COALITION
FOR INVESTOR CHOICE INC.

Preserving Money Market Funds for Public Infrastructure Investment and Economic Growth

Money Market Funds and S. 1802, The Consumer Financial Choice and Capital Markets Protection Act

On May 19, 2016, the Senate Banking Subcommittee on Securities, Insurance and Investment will hear testimony on S. 1802 as part of a hearing on the topic of improving communities and businesses access to capital and economic development. This document provides background information on the legislation and its impact on the operation of money market funds, investors in the funds, and issuers and borrowers of debt held by the funds.

I. SUMMARY OF S. 1802

S. 1802 was introduced on July 16, 2015 by Senators Patrick Toomey (R-PA), Robert Menendez (D-NJ), Michael Crapo (R-ID) and Joe Manchin (D-WV). It was referred to the Committee on Banking, Housing and Urban Affairs. A companion bill, H.R. 4216, was introduced in the House on December 10, 2015 by Representatives Gwen Moore (D-WI) and Steve Stivers (R-OH). It was referred to the Committee on Financial Services.

S. 1802 amends the Investment Company Act (ICA) of 1940 to expressly provide any open-end investment company with the choice to operate as a stable net asset value (NAV) money market fund if it adheres to certain requirements and restrictions. The bill would not have any impact on the other changes to the regulation of money market funds that were adopted by the Securities and Exchange Commission (SEC) in 2010 and 2014. The bill also prohibits Federal Assistance to any money market fund.

Specifically, S. 1802 allows any open-end investment fund, including a fund which accepts investors that are not "natural persons" (referred to as an "Institutional Fund"), to operate as a money market fund that computes its price per share under the stable NAV approach historically contained in SEC Rule 2a-7 without regard to the identity of its investors, provided that it meets the following requirements:

a. The Fund's investment objective must be the generation of income and preservation of capital through investment in short-term, high-quality debt securities;

b. The Fund's board of directors must determine, in good faith, that it is in the best interests of the fund and its shareholders to operate on a stable NAV basis, and the money market fund may continue to operate on that basis only as long as the board of directors believes it fairly reflects the fund's market-based NAV; and

c. The Fund must comply with quality, maturity, diversification, and liquidity requirements, including reasonable procedural and recordkeeping requirements and provisions relating to liquidity fees and restrictions on redemptions that are required under Rule 2a-7, or any other rules or regulations that the Commission may prescribe or has prescribed as necessary or appropriate in the public interest or for the protection of investors.

The bill prohibits “Federal Assistance” from being provided directly to any money market fund, regardless of whether it operates as a Stable Value Fund or a Floating NAV Fund.[1] To underscore that money market funds and their investors understand that money market funds will not be eligible to receive Federal Assistance under any circumstances, money market funds would be required to disclose this prohibition in any prospectus, advertising, or sales literature.

S. 1802 provides the SEC with the authority to adopt rules and issue orders, prescribing the manner in which such disclosure shall be provided, after consulting with the Board of Governors of the Federal Reserve System, the FDIC, and the Department of the Treasury.

Finally, the bill specifically provides that any company that elects to be a money market fund or that is otherwise a money market fund under the rules and regulations of the SEC will remain subject to all the provisions of the ICA that would otherwise apply to a registered open-end investment company that do not conflict with the Act.

II. BACKGROUND ON MONEY MARKET FUND REGULATION

Congress broadly addressed the regulation of the mutual fund industry in the ICA more than 70 years ago to, among other things, define open-end investment companies, establish federal regulation of them and require their registration with the Commission. The ICA has never expressly addressed the category of mutual funds known as “money market funds.”

Since the 1970’s, money market funds have grown to become a popular consumer and institutional investment vehicle. Since their inception, they have been permitted by SEC rule to maintain a stable NAV (typically of $1.00 per share), rather than calculating the daily NAV based on the value of the fund’s underlying portfolio securities. In 1983, the SEC adopted Rule 2a-7 under the ICA to codify the conditions under which an investment company would be permitted to operate as a money market fund.[2]

Private and public sector institutions are the largest users of money market funds, which provide a practical way for these investors to both diversify risk and increase investment earnings. The cash held in the accounts is used to fund payroll accounts, tax payments, and payments to suppliers and vendors. With their unique mix of stable $1 share price, risk diversification, same-day liquidity, and a market yield, money market funds are an effective vehicle for holding these critical operating cash balances.

