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Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

**RE: Money Market Fund Reform; Amendments to Form PF,
File Number S7-03-13**

Dear Ms. Murphy:

The U.S. Chamber of Commerce (“Chamber”) is the world’s largest business federation, representing more than three million businesses and organizations of every size, sector and region. The Chamber created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory system for the capital markets in order to promote economic growth and job creation. CCMC appreciates the opportunity to comment on the Securities and Exchange Commission’s (“Commission” or “SEC”) proposed rule regarding the regulation of money market mutual funds (“money market funds” or “MMFs”). *See* Notice of Proposed Rulemaking, Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (June 5, 2013), 78 Fed. Reg. 36833 (June 19, 2013) (“Proposal”).

While the debate over additional money market fund regulation has continued among financial regulators despite the Commission’s extensive amendments to Rule 2a-7 in 2010, CCMC believes that this rulemaking is an opportunity for the Commission to take a well-balanced and data-driven approach to strengthen MMFs and preserve the critical role they serve for U.S. businesses, state and local governments and for the economy as a whole. Failure to do so will impose significant costs and inefficiencies upon U.S. businesses, and the SEC will fail to fulfill its legal mandate to promote efficiency, competition and capital formation.

With respect to money market funds' importance to U.S. businesses, corporate treasurers use money market funds as a key tool in meeting their needs for short-term cash management, with U.S. businesses putting upwards of 50 percent of their cash in these funds at any one time. These funds are widely used because of the stability, liquidity, investment diversification and portfolio management expertise that they provide to investors.

Money market funds are also an important source of short-term financing for U.S. businesses, as these funds hold nearly 50 percent of high-quality short-term commercial paper. Because of their significance in cash management and short-term financing, CCMC therefore urges the Commission to move with extreme caution in adopting any significant additional reforms in the regulation of money market funds.

If the Commission's goal is to preserve the viability of MMFs while addressing the risk of heavy redemptions during times of severe market stress, for the reasons we explain below, we believe that the Proposal's Alternative 1, the floating net asset value, does not advance this goal. Indeed, CCMC is greatly concerned that certain regulatory changes described in the Proposal would seriously degrade the benefits of money market funds for U.S. businesses and that the predictable dislocations that would follow from these changes would impose substantial costs on job growth and the U.S. economy generally, in terms of less efficient cash management, less competition in markets for cash management and short-term financing, and higher costs of day-to-day financing for U.S. corporations.

CCMC believes that these economic consequences are reasonably quantifiable. The adverse effects that Alternative 1 would have on competition, efficiency, and capital formation are discussed in detail in the accompanying report prepared by Professor James J. Angel, Ph.D., of Georgetown University ("Angel Report" or "Report").¹ Professor Angel estimates initial costs of Alternative 1 to be in the range of approximately \$14 to over \$90 billion and recurring annual costs to be in the range of approximately \$5 to \$24 billion.² For these reasons, CCMC strongly urges the Commission to reconsider the alternatives presented in the Proposal, as discussed in detail below.

¹ The Angel Report is attached as Appendix A.

² Angel Report at 3.

Summary

In its Proposal, the Commission lays out two “alternatives” for significant changes in money market fund regulation, proposed to be adopted either separately or in combination. Alternative 1 would require so-called “institutional prime” money market funds to operate on the basis of a floating net asset value (“NAV”), rounded to the fourth decimal place, rather than the traditional stable NAV of \$1.00 per share. Alternative 2 would generally require money market funds other than “government” funds, as defined by the Commission, to impose a 2 percent liquidity fee on certain shareholders during periods of stress and would allow such non-government funds to suspend redemptions temporarily using “redemption gates” during the same periods. Under both alternatives, the Commission has proposed to remove the exemption permitting MMFs to use the amortized cost method of valuation.

CCMC strongly opposes the adoption of Alternative 1 (the floating NAV for institutional prime MMFs) and the removal of the amortized cost exemption. The dramatic structural change of floating NAV would largely eliminate the stability in share value that makes MMFs so attractive as a cash-management tool to institutional investors and would therefore cause severe economic dislocations as these investors move their money elsewhere in search of stability, including into bank deposits that offer lower yields. Eliminating the amortized cost method of valuation will likely prevent MMFs from providing intra-day settlements, thereby dramatically compromising their value as a cash management tool. As investors flee from institutional prime MMFs, the ability and willingness of these MMFs to purchase commercial paper will evaporate, and, as a consequence, U.S. businesses will find it significantly more costly to raise short-term financing to meet payroll and other operating needs, which will have a predictably adverse impact on job creation and economic growth. Professor Angel’s Report discusses these reasonably predictable economic consequences of the Commission’s proposed reforms and explains how they are reasonably quantifiable and will impose a series of large costs on U.S. businesses and the overall economy. The Proposal includes no rigorous empirical analysis of these economic impacts on “efficiency, competition and capital formation” and thus fails to satisfy the basic requirements of section 2(c) of the Investment Company Act of 1940 (“ICA”).³

³ 15 U.S.C. § 80a-2(c).

There is no need to inflict these dramatic consequences on the fragile U.S. economy to achieve the purported benefits the Commission sees in a floating NAV and the elimination of the amortized cost method of valuation. All of the purported benefits cited by the Commission can be effectively realized through the simple disclosure of a “shadow NAV” by money market funds, which is something many funds are already disclosing today, and the use of a shadow NAV will not precipitate the serious negative consequences that would flow from the Commission’s Alternative 1 and the elimination of the amortized cost method of valuation. The Proposal contains just such a disclosure-based approach that CCMC supports. In fact, there is no evidence that a floating NAV would prevent runs and, to the contrary, a floating NAV could cause investors to redeem their MMF shares more rapidly.

