Top of the Ninth? The State of Play for Money Market Funds

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Thank you very much, Peter [Crane], for that kind introduction. It’s a pleasure to be joining you and so many distinguished colleagues today.

You know, we have been working on money market fund issues so long and so intently that they seem to have become the national pastime.

Just as in a baseball game, we’ve had long stretches of inactivity punctuated by furious bursts of action. And just as baseball isn’t played against a clock, this game has lasted a lot longer than anyone might have expected.

We’re gathered in a city with a rich baseball heritage. To name just a few of Baltimore’s greats, there’s Cal Ripken, Jr., Brooks Robinson, Frank Robinson—even Babe Ruth. That’s right: Ruth may be known as the Bronx Bomber, but he was born here in Baltimore in 1895 and made his debut as a professional ballplayer with the Baltimore Orioles 19 years later.

Baseball is also a fitting theme as I follow up on a regulatory update that I gave to this very symposium back in 2010.

At the time, I suggested that we were in the “seventh-inning stretch” for money market funds. The ballgame was well advanced, and a few innings lay ahead.

Sometimes those late innings bring surprises.

Lots of surprises.

Three years later, it seems to me that we might have progressed to the top of the ninth. The end is in sight. But as Yogi Berra said, “It ain’t over till it’s over.”

This is an audience that has tracked every pitch and followed all the color commentary. So today, I want to offer my own perspective on the state of play, particularly on three topics:

- First, the importance of playing the game on the right field, with the right rulebook. You can’t play baseball on a hockey rink or by the rules of golf. So, too, money market funds are not banks, nor should they be regulated as such. The fact that this issue is now back before the Securities and Exchange Commission (SEC) is vitally important to investors as well as to funds.
- Second, the wind-up and the pitch: ICI’s views on the proposal for further regulation that the SEC voted to release for comment on June 5.
- And, lastly, the puzzling developments in that other league: regulatory developments overseas regarding money market funds.

Let me start with a brief recap of the game so far.

From the start, ICI and the fund industry have consistently supported measures designed to make money market funds more resilient, subject to two conditions.

First, we must preserve the key features of money market funds that make them so valuable for investors and issuers.

Second, we must preserve choice for investors by ensuring a robust and competitive global money market fund industry.

The 2010 amendments to Rule 2a-7 met those conditions—they made money market funds stronger without damaging their core features or undermining competition.

Those reforms have produced extraordinary results, which were tested and proven in 2011, when Europe's sovereign debt crisis and the federal debt-ceiling crisis rattled the markets. Prime money market funds faced heavy redemptions—but those redemptions never threatened their stable value. Indeed, among prime funds with greatest exposure to European financial institutions, the average mark-to-market price fell by a mere nine-tenths of a basis point.

So money market funds are plainly much stronger products than they were in 2008.

Unfortunately, this evidence was largely dismissed last summer, when the SEC was working on proposals championed by then-Chairman Mary Schapiro.

As members of the Commission themselves noted, those 2012 proposals were drafted without a proper economic study on the impact of the 2010 reforms.

Instead, as Commissioner Gallagher said, the 2012 proposal was prepared "without the input of the Commissioners and presented to the Commission as an inviolate fait accompli."

We all know what happened: A bipartisan majority of the Commission opposed Chairman Schapiro's plan, and she in turn invited the Financial Stability Oversight Council, or FSOC, to intervene in the issue. Or, to quote Commissioner Gallagher again, the SEC "abdicate[d] responsibility for money market fund regulation to the Financial Stability Oversight Council."

That rush to judgment clearly was a mistake—for the SEC as an institution and indeed for all concerned. The flawed ideas for capital buffers and redemption holdbacks that the Council put forward clearly reflected FSOC's domination by banking regulators—with their decades-old antipathy toward money market funds, indifference to the interests of investors, and faith in bank regulatory concepts.

Fortunately, the regulatory process took a distinct and encouraging turn for the better last autumn, thanks to the persistent efforts of the SEC. The game is back on the field where it belongs.

Last November, the agency's Division of Risk, Strategy, and Financial Innovation[1] released an economic study that offered the first official examination of the experience of money market funds in 2008 and the effectiveness of the SEC's 2010 reforms. The Commissioners who insisted on this study recognized that no one—not the President's Working Group, not FSOC, and not even the SEC under its former leadership—had attempted such an objective, rigorous analysis.

Then-Chairman Elisse Walter launched a collaborative process to bring forward a new proposal, considering the views of all the commissioners as well as the economic analysis that the staff and others have offered.

And in first her two months on the job, SEC Chair Mary Jo White has engaged deeply on this issue. Crucially, she has made it clear that she grasps the vital role that money market funds play in our financial system.

Indeed, the SEC should be strongly commended for pursuing an appropriate and thoughtful process before bringing the current proposal to a vote.