In turn, money market funds hold more than one-third of the commercial paper that businesses issue to finance payrolls and inventories. State and local governments rely on tax-exempt money market funds as a significant source of funding for public infrastructure projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing.

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[1] “Federal Assistance” means Federal Deposit Insurance Corporation (“FDIC”) insurance or guarantees; transactions involving the Secretary of the Treasury; or the use of any advances from Federal Reserve credit facilities that are not part of a program of broad-based eligibility established in unusual or exigent circumstances – for the purpose of (i) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any money market fund, (ii) guaranteeing any loan or debt issuance of any money market fund, or (iii) entering into any assistance arrangement, loss sharing or profit sharing with any money market fund.

[2] https://www.sec.gov/rules/final/1983/ic-13380.pdf

A. Basis for Using Amortized Cost Accounting

Money market funds historically have priced their shares at $1, a practice that facilitates their widespread use by corporate treasurers, municipalities, individuals, and many others who seek the convenience of low-risk, highly liquid investments. This share pricing convention, which uses amortized cost to produce a stable net asset value (NAV), is preferable to mark-to-market pricing, which produces a floating NAV, because amortized cost provides a more efficient and accurate means to value portfolio assets held by funds that operate as cash pools.

Until implementation of the SEC's floating NAV amendment on October 14, 2016, money market funds are permitted to use amortized cost to maintain a stable NAV "only so long as the board of directors believes that it fairly reflects the market-based net asset value per share." Funds must estimate and make public their market-based NAV per share (known as its "shadow price") each week and the Board is required to monitor the deviation between the shadow price and $1 at each regular meeting.

Money market portfolio assets are typically held to maturity and trade very infrequently. In addition, the maturity, credit quality, and liquidity restrictions in Rule 2a-7 ensure that any deviation between market value and amortized cost generally is immaterial. Rather than improve the quality or accuracy of the valuations of the individual portfolio assets, the pool as a whole, or the pricing of units of the pool, critics of the floating NAV rule argue it will complicate and slow down the process for establishing unit values, thereby delaying settlement of fund unit purchases and redemptions.

The widespread use of money market funds by large and small institutional investors would not have been possible without a stable $1 per share value characteristic. The ability of funds to offer their shares at a stable NAV using the amortized cost method of valuation provides significantly administrative and accounting cost benefits for both fund companies and short-term cash management investors.

B. 2010 and 2014 Amendments

In 2010, in response to the financial crisis and the weaknesses revealed by the Reserve Primary Fund's "breaking the buck" in September 2008, the SEC adopted a series of revisions to Rule 2a-7 in an effort to significantly strengthen the regulatory requirements governing money market funds and better protect investors.[3] Among other things, the 2010 Amendments require money market funds to have a minimum percentage of their assets in highly liquid securities so that those assets can be readily converted to cash to pay redeeming shareholders. They also shortened the average maturity limits to limit the exposure of funds to certain risks such as sudden interest rate movements. As a result, 30 percent or more of a money market fund's portfolio assets mature in a week or less, and their weighted average portfolio maturity is 60 days or less.

In July 2014, the Commission again amended Rule 2a-7.[4] Under the 2014 amendments, the board of directors of a money market fund is authorized to impose a liquidity fee and/or a redemption gate if the fund's weekly liquid assets fall below 30% of its total assets under certain conditions. In addition, if the level of a money market fund's liquid assets were to drop below 10% of its total assets, the fund (other than a fund that limits its investments to government securities) would be required to impose a 1% liquidity fee *unless* its board of directors determines that imposing a fee would not be in the best interests of the fund or that a lower or higher fee that would be appropriate. These provisions are referred to as the "2014 Fees and Gates Provisions."

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[3] https://www.sec.gov/news/press/2010/2010-14.htm

[4] https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679

The 2014 Amendments also provide that, following a two-year phase-in period, money market funds that are available to institutional investors would no longer be permitted to operate on a stable NAV basis, and would instead be required to use a floating NAV using market-based estimated values so that purchases and redemptions will be effected at prices rounded to the nearest 1/100th of one cent (or four decimal places). Money market funds that invest in U.S. government securities, or are available only to retail investors, are exempt from the floating NAV requirement.

