COALITION
FOR INVESTOR CHOICE INC.

Preserving Money Market Funds for Public Infrastructure Investment and Economic Growth

Responses to Questions about S. 1117/H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017

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Background:

S. 1117 and H.R. 2319 are bipartisan bills to reverse the unintended consequences of changes to Rule 2a-7 governing money market funds (MMFs), which were adopted by the SEC in 2014 for implementation in October 2016. Over $1.2 trillion of private, low-cost capital markets financing for community infrastructure, main street business, and economic growth and development has been lost, without any corresponding benefit to the stability, safety and soundness of our financial system.

The SEC rule stops MMFs that are available to "non-natural persons" such as corporate treasurers, public finance officers, and pension fund managers investing short-term cash from offering a stable one dollar share price or net asset value (NAV). These funds were forced to a "floating NAV". Funds that invest in U.S. government securities, or are available only to investors who are "natural persons," are exempt from the floating NAV requirement.

S. 1117 and H.R. 2319 restore the ability of all MMFs to use a stable share price (NAV) if they adhere to certain requirements and restrictions. They prohibit a taxpayer bailout of any MMF. They allow all funds (not just U.S. government funds) to opt out of a requirement to impose a liquidity fee on redemptions when a fund has invested less than ten percent of its total assets in "weekly liquid assets".

H.R. 2319 was ordered reported on January 18, 2018, by the House Financial Services Committee with strong bipartisan support. Both the House and Senate versions have the support of organizations representing a broad spectrum of public and private sector finance officers and entities, including:

American Association of Metropolitan Water Agencies
American Public Power Association
Association of Financial Professionals
Association of School Business Officials International
Government Finance Officers Association
Large Public Power Council
National Association of Corporate Treasurers
National Association of Counties
National Association of Health and Educational Facilities Finance Authorities
National Council of State Housing Agencies
National League of Cities
State Financial Officers Foundation
U.S. Conference of Mayors

The following are responses to questions that have been raised about H.R. 2319 and S. 1117:

1. **Does the legislation roll back the SEC's reforms to money market funds in 2010 that strengthened them in response to the 2008 financial crisis?**

   Long before the SEC's 2014 amendments to Rule 2a-7, and even before the enactment of the Dodd-Frank Act, the SEC adopted amendments to Rule 2a-7 in 2010 in an effort to strengthen them against any future financial crisis. Those amendments increased the already high credit quality of the assets held in MMFs, and increased the already high liquidity of MMFs by requiring MMFs 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. The amendments also increased transparency by requiring MMFs to regularly disclose their "shadow prices" (i.e., their portfolios' per-share values at market prices). S. 1117 and H.R. 2319 do nothing to alter those amendments.

2. **What were the reasons why the floating NAV rule was implemented in the first place?**

   The floating NAV rule was not intended to create market stability or protect investors; otherwise, it would have also been applied to MMFs offered to "natural persons" (retail MMFs) and U.S government funds. Rather, it was intended to protect the large, systemically risky Wall Street asset managers from Fed oversight.

3. **Some in the MMF industry contend that the SEC's floating NAV rule has not negatively impacted municipal borrowing costs, so why is the legislation needed?**

   Testifying before the Capital Markets Subcommittee in support of H.R. 2319 on November 2, 2017,[1] Pat McCoy, President of the Government Finance Officers Association (GFOA), which represents 19,000 public finance officers from State and local governments, schools and special districts throughout the U.S., stated:

   - "… the impact of the SEC rule on governments is real and it affects not only large governmental entities like mine (New York Metropolitan Transportation Authority), but also small communities throughout the country."

   - "Between January 2016 and July 2017, tax-exempt MMFs assets under management fell by 50 percent, from $254 billion to $135 billion, dramatically shrinking an important market for municipal debt. At the same time, municipalities issuing variable rate demand bonds saw their borrowing costs nearly double the Federal Reserve's rate increases over the same period. Many state and local governments determined that issuing variable rate debt to MMFs was excessively costly, and opted to issue higher cost fixed-rate bonds. These increased costs are shouldered by taxpayers and ratepayers."

4. **What evidence exists of long-term market dislocations due to implementation of the SEC's floating NAV rule?**

   First, nearly $1.2 trillion has exited prime and tax-exempt MMFs, and moved into U.S. treasury and government funds, as a result of the rule. Tax-exempt MMFs, a key source of funding for state and

[1] https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-pmccoy-20171103.pdf.

local governments and their infrastructure projects, experienced a 50 percent decline between January 2016 and August 2017. This caused the SIFMA Municipal Borrowing Index to increase from 1 to 92 bps, or more than double the Fed rate increase on an after tax basis, over the same period.

