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January 30, 2013

ICI Comment Letter on FSOC's Proposals for Money Market Fund Reform

[26952]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 5-13
BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 5-13
BROKER/DEALER ADVISORY COMMITTEE No. 8-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 5-13
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 2-13
OPERATIONS COMMITTEE No. 10-13
SEC RULES COMMITTEE No. 8-13
SMALL FUNDS COMMITTEE No. 3-13
TRANSFER AGENT ADVISORY COMMITTEE No. 15-13 RE: ICI COMMENT LETTER ON FSOC'S PROPOSALS FOR MONEY MARKET FUND REFORM

As you know, the Financial Stability Oversight Council ("FSOC" or "Council") is requesting comment regarding its Proposed Recommendations Regarding Money Market Mutual Fund Reform ("Report"). [1] The proposed recommendations were issued under Section 120 of the Dodd-Frank Act, which authorizes FSOC to determine that a financial activity or practice could create or increase the risk of significant liquidity, credit, or other problems and to issue recommendations for more stringent regulation to the primary financial regulatory agency; which in this case would be the SEC. FSOC proposes to determine that money market funds' activities and practices could create or increase these risks and to recommend three alternative reforms to money market funds. These reforms could be adopted in the alternative, in which case a money market fund could choose which reform applied to it. FSOC also requests comments on other possible reforms, including liquidity fees and gates. ICI filed a comment letter, which is attached.

A summary of our comments follows.

FSOC's Determination Is Not Firmly Grounded in Law. The Council's authority under Section 120 of the Dodd-Frank Act is expressly limited: it can only make recommendations regarding enhanced regulatory standards for a financial activity or practice conducted by "nonbank financial companies" or bank holding companies. Congress defined "nonbank financial company" generally to mean a company that is "predominantly engaged in financial activities." Congress then expressly charged the Board of Governors of the Federal Reserve System ("Board") with the responsibility to establish criteria necessary for applying this definition to specific companies—a task that the Board has not yet completed. This is more than a technical deficiency. It is indicative of the undue haste and lack of analytical rigor with which FSOC has pursued this matter. FSOC has not provided an adequate basis to support a determination that any money market funds would qualify as nonbank financial companies, and thus lacks the authority to issue these recommendations. Accordingly, we respectfully request that FSOC withdraw the proposed recommendations.

FSOC's Determination Is Not Grounded in Fact. The Council's basis for determining that "the conduct, scope, nature, size, scale, concentration, or interconnectedness" of money market funds pose systemic risks is also materially flawed in substance. The Report's assertions about money market funds distort these funds' nearly 40-year record of resilience, exaggerate the impact of money market funds on the financial crisis of 2007–2008, and ignore the substantial benefits of the 2010 SEC reforms. The Council's determination also is based on the myopic premise that the features it ascribes to money market funds (e.g., risk-averse investors, lack of explicit loss-absorption capacity, and use of amortized cost accounting) are unique, and that any related risks are not attributable to the functioning of cash-management products or the short-term markets generally. Our comments demonstrate, with substantial empirical data, that this premise is incorrect, and point out that focusing attention on one product will not address broader systemic concerns in the short-term markets.

We also analyze the events of the 2007–2008 financial crisis, finding that many factors (including repeated shocks from failures by banks and other financial institutions and the lack of coherent, consistent government response to those failures) spurred redemptions from money market funds. Last, we discuss the SEC's 2010 reforms and demonstrate that the Council's concerns about the ability of money market funds to meet large-scale redemptions unquestionably reflect an out-of-date view of the industry that wholly ignores the 2010 amendments.

These misstatements and omissions are not merely incidental mistakes—they are the foundation of FSOC's case for fundamental changes to money market funds. We strongly object to FSOC taking the drastic step of using its Section 120 authority based on faulty assumptions or data that do not reflect the current regulatory regime or actual market experiences of money market funds.

Further Fundamental Changes Are Not Necessary for Treasury, Government, or Tax-Exempt Money Market Funds. FSOC's proposed determination also fails to reflect a nuanced and thoughtful analysis of the various types of money market funds and their distinct risk profiles. As a result, FSOC in some instances proposes to recommend reforms broadly to all money market funds. In fact, there are four distinct types of money market funds—Treasury, government, tax-exempt, and prime funds—and each holds securities that trade in markets with varying degrees of liquidity, has somewhat different levels of default risk, and had distinct investor redemption experiences during the financial crisis of 2007–2008 and the events of 2011. Based on our analysis of the experience of each type of fund and the public record, it is abundantly clear that no case can be made for applying fundamental changes to Treasury, government, or tax-exempt money market funds. Even for prime money market funds, the measures FSOC proposes to recommend are wholly inappropriate and disproportionate to any theoretical threat.