The amendments to ICA Rule 2a-7,⁴ and related MMF reforms adopted by the Commission in February 2010 strengthened money market funds through enhanced disclosure requirements and other safeguards (“2010 Amendments”).⁵ The 2010 Amendments were carefully designed to respond to concerns about MMF resiliency raised during the 2008 financial crisis, and they did so without impairing the benefits that these funds offer to institutional investors and without compromising the important role they play in providing a ready source of financing for commercial paper issuers. CCMC strongly supports the reforms put in place by the Commission in 2010 and notes that since the adoption of the 2010 Amendments, money market funds have operated without incident. Nevertheless, should the Commission determine that further reforms in MMF regulation are appropriate beyond enhanced disclosure requirements, CCMC would support a variation of the liquidity fee and redemption gates concept contained in Alternative 2 of the Proposal. CCMC opposes the adoption of a mandatory combination of Alternative 1 and Alternative 2.

Background

Money market funds provide two essential services for U.S. businesses. First, MMFs are an essential short-term investment vehicle and cash management tool.

⁴ 17 C.F.R. § 270.2a-7.

⁵ Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010), 75 Fed. Reg. 10060 (Mar. 4, 2010).

Second, they play a crucial role in the operation of U.S. businesses as a major source of funding for commercial paper financing.

Corporate treasurers rely on MMFs to manage cash efficiently and affordably. Their main priorities are to ensure the stable value and liquidity of their companies' cash. As such, MMFs' stable \$1.00 price per share and easy investment and redemption features have made them a major investment choice for U.S. businesses. Investments can be made and redeemed on a daily basis without fees, penalties, or tax implications. Moreover, MMFs offer corporate treasurers diversified and expertly managed short-term investment of their cash. Quite simply, it is more efficient and economical to use an MMF than to hire internal staff to manage the investment of cash.

As the Commission recognizes, MMFs also represent a major source of funding to the U.S. commercial paper market, holding approximately 46 percent of total nonfinancial and financial company commercial paper outstanding as of December 31, 2012.⁶ This source of funding is vital to companies across America as commercial paper is an efficient and affordable means to obtain short-term financing.

I. Grounds for Rejecting Proposed Alternative 1 (Floating NAV)

The Commission should reject Alternative 1. Requiring institutional prime money market funds to use a floating NAV would fundamentally alter the structure and nature of the affected funds by eliminating the critical attribute of stability that makes these funds an attractive and efficient cash management tool for corporate treasurers. As investments are withdrawn from these MMFs, they will largely disappear as a reliable source of short-term financing for U.S. businesses. As a consequence, the imposition of floating NAV for institutional prime MMFs would inevitably generate large costs and reduce efficiency in the U.S. economy, as described by Professor Angel, and the Commission has not even begun to analyze and address those costs in its Proposal. Moreover, if adopted, Alternative 1 would not reduce the

⁶ 78 Fed. Reg. at 36921.

possibility of rapid redemption requests, as the Commission posits, but would, in fact, *increase* the likelihood that they would occur.⁷

1. Reduced Demand for Floating NAV Money Market Funds

U.S. businesses currently invest hundreds of billions of dollars in prime MMFs because of the stability, liquidity, investment diversification, and competitive returns offered by these funds. CCMC has consulted broadly with the corporate treasurers of its members regarding the Proposal, and based on these consultations, CCMC believes that adoption of Alternative 1 would cause U.S. businesses to dramatically reduce their investments in the affected prime MMFs and turn to other options for short-term cash management.

1.1. Loss of Stable Value

The most important attribute that money market funds offer to corporate treasurers is stability of principal value. According to a recent survey by the Association for Financial Professionals (“AFP”) of senior finance and treasury executives at a broad range of companies, the AFP found that more than two-thirds (68 percent) of respondents indicated that safety of principal is the most important short-term investment objective for their organization.⁸ Not coincidentally, about two-thirds (65 percent) of the respondents said their organizations would be less willing to invest in MMFs or would eliminate or reduce current holdings if a floating NAV were implemented.⁹

These recent statistics are consistent with other surveys conducted over the past few years. For example, in a survey of financial executives representing corporate, government, and institutional investors conducted by the independent

⁷ Although our comments are focused on the perspective of U.S. businesses, CCMC also recognizes that there are separate and legitimate concerns relating to the impact of Alternative 1 on tax-exempt MMFs and state and local governments. Like many other stakeholders, CCMC believes that the Commission should consider excluding all tax-exempt MMFs from Alternative 1.

⁸ 2013 AFP Liquidity Survey (June 2013), available at http://www.afponline.org/uploadedFiles/Association_of_Financial_Professionals/mbr/reg/pdf/2013%20AFP%20Liquidity%20Survey.pdf, at 9 (“AFP Liquidity Survey”).

⁹ *Id.* at 24.

treasury management firm Treasury Strategies, Inc. (“Treasury Strategies”), 94 percent of survey respondents rated safety of principal an “extremely important factor” for their businesses when making cash and short-term investment decisions.¹⁰ The survey also found that 79 percent of respondents would either decrease their use of MMFs or discontinue using them altogether if MMFs were required to have a floating NAV.¹¹ In addition, the survey estimated that assets in MMFs would see a net decrease of 61 percent if a floating NAV were adopted.¹² Another survey conducted by Fidelity Investments further confirms that the majority of institutional investors (57 percent) would reduce their investments in or cease using MMFs if a floating NAV requirement were imposed.¹³

Based on feedback from businesses, including the surveys cited above, CCMC believes there is no doubt that if Alternative 1 were adopted, U.S. businesses would substantially reduce their investments in institutional prime MMFs due to the loss of principal stability associated with a floating NAV.

1.2. Issues with the Loss of Liquidity

A stable NAV and use of the amortized cost method of valuation exemption allow MMFs to execute same day and intra-day settlements in a cost-effective way for the benefit of U.S. businesses. Currently, an MMF is able to offer investors intra-day settlement, because the MMF can quickly calculate its stable NAV using amortized cost, absent a material credit event or other event that could cause the MMF’s market-based NAV to move below \$0.9950 or above \$1.0050. Without the ability to maintain a stable NAV and use the amortized cost method of valuation, an MMF would be required to obtain market prices for each portfolio security from its pricing vendor and calculate its price.

