INVESTMENT COMPANY INSTITUTE
The Asset Management Industry SERVING INDIVIDUAL INVESTORS

MEMO# 27573

September 19, 2013

ICI Comment Letter to SEC on Money Market Fund Reform Proposal

[27573]

September 19, 2013

TO: ACCOUNTING/TREASURERS COMMITTEE No. 27-13
BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 33-13
BROKER/DEALER ADVISORY COMMITTEE No. 45-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 25-13
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 25-13
OPERATIONS COMMITTEE No. 48-13
SEC RULES COMMITTEE No. 38-13
TAX ADVISORY COMMITTEE RE: ICI COMMENT LETTER TO SEC ON MONEY MARKET FUND REFORM PROPOSAL

As you know, the SEC has proposed amendments to rules under the Investment Company Act of 1940 and related requirements that govern money market funds. * Specifically, the SEC is considering two reform alternatives that it could adopt either alone or in combination: (i) require prime and tax-exempt institutional money market funds to "float" their net asset values ("floating NAV proposal"); or (ii) require all non-governmental money market funds to impose liquidity fees of up to 2 percent and to have the option to temporarily suspend redemptions (or "gate" the fund) upon the occurrence of specified events indicating that the fund may be under stress ("liquidity fee/temporary gate proposal"). The Release also includes a number of less fundamental, yet significant, reforms that would apply under either proposal. These include enhanced disclosure and reporting requirements; more stringent diversification requirements; enhanced stress testing; and improved private liquidity fund reporting.

ICI filed a comment letter with the SEC, which is attached and briefly summarized below.

Application of Fundamental Structural Reforms to Government and Tax-Exempt Money Market Funds. The Release proposes to exempt government money market funds from further structural reform because, among other things, government money market funds are not susceptible to the risks of mass investor redemptions as other money market funds; their securities have low default risk and are highly liquid in even the most stressful market scenarios; and interest rate risk is generally mitigated because government funds typically hold assets that have short maturities and hold those assets to maturity. We agree with the SEC that no case can be made for applying fundamental changes to government money market funds. We strongly believe that such changes likewise should not apply to tax-exempt money market funds for similar reasons.

A fundamental restructuring of tax-exempt money market funds could compromise the critical source of short-term funding that these funds provide for state and local government entities across the United States. The SEC has produced no evidence that these funds are vulnerable to significant redemptions or otherwise pose systemic risk. Indeed, there is no evidence that investors in tax-exempt money market funds redeem en masse during periods of market stress. Moreover, in the unlikely event that tax-exempt money market funds did in fact face widespread redemptions, these funds hold the great majority of their assets in highly liquid securities that can be liquidated to meet redemptions. Additionally, because of these securities' structures, they are likely more immune to credit deterioration. Consequently, tax-exempt funds, like government funds, should be exempt from both the floating NAV proposal and the liquidity fee/temporary gate proposal.

Liquidity Fee/Temporary Gate Proposal. The SEC's liquidity fee/temporary gate proposal—i.e., allowing money market funds to continue to transact at a stable share price under normal market conditions, but under certain circumstances when a fund may be stressed from a liquidity standpoint (i) requiring the fund to institute a liquidity fee designed to deter further redemptions and (ii) permitting the fund to temporarily suspend redemptions—has the support of many of our members because it promises to slow or stop significant fund outflows. These tools, together with enhanced disclosure, directly address regulators' concerns about redemption pressures on prime money market funds.

To make these tools even more useful to fund boards, we recommend that the SEC expand the circumstances under which a board may impose a liquidity fee or temporarily suspend redemptions to cover situations when heavy redemptions are already underway or are clearly foreseeable.

Notwithstanding the support for the liquidity fee/temporary gate proposal, it has potential drawbacks. It is unclear how many investors would use a money market fund with liquidity fees and gates given the explicit possibility of restricted liquidity; what impact this measure would have on certain transaction types; and what tax implications a liquidity fee might have for money market funds and their shareholders. There is no question that complex and costly system modifications by fund transfer agents and intermediaries would be necessary to handle liquidity fees and temporary gates. We anticipate that it may take at least three years to allow the industry to complete the operational and other changes necessary to successfully implement liquidity fees and temporary gates.

Floating NAV Proposal. The SEC's floating NAV proposal would require prime and tax-exempt institutional 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 forcing funds to float their NAVs does not address the problem that most preoccupies many regulators—how to avert heavy redemptions from money market funds. It also is an inefficient way to educate investors that money market funds may lose value—it is extremely costly to fund complexes, to intermediaries, to investors, and to the economy as a whole. Effective disclosure of funds' portfolio holdings and other key characteristics, combined with daily disclosure of funds' mark-to-market share prices accomplish the same goal, without the potential for troubling disruptions to our economy and fundamentally altering the key features that investors value most.