Second, state and local governments hold over $186 billion of assets in MMFs.[2] Because of the rule, the only money market fund options available to state and local governments are those that invest solely in U.S. government debt. They are no longer able to invest their short-term cash in prime MMFs, which have always been a safe investment providing a market rate of return. According to a report by BlackRock, "prime money market mutual funds have consistently yielded 30 basis points more than government money market mutual funds since the beginning of 2017."[3] As a result, state and local governments were prevented from taking advantage of over $500 million in additional investment earnings that would otherwise have been available, and had to be made up through reduced services or higher taxes.

Third, main street businesses have been severely impacted. Large, highly rated corporate borrowers have easily replaced the $161 billion they lost from prime MMFs with bank borrowings. The shortfall burden, however, fell on the shoulders of main street businesses. They have been crowded out of bank lending by the larger companies. Some Main Street firms now pay higher rates to alternative lenders; others are simply unable to borrow at any competitive rate. According to a study by Treasury Strategies[4], for each $1 billon of prime MMF debt that a large company replaces with bank borrowing, 10,000 main street businesses lost access to $100,000 in funding.

5. **The MMF industry incurred enormous costs to implement the SEC rule. Isn't it is unfair to change some aspects of it so soon before the industry has had time to "recover" its investment?**

According to a recent study by Treasury Strategies[5], total one-time implementation costs ranged from $120 - $200 million, and all of those costs were passed on to the end-users through fees. Also, this is an insignificant part of the $4.8 billion in annual expenses that the industry passed through to its customers last year, and it is an insignificant part of the $2 billion in annual yield which investors are losing each year on their investments in government funds vs. prime funds.

6. **If there is little material difference between a floating NAV and a stable NAV when it comes to MMF valuations, why don't state and local governments and other institutional investors simply change their investment policies?**

Underlying this argument is a fundamental misunderstanding of investment policies. Such policies establish general investment goals and objectives, and describe the strategies that finance officers should employ to meet these objectives. If municipalities and other institutional investors are going to change their investment policies to fit the products they want to invest in, then why have a policy process at all?

7. **The primary reason that investors fled floating NAV prime and tax-exempt MMFs is because of the redemption gates and liquidity fees. Do S. 1117 and H.R. 2319 address that issue?**

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[2] See https://www.federalreserve.gov/releases/z1/current/z1.pdf, page 84.

[3] See https://www.blackrock.com/investing/financial-professionals/defined-contribution/news-insight-analysis/dc-and-money-market-funds.

[4] www.treasurystrategies.com/wp-content/uploads/2017/11/NegativeImpactsOfNewUSMoneyMarketFund.pdf.

[5] www.treasurystrategies.com/industry_insight/the-cost-of-implementing-the-2016-mmf-regulations/

The stable NAV is an essential element of the utility of the MMF product to the investor. Liquidity fees and redemption gates do raise additional concerns. S. 1117 and H.R. 2319 address a large part of this concern by enabling funds to elect out of mandatory liquidity fees that were part of the 2014 amendments to Rule 2a-7. Institutional investment policies emphasize preservation of principal and access to liquidity, and mandatory liquidity fees violate those principles.

Notably, since enactment of the Investment Company Act in 1940, and with that statutory enabling enhanced under the 2010 amendments for MMFs, all mutual funds are permitted to suspend redemptions and postpone payment of redemption proceeds. A MMF is required to immediately commence an orderly liquidation if the fund Board determines that there is material dilution that could lead to a loss of principal for shareholders. That discretionary authority, which exists to protect shareholders, has never deterred investors from using MMFs.

8. Before enacting these bills, shouldn't the SEC conduct a study of the long-term impact of the SEC's 2014 amendments and report back with recommendations?

The SEC did perform a study before adopting its rule. Now, well over three years after adoption and over 15 months since the loss of stable-value nongovernment MMFs, the effects are clear and they are fact. The SEC's study and anticipated impact was wrong. The permanent disruptions to our short-term capital markets are real and irrevocable short of restoring the stable NAV, hurting both municipal and business borrowers alike. That's because the operating features of a floating NAV make prime and tax-exempt funds unworkable for cash management applications, as stated by virtually every commenter on the proposed rule.

No amount of additional study or wishful thinking will restore the utility of a floating NAV MMF to investors. We know, for example, that:

- Sweep Accounts were rendered inoperable by the floating NAV. These popular operating accounts simply cannot work without a stable share price.

