Statement at Open Meeting Regarding Money Market Fund Reform

Washington, D.C.

July 23, 2014

Thank you, Chair White.

The money market fund reforms before us today address many complex issues, and I want to join my fellow commissioners in thanking the rulemaking team for all of their hard work and dedication. They spent countless hours, including many late nights and weekends over the past several months, working through the issues, reviewing numerous detailed comment letters, and formulating their three recommendations for our consideration today. As to the first recommendation, while I support the adoption of all the amendments to the disclosure, reporting, and stress testing requirements, I am not able to support the adoption of the so-called combination approach which would require institutional prime and tax-exempt money market funds to price and transact at a floating net asset value (NAV) calculated to the fourth decimal place (nearest basis point) and also would require liquidity fees and discretionary redemption gates. As to the second recommendation, I support the issuance of a notice of the proposed order to allow broker-dealers to continue to provide money market fund shareholders transaction information on a monthly basis. As to the third recommendation, I am pleased to support the re-proposed amendments to replace references to credit rating in the money market fund rule, modify disclosures of credit ratings in Form N-MFP, and the proposed amendments to eliminate an exclusion in the money market fund rule's issuer diversification requirement.

Before discussing these specific reforms, a brief summary of where we are would be helpful. Money market fund reform was triggered by the global financial crisis. During the crisis, a single money market fund – the Reserve Primary Fund – "broke the buck" on September 16, 2008 principally because of its large position in commercial paper of Lehman Brothers Holdings Inc., which announced its bankruptcy the day before. At the same time, there were other stresses in the money markets, including the near failure of American International Group (AIG), whose commercial paper was held by many money market investors. Heavy redemptions occurred in other institutional prime funds and during the week the Reserve Primary Fund broke the buck; it is estimated that investors withdrew around $300 billion (or about 14% of the assets) from prime money market funds.[1] No other fund broke the buck. However, due to the heavy redemptions, money market managers began to retain cash rather than reinvest in commercial paper, which resulted in a lack of availability of short-term credit for businesses and financial institutions. According to one estimate, in the last two weeks of September 2008, money market funds reduced their holdings of top-rated commercial paper by $200 billion (or 29%).[2] In an effort to stem the heavy redemptions, the Treasury Department instituted a program, which temporarily guaranteed certain investments in money market funds that decided to participate in the program.

In response to the financial crisis, the Commission, in 2010, adopted several money market fund reforms. The Commission noted that the reforms were intended to be a first step to addressing concerns about runs on money market funds and advised that more fundamental changes might be warranted. The 2010 reforms were designed to make money market funds more resilient to short-term market risks by reducing the interest rate, credit and liquidity risks of fund portfolios, and to provide greater protections for investors in a fund that is unable to maintain a stable NAV by allowing the fund to suspend redemptions in order to facilitate an orderly liquidation. To increase liquidity, among other things, funds were required to invest at least ten percent of their assets in "daily liquid assets," and at

least thirty percent in "weekly liquid assets." Money market funds also were required to provide monthly information on their portfolio holdings by filing new Form N-MFP with the Commission. Additionally, the reforms provided for periodic money market fund stress testing under board direction. [3]

In 2011 and 2013, major market events tested money market funds and the 2010 reforms. In the summer of 2011, the Eurozone sovereign debt crisis and an impasse over the debt ceiling occurred. During the fall of 2013, another debt ceiling impasse occurred. No fund broke the buck during any of these events. Although prime money market funds experienced substantial redemptions during the Eurozone crisis, unlike in 2008, money market funds had sufficient liquidity to satisfy redemption requests. Thus, the 2010 reforms were successful in increasing fund liquidity and enhancing their resiliency.

Although effective, the Commission's Division of Economic and Risk Analysis (DERA) noted in a 2012 report that the 2010 reforms would have been unlikely to prevent a money market fund from breaking the buck when faced with large credit losses like the ones experienced in 2008.[4] The reforms we are considering today are designed to further address their susceptibility to heavy redemptions, improve their ability to manage and mitigate potential contagion, and increase the transparency of their risks.

