Regs to the Rescue?

The world of money market funds changed forever back in 2008, when an investment vehicle called the Reserve Primary Fund loaded up on loan obligations backed by Lehman Brothers. Lehman famously went under, and the fund "broke the buck," meaning that when Lehman was unable to pay back its loans, the value of a share of the Reserve Primary Fund dipped under $1.

This was the first time many investors realized that money market funds were not risk-free. Many panicked, causing a run on other money market instruments, and overall the event added another unhappy twist to the financial crisis.

Fast forward to the near future: October 14, 2016, the date when new protective regulations implemented by the Securities and Exchange Commission will go into effect. Yes, the government wheels creak along slowly.

What regulations? To make sure that the funds are able to redeem at par, all money market instruments that invest in taxable corporate debt or municipal bonds, and have institutional investors, will have to keep at least 10% of their assets either in cash, U.S. Treasury securities or other securities that will convert to cash within one day. (Many money market funds make overnight loans to lending institutions in the U.S. and Europe.)

As further safeguards, at least 30% of a money market fund's assets will have to be liquid within one week, and funds will be restricted from investing more than 3% of their assets in lower-quality second-tier securities. No more than half of one percent of their assets can be invested in second-tier securities issued by any single issuer. Finally, money market funds will not be allowed to buy second-tier securities that mature in more than 45 days.

What happens if all these safeguards don't work, and a share of the money market fund still goes below $1? In those (probably rare) instances, the fund's board of directors are permitted to suspend your ability to redeem your investment for up to ten days, and under certain circumstances, they may impose a 1% or 2% fee on your redemptions.

The bottom line is that investors will still be able to put $1 into a money market fund and expect to get $1 back out again when they sell shares—with, perhaps, a tiny bit more confidence a few months from now.

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