The Commission has unique expertise—expertise in depth, developed over eight decades of overseeing the U.S. securities markets.

The SEC recognizes the crucial role that money market funds play for individuals, businesses, state and local governments, and nonprofits.

As the Commission's release states, these funds are not just "popular cash management vehicles for both retail and institutional investors," but also provide "an important source of financing" for the economy.

And significantly, the SEC has recognized that different types of money market funds pose different risks and thus should be addressed by different reforms—a point I'll return to later.

Against this backdrop, it seems clear that the FSOC would have no basis for intervening in this regulatory process again.

Fortunately, we've heard recently from regulators in Washington who recognize and support the SEC's role as the industry's primary regulator.

For instance, Mary John Miller, the U.S. Treasury Department's Under Secretary for Domestic Finance, recently appeared at ICI's General Membership Meeting.

Under Secretary Miller, who coordinates Treasury's capital markets policy, said that the FSOC would "gladly" defer to the SEC as the Commission proceeds with another round of reforms.

We think that deference to the SEC is the appropriate and correct approach. That doesn't mean we love everything in the SEC's proposal— because we do not. But we respect the integrity of the process that Chairs Walter and White have pursued.

So let's turn now to substance—the content and quality of the ideas the Commission has brought forward.

As you all know, the 698-page proposal has three central components that can either stand alone or be combined.

Reform option number one: requiring Institutional prime and tax-exempt funds to adopt floating net asset values.

This proposal exempts funds that invest principally in Treasury and government agency securities, reflecting the SEC's recognition that different types of funds pose different risks.

It also attempts to exempt "retail" funds, which the SEC identifies as those that would bar shareholders from redeeming more than $1 million per business day.

Reform option number two would allow all money market funds to offer a stable NAV, coupled with the new ability to impose liquidity fees and redemption gates when a fund's liquidity is constrained. Government funds would not be required to offer fees and gates, although they could opt in.

Under this alternative, if a money market fund's level of weekly liquid assets dipped below 15 percent of its total assets, the fund would impose a liquidity fee of up to 2 percent on all redemptions, unless its board determines the fee is not in the fund's best interests.

As for gates, the proposal sets forth that once a money market fund crosses the 15 percent threshold, its board of directors may temporarily suspend redemptions altogether.

The third core component of the proposal provides a set of enhanced standards on disclosure, reporting, and diversification.

Those are the broad outlines. Please understand that we have had just two weeks to study the 698 pages of detail fleshing out the proposal. There is a lot to chew over. With that in mind, what do we make of it so far?

Let's work backwards, starting with the third component that I mentioned: enhanced disclosure and diversification.

We're still examining the particulars, but we see potential for positive changes. Some of these items bring the rules up to speed with practices already taking place in the industry. For example, many fund complexes are already disclosing their funds' mark-to-market value on a daily basis.

We need more time, however, to assess the costs of providing the other disclosures, and how the information would affect investors.

Next, alternative two: liquidity fees and redemption gates.

To us, this is the best alternative. Liquidity fees and gates precisely address the core problem that regulators express greatest concern about: heavy redemption pressure in periods of market turmoil.

A liquidity-based trigger introduces immediate redemption frictions and exacts a substantial cost for liquidity when liquidity in a particular fund is at a premium.

Liquidity fees, if deemed appropriate by a fund's board, still allow investors access to their cash. But the fees compensate both the fund and its remaining shareholders for the potential cost to the fund of withdrawing liquidity. Thus, the fees both help slow redemptions and protect investors when they most need that protection.

As for temporary gates, they provide breathing room for a fund under intense pressure. They give the fund's board time to assess whether it can restore liquidity or should move to an orderly liquidation. Fees and gates also can relieve other funds and the markets if they too are facing tight liquidity pressures.

A number of European funds—and a few U.S. funds—were able to suspend redemptions during the financial crisis in 2008, and thus successfully protected their investors.

Some critics claim that liquidity fees and gates will induce "preemptive runs"—that investors will flee a fund when its weekly liquidity is approaching the trigger. We don't buy that.

As Commissioner Paredes pointed out, under the SEC's proposal, fees and gates are imposed at the discretion of the board—so investors "may find it difficult to redeem preemptively with any confidence that their timing is correct."

It's also important to note that these gates and fees are triggered on a fund-by-fund basis. So even if investors redeem preemptively at one fund, any systemic effect—in other words, spillover to other funds—is unlikely.

And the mere presence of a liquidity trigger will encourage portfolio managers to operate their funds even more conservatively—particularly when coupled with enhanced disclosure that would allow investors and regulators to frequently monitor funds' mark-to-market prices and liquidity.