As a threshold matter, there is no evidence that money market funds themselves pose any threat to the stability of the U.S. financial system. Rather, if there were any systemic risk related to the money markets, it would be over-reliance by financial institutions, particularly banks, on the money markets for short-term funding. In fact, it has been argued that the reason Treasury instituted the guarantee program in 2008 was to reduce financial pressure on banks that had guaranteed the commercial paper of off-balance sheet conduits established by the banks with the approval of the Federal Reserve.[5] As I have said before, if the banking regulators are concerned by banks' over-reliance on short-term funding from money market funds, then they have the authority to address this bank regulatory shortcoming directly. Nothing in the Dodd-Frank Act weakened or repealed this authority.

While I support most of today's recommendations, I cannot support the so-called combination approach. I cannot support the imposition of both a basis point floating NAV per share on institutional prime and tax-exempt money market funds and liquidity fees and redemption gates. The combination impedes one of the Commission's stated goals of this reform effort – "preserving, as much as possible, the benefits of money market funds."[6] Other less onerous alternatives exist that would sufficiently achieve the Commission's goals of lessening money market funds' susceptibility to heavy redemptions, improving their ability to manage and mitigate potential contagion from high levels of redemptions, and increase the transparency of their risks.[7]

Most commenters opposed the combination of a floating NAV and liquidity fees and gates because it would not offer either stability of principal or liquidity. Therefore, the continued utility of institutional prime and tax-exempt money market funds as a cash management tool is highly questionable. All of the investors with whom I spoke opposed the combination approach for the same reason. The investors were divided between those that could invest in a fund with a floating NAV calculated to the third decimal place, subject to the tax and operational issues being solved, and those that could invest in a fund subject to a liquidity fee and gate. As a result, I suggested an "investor choice" approach as a possible alternative to consider. The investor choice alternative would allow investors to choose whether to invest in a fund that floats its NAV or one that can impose a liquidity fee and gate. The key feature of this approach is that investors, after receiving complete information as to the benefits and risks of each alternative, could choose which alternative best fits their own unique investment objectives, rather than the Commission choosing which to impose on all investors.

After carefully reviewing the possible alternatives for addressing susceptibility to heavy redemptions, I believe that the fees and gates approach would be the most effective at stopping runs on money market funds and would best preserve their benefits. Only the imposition of a gate would stop redemptions, thus ending any run on a money market fund and obviating the need for any future

taxpayer bailouts. In addition, the imposition of a liquidity fee increases the cost of redeeming shares, which may mitigate investors' incentives to redeem and would treat remaining investors more equitably by offsetting the costs of liquidity provided to redeeming shareholders. Moreover, the ability to impose fees and gates should not preclude investors from using prime money market funds as effective cash management tools because, in the absence of severe market stress, the day-to-day operations of the funds would not be affected and investors would still have the protection of their principal and the liquidity that they seek in order to cover their expenses as needed.

I would support giving money market fund boards even more discretion in imposing gates. It is possible that, due to specified triggers for when boards may impose fees and gates, investors may seek to redeem shares as the triggers are approached. Giving the board the power to impose a gate at any time when the board finds it is in the best interests of the fund would make it much more difficult for investors to anticipate exactly when a fund might be subject to a gate, thus mitigating the risk of anticipatory runs. However, even if a run were to commence, the imposition of a gate would stop it. Moreover, in an important change from the proposed reforms, the reforms we are adopting today give the board the power, once the trigger is reached, to impose a gate immediately, rather than wait until the next business day.

While fees and gates would stop runs, requiring institutional prime and tax-exempt money market funds to float their NAV would not. The imposition of a floating NAV on these funds is intended to reduce the "first mover advantage" and the chance of unfair investor dilution. The first mover advantage, as described in the adopting release, is the incremental incentive to redeem from a money market fund with a market-based NAV (also known as the "shadow NAV") below $1.00 that is at risk of breaking the buck. Thus, the floating NAV is designed to combat the risks of heavy redemptions during times of stress. However, even putting aside that a floating NAV will not stop runs and will not deter redemptions that constitute rational risk management by shareholders or reflect an incentive to avoid loss, a floating NAV would not stop the first mover advantage during times of stress. During times of stress, when cash on hand is more likely to be insufficient to meet redemptions, a fund may be forced to sell portfolio securities into illiquid secondary markets at discounted prices, and the market-based NAV may not capture the likely increasing illiquidity of a fund's portfolio. Therefore, even if the NAV floats, sophisticated investors with significant money at stake that have a lower risk tolerance, the very investors at which the floating NAV is aimed, will still have incentive to redeem ahead of other investors.