Government money market funds will be defined as funds that invest 99.5% or more of total assets in cash, government securities and/or repurchase agreements that are collateralized solely by cash or government securities. Retail money market funds are defined as funds limiting beneficial owners to natural persons, which includes participant-directed accounts and omnibus accounts for the benefit of natural persons.

C. GASB and LGIPs

Many state governments operate Local Government Investment Pools (LGIPs), which are investment pools that invest in short-term securities and operate much like prime money market funds. They are required by law or investment policies to maintain a stable NAV per share. According to iMoneyNet, there are more than 110 LGIPs with more than $250 billion in assets serving the short-term investment needs of state and local agencies and other public entities in 45 of the 50 states.[5][6]

LGIPs are exempt from registration and regulation under Section 2(b) of the ICA. However, until recently, the Government Accounting Standards Board's (GASB) Statement No. 31 (Accounting and Financial Reporting for Certain Investments and for External Investment Pools) provided that LGIPs that are operated in a manner consistent with SEC Rule 2a-7 may use amortized cost to value securities.[7]

In December 2015, in response to the SEC's 2014 amendments, GASB issued Accounting Statement No. 79,[8] which effectively delinked LGIP financial reporting from Rule 2a-7, effective June 15, 2015. One basis for the new GASB statement is that the requirements outlined in the statement for average investment maturity, quality of portfolio assets, diversification of investments, and portfolio liquidity, which are similar to Rule 2a-7, are sufficient to justify the use of amortized cost as an approximation of fair value.

D. European Money Market Fund Regulations

In September 2013, the European Commission proposed for consideration by the Council of the European Union and the European Parliament a new regulatory framework for money market funds.[9] Among other things, the proposal called for requiring stable value money market funds to establish and maintain capital buffers of at least three percent of the total value of the assets in the fund. Such a requirement would have the effect of making stable value money market funds unviable because building a capital buffer that large would consume years of fund profits and investor yields.

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[5] http://www.imoneynet.com/products-services/special-reports.aspx
[6] States that currently do not have LGIPs are Alabama, Hawaii, Mississippi, North Dakota and Vermont.
[7] http://www.gasb.org/st/summary/gstsm31.html
[8] http://www.gasb.org/cs/ContentServer?c=Pronouncement_C&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage&cid=1176167863852
[9] http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-regulation_en.pdf

In April of 2015, after a year and a half of discussion and analysis, the European Parliament published its proposed regulation of money market funds.[10] The European Parliament's proposal eliminated any capital buffer requirements and instead authorized certain kinds of stable money market funds (both retail and institutional) for a period of five years after implementation.

Nearly a year later, in April 2016, the European Council, having reviewed both the European Commission and the European Parliament proposals, and having observed the market effects of money market reform in the U.S., made public the key details of the proposed European Council Compromise.[11] That compromise preserves the creation of certain stable and low volatility products and eliminates the five year sunset provision. Upon agreement between the European Council and European Parliament, expected later this year, the new European money market fund regulation would go into effect two-years after adoption and will preserve stable and low volatility options for all investors.

E. Bank Short-Term Investment Funds

Short-Term Investment Funds (STIFs) are collective investment funds used by banks to invest cash balances of state and local governments, trust accounts and pension plans. In October 2012, the Office of the Comptroller of the Currency (OCC) amended its Rule 9.18 governing STIFs to adopt variations on some portions of the Commission's Rule 2a-7.[12] The OCC's amended STIF rule continues to allow the use of amortized cost accounting to value portfolio assets, and rounding of unit prices to the nearest penny to allow STIFs to seek to maintain a stable NAV of $1 per unit. The OCC determined that there were good and sufficient reasons to continue to allow STIFs to value their assets using amortized cost accounting and round unit values to the nearest penny.

III. RATIONALE FOR S. 1802

Throughout the rulemaking process that culminated in the 2014 amendments to Rule 2a-7, organizations representing a broad cross-section of the public, non-profit and private sectors, as well as a number of Members of Congress, expressed opposition to various proposals to require money market funds to abandon stable value accounting and switch to a floating NAV.[13] Such a change, the groups noted, would negatively affect the ability of these entities to use money market funds as an efficient cash management tool. More importantly, it would also hamper the ability of main street businesses and state and local governments to attract investors for short-term debt issued to meet a variety of economic development needs.

Notwithstanding the significant concerns raised by businesses, non-profits and public sector entities, the SEC adopted an amendment to Rule 2a-7 that established a compliance date of October 14, 2016, for stable value institutional prime money market funds and stable value institutional tax exempt money market funds to be offered only with a "floating NAV."