- Floating NAVs and mandatory liquidity fees are not permitted under many institutional investment policies, including those of most state and local governments. Such policies are black and white; investments which do not meet minimum policy requirements may not be used under any circumstances.

- Floating NAVs and mandatory liquidity fees are not permitted by many loan covenants and bond indentures. In the past, many loan and bond proceeds were invested in prime MMFs. .

- Tax and recordkeeping requirements raise operational costs to investors in prime and tax-exempt funds.

9. MMFs are not bank products. But many investors believe they provide the equivalent of federally insured bank products. Wouldn't a floating NAV make that more apparent?

Confusion about whether MMFs are government insured may be true for retail investors, but retail funds are not required to comply with the floating NAV. Only institutional investors in prime and tax-exempt funds are covered, and no financial officer for a company or municipality is unaware of the fact that MMFs are not bank-like products.

10. Isn't a floating NAV more transparent because it reflects the actual value of the underlying assets, whereas the stable NAV hides the true value of risky assets to investors?

The SEC's 2010 amendments to Rule 2a-7 already require the publication of "shadow prices" based on a floating NAV. Those shadow prices show that a floating NAV does not materially provide more transparency than a stable NAV. That's because MMFs invest in short-term securities representing high-quality, liquid debt that is held to maturity. (MMFs do not, and have never, invested in "risky" assets.) Under the SEC's 2010 amendments, 30 percent or more of a MMF's portfolio assets must mature in a week or less, and their weighted average portfolio maturity must be 60 days or less. Today, total weekly liquidity in prime MMMFs is 51 percent[6]. To show any variability, the 2014 rules require prices to be rounded to the nearest 1/100th of one cent (or four decimal places).

In the case of the Reserve Fund breaking the buck in 2008, a floating NAV would not have provided any additional transparency. Shareholders would have experienced exactly the same losses as occurred under the stable NAV. That's because the Lehman commercial paper held by the fund was "marked to model," and the pricing services had not discounted the paper prior to the bankruptcy. Therefore, on the business day before the Lehman bankruptcy, a floating NAV of the Reserve Fund would have been substantially the same as the stable NAV.

If anything, a floating NAV may contribute to less transparency by forcing investors seeking a market rate of return on short-term liquidity to move their cash into non-regulated funds and riskier products. And for municipal borrowers who lost access to MMFs, but still want to benefit from the yield curve, riskier interest rate swaps will become more appealing.

11. Why not just exempt tax-exempt funds from the floating NAV rule as a way to address the impact on state and local governments?

Excluding just tax-exempt MMFs from the floating NAV rule would not address problems for municipalities both as investors and as issuers of debt. According to the Government Finance Officers Association[7]: "Restoring the stable NAV for both prime and municipal money market funds will restore the ability of state and local government to access permissible funds for investing their operating cash. In addition, it will lower short-term funding costs for municipalities by increasing overall liquidity in the market." GFOA explains that state and local governments depend on the safety and stability of prime MMFs, how they need both prime and tax-exempt funds to finance infrastructure and economic development, and that they look to both prime and tax-exempt funds for disaster recovery efforts.

12. Doesn't the SEC rule protect municipalities by forcing them to shift their operating cash from risky investments (prime and tax-exempt funds) to less risky investments (U.S government funds)?

By design and regulation, prime and tax-exempt money market funds are only permitted to invest in the very highest quality, short term fixed income securities that are largely held to maturity and

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[6] https://www.sec.gov/divisions/investment/mmf-statistics/mmf-statistics-2017-10.pdf, page 9.

[7] http://protectinvestorchoice.com/wp-content/uploads/2018/01/How_Municipalities_Depend_on_Prime_MMFs-GFOA.pdf.

do not have material fluctuation due to either market interest rate risk or credit risk. There is no safer product available for cash management other than an insured bank deposit. By forcing municipal investors out of prime and tax-exempt funds and into government funds, the SEC's floating NAV rule has increased costs on taxpayers and businesses without any material benefit.

13. The SEC went through a rigorous rulemaking process. Why should Congress second-guess those who have the duty and expertise to ensure our financial markets are functioning properly?

It is always good to be skeptical of legislative efforts to overturn regulatory actions. But sometimes the regulators get it wrong, and Congress needs to step in and right the wrong. In the case of MMFs, the SEC laid out a theory that suggested that the benefits of a floating NAV would exceed the costs to investors and issuers. Fifteen months into implementation of the rule, there is no evidence to suggest that theory is correct, and plenty of evidence to prove it wrong.