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**TESTIMONY OF**

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**PRESIDENT AND CEO**
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**BEFORE THE**

**SUBCOMMITTEE ON CAPITAL MARKETS AND**
**GOVERNMENT SPONSORED ENTERPRISES**

**COMMITTEE ON FINANCIAL SERVICES**
**U.S. HOUSE OF REPRESENTATIVES**

**ON**

**"EXAMINING THE SEC'S MONEY MARKET FUND RULE PROPOSAL"**

**SEPTEMBER 18, 2013**

## I. Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $15.3 trillion and serve over 90 million shareholders.

I very much appreciate the opportunity to appear before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee and offer our perspectives on the Securities and Exchange Commission's pending rule proposals on money market funds.[1] Money market funds, which date back to the early 1970s, are one of the most significant and successful financial product innovations of the past half century. Today, over 61 million retail investors, as well as corporations, municipalities, and other institutional investors, rely on the $2.6 trillion money market fund industry for a low-cost, efficient cash management tool that provides a high degree of liquidity, stability of principal value, and a market-based yield. Money market funds also serve as an important source of direct financing for state and local governments, businesses, and financial institutions, and of indirect financing for households. Without these funds, financing for all of these institutions and individuals would be more expensive and less efficient.

Money market funds owe their success, in large part, to the stringent regulatory requirements to which they are subject under the federal securities laws including, most notably, Rule 2a-7 under the Investment Company Act of 1940. The regulatory regime established by Rule 2a-7 has proven to be flexible and effective in protecting investors' interests and maintaining their confidence in money market funds. The SEC deserves tremendous credit for crafting these requirements and administering them in a manner that has allowed money market funds to thrive and to serve so many investors. The SEC also has modernized and strengthened the rule from time to time as circumstances warranted—most recently, and very significantly, in 2010. Indeed, it is the SEC's deep and extensive experience that best positions it to consider and implement any further reforms to money market funds.

In recognition of the importance of money market funds to the global economy and to investors, ICI and its members have devoted significant time and effort to considering how to make money market funds more robust under even the most adverse market conditions— such as the serious liquidity challenges arising in 2007-2008 related mainly to rising concerns about U.S. mortgage credit quality and the difficulty in determining the value of mortgage-related assets. These concerns created uncertainty about the balance-sheet strength of large banks and non-bank financial institutions and ultimately led these institutions to become wary of lending to one another, even on a short-term basis.

Since 2008, the SEC and the fund industry have made a great deal of progress toward their shared goal of strengthening the resiliency of money market funds. Taking the initiative to respond quickly and aggressively to the events of fall 2008, ICI formed a Money Market Working Group to

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[1] *See Money Market Fund Reform; Amendments to Form PF*, SEC Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19. 2013) ("Release"), available at http://www.sec.gov/rules/proposed/2013/33-9408.pdf. Pages referenced in this testimony are to the version of the Release on the SEC's website.

study the money market, money market funds and other participants in the money market, and recent market circumstances. The March 2009 *Report of the Money Market Working Group* ("MMWG Report") addressed these topics and advanced wide-ranging recommendations for the SEC to strengthen money market fund regulation.[2]

In 2010, with the industry's strong support, the SEC approved far-reaching rule amendments that incorporated many of the MMWG Report's recommendations and enhanced an already-strict regime of money market fund regulation.[3] The amended rules have made money market funds more resilient by, among other things, imposing tighter credit quality, maturity, and liquidity standards and increasing the transparency of these funds. The amended rules also provided for an orderly liquidation process in the event that a money market fund proves unable to maintain a stable $1.00 net asset value ("NAV")—an ability that was not available to the Reserve Fund or any other money market fund during the crisis. The 2010 reforms proved their value in 2011 when money market funds—without incident—met large volumes of shareholder redemptions during periods of significant market turmoil, including a credit event involving the historic downgrade of U.S. government debt. Indeed, so far-reaching were these reforms that today's money market fund industry is dramatically different from that of 2008. These reforms were studied by the SEC staff and their findings generally support our views as to the reforms' efficacy.[4] Yet, the calls for further reform continue.

