SEC Limits Money-Market Funds' Risk

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WASHINGTON—The Securities and Exchange Commission changed its rules to improve the stability of popular money-market funds, in part by prohibiting them from investing in certain risky derivative securities.

Most of the changes apply to tax-exempt money-market funds, which invest in securities not subject to various federal or state taxes. But they also tighten standards for taxable money-market funds of the kind that had losses in 1994 because of their holdings of adjustable-rate derivative securities, said Barry Barbash, director of the SEC's investment-management division.

Derivatives are instruments whose values are tied to the performance of other securities on which they are based; because they are often heavily leveraged, their values frequently fluctuate sharply.

Investors have poured more than $830 billion into 1,100 money-market funds, including about $134 billion into funds of the tax-exempt variety. These funds are popular, in some cases as substitutes for bank accounts, because they generate good short-term returns while still providing relative safety and stability.

Yet in 1994, when interest rates fell sharply, a number of these funds had problems because of losses on the adjustable-rate securities they held. One taxable money-market fund even rattled investor confidence by "breaking a dollar"—meaning its share price fell below the $1 level all such funds seek to maintain. Others were bailed out by the investment advisers that run the funds, who took the losses themselves to avoid the taint of breaking a dollar.

The new standards stipulate that "funds have to be concerned about securities that are too interest-rate sensitive and too volatile," Mr. Barbash said. SEC Chairman Arthur Levitt added that the changes "are designed to tighten the risk-limiting conditions of the rule for tax-exempt money-market funds so that investors in these funds will have protections similar to those provided to taxable-fund investors."

While the rules were mainly intended to extend existing protections for taxable funds to tax-exempt funds, they also have broad implications for all money-market funds, Mr. Barbash said.

By imposing the new standards, the SEC is requiring funds to diversify their investments and otherwise reduce their exposure to interest-rate, credit-quality and currency-related risks. This means, for instance, that a taxable fund can't invest more than 5% of its assets in the securities of a single issuer. For a tax-exempt fund, it means the fund can't invest more than 5% of its assets in certain "conduit" securities ultimately guaranteed by nongovernment issuers.

The changes won't occur for six months, and then will begin to take effect gradually "to make sure there are no disruptions in the marketplace," said Robert Plaze, associate director of the SEC's investment-management division. As a result, funds with investments that don't comply with the changes can hold some of them until maturity, rather than immediately selling them.