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January 11, 2011

ICI Files Comment Letter on PWG's Money Market Fund Reform Options

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TO: INVESTMENT COMPANY DIRECTORS No. 2-11
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 1-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 1-11
SEC RULES MEMBERS No. 3-11 RE: ICI FILES COMMENT LETTER ON PWG'S MONEY MARKET FUND REFORM OPTIONS

The Investment Company Institute has filed a comment letter with the Securities and Exchange Commission expressing our views on the October 2010 Report of the President's Working Group on Financial Markets ("PWG") on Money Market Fund Reform Options ("Report"). [1] The Report does not make specific reform recommendations. Rather, the PWG requests that the newly-established Financial Stability Oversight Council consider the options presented in the Report and identify and pursue those "most likely to materially reduce MMFs' susceptibility to runs." The Report also indicated that the SEC, as the regulator of money market funds, would seek comment on the Report. [2]

The SEC requested comments on the options described in the Report both individually and in combination. These include: (1) floating NAVs for money market funds; (2) a private emergency liquidity facility for money market funds; (3) mandatory redemptions in kind; (4) insurance for money market funds; (5) a two-tier system of money market funds, with enhanced protection for stable NAV money market funds; (6) a two-tier system of money market funds, with stable NAV money market funds reserved for retail investors; and (7) regulating stable NAV money market funds as special purpose banks. The Report also discusses the possibility of imposing enhanced constraints on less regulated money market fund substitutes to address concerns that new requirements for money market funds will reduce their appeal to many investors.

Summary of Comments

ICI's letter begins with an overview of the U.S. money market to provide context. Next, we describe the regulation of money market funds, including the SEC's recent reforms. We then examine each of the reform options outlined in the Report. The letter explains that three principles have guided our analysis of possible additional money market fund reform measures. First, given the tremendous benefits money market funds provide to investors and the economy, it is imperative to preserve this product's essential characteristics. Second, in devising a solution, we need to stay focused on the objective policymakers are seeking to achieve: to strengthen money market funds even further against adverse market conditions and enable them to meet extraordinarily high levels of redemption requests. Finally, any solution must be designed to promote this important policy goal while minimizing the potential for unintended negative consequences.

The letter states that our examination of the reform options outlined in the Report and other reform ideas has led us to the same conclusion the PWG apparently reached: namely, that there is no "silver bullet" for safeguarding money market funds against the severest market distress. Each option has its drawbacks, ranging from potential detrimental impacts on money market funds, their investors, and the market, to complicated regulatory, structural, and operational hurdles. Nevertheless, the letter states our belief that the option of a private emergency liquidity facility for prime money market funds has the most promise for addressing policymakers' remaining concerns with the least negative impact.

The letter explains that the other options presented would not solve the problem at hand, could increase rather than decrease systemic risk, would adversely impact the market, or would result in some combination of the foregoing. In many cases, transitioning to a new approach in and of itself would have systemic risk implications. The letter also proposes one additional measure: a rule mandating that intermediaries provide information to facilitate money market funds' ability to comply with "know your investor" requirements.

A summary of our comments on a private emergency liquidity facility and other possible money market fund reform measures follows.

Private Emergency Liquidity Facility for Money Market Funds. Over the past year and a half, ICI has worked to develop a model for an emergency liquidity facility for prime money market funds. Our proposed liquidity exchange facility ("LF") is an industry-sponsored solution intended to serve as a liquidity backstop for prime money market funds during times of unusual market stress. It would be formed as a state-chartered bank or trust company and capitalized through a combination of initial contributions from prime fund sponsors and ongoing commitment fees from member funds. The LF would gain additional capacity from the issuance of time deposits to third parties as well as access to the Federal Reserve discount window in the normal course. All prime money market funds would be required to participate in the LF.

During times of unusual market stress, the LF would buy high-quality, short-term securities from prime money market funds at amortized cost. In so doing, the LF would (1) enable funds to meet redemptions while maintaining a stable $1.00 NAV—even when markets are frozen—and (2) help protect the broader money market by allowing funds to avoid the need to sell portfolio instruments into a challenging market. Also, the very existence of such a liquidity backstop could provide reassurance to investors and thereby limit the risk that liquidity concerns in a single fund might spur increased redemptions in all prime money market funds.

Importantly, the LF is not intended to provide credit support; rather, it is intended to meet liquidity needs brought on by market stresses through the acquisition of high-quality instruments. Further, the LF would provide a liquidity backstop only after a substantial portion of a fund's legally mandated liquidity positions are utilized.

As detailed in the letter, our LF model addresses many of the policy concerns the Report identifies with respect to a private emergency liquidity facility. While some hurdles remain, such as the cost of participation and the need for regulatory action to implement our design, we believe that the prime money market fund industry generally could support the LF as the best option for further reform so long as: (1) prime money market funds participating in the LF would be permitted to use amortized cost and continue to seek to maintain a stable NAV; (2) the cost of participation is reasonable given the current yield environment; and (3) the LF is a factor when regulators consider bank liquidity and capital requirements for banks that sponsor money market funds.