¹⁰ See Money Market Fund Regulation: The Voice of the Treasurer (Apr. 2012), available at http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf, at 36 (“TSI Survey”).

¹¹ *Id.* at 12

¹² *Id.*

¹³ See Fidelity Investments, The Investor’s Perspective: How Individual and Institutional Investors View Money Market Mutual Funds and Current Regulatory Proposals Designed to Strengthen Money Funds (Dec. 2, 2011), available at <http://www.sec.gov/comments/4-619/4619-116.pdf>.

Indeed, as Professor Angel has noted, short-term securities held by MMFs are not actively traded on organized exchanges with publicly observable prices.¹⁴ In fact, some short-term securities even lack CUSIP numbers.¹⁵ As a result, pricing vendors typically base a short-term security's price on models, rather than actual market transactions or quotations.¹⁶

By removing the amortized cost method of valuation, MMFs would therefore be relying on pricing information from pricing vendors, which, as Professor Angel explains, may not be more accurate than amortized cost.¹⁷ Furthermore, pricing vendors may not be able to provide accurate prices for portfolio securities multiple times throughout the day and, even if they are able to do so, MMFs would still need to confirm those prices and accurately calculate their NAVs. As a result, MMFs may not be able to continue to offer same day and intra-day settlements to investors if the amortized cost method of valuation is removed and MMFs are required to use a floating NAV.

The loss of the ability to access and transmit corporate funds during the course of the day would severely compromise the utility of MMFs for corporate treasurers. Corporate treasurers value the ability to have rapid access to corporate funds. In fact, the AFP found that 29 percent of respondents indicate that liquidity is the most important short-term investment objective for their organization.¹⁸ If this were lost, they would move to competitive short-term investment products that do offer such a feature. As a result, MMFs would experience significantly reduced demand if the stable NAV and amortized cost method of valuation is removed.

1.3. Issues with Investment Policies and Other Covenants or Agreements

If the Commission adopts a floating NAV requirement, U.S. businesses would be required to review, reassess, and in most cases revise their investment policies in order to accommodate investments in a floating NAV MMF. According to the AFP

¹⁴ Angel Report at 27.

¹⁵ *Id.* at 28.

¹⁶ *Id.* at 27.

¹⁷ *Id.* at 27 – 29.

¹⁸ AFP Liquidity Survey at 9.

Liquidity Survey, 74 percent of organizations have a written document in place defining their short-term investment policies.¹⁹ A majority of these companies review their investment policies on an annual basis.²⁰ Based on the results of the TSI Survey, 33 percent of the financial executives representing corporate, government, and institutional investors surveyed indicated that they have an existing investment policy or other restriction that prohibits them from investing short-term cash in a floating NAV instrument.²¹

The process of rewriting a company's policy is complex, because it requires input from the company's most senior executives and ultimately the board of directors. As the Commission is aware, the board of a company has a fiduciary obligation to ensure that the company's available cash is invested in investment vehicles with appropriate liquidity and credit risk. As such, boards generally allow investment of cash only in stable value products where there is a low degree of risk of loss as funds intended for liquidity purposes are the lifeblood of any company. Given the fiduciary responsibilities of corporate boards, it is unlikely that they will allow cash investments in a floating NAV product if they have an existing investment policy, law or other restriction that prohibits them from investing short-term cash in a floating NAV instrument, even if the appropriate investor protections are in place and the tax and accounting issues discussed below have been accommodated by regulators.

In addition to investment policies, U.S. businesses may have debt covenants or cash collateral, escrow or leverage agreements that require collateral to be invested in a stable NAV product. If the SEC adopts Alternative 1, U.S. businesses would need to examine those covenants and agreements to determine if a floating NAV would be a permitted investment and, if not, both parties to the covenant or agreement would need to agree to a change. This review and any change would require additional legal review and significant costs. In addition, certain parties may not agree to accept a floating NAV instrument. In order to avoid the additional costs associated with such a review and to ensure that the company is not in default of a covenant or other agreement, corporate treasurers would likely reduce their investments in floating NAV MMFs in favor of other stable value products. Indeed, part of the Commission's

¹⁹ AFP Liquidity Survey at 8.

²⁰ *Id.*

²¹ TSI Survey at 14.

analysis of the Proposal should include a study of the change in risk tolerances and capital requirements for banks and their holding companies if these debt covenants are renegotiated.

In the case of many state and local governments, the consequences of a floating NAV could not be clearer. Many state and local governments are subject to statutory prohibitions against investing in products that do not have stable NAVs.²² Therefore, should Alternative 1 be adopted and a floating NAV be implemented, these investors will have no choice but to withdraw their investments in floating NAV MMFs.

1.4. Tax Issues with “Basis Point” Rounding

Under the Proposal, the Commission proposed that floating NAV MMFs must calculate their NAVs using “basis point” rounding. This rounding convention would require an MMF to calculate its share price to the fourth decimal place if it prices its shares at one dollar per share (*e.g.*, \$1.0000). This degree of meticulousness is ten times greater than that required for other mutual funds²³ and 100 times greater than the penny rounding method currently utilized by MMFs.

The effect of the new “basis point” rounding (0.0001) convention is that taxable shareholders in floating NAV MMFs would be required to track the timing and price of purchases and sales of MMF shares to determine the amount of taxable gains and losses realized. These gains and losses would normally be small. For example, a redemption of 10,000,000 shares when there is a one basis point drop in an MMF’s NAV after purchase would result in a loss of \$1,000. Although such losses would not have a substantial impact on a company’s balance sheet, keeping track of such minor losses and gains would be extremely burdensome and inefficient.