Forcing money market funds to float their NAVs would impose significant burdens on funds and investors in the tax and accounting treatment of gains and losses. It also could result in the loss of same-day settlement—a service that is extremely important to institutional investors managing their daily cash. Moreover, the product would be unusable as a sweep vehicle. Without these benefits, widespread investor acceptance of a floating NAV money market fund product is unlikely. It is critical, therefore, that the changes necessary to alleviate these burdens be implemented before any floating NAV requirement takes effect.

One clearly foreseeable impact of the floating NAV proposal is a reduction in capital market funding to the private sector. Requiring prime institutional money market funds to float their NAVs risks precipitating an outflow of hundreds of billions of dollars from prime money market funds to other products, including government money market funds. This could result in a major restructuring and reordering of intermediation in the short-term credit markets, and the transition is likely to be highly disruptive. Regulatory changes that push assets from money market funds toward other money market instruments and uninsured bank deposits would be disruptive to the capital markets and fail in the long-run to address the concerns the SEC has raised, such as promoting safer capital markets and reducing risks to the economy at large. It also is not clear that regulatory policies that further concentrate deposits in the largest banks reduce systemic risks.

The SEC's proposal would require floating NAV money market funds to comply with a pricing standard that is 10 times more onerous than the standard articulated by long-standing SEC accounting guidance for all other floating NAV mutual funds. We question whether investors would buy and sponsors would offer such money market funds.

If the SEC nevertheless determines, despite our longstanding concerns, to require funds to float their NAVs, we agree that the reach of that action should be reasonably tailored and that it is appropriate to exempt "retail" funds from the floating NAV requirement. Money market funds provide retail investors access to investments not otherwise affordable or accessible—such as commercial paper issued in minimum denominations beyond the reach of the average investor. Maintaining the availability of prime stable NAV money market funds for retail investors, therefore, is particularly important because these funds provide diversification and a market-based rate of return that is not otherwise available through a bank deposit account. (Indeed, these features are often important to certain institutional investors as well.)

We have significant concerns, however, that the SEC's proposal to define retail funds through a daily redemption limit would impair investor liquidity and be more onerous operationally than other methods. Instead, we recommend the use of a U.S. Social Security Administration ("SSA") issued social security number ("SSN") as the fundamental characteristic to identify an investor eligible to invest in a retail money market fund. Under this recommended approach, any account opened by a fund or intermediary that has captured an SSN as a (tax) identification component for the registered owner or beneficial owner of an account would qualify for investment in a stable NAV retail money market fund under the retail exception. This approach would capture a very large percentage of the retail investors who invest in money market funds directly. It also would include accounts whose underlying owners or beneficiaries have an SSN, such as those invested in tax-advantaged savings accounts, retail brokerage, and certain trust accounts that are held in the name of intermediaries on fund transfer agent records. Importantly, using SSNs would be far less costly to implement than other methods of defining retail funds, including the SEC's proposed daily redemption limit.

We support retaining the exemptive rules that permit money market funds to engage in certain affiliated transactions subject to strict conditions (Rule 17a-9) and authorize money market fund boards of directors to suspend redemptions in narrow circumstances (Rule 22e-3). We explain why we believe Rule 17a-9 transactions are in the best interests of shareholders, whether a fund's NAV is stable or floating, and Rule 22e-3 provides needed flexibility for emergency situations when it would be difficult for the SEC to provide individual exemptive orders as quickly as a fund's board might need to react to protect shareholders' interests.

Finally, we are concerned that the transition from stable to floating NAV could be destabilizing to the financial markets because it could require money market funds to potentially shed hundreds of billions of dollars of money market instruments as their investors redeem in favor of other products. We anticipate that it may take at least three years for funds and intermediaries to adapt to the new requirements of a floating NAV.

Potential Combination of Floating NAV and Liquidity Fee/Temporary Gate Proposals. The Release suggests that the combination would provide a broader range of tools to a floating NAV money market fund to manage redemptions in a crisis, would further enhance the ability of money market funds to treat shareholders equitably, could allow better management of funds' portfolios in a crisis to minimize shareholder losses, and would provide fuller transparency of fund valuation and liquidity risk. As noted above, we strongly oppose the combination of the two proposals.

An investor simply would not purchase a fund that is saddled with the combination of a floating NAV, the prospect of having to pay a fee to redeem or of being prohibited from redeeming for some time, and the strict portfolio requirements imposed by Rule 2a-7 when other, less onerous, options are readily available. Instead, institutional investors would seek out other cash management investment alternatives that offer principal stability (e.g., government money market funds, investment products not registered under the Investment Company Act such as separate accounts or unregistered cash management pools, or bank deposits) or that have neither potential restrictions on redemptions nor the yield-limiting restrictions of Rule 2a-7 (e.g., all other mutual funds).