Finally, I'll mention what is perhaps the foremost advantage to liquidity fees and redemption gates: the approach would in no way limit investors' access to their shares when their fund has adequate liquidity. That clearly distinguishes it from the FSOC's proposed minimum balance at risk suggestion, which would penalize investors and impose heavy costs on funds and intermediaries even when liquidity is plentiful.

Thus, gates and fees would not radically change the characteristics of money market funds—or their value to investors and the economy.

That brings me at last to the SEC's alternative number one: forcing institutional prime and tax-exempt funds to float their share prices.

This option is a nonstarter, in our view.

Yes, our opposition to floating NAVs remains as firm as ever. And this opposition springs in large part from the same notion that—on the flip side—makes liquidity fees and gates a more compelling alternative. Simply put, forcing funds to float their NAVs doesn't address the problem that most preoccupies many regulators—how to avert heavy redemptions out of money market funds.

As Commissioner Paredes quite succinctly said: "If a run does start, a floating NAV is unable to stop it."

Regulators also argue that floating NAVs will make investors more aware that the assets held by money market funds may fluctuate in value. The trouble with that argument is that there's no evidence that investors are operating under any illusions on that score now. And if they are, enhanced disclosure can educate them just as well—without destroying the value of money market funds for shareholders or the markets.

Failing to address the central problem that regulators want to solve—that would seem to be one big strike against floating NAVs. Here's strike two: Floating NAVs will eliminate important benefits to investors.

A stable $1.00 transaction price provides shareholders convenience and simplicity in terms of taxes, recordkeeping, and accounting. And, with this simplicity, fund investors obtain unmatched diversification in a money market fund that otherwise would be very difficult to access.

We're still studying the proposal to see whether the SEC's approach to accounting issues will satisfy investors and their accountants—and what the IRS or Congress must do to address the wash sale rule and the huge burden of tracking and taxing minuscule changes in net asset values. So far, we have seen little that is encouraging. But a proposal that forces funds to transact at floating values without first resolving tax and accounting questions will severely undermine the value that investors seek when they use those funds for cash management. We should be under no illusions—those issues are thorny and may well take years to resolve.

Strike three against floating NAVs: Ultimately, they will harm the economy. No one denies that the imposition of floating NAVs will be costly and burdensome—for funds, for intermediaries, and for shareholders. As investors exit money market funds, one implication is that cash could flow to traditional banks—where capital and regulatory requirements will make it difficult for banks to lend those funds. Thus, corporate America could see a significant reduction in the supply of short-term credit.

Even if banks could raise the capital to accommodate these changes, the lending market would be less efficient, and the cost of short-term credit will rise.

State and local governments will also feel the pain. Few have realized that the SEC proposal would require floating NAVs for tax-exempt money market funds used by institutional investors. As you know, these muni funds hold almost three-fourths of the short-term debt issued by cities and states. If floating NAVs push investors out of tax-exempt money market funds, the pool of capital that state and local governments use for financing vital needs will shrink or dry up.

Three strikes and you're out, right? But we have still more concerns about floating NAVs.

Floating NAVs stand to increase—not decrease—risks to the financial system. Institutions that want or require stable value funds for their cash balances may turn to private pools—operated in the United States or overseas—that promise to maintain a fixed price.

Commissioner Aguilar has been rightly concerned throughout this debate that cash will flow to less-regulated, less-transparent vehicles.

Now, in its proposal the SEC acknowledges this possibility and tries to address it by increasing reporting by private funds. But we still must ask—as we have been asking for five years—why regulators seeking to reduce systemic risk would bring forward a proposal that pushes investors into less-regulated funds.

Finally, we can't ignore the operational complications.

I'm happy to note that in recent months we have seen greater sensitivity among the SEC staff to the operational challenges and costs that funds, intermediaries, and investors face.

The operational challenges of floating NAVs remain stark, however, even with the SEC's fine-tuning of the proposal. Complex and unavoidable system changes would pose significant cost and feasibility challenges for funds and intermediaries offering money market funds, including broker-dealers, banks, retirement plan administrators, and portals.

Facing these challenges, intermediaries are likely to decide not to offer money market funds—to the detriment of retirement savers and others.

So let's check the count against floating NAVs.

They don't address regulators' goals.

They eliminate key benefits to investors.

They harm the economy.

They increase systemic risk.

And they carry immense costs and operational complications.

All that for a goal—greater transparency to investors—that can be achieved at far less cost through enhanced disclosure.

Given all these negatives, it's not hard to see why opposition to floating NAVs runs wide and deep.

Since 2009, hundreds of entities from the private and public sectors across the economy have expressed their opposition to floating NAVs and other ill-considered proposals.

Just today, we've heard again from one of those groups: the Association for Financial Professionals (AFP).

In its annual survey of corporate treasurers and CFOs, AFP found that up to 65 percent of the responding organizations said they would be less willing to invest in money market funds, or would reduce their current holdings, if those funds were required to float their value. Jeff Glenzer from AFP will discuss those findings here shortly.