Because the Proposal would require this basis point rounding for shares of floating NAV MMFs, most redemptions could result in small gains and losses. The

²² See Letter from 12 State and Local Entities to Elizabeth Murphy RE: File No. 4-619; Release No. IC-29497 *President’s Working Group Report on Money Market Fund Reform* (Jan. 10, 2011), available at <http://www.sec.gov/comments/4-619/4619-39.pdf>.

²³ Under valuation guidance from the SEC, many mutual funds that are not MMFs price their shares at an initial NAV of \$10.00 and round their NAV to the nearest penny. See *Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies*, Investment Company Act Release No. 9786 (May 31, 1977).

frequency of purchases (including any reinvested dividends) in varying amounts and at different NAVs would make it difficult to determine the cost of shares being redeemed. For businesses that frequently move in and out of numerous MMFs on a daily or weekly basis, having to keep track of these gains and losses without human error would be enormously challenging.

Shareholders may potentially choose different methods to identify the cost of the particular shares being redeemed when there were purchases at different times (*e.g.*, FIFO, LIFO, average cost and specific identification). In addition, complexities would be caused by the fact that gains and losses may be either short-term or long-term depending on the holding period of the redeemed MMF shares. Various netting rules would also apply to such gains, including any capital gains and losses from other investments. Finally, capital losses can generally only offset capital gains, and rules for capital loss carryovers can result in further complexities.

Although the Proposal appears to contemplate that MMFs could determine and report gains and losses, any such requirements would be very costly and burdensome. A floating NAV requirement would require MMFs and any relevant intermediaries to implement systems, processing and reporting changes which would cause substantial additional costs. Increased complexity would arise in light of the potentially different tax years for taxable corporate investors and the various potential methods for lot selection by investors with respect to redeemed shares.

With respect to the application of the “wash sale” rules to redemptions of shares in floating NAV MMFs, the Internal Revenue Service (“IRS”) recently proposed a new Revenue Procedure (“Proposed Revenue Procedure”) regarding the application of the wash sale rules under Section 1091 of the U.S. Internal Revenue Code (“Code”) to floating NAV MMFs.²⁴ Under the Proposed Revenue Procedure, if a shareholder realizes a loss upon the redemption of floating NAV MMF shares and the amount of the loss is *de minimis*, the IRS would not treat the loss on the redemption as subject to the wash sale rules under Section 1091 of the Code. The IRS defines a *de minimis* loss as a loss realized upon a redemption of a floating NAV money fund share, the amount of which (expressed as a positive number) is not more than one-half of 1% (*i.e.*, 0.5%) of the shareholder’s basis in the share.

²⁴ See Application of Wash Sale Rules to Money Market Fund Shares, IRS Notice 2013-48 (July 3, 2013).

Notwithstanding the IRS's efforts to exempt certain *de minimis* transactions in MMF shares from the wash sale rules, the Commission noted in the Proposal that "money market funds would still incur operational costs to establish systems with the capability of identifying wash sale transactions, assessing whether they meet the *de minimis* criterion, and adjusting shareholder basis as needed when they do not."²⁵ Likewise, shareholders in floating NAV MMFs would need to identify wash sales transactions for their own purposes. These issues are not addressed by the Proposed Revenue Procedure.

The burdens associated with tracking these transactions require fundamental changes to treasury systems that will take months and years to test and complete. Moreover, these changes would have to take place after prioritization with other business needs a company's IT department must meet. It is likely that some U.S. businesses will choose not to dedicate resources to make the necessary changes to their systems in order to accommodate the tax issues associated with a floating NAV while others will need to forgo their investments in floating NAV MMFs until such systems are upgraded, which could be a period of years. Therefore, it is clear that U.S. businesses will reduce their investments in floating NAV MMFs as a result of these tax implications.

1.5. Operational and Systems Issues

A floating NAV requirement under Alternative 1 would impose an enormous burden on U.S. businesses to reengineer their investment processes for a floating NAV product. Specifically, additional procedures to match and confirm purchases and redemptions of MMF shares under a floating NAV would have to be implemented—something that is not necessary for a stable NAV MMF. Any differences detected must be reconciled. Businesses must also take the extra step to ensure compliance with investment policies because the floating NAV may fall outside of acceptable guidelines.

In addition to the changes in investment processes, U.S. businesses will have to revamp existing IT systems. Currently, accounting systems and treasury workstations are not programmed to accept a floating NAV for MMFs. Corporate treasurers are

²⁵ 78 Fed. Reg. at 36869.

focused on managing cash and liquidity to meet working capital needs. Cash management involves daily balance, overnight borrowing or investing, and multiple transactions in a short period of time. Therefore, cash investments made by corporate treasurers are placed into very liquid, short-term, low risk and stable value products, so the stable value feature is embedded in the corporate treasurer workstations. While some U.S. businesses invest in floating NAV investment products such as short-term bond funds, those transactions are generally made for the purpose of having a longer investment time horizon and does not involve frequent movement of cash. Thus, these transactions are handled through company's investment management divisions where systems are programmed for this purpose.

In the Proposal, the Commission estimated the costs to a business of implementing the systems necessary to handle floating NAV transactions. This estimate projected an initial cost of between \$1.4 million to \$2.9 million per company.²⁶ It further estimated that the ongoing annual costs to keep the procedures and controls current and to provide continuing training would range from 5 percent to 15 percent of those one-time costs.²⁷

CCMC recently issued a report prepared by Treasury Strategies titled "Operational Implications of a Floating NAV across Money Market Fund Industry Key Stakeholders" that examined the operational complexity, systems alterations, and business process changes needed to support a floating NAV ("TSI Report").²⁸ The TSI Report also estimated the costs of implementing the changes. With respect to individual companies, the TSI Report estimated that the initial reengineering and reporting development costs for a U.S. business with complex enterprise risk management or treasury management system technology could be as high as \$2 million.²⁹ Treasury Strategies estimated that U.S. businesses that chose to invest in floating NAV MMFs without making major system and process changes would be closer to an initial cost of \$250,000.³⁰ On an ongoing basis, Treasury Strategies

²⁶ 78 Fed. Reg. at 36873.