We find it particularly troubling that FSOC—composed as it is of the heads of U.S. federal financial regulators—would see fit to propose drastic reforms for funds whose portfolios consist almost entirely of short-term Treasury and government securities. Absent implicit concerns about a default by the U.S. Government, these proposals seem wholly misplaced. If these proposals actually are motivated by such concerns, the implications for the financial system hardly can be confined to money market funds.

Temporary Gates and Liquidity Fees Could Serve as Effective Tools to Address Redemption Pressures in Prime Money Market Funds. We do not believe the Report has made the case for further fundamental changes to money market funds. If, however, FSOC can demonstrate that changes are needed for prime money market funds, we would support FSOC's recommending that the SEC propose requiring a prime money market fund to impose a liquidity "gate" if its "weekly liquid assets" fall to a specific, objective "trigger point," set between one-quarter and one-half of the minimum weekly liquid asset level required by the 2010 amendments to Rule 2a-7 (i.e., weekly liquid assets at 7.5 percent to 15 percent of a fund's assets). When a prime money market fund trips the trigger point, gates would automatically be imposed after the close of business to suspend redemptions received for processing the next business day. Money market fund boards then would be permitted to lift the gate and honor redemptions, provided that redeeming shareholders pay a nonrefundable liquidity fee to the fund equal to 1 percent of redemption proceeds—a level set to discourage redemptions, yet to allow investors truly in need of liquidity to have access to their funds. The redemption fee would benefit remaining shareholders by mitigating liquidation costs and potentially rebuilding net asset values ("NAVs"). We further suggest that prime funds be required to make frequent website disclosure of their mark-to-market share prices and weekly liquid asset levels to enhance transparency and encourage a highly conservative approach to portfolio management. Our discussion addresses the experience of U.S. and European funds with redemption gates, tax and operational issues, and the impact of this proposal on certain types of money market fund transactions.

Our proposal differs from the Council's MBR concept in that liquidity gates would not be imposed during "normal" market conditions, but only when a fund's available weekly liquid assets fall to a specific threshold. In contrast to the MBR or FSOC's other alternative recommendations, a liquidity-based trigger for gates aligns precisely with FSOC's stated goal of stopping excessive or unexpected redemptions from a prime fund (in FSOC's terminology, "runs"). This proposal has the immediate effect of suspending further redemptions and exacts a substantial cost for liquidity when liquidity is at a premium.

Requiring Floating NAVs Would Harm the Market. FSOC Alternative One would require all money market funds to let their NAVs float and to transact share purchases and redemptions at the portfolio's daily mark-to-market value. ICI has maintained consistently since 2009 that proposals to force funds to float their NAVs reflect fundamental misunderstandings of the operation and role of money market funds, would increase systemic risk by driving investors away from money market funds to alternative products that strive to maintain stable values but that are not regulated under the Investment Company Act, and would disrupt well-established and efficient financing arrangements in the markets. FSOC's proposal does not alleviate these problems.

FSOC's proposal would require money market funds to reprice their shares from $1.00 to $100.00 and would limit the use of amortized cost accounting for portfolio securities. These conditions, it contends, are "consistent with the valuation requirements that apply to all other mutual funds." This statement is incorrect. FSOC's recommendation in fact would require money market funds to comply with a pricing standard that is at least 10 times more onerous than the standard articulated by long-standing SEC accounting guidance. We question why sponsors would offer and investors would buy such funds. We then demonstrate, based on the experience of U.S. and European funds, that it is highly doubtful that forcing money market funds to float their NAVs would accomplish FSOC's objective—inducing fund shareholders to refrain from reacting during periods of market stress.