Views such as these have resonated on Capitol Hill. More than 100 members of the House and Senate, hailing from across the country and from across the political spectrum, have expressed their concerns that bad policy choices could destroy the value of money market funds for their constituents.

We expect many of these groups to weigh in again during the next three months, and we expect Congress will also continue to take a keen interest.

Despite the many policy arguments and this massive public opposition, we recognize that regulators may decide to forge ahead with floating NAVs. Or perhaps—in the very worst case—to force funds to float and to have liquidity fees and gates.

In that case, it would seem incumbent upon the SEC to minimize the adverse impact of floating NAVs to the fullest extent possible.

We've seen some tailoring along these lines already, in the SEC's proposal to exempt Treasury and government funds from the floating NAV requirement. This is sensible, in our view, as there is no evidence that Treasury or government money market funds were subject to rapid redemptions or other pressures during the financial crisis. In fact, government funds received considerable inflows during the crisis.

Curiously, the SEC proposal does not allow an exception for tax-exempt funds. This, in our view, is a mistake. While they might not have been a refuge during the financial crisis, tax-exempt funds did not suffer heavy outflows. And their liquidity provides a strong shield against redemption pressure. As of December 2012, tax-exempt funds had $288 billion in weekly liquidity, amounting to 77 percent of their total assets.

The SEC also proposes to allow funds that serve retail investors to continue to operate with a stable value. We haven't yet wrapped our minds around the SEC's definition of "retail" and its implications for funds and their investors. But we welcome the Commission's recognition that its proposals should be carefully targeted.

We will address these points and many others in our comment letter, which we look forward to filing in September.

When that comment period closes, the SEC will work to craft its final rule. In baseball terms, the Commission always has the last chances at the plate—at least in the United States.

This game, however, is being played in other venues as well. In particular, the European Commission is considering a sweeping reform package that appears to promise far more harm than even the worst elements of the SEC's proposal.

I know Pete Crane is holding a conference on this topic in Dublin in September. But I think the EC activity is worth discussing briefly today, given the global product mix of firms represented in this audience.

At the moment, everyone is working off a leaked draft of proposed European Commission legislation.

This legislation targets all of Europe's money market funds: variable net asset value, or VNAV, and constant net asset value, or CNAV.

One concern we have with this legislation regards process. Yes, arguably, some consultation with stakeholders has taken place—a conference and paper last year on shadow banking and a UCITS consultation document.

None of that, however, foretold the substantial and dramatic changes that the European Commission appears to contemplate for both CNAV and VNAV money market funds in Europe.

We have very little insight or explanation as to how certain ideas found their way into the draft—or what rationale underpins them. A comment period would provide interested stakeholders a chance to further the public dialogue with policymakers on this very important and complex issue.

We continue to have very strong concerns over what may be ultimately released.

One problem is the presence of capital requirements in the draft. As proposed, CNAV funds would have to keep a 3 percent capital buffer in place and in operation at all times—3 percent of assets held solely in cash in a bank reserve account.

In essence, such a buffer would spell the end of CNAV funds in Europe. As the SEC concluded after years of consideration, the cost and complexity of this buffer would simply compel sponsors and investors to take their business elsewhere.

Another concern is the draft's set of proposed requirements around repurchase agreements. One of those requirements, for example, stipulates that the underlying collateral in any repo transaction can only be collateral that the fund itself could hold directly. That means, for example, that collateral must mature in 397 days or less.

We estimate that this requirement would put the vast majority of repo collateral now held by European money market funds off limits. The result: funds would be forced into unsecured investments, because holding repo would be unworkable.

The repo rules also would make it very hard for funds to meet the proposed new liquidity requirements. That's a terrible result for investors and for the Continent's financial markets.

I could go on about Europe … I could go on about the United States. But I think it's time I yield the podium to others on Peter's distinguished list of speakers.

Permit me, however, one parting thought.

The comment period is now open on the SEC proposals—and it presents all of you with the opportunity to express your views. I hope every organization represented here will help round out the record at the SEC with your expertise and your views on the proper course for further money market fund regulation.

As I said at the outset, one of ICI's overarching goals has been to preserve the core features of money market funds that make them so valuable to investors and issuers.

ICI will continue to speak out against ill-considered regulatory changes, bringing to bear our data, our analysis, and our industry's expertise.

But this is not a fight for the fund industry alone. Money market funds are used by more than 60 million individual Americans. These funds are vital for businesses, nonprofits, and governments across the country—both for cash management and as a crucial source of short-term financing. They are critical to our economy.

Yours are the voices of that economy—and those voices must be heard in Washington. Now that we are in the final inning, I hope you will raise your voice too.

Thank you.

Endnotes

[1] The Division has since been renamed the Division of Economic and Risk Analysis.