For our part, ICI consistently has supported exploring reasonable options to make money market funds even more resilient while preserving the fundamental characteristics of these funds that are critical to investors. While we continue to believe that the reforms already adopted by the SEC are sufficient, we understand that regulators do not all share that view.

## II. The SEC's Proposals

We remain committed to working with the SEC on this important issue, but we submit that this process should be guided by two principles. First, we should preserve to the greatest extent possible those key features of money market funds that have made them so valuable and attractive to investors. Second, we should preserve choice for investors by ensuring a continued robust and competitive global money market fund industry.

With these goals in mind, we are particularly supportive of the SEC's decision not to pursue proposals that would require money market funds or their advisers to maintain capital against fund losses (also known as NAV buffers) and/or implement a "minimum balance at risk." These concepts are deeply flawed. The likeliest impact of a NAV buffer requirement would be to impel money market

[2] *See* Investment Company Institute, *Report of the Money Market Working Group* (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[3] *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010).

[4] *See* SEC Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (November 30, 2012), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

fund sponsors to exit the business, thus depriving investors, issuers, and the economy of the benefits these funds provide. Indeed, the SEC itself acknowledged that the significant ongoing costs associated with a NAV buffer would directly affect money market fund sponsors or investors and indirectly harm capital formation. The minimum balance at risk also has a number of serious drawbacks. Not only would it constantly restrict some portion of an investor's holdings without regard to the fund's circumstances at the time of redemption, but also it would impose significant operational costs on fund complexes, intermediaries, and service providers. Citing these concerns, the SEC notes that a "[minimum balance at risk] coupled with a NAV buffer would turn money market funds into a more complex instrument whose valuation may become more difficult for investors to understand."[5]

Instead, the SEC is considering two reform alternatives that could be adopted either alone or in combination: (i) require prime and tax-exempt institutional money market funds to "float" their net asset values ("floating NAV proposal"); or (ii) require all non-governmental money market funds to impose liquidity fees of up to 2 percent and to have the option to temporarily suspend redemptions (or "gate" the fund) upon the occurrence of specified events indicating that the fund may be under stress ("liquidity fee/temporary gate proposal").[6]

In the course of our discussions of these proposals with ICI members, and members' discussions with fund shareholders, one thing became abundantly clear: shareholders continue to value the stability of principal and ready liquidity provided by money market funds. When pressed to choose one or the other of the proposals put forth by the SEC, however, it appears that some investors place a higher premium on principal stability, while others more heavily value ready access to liquidity. To a great extent, these differing investor perspectives reflect the circumstances and characteristics of the wide range of investors that our member firms serve. It is quite certain, therefore, that combining the SEC's two proposals would devastate the industry, rendering money market funds entirely unattractive to investors.

On September 17, ICI submitted a comprehensive comment letter to the SEC on its money market fund reform proposals.[7] Our views on the key elements of the proposal are briefly described below.

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[5] Release, *supra* note 1.

[6] The SEC's proposal also includes a number of less fundamental, yet significant, reforms that would apply under either proposal. These include enhanced disclosure and reporting requirements; more stringent diversification requirements; enhanced stress testing; and improved private liquidity fund reporting.

[7] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (September 17, 2013) ("ICI Comment Letter"), available after September 17, 2013 at http://www.ici.org/pdf/13_ici_mmf_ltr.pdf.

### A. No Basis for Fundamental Structural Reforms to Government and Tax-Exempt Money Market Funds

The Release proposes to exempt government money market funds from further structural reform because of, among other things, the following: government money market funds are not susceptible to the risks of mass investor redemptions; their securities have low default risk and are highly liquid in even the most stressful market scenarios; and interest rate risk is generally mitigated because government funds typically hold assets that have short maturities and hold those assets to maturity.[8] We agree with the SEC that no case can be made for applying fundamental changes to government money market funds. We strongly believe that such changes likewise should not apply to tax-exempt funds, for similar reasons.

There is no evidence that investors in tax-exempt money market funds redeem *en masse* during periods of market stress. Moreover, in the unlikely event that tax-exempt money market funds did in fact face widespread redemptions, these funds hold the great majority of their assets in highly liquid securities that can be sold to meet redemptions. Additionally, because of these securities' structures, they are likely more immune to credit deterioration. Consequently, tax-exempt funds, like government funds, should be exempt from both the floating NAV proposal and the liquidity fee/temporary gate proposal. Our comment letter supports this position with data from three events: recent developments surrounding the City of Detroit, Michigan's 2013 bankruptcy; the financial crisis month of September 2008; and the default of Orange County, California in 1994.[9]

Moreover, a fundamental restructuring of tax-exempt funds could compromise the critical role that these funds play in providing affordable short-term funding for state and local entities across the United States. Tax-exempt money market funds are the largest investors in short-term municipal debt, holding $252.7 billion as of June 30, 2013. This was almost two-thirds of state and local short-term debt (64 percent as of June 2013). Requiring tax-exempt money market funds to restructure themselves to accommodate a floating NAV could be highly disruptive to their investors and the short-term tax-exempt debt markets.

Voicing these very concerns, a wide range of state and local government entities have argued that a floating NAV would destroy the convenience and simplicity of tax-exempt money market funds for investors, and compromise an important source of financing for many state and local governments.[10] Indeed, the United States Conference of Mayors recently unanimously adopted a resolution that expresses opposition to the floating NAV proposal, stating that "[f]orcing [money market funds] to float their value would likely eliminate the market for those products by forcing investors, including state and local governments, to divest their [money market fund] holdings as well as discourage others

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[8] *See* Release, *supra* note 1, at 66.

[9] *See* ICI Comment Letter, *supra* note 7.

[10] For examples of governments, government officials, and organizations that have voiced support for maintaining the stable NAV for tax-exempt money market funds, *see* http://www.preservemoneymarketfunds.org/what-others-are-saying/.

from using these funds."[11] Members of Congress also have shared their concerns regarding how new regulations on money market funds would impact municipalities' costs of borrowing.[12]

### B. **Liquidity Fee/Temporary Gate Proposal**

The SEC's liquidity fee/temporary gate proposal—*i.e.,* allowing money market funds to continue to transact at a stable share price under normal market conditions, but under certain circumstances when a fund may be stressed from a liquidity standpoint (i) requiring the fund to institute a liquidity fee designed to deter further redemptions and (ii) permitting the fund to temporarily suspend redemptions—has the support of various of our members because it promises to slow or stop significant fund outflows. These tools, together with enhanced disclosure, directly address regulators' concerns about redemption pressures on prime money market funds.

Under the liquidity fee/temporary gate proposal, if a money market fund's level of "weekly liquid assets" were to fall below 15 percent of its total assets (half the required amount) after the close of business, the money market fund would automatically impose a liquidity fee in connection with redemptions received for processing the next business day. The nonrefundable liquidity fee, which would be equal to 2 percent of redemption proceeds, would be paid to the fund by redeeming shareholders. A 2 percent liquidity fee would not be imposed, however, if the fund's board of directors determines that the fee is not in the best interest of the fund or that a lesser liquidity fee is in the best interest of the fund.

Once a money market fund's weekly liquid assets fell below 15 percent of total assets, its board of directors also would be permitted to impose a temporary gate. A money market fund that suspends redemptions would need to restore the right to redeem within 30 days, although the board of directors could determine to restore it earlier. Money market funds would not be able to suspend redemptions for more than 30 days in any 90-day period.

The SEC explains that the liquidity fee/temporary gate proposal is designed to address the contagion effects of heavy redemptions in money market funds that had a significant impact on investors, funds, and the markets during the financial crisis. Regardless of the incentives to redeem, the Release notes that a liquidity fee would make redeeming investors pay for the costs of liquidity and, if investors continued to redeem from a fund, temporary restrictions on redemptions would directly halt a run.

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[11] See Letter from Scott Smith, Mayor of Mesa, President, The United States Conference of Mayors, to Mary Jo White, Chairman, Securities and Exchange Commission (July 18, 2013), available at http://www.sec.gov/comments/s7-03-13/s70313-30.pdf.

[12] For example, during a hearing by the House Committee on Financial Services on the SEC's FY 2014 budget request, Representative Michael G. Fitzpatrick (R-PA) noted to SEC Chair Mary Jo White the importance of money market funds to municipalities. "[B]efore I came to Congress, I was a local elected official in Bucks County, [PA] . . .and a lot of local officials and state officials rely on money market funds as a source of sort of cash management. It's an important tool to have in the toolbox." *See Oversight of the SEC's Agenda, Operations, and FY 2014 Budget Request*, Hearing before the House Committee on Financial Services (May 16, 2013), available at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=333327.

To make these tools even more useful to fund boards, our comment letter recommends that the SEC expand the circumstances under which a board may impose a liquidity fee or temporarily suspend redemptions to cover situations when heavy redemptions are already underway or are clearly foreseeable.

Notwithstanding the support for the liquidity fee/temporary gate proposal, it has potential drawbacks. It is unclear how many investors would use a money market fund with liquidity fees and gates given the explicit possibility of restricted liquidity, what impact this measure would have on certain transaction types; and what tax implications a liquidity fee might have for money market funds and their shareholders. There is no question that complex and costly system modifications by fund transfer agents and intermediaries would be necessary to handle liquidity fees and temporary gates. We anticipate that it may take at least three years to allow the industry to complete the operational and other changes necessary to successfully implement liquidity fees and temporary gates.

### C. **Floating NAV Proposal**

The SEC's other proposed approach would fundamentally alter prime and tax-exempt institutional money market funds by requiring these funds to have a floating NAV instead of a stable NAV. Specifically, these funds would be required to sell and redeem shares based on the current market-based value of the securities in their underlying portfolios and "basis point round" their share price to the nearest 1/100th of one percent (*e.g.*, the fourth decimal place in the case of a fund with a $1.0000 share price). The Release indicates that the floating NAV proposal is designed primarily to address the incentive of money market fund shareholders to redeem shares in times of fund and market stress based on the fund's valuation and pricing methods, and to improve the transparency of pricing associated with money market funds.

ICI has maintained consistently since 2009 that forcing funds to float their NAVs would not achieve such goals. Even assuming that investors are willing to use floating NAV money market funds, a floating NAV is unlikely to alter meaningfully investors' behavior during a market crisis. On the contrary, there is considerable evidence, as the SEC itself acknowledges, that the outflows from prime money market funds during September 2008 were part and parcel of a flight by investors to the quality and liquidity of the Treasury market. Indeed, there is evidence, as the SEC also acknowledges, that long-term funds (whose NAVs have always floated) experienced significant outflows during the financial crisis.

#### 1. **Loss of Key Benefits Valued by Investors**

The floating NAV proposal would require funds, intermediaries and investors to make very significant and costly operational changes to accommodate floating NAV money market funds. Forcing money market funds to float their NAVs would impose significant tax burdens on funds and investors. Unlike investors in stable NAV money market funds, those in floating NAV money market funds could have taxable gains and losses upon every redemption. Even though those gains and losses likely would be very small, they would be subject to tax reporting. This means that funds, intermediaries, and most institutional investors would have to build new or expand existing systems to track, calculate and report gains and losses, at a significant cost. It bears emphasizing, contrary to some media commentary, these changes would be onerous because, among other things, the volume and frequency of transactions in money market funds makes this reporting exponentially more difficult than it is for other floating NAV mutual funds. The Treasury Department and the Internal Revenue Service have suggested measures to mitigate these burdens; however, their suggested *de minimis* exceptions and simplified reporting schemes do not go far enough and in some cases may exacerbate the problems. We are discussing these concerns with the Treasury Department and the IRS. Congressional action may be necessary, however, if regulatory solutions are not possible or are inadequate.

Requiring floating NAVs also complicates the accounting treatment of money market funds and could result in the loss of same-day settlement services, which are extremely important to institutional investors managing their daily cash. Moreover, the product would be unusable as a sweep vehicle. Without these benefits, widespread investor acceptance of a floating NAV money market fund product is unlikely. It is critical, therefore, that the changes necessary to alleviate these tax and accounting burdens be implemented *before* any floating NAV requirement takes effect.

### 2. **Reduction in Capital Market Funding**

One clearly foreseeable impact of the floating NAV proposal is a reduction in capital market funding to the private sector. Requiring prime institutional money market funds to float their NAVs risks precipitating an outflow of hundreds of billions of dollars from prime money market funds to other products, including government money market funds. This could result in a major restructuring and reordering of intermediation in the short-term credit markets, and the transition is likely to be highly disruptive. Regulatory changes that push assets from money market funds toward other money market instruments and uninsured bank deposits would disrupt the capital markets and fail in the long run to address the concerns the SEC has raised, such as promoting safer capital markets and reducing risks to the economy at large. It also is not clear that regulatory policies that further concentrate deposits in the largest banks reduce systemic risks.

### 3. **Disclosure Achieves Same Goals**

The SEC itself questions whether a floating NAV would help limit widespread redemptions, focusing instead on the potential ability of a floating NAV to heighten investors' awareness that these funds hold securities whose market values fluctuate. If this is the goal, it could be achieved more simply and at less cost by requiring these funds to publish their daily mark-to-market values.

Regulators might argue that such costs are justified by the benefits of reducing risks to the financial system. Because the operational changes required are so extensive, difficult and costly to make, many sponsors, intermediaries, and institutional investors will not make them, potentially resulting in increased assets in unregulated products or a risky buildup of uninsured deposits in the banking system. These disincentives to offer floating NAV funds would be compounded by additional regulatory requirements. Like all long-term funds, prime and tax-exempt institutional money market funds would have to float their NAVs but, unlike long-term funds, these funds would still be required to adhere to

Rule 2a-7 *and* a proposed pricing standard that is 10 times more stringent than the pricing standard for other floating NAV products.

### 4. **Retail Fund Exception**

If the SEC nevertheless determines, despite our longstanding concerns, to require funds to float their NAVs, we agree that the reach of that action should be reasonably tailored and that it is appropriate to exempt "retail" funds from the floating NAV requirement. Money market funds provide retail investors access to investments not otherwise affordable or accessible, such as commercial paper issued in minimum denominations beyond the reach of the average investor. Maintaining the availability of prime stable NAV money market funds for retail investors, therefore, is particularly important because those funds provide diversification and a market-based rate of return that is not otherwise available through a bank deposit account.

We have significant concerns, however, that the SEC's proposal to define retail funds through a redemption limit would impair investor liquidity and be more onerous operationally than other methods. Instead, we recommend using a social security number ("SSN") as the fundamental characteristic to identify an investor eligible to invest in a retail money market fund. Under this recommended approach, any account opened by a fund or intermediary that has captured an SSN as a (tax) identification component for the registered owner or beneficial owner of an account would qualify for investment in a stable NAV retail money market fund. This approach would capture a very large percentage of the retail investors who invest in money market funds directly. It also would include accounts whose underlying beneficiaries have an SSN, such as those invested in tax-advantaged savings accounts, retail brokerage, and certain trust accounts whose beneficiaries have SSNs that are held in the name of intermediaries on fund transfer agent records. Importantly, using SSNs would be far less costly to implement than other methods of defining retail funds, including the SEC's proposed daily redemption limit.

Finally, regulators should be concerned that the transition from stable to floating NAV could be destabilizing to the financial markets because it could require money market funds to potentially shed hundreds of billions of dollars of money market instruments as their investors redeem in favor of other products. If the SEC's proposed changes are adopted, mitigating transitional impacts to shareholders must be a primary goal for regulators. With all that needs to be considered and accomplished by funds, intermediaries, and investors, the industry needs a significant transition period with a compliance date of the later of at least 3 years following issuance of final SEC rules; or January 1 of the calendar year that begins at least 12 months after final tax guidance is issued or, if needed, new legislation has been passed.

## D. Potential Combination of Floating NAV and Liquidity Fee/Temporary Gate Proposals

The SEC also is considering whether to combine the floating NAV and the liquidity fee/temporary gate proposals into a single reform package. If the proposals are adopted in combination with each other, prime and tax-exempt institutional money market funds would be required to transact at a floating NAV and, in addition, all non-government money market funds would be required to impose liquidity fees (unless waived by the board) and permitted to impose temporary gates in certain circumstances.