Upon implementation of the amended Rule 2a-7, investors who are not "natural persons" (organizational entities) and who desire a stable NAV cash management vehicle will be limited primarily to bank deposits, money market funds that invest exclusively in U.S. government securities, and unregulated investment pools.

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[10] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2015-0170+0+DOC+PDF+V0//EN
[11] http://data.consilium.europa.eu/doc/document/ST-7828-2016-INIT/en/pdf
[12] http://www.occ.treas.gov/news-issuances/bulletins/2012/bulletin-2012-31.html
[13] https://www.sec.gov/comments/s7-03-13/s70313.shtml

a. Potential Impact on Public Infrastructure Investment

Money market funds hold nearly two-thirds of the short-term debt that finances state and local governments and other municipal entities. As of September 30, 2015, tax-exempt funds held about $245 billion of all short-term debt issuances from all 50 states and the District of Columbia. State and local governments and other tax-exempt issuers rely on the sale of these bonds to build and maintain schools, roads, public transportation systems and airports. Money market funds also provide financing for public safety infrastructure, water infrastructure projects, public utilities, health care facilities and affordable housing.

By making tax-exempt money market funds far less attractive to investors, there is concern that it will limit the availability of the funds to purchase municipal securities, and will cost municipalities an important source of financing in the short-term markets. A recent study by Treasury Strategies, a financial industry consulting firm, found that the new regulations are already having major negative consequences for issuers of debt held by tax-exempt money market funds.[14] According to the study, more than 40 percent of tax-exempt money market fund assets are directly at risk due to the floating NAV rule, and the indirect impacts are significantly higher because of the complexity of the rule's definition of non-natural persons.

The study notes that, in 2016 alone, 16 tax-exempt money market funds holding more than $14.5 billion in assets have closed or announced they will close, and the pace of closures is accelerating. This is resulting in higher debt issuance costs for state and local governments across the country, which could force the delay or cancellation of infrastructure and economic development projects. In March 2016, for example, tax-exempt money market fund yields increased significantly, from eight basis points to 33 basis points.[15]

b. Potential Impact on Business Investment

As of November 2015, prime money market funds held approximately $1.4 trillion of commercial paper that businesses issue to finance payrolls and inventories, and two-thirds of that were held by institutional prime funds.[16] According to a recent Bloomberg Business report, industry observers predict that investors are poised to pull as much as $400 billion from U.S. money market funds as a result of the 2014 amendments.[17] Much of that is being shifted to government funds. In fact, as of May 2, 2016, $242.1 billion of assets in prime money market funds had converted to government funds, and another $47.6 billion is scheduled to convert before October 14.[18]

Prime money market funds are a key source of short-term financing for businesses to purchase seasonal inventory, pay suppliers, and fund payroll and other expenses when cash outflows are greater than inflows. Commercial paper is preferable to secure bank loans for businesses that want or need the flexibility, efficiency, and low cost. Commercial paper can be issued in a matter of hours for maturities as short as 30 days, and its favorable interest rates over bank loans allow businesses to invest more in job creating activities. By shifting a significant amount of capital away from private sector businesses and to the federal government, the floating NAV rule is having the unintended consequence of driving up costs for businesses large and small.

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[14] http://treasurystrategies.com/sites/default/files/Preserving%20MMFs.pdf

[15] http://cranedata.com/archives/all-articles/6075/

[16] See "Weekly Money Market Funds Assets" at https://www.ici.org/research/stats

[17] See "The $400 Billion Money-Fund Exodus With Banks in Its Crosshairs," Bloomberg Business, Feb. 23, 2016.

[18] http://cranedata.com/archives/all-articles/6087/

IV. TIMELINE OF EVENTS IMPACTING MONEY MARKET FUNDS

1978: The money market fund is born when the SEC approves an exemptive order allowing such funds to use amortized cost methods of valuation.

February 1981: SEC codifies 1978 exemptive order as Rule 2a-7. For the next 38 years, money market funds provide a safe, market rate alternative to bank deposits as a place for governments, businesses and individuals to invest liquid, short-term cash.

June 1981: Federal Reserve Chairman Paul Volcker testifies at a congressional subcommittee that money market funds should be subject to bank-like regulations so they would be less attractive to investors.[19]

1994: Community Bankers U.S. Government Fund is the first MMF to "break the buck." Investors repaid 96 cents on the dollar.