²⁷ *Id.*

²⁸ Operational Implications of a Floating NAV across Money Market Fund Industry Key Stakeholders (Summer 2013) ("TSI Survey"). The TSI Report is attached as Appendix B to this letter.

²⁹ *Id.* at 5.

³⁰ *Id.*

concluded that the equivalent of one-half to one additional full-time employee would be required to manage additional processing, policy compliance and reporting tasks.³¹

Overall, the TSI Report estimated that total upfront cost for investors to move from a stable to a floating NAV would be between \$1.8 and \$2 billion.³² Further, the TSI Report estimated that new annual operating costs would be an additional \$2 to \$2.5 billion.³³ Treasury Strategies based its estimates on an assumption that all MMFs in which a company would invest would have a floating NAV. Treasury Strategies stated that having a dual system where some MMFs have a stable NAV while others have a floating NAV would be more expensive and complicated.³⁴ Therefore, the estimates in the TSI Report may be less than the actual costs.

In addition to the direct costs highlighted above, moving to a floating NAV would require a substantial amount of time to implement the appropriate systems changes. As a first step, the MMF industry as a whole would need to develop a reporting format for a floating NAV MMF and each individual MMF would need to update its systems accordingly. Only when this update is accomplished would investors, particularly corporate treasurers, be able to make the necessary adjustments to their accounting and treasury systems and work with their software vendors to determine how those modifications would need to be made—both in terms of software development and software implementation and testing.

Because technology innovation is dynamic, the capital outlay for these system changes will have to be incorporated and prioritized among a pre-existing pipeline of corporate information technology projects and other major corporate capital expenditures. Financial and resource constraints may result in a long lead time to develop and implement systems that will allow corporate treasurers to deal with MMFs with floating NAVs.

³¹ *Id.* at 17.

³² *Id.* at 3.

³³ *Id.*

³⁴ TSI Report at 2.

Discussions with corporate treasurers suggest the following general parameters for the timing of a transition from stable NAV to floating NAV for MMF sponsors and investors:

Phase 1—MMF industry modifies reporting and systems: 12 to 24 months

Phase 2—software vendors and corporate investors develop necessary software upgrades, corporate investors get approval for capital expenditures on software systems: 6 to 12 months after Phase 1.

Phase 3—implementation and testing of upgraded treasury workstations and accounting software: 18 to 24 months after Phase 2.

In addition, not only do treasury workstations not currently accommodate floating NAV MMFs, but the standard protocol to transmit that data from the MMFs does not yet exist. Every aspect of the data transmission would have to be developed from the ground up. Any implementation of Alternative 1 must take into consideration the time needed for the foregoing systems changes in order for a floating NAV system to be put into place without major disruptions. Allowing an inadequate amount of time for a transition will force corporate treasurers—and other investors with similar operational issues—to withdraw from investments in MMFs.

Based on the high costs and effort to adapt systems to support a floating NAV, it is clear that U.S. businesses will reduce their investments in the affected funds as a result of the operational and systems issues associated with a floating NAV MMF. To the extent U.S. businesses continue to invest in floating NAV MMFs, the direct costs to U.S. businesses noted above would need to be considered by the Commission as part of its cost-benefit analysis.

1.6. Issues with Accounting Treatment as a Cash Equivalent

In the Proposal, the Commission acknowledged that there would be an accounting issue as to whether a floating NAV MMF would meet the characteristics of a cash equivalent under U.S. GAAP. The SEC, Financial Accounting Standards Board (“FASB”), and any other relevant domestic and international accounting standard setting bodies should make the necessary regulatory and policy changes prior

to moving forward with any substantive steps to impose a floating NAV. If the Commission, FASB, and any other relevant domestic and international accounting standard setting bodies are unable to specifically provide guidance that a floating NAV MMF can qualify as a cash equivalent, corporate treasurers will be forced to withdraw their companies' investments from MMFs. This is because investors in a company generally prefer a company's balance sheet to reflect a stronger "cash and cash equivalents" position. In addition, there are burdens associated with tracking gains and losses of "investments" on a company's balance sheet. Absent clear guidance, U.S. businesses will move out of floating NAV MMFs.

It should also be noted that in some cases a change in U.S. GAAP may trigger the need to renegotiate debt covenants. The cost to businesses and the changes in risk tolerances and capital requirements for banks and their holding companies must be considered by the Commission and addressed in any final rule. Similarly, the Commission must examine the costs to international businesses that file financial statements in the U.S. under the International Financial Reporting System, but used MMFs for cash management purposes in the U.S.

2. The Proposal Fails to Quantify and Rigorously Analyze the Economic Burdens that Alternative 1 Would Impose on Efficiency, Competition, and Capital Formation in Important U.S. Markets, as Required by Section 2(c) of the ICA

Under section 2(c) of the ICA, the Commission must consider whether a rule will promote efficiency, competition, and capital formation when promulgating rules that require consideration of the public interest. In discharging these responsibilities, the Commission has a "statutory obligation to determine as best as it can the economic implications of the rule that it has proposed,"³⁵ and it must subject that analysis to public comment.³⁶

If adopted, Alternative 1 would impose very significant costs on efficiency, competition, and capital formation in both the market for short-term cash management products and the commercial paper market. These costs are both

³⁵ See *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C.Cir. 2005).