As FSOC acknowledges, forcing money market funds to float their NAVs would confront funds and investors with significant burdens in the tax and accounting treatment of gains and losses. While we offer suggestions for how the Internal Revenue Service, Treasury Department, SEC, and accounting authorities could alleviate these burdens, it is important to note that providing the specified relief would not cure FSOC's proposal for floating NAVs of its significant shortcomings, nor justify FSOC's recommending this alternative to the SEC. We stress that the necessary changes must be implemented before any floating NAV requirement takes effect. We also address the significant costs of operational and systems changes needed to implement a floating NAV, and the prospect that floating NAV funds would be unable to provide certain services to shareholders, including efficient processing of cash balances through sweep accounts.

In the face of these many burdens and barriers to the use of floating-NAV money market funds, the principal impact of FSOC Alternative One would be a major restructuring and reordering of intermediation in the short-term credit markets. It is very likely that institutional investors would continue to seek out diversified investment pools that strive to maintain a stable value. Most of these pools are not regulated under the Investment Company Act—and some of them lie beyond the jurisdictional reach of U.S. regulators. Regulatory changes that push assets from highly regulated, transparent products—i.e., money market funds—to less-regulated and less-transparent products arguably serve to increase systemic risk. Moreover, FSOC's proposals for a transitional regime between stable value and floating NAV money market funds would be confusing and costly to investors; indeed, the transition itself could be destabilizing to the financial markets.

The "Minimum Balance at Risk" Requirement Would Drive Investors and Intermediaries Away from Money Market Funds. FSOC Alternative Two proposes an untested experiment on $2.3 trillion in prime, tax-exempt, and government money market funds, requiring such funds, irrespective of current market conditions, to delay redemptions of a portion of shareholder accounts.

We strongly oppose any sort of redemption restriction that would impair investor liquidity when liquidity is readily available within the money market fund. Alternative Two's MBR restriction would impair a core mutual fund investor protection and reverse more than 70 years of SEC practice in fund regulation. Moreover, investor reaction to continuous redemption restrictions suggests that an MBR would greatly reduce investor use of money market funds. One survey of institutional investors indicates that institutional assets in money market funds would shrink by two-thirds if such restrictions were imposed.

Although the Report asserts that an MBR would discourage shareholders from redeeming in times of stress, FSOC has not provided any data or analysis to support this assertion. To the contrary, discussions with investors indicate that shareholders would be more likely to redeem at the slightest sign of stress in the markets, given the punitive nature of the MBR.

An MBR also would create serious operational issues that would reduce or eliminate the usefulness of many services that money market funds and financial providers extend to investors. Drawing from a recent ICI study on the operational implications of an MBR-type proposal, our comments find that implementing FSOC's proposed freeze on shareholders' assets would require fund complexes, intermediaries, and service providers to undertake intricate and expensive programming and other significant, costly system changes. [2] Our analysis indicates, however, that the costs of these changes could be so prohibitive that market participants are highly unlikely to undertake them, particularly if FSOC's changes greatly curb investor interest in money market funds. FSOC's proposal to exempt accounts with balances below $100,000 does not alleviate these burdens, instead, it would create an additional level of operational complexity and cost.

The likely consequences of an MBR requirement thus are mutually reinforcing. Fund complexes, intermediaries, and service providers would be hard-pressed to justify undertaking the significant costs of compliance with an MBR in the face of the rapid shrinkage of fund assets. We believe many intermediaries instead would make the business decision to migrate to unregulated or less-regulated money market investment vehicles or bank deposit products, disrupting short-term financing in the economy and increasing systemic risk.

NAV Buffers and Capital Proposals Would Drive Sponsors from the Money Market Fund Product. FSOC Alternative Three contemplates that stable NAV money market funds would have a risk-based NAV buffer of up to 3.00 percent to provide an explicit loss-absorption capacity, potentially combined with other measures. A recent ICI study clearly shows the infeasibility of building capital at the levels suggested for either Alternative Two or Alternative Three, whether the capital is committed by fund advisers, raised in the market, or accumulated from fund income. [3] Requiring money market fund advisers to commit capital to absorb possible future losses would alter fundamentally the business model of these funds, essentially requiring advisers to guarantee a portion of their funds. Rather than spreading small and infrequent losses across a large number of fund investors, an adviser-provided NAV buffer would concentrate losses on a single investor (the adviser) and on a small asset base (the NAV buffer). Fund advisers would require compensation for providing such guarantees, and the cost would be significant.