In addition, because most, if not all, money market fund portfolio securities are not actively traded in the secondary markets, in order to determine a fund's market-based NAV, these securities will be valued largely based upon "mark-to-model" or "matrix pricing" estimates. Matrix pricing and similar pricing methods involve estimates, assumptions, and judgments—and thus may be no more accurate than the amortized cost method upon which portfolio securities are currently priced. Market-based pricing also will limit same-day settlements. At a minimum, closing times for same-day settlement will likely need to be moved earlier in the day to allow sufficient time to calculate the NAV prior to the close of the Federal Reserve Cash Wire. It is also likely, at least initially, that floating NAV money market funds will only be able to price once a day, thus limiting the funds' use as an efficient cash management tool by Main Street businesses and state and local governments.

Today's recommendation requires institutional prime funds to transact at four decimal places (the nearest 1/100th of one penny) instead of rounding to the nearest penny when selling and redeeming shares. All other mutual funds are permitted to transact at three decimal places (the nearest 1/10th of one penny). The stated rationale for transacting at four decimal places is that, as intended by rule 2a-7's investment duration and quality limitations, the floating NAV rarely floats when calculated to the third decimal place and, therefore, some institutional investors may not appreciate the risk associated with money market funds. However, the reason for requiring institutional funds to float their NAVs at all is precisely because institutional investors are sophisticated and well aware of the actual market-based per share value. Moreover, included in today's package of reforms are two related disclosure

requirements that I support. The first requires all money market funds to disclose their market based NAVs daily on their websites to the fourth decimal place. The second requires all money market funds to prominently disclose in their prospectuses and advertisements that investors could lose money and, in the case of a stable value fund, that although the funds seek to preserve the value of shareholders' investments at $1 per share, the funds cannot guarantee that they will do so. If we justify imposing a four decimal place transaction requirement because we do not believe that even institutional investors would look at or understand this information, then the utility of our entire disclosure regime is dubious at best.

The floating NAV also creates tax issues for funds and investors. Because investors in floating NAV funds will now experience capital gains and losses on the sale of their shares, they will be required to track their purchase and sales to determine those amounts. The tax rules generally require mutual funds to report to the IRS and shareholders certain information about sales of shares, including sale dates and gross proceeds. Stable value funds are excluded from this transaction reporting obligation. The Department of the Treasury ("Treasury") is expected to propose today new regulations that would make a simplified aggregate method of accounting available to investors in floating NAV money market funds and would allow taxpayers to rely on the regulations for tax years ending on or after the date the proposed regulations are published in the Federal Register. Treasury believes that this would eliminate any requirement to track individually each share purchase and redemption, and the basis of each share redeemed. However, investors, funds, and outside tax experts have not yet had an opportunity to review and comment on whether this Treasury proposal will solve the tax issues. In fact, a bipartisan group of four members of the Senate Committee on Banking, Housing, and Urban Affairs have requested that the Commission refrain from adopting a floating NAV for any money market funds until the public has had an opportunity to review and comment on the proposed Treasury regulations.[8] While their concerns should not dissuade us from moving forward with the rest of our reforms, I agree with this bipartisan group of Senators that we should wait to adopt the floating NAV until the public has had a chance to comment on Treasury's proposed tax fix.