³⁶ See *Chamber of Commerce v. SEC*, 443 F.3d 890, 905 (D.C.Cir. 2006).

reasonably predictable and readily quantifiable, as Professor Angel's report makes clear. The Proposal fails to provide any empirical analysis of these critical negative impacts, to consider whether the purported benefits sought by the Commission could be effectively obtained without inflicting these serious costs on the U.S. economy, and to provide the public any meaningful opportunity to understand and comment on the Commission's consideration of the costs of Alternative 1. For these reasons, the Proposal does not come close to satisfying the requirements of section 2(c), and Alternative 1 may not be validly adopted unless the Commission has first conducted the required analysis and published it for public comment.

2.1. Costs Imposed in the Market for Short-Term Cash Management

The Proposal does not quantify or adequately analyze the impact of Alternative 1 on efficiency, competition, and capital formation in the market for short-term cash management products. Alternative 1 would indeed have a seriously negative impact in each respect in this market.

Loss of Efficiency in Short-Term Cash Management. The Commission itself recognized in the Proposal that money market funds today are an efficient cash management tool for companies and other institutional investors:

Institutional investors commonly use money market funds for cash management in part because . . . money market funds provide efficient diversified cash management due both to the scale of their operations and their expertise.³⁷

The Commission further explained why investors value the efficiency of MMFs over other investment options for cash management:

Many investors likely would find it impractical or inefficient to invest directly in the short-term financing markets, and some investors likely would not want the relatively undiversified exposure that can result from investing in those markets on a smaller scale or that could be associated

³⁷ 78 Fed. Reg. at 36837 (footnote omitted).

with certain alternatives to money market funds, like bank deposits.³⁸

The Proposal noted that stability of principal is a central reason why corporate treasurers choose to invest in money market funds. The Proposal also recognized that investors who are not willing to accept a risk to principal will not continue to invest in an MMF operating under a floating NAV. The Commission admitted that “investors unwilling to bear the risk of a floating NAV would likely move to other products.”³⁹

The Proposal conceded, in particular, that a floating NAV would significantly dampen the interest of institutional investors to put their cash in the affected funds by reducing the efficiency of these funds as a cash management vehicle:

[W]e anticipate that some institutional investors would not or could not invest in a money market fund that does not offer principal stability or that has restrictions on redemptions. We do expect that more institutional investors would be unwilling to invest in a floating NAV money market fund than a money market fund that might impose a fee or gate because a floating NAV would have a persistent effect on investors’ experience in a money market fund. These investors may be unwilling to incur the operational and other costs and burdens . . . that would be necessary to use floating NAV money market funds.⁴⁰

Finally, the Commission specifically recognized the efficiency benefit that institutional prime funds currently offer to institutional investors who wish to participate in the commercial paper market through MMFs:

Rule 2a-7 . . . benefits investors by making available an investment option that provides an efficient and diversified

³⁸ *Id.* (footnote omitted).

³⁹ *Id.* at 36851.

⁴⁰ *Id.* at 36915.

means for investors to participate in the short-term financing markets through a portfolio of short-term, high-quality debt securities. Many investors would likely find it impractical or inefficient to invest directly in the short-term financing markets⁴¹

The Commission discussed the alternatives that might be available to investors no longer attracted to floating NAV MMFs. It suggested that such investors might shift to non-prime money market funds that are not subject to floating NAV, but that this shift would involve sacrificing yield.⁴² The Commission also noted that investors could shift to bank deposit products, subject to their willingness to hold deposits in excess of the deposit insurance thresholds.⁴³ But the Commission forthrightly acknowledged that investors who value principal stability “would find most other alternative investment vehicles unattractive.”⁴⁴

All of these efficiency benefits of institutional prime MMFs would be lost if Alternative 1 were adopted. Corporate treasurers who choose to keep their companies’ cash in floating NAV MMFs will experience reduced efficiency due to the initial and ongoing systems and operational costs associated with such funds. Businesses that shift their cash to bank deposits will also suffer a loss of efficiency because bank deposits do not offer the opportunity to invest the deposited funds efficiently in short-term commercial paper. Furthermore, as the Commission acknowledged, institutional investors could not achieve comparable efficiencies by self-investing directly in commercial paper because such direct investments would not offer the economies of scale made possible by institutional prime MMFs.⁴⁵

The Proposal fails to make any effort whatsoever to quantify the predictable loss of efficiency in cash management that would follow from the adoption of

⁴¹ *Id.* at 36837 (footnote omitted).

⁴² *See id.* at 36918.

⁴³ *See id.*

⁴⁴ *See id.* In this regard, the Commission evaluated a range of potential alternative investment vehicles, including offshore money funds, enhanced cash funds, ultra-short bond funds, collective investment funds, short-term investment funds, local government investment pools, short-duration ETFs and separately managed accounts.

⁴⁵ *See id.* at 36916.

Alternative 1. Professor Angel indicates that the overall efficiency of the economy will be harmed by unnecessarily tying up large amounts of capital in the banking sector to accommodate the potential ranges of shifts of business funds from floating NAV MMFs to bank cash management products.⁴⁶ The Angel Report sets forth four scenarios for possible levels of such shifts in funds. These scenarios could result in additional required bank capital ranging from approximately \$12 to \$90 billion.⁴⁷ Professor Angel notes that this capital would not be available for other productive uses in the economy thereby hurting economic growth and efficiency.⁴⁸

Loss of Competition in Cash Management. Federal Reserve Board data demonstrates that under their current stable value structure, money market funds are a strong competitive alternative to bank deposits for providing the efficient cash management service that institutional investors need. As of March 31, 2013, all businesses held \$1.258 trillion of their cash in checkable deposits and currency and \$1.258 trillion in MMFs.⁴⁹ Thus, the market for short-term cash management investment vehicles for U.S. businesses is equally divided between bank deposits and MMFs.

The bulk of the cash that U.S. businesses put into money market funds is held by the funds that the Commission identifies as institutional prime MMFs and that would become subject to the floating NAV requirement under Alternative 1. The Proposal itself states that, as of February 28, 2013, institutional prime MMFs held approximately \$974 billion in assets,⁵⁰ which translates into approximately 77 percent of the MMF shares held by U.S. businesses.