Raising capital in the markets also faces formidable, if not insurmountable, hurdles. Working with capital market experts, ICI determined that adding subordinated debt or equity might require more than 560 individual money market funds to enter the market seeking to raise capital simultaneously. Small funds and small fund complexes likely would find it difficult and costly to issue and roll over subordinated securities, resulting in further industry consolidation and raising a barrier to entrants. Issuing subordinated debt also would add "rollover risk" to money markets funds, because investors in this class of money market fund shares might well be reluctant to roll over their investments in times of market stress. Thus, capital would disappear just when it might actually be needed—making such capital a source of instability in the markets.

A third alternative—a within-fund capital buffer accumulated by retaining fund earnings—would be limited by legal and accounting considerations to 0.5 percent of fund assets. Capital at this level would not absorb large credit losses; at best it would provide funds somewhat greater flexibility in selling securities at a price below amortized cost. Even at that limited level, building such a buffer might take a typical prime fund 10 to 15 years.

In sum, FSOC Alternative Three is a deeply flawed proposal. Its likeliest impact would be to impel money market fund sponsors to exit the business, thus depriving investors, issuers, and the economy of the benefits these funds provide.

FSOC Failed to Meet Dodd-Frank or SEC Statutory Requirements for Economic Analysis. Under Section 120 of the Dodd-Frank Act, the Council must "take costs to long-term economic growth into account” when recommending new or heightened standards and safeguards for a financial activity or practice. Measured against this statutory mandate, the Report’s economic analysis has a number of significant shortcomings that exaggerate the potential benefits of the proposed reforms and may significantly underestimate their costs to the economy. The Report also fails to address—let alone satisfy—the SEC’s statutory and rulemaking requirements for analysis of the economic consequences of any eventual rule. We question why FSOC would use its Section 120 authority to propose recommendations without any consideration given to whether the recommended proposals will satisfy the SEC’s own governing statutes and other regulatory requirements.

The Report’s discussion of the benefits of new regulations is flawed. The Council argues that its recommendations would reduce future outflows from money market funds during crises, which, in turn, would lower the probability and dampen the severity of any future crises. The Report, however, fails to show that the reforms it advocates would reduce risks; it ignores the salutary effects of the SEC’s 2010 amendments to Rule 2a-7; and it assumes that the regulatory system can ensure that investors in short-term markets will not react to vast, systemic events. The Council further assumes that money market funds have sufficient market power to compel fund investors (or, in some cases, issuers of short-term debt and intermediaries) to bear the costs and burdens of the Report’s recommended proposals. Given the numerous alternative products and services available to investors, particularly institutional investors, that is a wholly unrealistic assumption. As a result, the Report conveniently ignores the very high probability that its proposed fundamental changes will increase systemic risk by driving investors from money market funds into less-regulated, less-transparent cash management products.

The Report’s analysis of the costs to long-term growth of its recommendations is highly speculative, perfunctory, and based on assumptions that are inconsistent with the Council’s assumed benefits. The Report asserts that its proposals’ costs to long-term economic growth are “very small.” These estimates are highly speculative and likely to be substantially understated. Curiously, this minimal estimate of the cost to long-term economic growth appears to contradict the Council’s own comments that money market funds “provide an economically significant service by acting as intermediaries between investors who desire low-risk, liquid investments and borrowers that issue short-term funding instruments.” The Council relies on models that fail to take seriously the role of financial intermediation—implicitly assuming that financial activity has no effect on real economic growth.

Alternative estimates based on similar models yield estimates of costs to long-term economic growth that are seven or eight times greater than the Report’s figures. While these figures also are highly speculative, the absence of these alternative estimates from the Report suggests that FSOC was attempting to offer the lowest possible estimate of the cost, while ignoring the large uncertainties around its estimate. It is clear from this approach that the Council gave only the most perfunctory nod to its legal obligation under the Dodd-Frank Act to assess the cost of its proposals on long-term economic growth.

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Attachment

endnotes

[1] The FSOC press release, with a link to the Report, is available at http://www.treasury.gov/press-center/press-releases/Pages/tg1764.aspx.

[2] See Investment Company Institute, Operational Impacts of Proposed Redemption Restrictions on Money Market Funds (2012), available at http://www.ici.org/pdf/ppr_12_operational_mmf.pdf.

[3] See Investment Company Institute, The Implications of Capital Buffer Proposals for Money Market Funds (May 16, 2012), available at http://www.ici.org/pdf/ppr_12_mmfs_capital_buffer.pdf.