June 2007: Difficulties in the subprime mortgage market began to spill over into the money and credit markets.

December 2007: Federal Reserve launches the Term Auction Facility, the first of over a dozen special liquidity programs.

March 2008: Bear Sterns falters, and is sold to J.P. Morgan Chase.

September 6, 2008: U.S. Government seizes Fannie Mae and Freddie Mac.

September 15, 2008: Lehman Brothers declares bankruptcy and Merrill Lynch was forced to sell itself to Bank of America

September 16, 2008: Reserve Primary Fund becomes only the second MMF in history to "break the buck," having been forced to mark its holdings of Lehman debt (1.2% of assets) to zero, but ultimately returning more than 99 cents per share to investors.

September 15-19, 2008: Investors redeem about $300 billion from prime money market funds throughout the week, much of which flowed to Treasury money market funds. Despite these difficulties, all money market funds other than the Reserve Primary Fund were able to maintain a stable $1.00 NAV.

September 19 2008: Treasury Dept. establishes guarantee program for money market funds, which is never used and earns the government $1.2 billion in premiums. Treasury also establishes Asset-Banked Commercial Paper MMF Liquidity Facility (AMLF) to promote short-term bank lending by allowing banks to purchase commercial paper from MMFs.

October 3, 2008: The Troubled Asset Relief Program (TARP) was created on October 3, 2008, which allows the government to invest $125 billion in preferred shares of nine banks.

February 2010: SEC adopted amendments to Rule 2a-7 requiring, among other things, that MMFs to hold at least 10% of its assets in cash and other securities that can be convertible into cash within one week, and 30% of assets in securities convertible into case within one week.

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[19] http://www.nytimes.com/1981/06/26/business/volcker-proposes-money-funds-be-subject-to-rules-on-reserves.html

July 2010: Congress enacts the Dodd-Frank Act, but not a single word of the law responding to the financial crisis either mandates or authorizes new rulemaking for MMFs.

November 2010: SEC begins soliciting comments on various options for further MMF reforms.

Summer 2011: MMFs effectively weather large scale redemptions related to the European debt crisis and concerns about the downgrading of U.S. debt as a result of the debt ceiling impasse.

April 9, 2012: Federal Reserve Chairman Ben Bernanke gives a speech in which he categorizes money market funds as part of the "shadow banking" system and calls for additional "macro-prudential" regulations on money market funds.[20]

August 2012: SEC Chair Schapiro announced that a majority of SEC commissioners opposes a proposal to require MMFs to float their NAV, or hold capital, or hold back a minimum balance from shareholder redemptions to serve as a first loss.

September 27, 2012: Treasury Secretary Geithner sends letter recommending the FSOC use its authority under Section 120 of the Dodd-Frank Act to recommend that either the SEC proceed with reforms or FSOC should begin to evaluate the MMF industry as a SIFI.

November 13, 2012: FSOC votes to recommend SEC regulatory action on MMFs.

February 20, 2013: Bipartisan group of former SEC officials, including four former chairmen and five former commissions, send letter to FSOC criticizing their process against MMFs and for not deferring to the full SEC. [21]

June 6, 2013: SEC votes to issue for public comment amendments to MMFs calling for, among other things, a floating NAV. Of 1,417 comments submitted on the topic, 1,397 express opposition or serious concerns.

September 2013: Office of Financial Research (OFR) issues report requested by FSOC to lay the foundation for consideration of various asset managers for SIFI designation.[22]

July 23, 2014: By a vote of 3-2, SEC adopts new money market fund rules, which include enhanced disclosures, diversification and stress testing requirements, authorities for redemption gates and liquidity fees, and requiring any non-government fund accepting investors who are not "natural persons" to have a floating NAV, which takes effect on October 14, 2016.

July 16, 2015: Senators Pat Toomey (R-PA), Joe Manchin (D-WV), Mike Crapo (R-ID) and Robert Menendez (D-NJ) introduce S. 1802, to provide institutional non-government MMFs with the option to maintain a stable NAV, notwithstanding amendments to Rule 2a-7 adopted by the SEC in July 2014.

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[20] https://www.federalreserve.gov/newsevents/speech/bernanke20120409a.htm
[21] http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/04/Former-SEC-staff.pdf
[22] https://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf