supra* note 52, at 222.

153. Hanson, *supra* note 52, at 14–20. In contrast to the relatively reasonable cost of capital buffers, switching to VNAV accounting is projected by some to impose significant

of capital should be relatively low. Estimates show that the cost would be far less dramatic than the cost banks face in meeting their capital requirements.¹⁵⁴ The extra level of security investors would receive justifies the costs that investors would incur, leading them to require a lower return on their investment.¹⁵⁵

Additionally, opponents of capital buffers often forget that the current system is effectively operating with free, implicit insurance from the U.S. Federal Government.¹⁵⁶ Due to the actions of the U.S. Treasury Department during the crisis, MMFs are currently benefitting from investors' assumption that the U.S. Federal Government will intervene again if another crisis leads to losses for MMF investors.¹⁵⁷ While capital buffers may be viewed as a cost, they could also be viewed, from a societal perspective, as payment for an implicit guarantee of the fund.¹⁵⁸

A second objection to capital buffers is that they do not completely solve the problem of runs.¹⁵⁹ This is certainly a valid criticism. Capital buffers cannot completely eliminate the possibility of a run. However, they do significantly reduce that risk and remove much of the incentive for investors to run early on an MMF in order to recoup as much of their investment as possible.¹⁶⁰ Because capital buffers significantly reduce the probability of a fund breaking the buck and would have prevented it altogether for the Reserve Primary Fund in 2008, it is clear that capital buffers can reduce the risk of runs.¹⁶¹ Beyond reducing the risk of runs on a given fund, capital buffers also increase the overall systemic stability of the MMF market, which will decrease the likelihood of systemic runs.¹⁶² A reform centered on capital buffers would, in one sense, concede that there is no magic bullet for runs. On the other hand, it would also be a strong step toward managing the risk of runs and reducing them substantially.

While capital buffers could generally be a very effective solution, there are at least two major problems with the specific EU proposal. The first problem is clear: capital buffers are only one option. By allowing funds to opt out of its capital buffer regime, the EU proposal presents a significant regulatory problem. While the industry professes a great fear of VNAV accounting, it is likely that funds would rather live in a VNAV system than comply with capital requirements. This is particularly relevant since, as discussed above, it appears that VNAV accounting may have little to no impact on the actual day-to-day operation of most MMFs. As discussed above, VNAV funds are not more stable than

costs on the industry, especially in the form of accounting and regulatory costs for institutional MMF clients. *See* Macey, *supra* note 52, at 171–72.

154. Hanson, *supra* note 52, at 18–19.

155. *Id.*

156. *Id.* at 11.

157. *Id.*

158. *Id.* at 20.

159. *Id.* at 19.

160. *Id.*

161. *Id.*; *Commission Proposal*, *supra* note 4, at 12.

162. Hanson, *supra* note 52, at 14–20; Brown, *supra* note 52, at 221–2.

CNAV funds. In fact, if anything, a shift to VNAV accounting could increase systemic risk and spark additional runs. As a result, providing funds with a choice between a regulatory solution that may actually increase systemic stability and a regulatory solution that would *decrease* systemic stability would be a mistake.

Second, the EU proposal does not include any sort of risk-weighting for determining the capital buffer's size.¹⁶³ This is a significant problem because it will encourage funds to take as much risk as possible within their portfolio restraints in order to deliver more aggressive returns to investors than the fund's competitors.¹⁶⁴ A regulatory scheme that rewards such risk-taking without providing any sort of extra protection would likely have a negative impact on the overall systemic stability of MMFs. Any capital buffer requirement should be risk-weighted, just like banking capital requirements.¹⁶⁵ By risk-weighting the capital requirements, regulators would reward responsible funds and ensure that riskier funds had more substantial capital reserves to better withstand the downside of those funds' portfolios.

Finally, any proposal that includes capital buffers should equip regulators with a strong mechanism for prompt corrective action when funds fall below the required capital buffer.¹⁶⁶ The EU proposal's only form of prompt corrective action is to allow regulators to force a fund to convert to a VNAV fund from a CNAV fund if the fund cannot sustain a 3% capital buffer.¹⁶⁷ This proposal is clearly aimed at incentivizing fund compliance by threatening funds with a measure that they fear: VNAV accounting. However, as discussed above, VNAV accounting does not enhance the stability of funds, it actually endangers funds and may increase the risk of systemic runs on MMFs. As a result, the EU's method of enforcing capital buffers could erode much of the value that capital buffers provide.

C. The FSB's Proposals:

The FSB's proposal focuses on the conversion of CNAV funds to VNAV funds.¹⁶⁸ The FSB claims that such a shift will reduce the likelihood of runs and will provide a more stable environment in which MMFs can operate.¹⁶⁹ Despite the obvious preference of a shift to VNAV accounting for MMFs, the FSB recognized that such a change may not be workable in certain markets, expressing particular concerns about the U.S. market¹⁷⁰ Interestingly, the FSB cited a 2012 report by the IOSOC in drawing its conclusion that requiring MMFs to change to VNAV accounting would be the correct course of regulatory reform.¹⁷¹ The

163. *Commission Proposal*, *supra* note 4.

164. Kacperczyk, *supra* note 52, at 1073.

165. Hanson, *supra* note 52, at 29–30.

166. *Id.* at 14–20.

167. *Commission Proposal*, *supra* note 4, at 18–19.

168. FSB, *supra* note 78, at 3–4.

169. *Id.*

170. *Id.*

171. *Id.*; see Technical Committee of the International Organization of Securities Commissions, *Money Market Fund Systemic Risk Analysis and Reform Options*, International Organization of Securities Commissions (Apr. 27, 2012) [hereinafter

report by the IOSOC, though, issued a far from ringing endorsement of the VNAV proposal, echoing many of the concerns that this Note has already explored about the effectiveness of VNAV reform proposals.¹⁷² Unfortunately, those concerns seem to have gone unheeded by the FSB.

It is important to recognize that the FSB's proposals are merely preliminary. The FSB has now handed the project back to the IOSOC, which will seek comments and study the feasibility of the policy proposals that the IOSOC put forward in its 2012 report.¹⁷³ Given the strong industry opposition to VNAV accounting and the severe problems with such a regulatory proposal, the IOSOC could focus more on its alternative policy proposals. In its initial report, the IOSOC also put forward the possibility of capital buffers, private insurance, and the conversion of MMFs into Special Purpose Banks (SPBs).^{174 175} However, even the IOSOC was concerned about the viability of private insurance and the conversion of MMFs into SPBs, questioning whether the insurance industry would actually be able or willing to provide insurance to MMFs on the scale necessary to implement the first option and noting that a conversion to SPBs would require a massive overhaul of the current system, especially in the United States.¹⁷⁶

If the IOSOC reaffirms the FSB's initial proposal in favor of converting CNAV funds to VNAV accounting, it could lead to a destabilizing reform that leaves the global financial industry more exposed to the risk of contagious runs on MMFs and the crippling effects of those runs. At a minimum, the FSB should allow countries the option of instituting other safeguards, such as capital requirements, that will increase the stability of CNAV funds without requiring a shift to a VNAV system.

III. A Possible Solution

All of the current proposals have significant flaws. Both the EU and the SEC have failed to put forward proposals that are likely to substantially enhance the stability of the financial system by eliminating contagious runs on MMFs. Instead, both proposals actually have the potential, especially through converting CNAV funds to VNAV funds, to seriously destabilize the MMF sector while eliminating the benefits that MMFs can provide the broader economy.

The EU came closer to the mark with its capital buffers option. By requiring CNAV funds to maintain a capital buffer, regulators could substantially enhance the stability of those funds.¹⁷⁷ A 3% capital buffer

Technical Committee Report], *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPdD379.pdf>.

172. Technical Committee Report, *supra* note 171, at 11–13.

173. FSB, *supra* note 78, at ii.

174. Technical Committee Report, *supra* note 171.

175. Reforming MMFs by converting them to SPBs involves chartering MMFs as banks with a “special” or “narrow” purpose. This reform would give MMFs access to deposit insurance along with discount window lending, but would also subject MMFs to the more stringent oversight applied to banks. *See id.*

176. Technical Committee Report, *supra* note 171.

177. *Commission Proposal*, *supra* note 4, at 18–19; Hanson, *supra* note 52, at 14–20.

would have been sufficient to prevent the Reserve Primary Fund from breaking the buck and igniting the panic that ensued.¹⁷⁸ Additionally, a 3% buffer would have allowed 120 out of 123 funds that received sponsor support to survive without sponsor support.¹⁷⁹ Other research has indicated that a capital buffer between 3% and 4% would reduce the chance that an MMF would break the buck to .1%.¹⁸⁰

Capital buffers as imagined in the EU's proposal, however, are not the magic bullet. The lack of risk-weighting in the buffer system would create a substantial incentive for funds to take risks in order to deliver better returns than competitors – a phenomenon witnessed in the MFF industry in the past.¹⁸¹ Consequently, any capital buffer system would need to differentiate between safe funds and risky funds. Risk-weighting capital buffer requirements serves a dual purpose. First, risk-weighting adjusts the level of protection to the actual risk that a fund could become unstable – enhancing the stability of the system. Second, risk-weighting serves as a check on excessively risky behavior by funds and incentivizes safer investment options.

One of the lessons of 2008 was that the heavy concentration of MMF investments in certain assets, both within the singular funds and across the industry, creates a substantial amount of systemic risk.¹⁸² Due to the correlation of risk across funds, sophisticated investors may withdraw their money from funds that have yet to experience financial difficulties based on the struggles of other funds with similar assets.¹⁸³ This phenomenon gives rise to the sort of contagion witnessed in 2008.¹⁸⁴ Consequently, any risk-weighted capital buffer should make every effort to substantially encourage diversification and take into account not only intra-fund diversification, but also the correlation of the fund's assets with the assets of other funds. Reducing the correlation of risk throughout the industry while simultaneously requiring funds to have enough capital on hand to meet their obligations should allay the concerns of sophisticated investors and reduce the risk of a contagious run.

Finally, while capital buffers will impose a cost on investors, that cost is likely to be minimal. The European Commission estimates that the imposition of a 3% capital buffer would result in an increase of the management cost incurred by funds of somewhere between .09% and .3%.¹⁸⁵ The fund managers would probably bear some of that increase. The rest would be passed on to investors.¹⁸⁶ The result would be a reduction in the returns that investors could realize by investing in

178. *Commission Proposal*, *supra* note 4, at 18–19.

179. *See id.*

180. *See Hanson*, *supra* note 52, at 2.

181. *See Kacperczyk*, *supra* note 52, at 1073.

182. *See Gordon & Gandia*, *supra* note 52, at 6–10.

183. *See id.* at 8 n.32.

184. *See id.*

185. *See Commission Proposal*, *supra* note 4, at 4.

186. *See id.*

MMFs, but an increase in the safety and security of those investments.¹⁸⁷ Some research indicates that investors would only realize a .05% reduction in their returns in exchange for the protection that capital buffers can afford.¹⁸⁸

Admittedly, capital buffers are not a perfect solution. A large enough crisis could exhaust them and cause funds to break the buck, possibly leading to a systemic panic. However, instituting risk-weighted capital buffers would substantially reduce the risk of such a scenario while imposing a minimal cost on investors and maintaining the benefits of the MMF industry. Simply put, when compared with other alternatives, risk-weighted capital buffers provide a much more effective means of increasing systemic stability.

IV. Conclusion

Contagious runs on MMFs played a significant role in the 2008 crisis. Due to the systemic importance of MMFs, any attempt to prevent the next crisis must attempt to prevent a similar collapse of public confidence in MMFs during a time of financial instability. While steps taken by the U.S. in 2010, and the E.U. in 2011, have increased the stability of MMFs, additional reform is necessary. While these post-crisis reforms increased the quality of the investments that MMFs hold, they failed to address the continued incentive for contagious runs.

Unfortunately, the SEC's new proposals are also unlikely to resolve the incentives for runs. Forcing funds to shift to VNAV accounting would probably not reduce the incentive for runs and could, instead, increase the likelihood and severity of runs on MMFs. The fees and gates alternative, on the other hand, places far too much discretion in the hands of fund managers, does not significantly enhance the protection of MMFs, and has the potential to trigger runs instead of stopping them.

The EU came closer to providing an effective solution, but the proposal still falls short. While capital buffers are likely the best option currently available to regulators, the EU plan allows funds to opt for a VNAV system, which could cause significant systemic problems. Additionally, the EU proposal lacks the necessary risk-weighting for capital requirements and an effective mechanism for prompt corrective action when a fund falls below the required capital threshold. The effect of these flaws is to incentivize irresponsible risk-taking by fund managers and leave regulators without the tools necessary to keep funds in compliance.

Finally, the FSB proposal again pushes funds to switch to VNAV accounting. Such a reform would fail to alleviate the risk of runs and could expose MMFs to yet more severe runs. Fortunately, the IOSOC has an opportunity to refocus the FSB's policy proposals with its forthcoming 2014 report.

Rather than pursuing the current reform options, regulators should focus on creating a more effective capital buffer solution. By

187. *See id.*

188. *See* Hanson, *supra* note 52, at 2–3.

implementing risk-weighted capital requirements, regulators could significantly reduce the probability that a fund would break the buck. Additionally, capital buffers would remove much of the incentive for early runs and provide the system-wide strength necessary to better withstand contagious redemption pressures. While capital requirements do not solve for run-like behavior, they do significantly reduce the probability that such behavior will occur, along with the negative side effects of a run. Finally, risk-based capital buffers would impose some cost on MMFs for the currently free, implicit government guarantees they are receiving, while simultaneously reducing the likelihood that the government will have to intervene.