Institutional prime MMFs and bank deposits currently exist as comparable alternatives for cash management purposes. Banks and prime institutional MMFs compete to attract corporate cash based on a range of factors, including rates paid,

⁴⁶ Angel Report at 21.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release, Z.1 Financial Accounts of the United States, Flow of Funds, Balance Sheets and Integrated Macroeconomic Accounts, First Quarter 2013 at 65 and 71, available at <http://www.federalreserve.gov/releases/z1/current/z1.pdf>.

⁵⁰ 78 Fed. Reg. at 36916.

fees charged and the types and quality of services offered, and U.S. businesses benefit greatly from this robust competition. By disrupting and suppressing the ability of institutional prime money market funds to compete with banks in the provision of efficient cash management services, Alternative 1 would predictably destroy the financial benefits of the present competition for U.S. businesses.

The Proposal stated that the Commission does not currently have a basis for estimating under either Alternative 1 or 2 “the number of investors that might reallocate assets, the magnitude of the assets that might shift, or the likely investment alternatives *because we do not know how investors will weigh the tradeoffs in reallocating their investments to alternatives.*”⁵¹

In fact, however, there is a readily available basis for estimating the magnitude of the likely shift away from floating NAV MMFs. The Proposal discussed a series of studies and surveys, including those conducted by Treasury Strategies and the Investment Company Institute, that indicate that a large majority of institutions would either stop investing in floating NAV MMFs or would substantially decrease their investments in such funds.⁵² The Commission may not disregard relevant and meaningful data in complying with its cost-benefit analysis obligations under section 2(c) of the ICA.

The Commission recognized that there are major barriers to the use of most investment alternatives to floating NAV MMFs. It acknowledged that bank cash management deposit products and MMFs not subject to floating NAV requirements are the principal alternatives for such institutional investors who will not or cannot invest in floating NAV MMFs.

Other types of money market funds will probably not be an attractive cash management alternative for current institutional prime MMF investors, because as the Commission acknowledges, investing in those funds will involve sacrificing yield and/or being subject to unacceptable daily redemption restrictions. Bank deposits will likely be more attractive than retail MMFs. Among other things, under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), banks

⁵¹ *Id.* at 36915 (emphasis added).

⁵² *See id.*

are no longer prohibited from paying interest on demand deposits held by businesses,⁵³ and thus, are free to actively compete for short-term funds from such corporate treasurers. Moreover, bank cash management deposits are not subject to daily payment and transfer limitations. For this and other reasons, CCMC believes it is likely that a large portion of the funds currently held in institutional prime MMFs would shift to bank deposits if Alternative 1 were adopted.

A massive shift of corporate cash from money market funds to bank deposits would dramatically alter the competitive equilibrium in the market for short-term cash management products for U.S. businesses. Banks would move from a 50 percent share of the overall market to a position of overwhelming dominance, thus further concentrating risk in one sector of the financial markets.

Professor Angel's Report provides an empirical analysis of the potential consequences of Alternative 1 in regard to the outflow and reallocation of funds held in institutional prime MMFs. The Angel Report sets forth four scenarios for the potential level of outflows from institutional prime MMFs.⁵⁴ The Angel Report then identifies three scenarios for substitute investments of such funds.⁵⁵ The Report estimates that the amount of funds in institutional prime MMFs that could move to bank cash management deposit products could range from approximately \$214 to \$974 billion.⁵⁶ The Angel Report estimates a net inflow of bank deposits ranging from approximately \$105 to \$792 billion.⁵⁷

The Proposal does not discuss these implications in any detail and makes no effort to quantify the economic impact on U.S. businesses and the economy generally of this predictable loss of competition. The Commission's failure to consider this impact renders the Proposal deficient under section 2(c) of the ICA.

⁵³ See Dodd-Frank Act section 627; Federal Reserve System, Prohibition Against Payment of Interest on Demand Deposits, 76 Fed. Reg. 42015 (July 18, 2011).

⁵⁴ Angel Report at 6-8.

⁵⁵ *Id.* at 9-15.

⁵⁶ *Id.* at 12.

⁵⁷ *Id.* at 17.

Negative Impact on Capital Formation. The Proposal recognized that investment in MMFs achieves the objective of capital formation, which is one of the factors section 2(c) of the ICA requires the Commission to consider.⁵⁸ Accordingly, a dramatic reduction in assets held by floating NAV MMFs could have a significant negative impact on capital formation, depending on the alternative investments that investors select.

The Proposal suggested that Alternative 1 may not have a large impact on capital formation because investors might be able to shift to direct investments in commercial paper and other securities currently held by institutional prime MMFs.⁵⁹ However, in the next breath, the Proposal conceded that there will be a range of daunting impediments that would likely render this suggestion unachievable.⁶⁰ Tellingly, the Proposal makes no effort to suggest that a shift in funds from floating NAV MMFs to bank deposit products would mitigate the negative impact on capital formation, because such a shift clearly would reduce the funds available to finance the issuance of new debt offerings.

Professor Angel's Report examines the likely adverse impact on capital formation that would be caused by Alternative 1. He notes that a shift of funds to bank cash management deposit products will require banks to raise and sequester substantial additional amounts of capital ranging from approximately \$20 to \$90 billion.⁶¹ These funds will not be available to other highly productive engines of capital formation in the economy. In fact, Professor Angel notes that a conservative estimate of funds being drawn into bank capital is comparable to the amount raised by U.S. venture capital firms in 2012.⁶² Professor Angel also notes that the cost of capital for U.S. banks will increase and that, assuming an 8% cost of capital, banks will experience annual capital charges of approximately \$1 to \$7 billion.⁶³

⁵⁸ See 76 Fed. Reg. at 36864 (exemption for retail prime MMFs would have a positive effect on capital formation by mitigating the reduction of the amount of assets held by MMFs); see *id.* at 36927 (discussing how certain potentially required disclosures could either have a positive or negative effect on capital formation, either by causing funds to be retained by MMFs or by causing redemptions).