A combination of the floating NAV proposal and the liquidity fee/temporary gate proposal also would undermine the attractiveness of retail money market funds. Under the proposal, a money market fund would be exempt from the floating NAV proposal if it does not permit a shareholder to redeem more than $1 million per day. It is simply overkill to add additional structural reforms to a fund that already meaningfully restricts the daily liquidity available to investors.

From an operational standpoint, the combination of the two proposals would impose excessive costs and burdens on the money market fund industry and money market fund shareholders. Importantly, a combined approach would drive the greatest number of shareholders and fund sponsors away from money market funds.

Elimination of Amortized Cost Method of Valuation for All Funds. We do not support the SEC's proposal that would require stable NAV money market funds under either the floating NAV or liquidity fee/temporary gate proposal to use the penny rounding method rather than the amortized cost method of valuing securities. The amortized cost method facilitates the current same-day settlement process—a feature available for all types of money market funds, including government funds, that is vitally important to many investors.

Enhanced Disclosure and Reporting. ICI consistently has supported efforts to increase the public disclosure of money market fund portfolio information and risks, and enhance the SEC's access to money market fund data. If the SEC requires money market fund NAVs to float, however, the proposed disclosure requirements would be unnecessary and we oppose them. Even the current level of money market fund disclosure and reporting—which is far more detailed and frequent than that for any other floating NAV funds—is unwarranted for money market funds that are required to float their NAVs.

Our support for further disclosure and reporting enhancements, therefore, turns on whether money market funds are permitted to maintain a stable NAV. We thus offer our overall support for enhancing the disclosure requirements for stable NAV money market funds. We do, however, have a number of comments, which are discussed in detail in our letter We also caution the SEC that it may take at least 18 months for the industry to successfully complete the operational and other changes necessary to successfully implement the new disclosure requirements.

More Stringent Diversification Requirements.

Issuer diversification. We support the SEC's proposal to require money market funds to aggregate affiliated issuers and count those issuers as one exposure. Limiting money market funds' exposure to affiliated entities appears to be consistent with the purposes of the Rule 2a-7 diversification requirements—to spread the risk of loss among a number of securities.

Asset-backed securities. We do not support the SEC's proposal to require money market funds (subject to an exception) to treat the sponsor of a special purpose entity issuing asset-backed securities as a guarantor of the securities subject to Rule 2a-7's diversification limitations applicable to guarantors and demand feature providers. Rule 2a-7 already counts toward a company's diversification limit any asset-backed security for which the company actually provides a guarantee or demand feature. The proposal would change this result by treating a sponsor of an asset-backed security as a guarantor of the entire amount of the security held by the money market fund, even if the sponsor's guarantee or demand feature is limited to a smaller amount or if the sponsor has no legal obligation to support its asset-backed security.

Credit Support Diversification (the 25 percent basket). We do not support the SEC's proposal to eliminate the so-called "25 percent basket," which currently allows up to 25 percent of the value of securities held in a money market fund's portfolio to be subject to guarantees or demand features from a single institution. Eliminating the basket would increase rather than decrease risk by increasing funds' reliance on less creditworthy credit support providers and unduly decrease the flexibility currently afforded funds.

More stringent investment diversification requirements. Due to unprecedented market conditions and consolidations since the financial crisis, the number of institutions issuing or providing guarantees or liquidity for eligible money market securities has dwindled. We are concerned that further restricting diversification limits may only heighten this problem by potentially forcing money market funds to invest in less creditworthy issuers, which could increase the risk within money market funds' portfolios, rather than decreasing it.

Revised Stress Testing. We do not support a dramatic overhaul of the current stress testing requirements. The SEC should consider the limitations of stress testing and of fund directors' capacity to review and interpret stress tests when reforming these provisions.

Amendments to Form PF Reporting Requirements. We believe that requiring large liquidity fund advisers to file virtually the same information with respect to their private liquidity funds' portfolios holdings on Form PF as money market funds are required to file on Form N-MFP would be more useful to regulators if advisers were required to file the form monthly rather than quarterly. Monthly filings would allow regulators more accurately to compare the information on Form PF with the monthly Form N-MFP filings that money market funds are required to file.

Jane G. Heinrichs
Senior Associate Counsel

Attachment

endnotes

*See Money Market Fund Reform; Amendments to Form PF, SEC Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013) ("Release"), available at http://www.sec.gov/rules/proposed/2013/33-9408.pdf.