While the floating NAV will not stop runs, it will impose costs on money market funds that will ultimately be borne by its shareholders in the form of higher fees and expenses, and lower returns. Funds likely will use third-party pricing vendors to help calculate their NAVs. Funds, intermediaries, and investors also will have to change their systems and operations in order to transact at four decimal places. It was just over four years ago that the Commission required money market funds to have the capacity to redeem and sell their securities at a price based on the funds' current net asset value per share to the third decimal place. Now they will be required to change their systems again to transact at a false level of precision required of no other funds. Commenters, including funds and investors, overwhelmingly opposed the floating NAV. Due to fund and investor opposition to a floating NAV and the fact that we are also combining it with the fees and gates alternative for institutional prime funds, many institutional money market fund sponsors and many, if not most, institutional investors could decide to abandon prime money market funds.

As of July 3, 2014, institutional prime money market funds, held more than $800 billion in assets, constituting about 33% of all money market fund assets.[9] It is estimated that institutional investors hold an additional $76 billion in tax-exempt funds.[10] Therefore, about $880 billion in assets will be subject to both the floating NAV and fees and gates requirements. Nobody knows how these assets will be allocated in the wake of today's reforms or the resulting impact. As of July 3, 2014, government money market funds held about $863 billion in assets (or about 35% of all money market fund assets).[11] If one assumes that stability of principal and liquidity are the paramount concerns for institutional investors, most of these assets could be reinvested in government money market funds. This would result in government funds more than doubling in total assets, while at the same time under our reforms today government funds would be more restricted as to the securities they may invest in. To the extent that these institutional assets are invested in government funds or deposited in banks, they would no longer be available for the short-term funding of state and local governments or businesses.

Finally, as I mentioned at the outset, I support the adoption of all of the amendments to the disclosure, reporting, and stress testing requirements. The disclosure reforms will ensure that investors have access to important information regarding the liquidity of the money market fund such as daily disclosure of the percentage of a fund's assets that are invested in daily and weekly assets and net shareholder flows. Investors also will be able to access, on each fund's website, daily information on the fund's current NAV, which will allow investors to understand better that they, not the fund sponsors or the taxpayers, bear the risk of loss. I believe that the enhancements to stress testing will help ensure greater standardization in the quality and comprehensiveness of stress tests by requiring funds to test their ability to maintain weekly liquid assets of at least 10% and limit principal volatility in response to specified hypothetical events in combination with various increases in shareholder redemptions. All of these reforms, as well as the other disclosure reforms we are adopting today, are consistent with our goal of increasing the transparency of money market fund risks and thereby should help reduce the chances of runs.

Thank you. I have no questions.

[1] *See* Investment Company Institute, Report of the Money Market Working Group, at 62 (Mar. 17, 2009), *available at* http://www.ici.org/pdf/ppr_09_mmwg.pdf (analyzing data from iMoneyNet).

[2] *See* Christopher Condon & Bryan Keogh, *Funds' Flight from Commercial Paper Forced Fed Move*, Bloomberg, Oct. 7, 2008, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5hvnKFCC_pQ.

[3] *See* Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010).

[4] *See* Response to Questions Posed by Commissioners Aguilar, Paredes and Gallagher, a report by staff of the Division of Risk, Strategy, and Financial Innovation (Nov. 30, 2012), *available at* http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf. The Division of Risk, Strategy, and Financial Innovation is now known as DERA.

[5] *See* Peter Wallison, *Money Market Funds Were a Victim, Not a Cause, Of the Financial Crisis* (May 2, 2014) *available at* http://www.realclearmarkets.com/articles/2014/05/02/money_market_funds_were_a_victim_not_a_cause_of_the_financial_crisis_101033.html.

[6] Cite to Adopting Release [Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. _____ (Jul. 23, 2014).

[7] *Id*.

[8] *See* Letter from Senator Michael Crapo to Secretary Lew (Jul. 15, 2014); Letter from Senators Robert Menendez and Mark Warner to Secretary Lew (Jul.15, 2014); Letter from Senator Pat Toomey to Secretary Lew (Jul. 15, 2014).

[9] This data is based on an analysis of information as of July 3, 2014 from Crane Data.

[10] It is estimated that institutional investors hold approximately 30% of all tax-exempt money market fund assets. As of July 3, 2014, Crane Data estimated that there was a total of $254.5 billion invested in tax-exempt money market funds.

[11] *Id*.