Requiring Money Market Funds to "Float" Their NAVs. As we, our members, issuers, and investors have stated many times, there is strong opposition to requiring money market funds to float their NAVs. We are highly skeptical that such a requirement would reduce risks in any meaningful way. There is compelling evidence that a substantial portion of money market fund investors either would be unable or unwilling to use a floating NAV money market fund. As a result, the primary effect of requiring money market funds to float their NAVs would be a major restructuring and reordering of intermediation in the short-term credit markets, which would not reduce—and might well increase—systemic risk.

Mandatory Redemptions in Kind. We do not believe that requiring money market funds to make certain large redemptions "in kind" would be an effective solution for the issue at hand. Investors would be likely to work around the requirement such as by allocating investments among multiple funds in amounts below the anticipated redemption threshold. Developing regulatory standards that would establish appropriate circumstances and threshold levels would present significant challenges. Even if this could be established, we are concerned that an in-kind redemption requirement, if triggered, could exacerbate market dislocations. A redeeming shareholder needing liquidity would be forced to sell into a declining market, adversely impacting not only the redeeming shareholder and the redeeming fund (and its remaining shareholders), but also all other money market funds holding the same portfolio instruments. Difficult operational hurdles also cause us to question the practicality of this approach. We believe that funds' current authority to redeem shares in kind voluntarily appropriately enables them to assess the advisability of redemptions in kind under the circumstances facing the fund and the market at the time. We recommend that the SEC provide additional guidance about the use of this voluntary authority so that money market funds might use this tool to greater effect in the event of another market crisis.

Insurance Programs for Money Market Funds. Having reexamined the possibility of developing some form of money market fund insurance—whether federal, private, or a hybrid of the two—we continue to conclude that this is not a viable option. To be effective in the kind of environment the global financial system experienced in 2008, any insurance program would need to cover all prime money market fund assets. An insurance program of that breadth would cause disintermediation from banks, resulting in negative consequences for the financial markets as a whole and the banking sector in particular. Such a program would need to have some kind of federal backstop as well as some access to the discount window to be effective or credible. Moreover, pooling of credit risk across money market fund providers raises moral hazard concerns.

Two-Tier System with Enhanced Protections for Stable NAV Money Market Funds. The Report suggests the possibility of having two types of money market funds—stable NAV money market funds subject to "enhanced" regulatory protections and floating NAV funds perhaps operating under less stringent restrictions than currently apply. More details about the precise nature of the “enhanced protections” would be necessary before ICI could determine whether to support or reject this approach.

Two-Tier System with Stable NAV Money Market Funds Reserved for Retail Investors. Under this option, stable NAV funds would be made available only to “retail” investors, while “institutional” investors would be restricted to floating NAV funds or alternative products. We believe that—as the Report acknowledges—the inability or unwillingness of many institutional investors to switch to floating NAV money market funds means that this approach could have the same unintended consequences as a requirement that all money market funds adopt floating NAVs. Many of these investors likely would seek to move their assets into less regulated money market fund alternatives. Moreover, we strongly question the feasibility of categorizing “retail” and “institutional” investors for this purpose in a way that makes sense and can be enforced effectively.

Regulating Stable NAV Money Market Funds as Special Purpose Banks. The Report raises the possibility of requiring bank-like regulation of stable NAV money market funds. There is no persuasive case for doing so; indeed, each of several possible motivations for such an approach is problematic. For example, judging from the proliferation of banking crises around the world over the past two decades, it is far from apparent that the bank regulatory and structural model is superior to that of mutual funds, including money market funds in particular. In addition, if the motivation behind this idea is to give money market fund investors deposit insurance protection, such insurance would have to be unlimited to protect against rapid redemptions in severely distressed market conditions. Unlimited deposit insurance could skew the competitive landscape away from bank deposits toward money market funds, possibly resulting in vast flows from one financial sector to another, which raises systemic risk concerns. If the objective is to require capital as a buffer against investment risk, it is unclear whether the business model for money market funds would remain viable. If the idea is to give money market funds a back-up source of liquidity during periods of financial stress, ICI’s view is that our proposed LF is a better and far less disruptive option.

Enhanced Constraints on Money Market Fund Substitutes. The Report discusses the possibility of imposing enhanced constraints on alternative investments to money market funds. These constraints would be intended to address concerns that new regulatory measures that reduce the appeal of money market funds might cause some investors to move their assets into less regulated products, thereby increasing systemic risk. Given the wide variety of alternative cash management products, many of which are beyond the jurisdictional reach of domestic regulators, we do not believe such an approach would be successful in achieving its goal.

Additional Reform for Consideration—Investor Transparency. In addition to a private emergency liquidity facility for prime money market funds, the fund industry has continued to explore other ideas for reform of money market funds and the overall money market. One such idea that we support is consideration of a new SEC rule mandating that intermediaries (e.g., broker-dealers) disclose to money market funds information about underlying investors in the funds to facilitate compliance with “know your investor” requirements. Greater transparency around investors owning shares in money market funds through intermediaries would mitigate risk by improving the funds’ ability to manage liquidity needs.

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Attachment

endnotes

[1] The Report is available at http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

[2]. See SEC Release No. IC-29497 (November 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf.