*We strongly oppose the combination of these two proposals.* The combination of the two SEC proposals will produce a fund that lacks both the share price stability and the assured redeemability of today's money market fund. The result: a fund that nobody will want because nobody will need. Instead, institutional investors would seek out other cash management investment alternatives that offer principal stability (*e.g.*, government money market funds, investment products not registered under the Investment Company Act such as separate accounts or unregistered cash management pools, or uninsured bank deposits) or that have neither potential restrictions on redemptions nor the yield-limiting restrictions of Rule 2a-7 (*e.g.*, all other mutual funds). Although for cash management purposes these options are not as ideal as money market funds, for many investors they are far more attractive than a floating NAV fund that also may not always provide ready liquidity. The principal impact of such a combination, therefore, would be to shrink dramatically, perhaps to extinction, the assets of prime and tax-exempt institutional money market funds.

A combination of the floating NAV proposal and the liquidity fee/temporary gate proposal also would undermine the attractiveness of retail money market funds. Under the SEC's proposal, a money market fund would be exempt from the floating NAV requirement if it does not permit a shareholder to redeem more than $1 million per day. It is simply overkill to add additional structural reforms to a fund that already restricts the daily liquidity available to investors.

From an operational standpoint, the combination of the two proposals would be extremely burdensome and cost prohibitive for the industry. Funds, transfer agents, intermediaries, institutional investors and others would incur significant operational costs that include establishing or modifying a wide range of systems and procedures to process transactions at floating NAVs (not to mention the necessary changes to accommodate increased recordkeeping, accounting and tax reporting burdens). Then, in addition, they would incur costs in establishing or modifying systems and related operational changes to administer a liquidity fee and temporary gate.

It is informative to consider the SEC's own estimated costs of its proposals. Using the Release's estimated one-time and ongoing costs[13] to implement the floating NAV and liquidity fee/temporary gate proposals, we estimate the following costs would be incurred:

- Funds and their transfer agent service providers would incur *one-time costs* ranging from approximately $400 to $712 million, and *annual ongoing costs* of approximately $40 to $137 million to implement both proposals. These estimates *do not include* one-time and ongoing costs for intermediaries, institutional investors, or others affected by the proposed changes.

- The cost for the industry (including funds, transfer agents, intermediaries, institutional investors, and service providers) to implement both proposals would be 2 to 2 ½ times the estimated costs for funds, with total *one-time costs* ranging from approximately $800 million to $1.75 billion, and *annual ongoing costs* of approximately $80 to $350 million.

Again, the key issue is not the size of these costs relative to potential benefits of reducing any potential risks that regulators believe money market funds may pose. Instead, the key fact is that these costs are so large that they will encourage the use of less regulated alternatives, an outcome that would not benefit investors, the economy or the financial system.

### E. **Enhanced Disclosure and Reporting**

ICI consistently has supported efforts to increase the public disclosure of money market fund portfolio information and risks, and to enhance the SEC's access to money market fund data. Our support for further disclosure and reporting enhancements turns on whether money market funds are permitted to maintain a stable NAV. We offer our overall support for enhancing the disclosure requirements for stable NAV money market funds. If the SEC requires money market fund NAVs to float, however, the proposed disclosure requirements would be unnecessary and we oppose them. Furthermore, we question the benefit of the current level of money market fund disclosure and reporting—which is far more detailed and frequent than that for any other floating NAV funds—for money market funds that are required to float their NAVs.

We appreciate the opportunity to share our views with the Subcommittee. We remain committed to working with Congress and the SEC as they seek to address this important issue in the best possible way for the millions of American investors who rely on money market funds as an effective cash management tool and as an indispensable source of short-term financing for the U.S. economy.

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[13] *See* Release, *supra* note 1, at 107, 126, 129, 203, and 227. In discussions regarding the one-time and ongoing annual costs estimated in the Release, our members have indicated that those cost estimates are low when compared to their own estimates.