⁵⁹ *Id.* at 36916.

⁶⁰ *Id.*

⁶¹ Angel Report at 21.

⁶² *Id.*

⁶³ *Id.* at 22.

Once again, the Commission has failed to meet the analytical requirements of section 2(c) of the ICA by making no effort to quantify the impact on capital formation from the suppression of cash management options that Alternative 1 would inflict.

2.2. Costs Imposed in the Market for Commercial Paper Financing.

The Proposal does not adequately consider or address the effects of Alternative 1 in the commercial paper market, which would suffer a serious adverse impact on competition, efficiency, and capital formation if this alternative were implemented.

Loss of Efficiency in Commercial Paper Financing. Raising funds through the commercial paper market is a low-cost, efficient way for businesses to obtain short-term financing. Other alternatives, such as bank loans, typically carry significantly higher costs and more burdensome terms and conditions.

Adverse changes in the rates and availability of commercial paper financing would have a negative impact on the operational efficiency of the commercial paper market. The loss of this efficiency would, in turn, harm U.S. businesses that depend on this market for short-term financing. U.S. businesses will have to confront higher costs and greater difficulties in obtaining such financing, as Professor Angel explains in his report.⁶⁴

The Commission has offered no explanation in the Proposal as to how assets would be reallocated in the event of the adoption of Alternative 1. As a result, the Proposal fails to address the predictable negative impact that Alternative 1 will have on efficiency for issuers of commercial paper and fails to satisfy the Commission's obligations under section 2(c) of the ICA.

Loss of Competition in the Financing of Commercial Paper. The Proposal recognized the important role that prime MMFs play in the commercial paper market when it noted that as of December 31, 2012, prime MMFs held 46.4 percent of outstanding nonfinancial company commercial paper and 45.2 percent of

⁶⁴ *Id.* at 22 – 23.

outstanding financial company commercial paper.⁶⁵ The Proposal stated that the Commission's alternatives *may or may not affect competition* within the short-term financing markets.⁶⁶ The Proposal stated that the competitive effects are likely to be small if investors either remain invested in money market funds (presumably referring to retail prime MMFs)⁶⁷ or move to alternative vehicles that invest in similar underlying assets. On the other hand, the Proposal indicated that the competitive effects are likely to be large if investors reallocate their investments into substantively different assets.

The Proposal frankly acknowledged the adverse competitive effects of such a reallocation:

In that case, issuers are likely to offer higher yields to attract capital, whether from the small money market fund industry or from other investors. Either way, issuers that are unable to offer the required higher yield may have difficulties raising their required capital, at least in the short-term financing markets.⁶⁸

The Proposal recognized that if investments in floating NAV MMFs move to bank cash management products, such a shift is likely to have an adverse impact on competition in the commercial paper market, since bank deposits tend to be used to fund longer-term lending and capital investments, rather than short-term commercial paper.⁶⁹ Again, however, the Proposal avoids providing the Commission's views as to how funds that leave floating NAV MMFs under Alternative 1 will be reallocated. By avoiding this central issue of Alternative 1's competitive impact in the commercial paper market, the Commission fails to meet its most basic analytical obligations under section 2(c) of the ICA.

⁶⁵ See 76 Fed. Reg. at 36916.

⁶⁶ *Id.* at 36923.

⁶⁷ The Proposal noted that if capital flowed from prime MMFs to government MMFs, issuers that primarily issue to prime funds (*i.e.*, commercial paper issuers) would be adversely affected. See *id.* at 36921.

⁶⁸ *Id.* at 36923.

⁶⁹ See *id.* at 36921.

Such an analysis must address the likely effects of the predictable reallocation on the rates paid by commercial paper issuers, the extent of the availability of continued funding available to commercial paper issuers, and the availability, costs, and terms of alternative funding that may be available to commercial paper issuers. The Proposal makes no attempt to quantify any of these likely impacts of Alternative 1, even though, as Professor Angel shows, they are reasonably quantifiable and will likely amount to between approximately \$2 and \$11 billion in annual costs.⁷⁰ Therefore, the Proposal falls short of the requirements of the section 2(c).

Negative Impact on Capital Formation. The Proposal also acknowledges that Alternative 1 could have an adverse impact on capital formation among commercial paper issuers, but here, too, it makes no effort to quantify this cost.

The Proposal first suggested that financial commercial paper issuers and other firms “would be able to identify over time alternative short-term financing sources if the amount of capital available for financial commercial paper declined in response to money market fund rule changes.”⁷¹ However, the Proposal does not explain what such alternative short-term funding sources would be. Nor does it indicate whether such sources would be sufficient to replace the loss of commercial paper financing or what the increase in cost for such sources of financing would be. Moreover, the Proposal fails to discuss the options and consequences for nonfinancial commercial paper issuers, who may have fewer alternative sources of short-term financing.

The Proposal stated:

Alternatively, commercial paper issuers may have to offer higher yields in order to attract alternate investors, potentially hampering capital formation for issuers. The increase in yield, however, may increase demand for these investments which may mitigate to some extent the potential adverse capital formation effects on the commercial paper market.⁷²

⁷⁰ Angel Report at 23.

⁷¹ 76 Fed. Reg. at 36922.

⁷² *Id.*

But the Proposal ignores that Alternative 1 would likely produce a dramatic shift of funds from floating NAV MMFs to bank cash management deposit products. As a result, the Proposal does not analyze the magnitude of the predictable adverse impact on capital formation in the commercial paper market and thereby fails to satisfy the requirements of section 2(c) of the ICA.

As Professor Angel has shown, it is indeed likely that if Alternative 1 were adopted, there would be a massive shift of funds from floating NAV prime MMFs to bank cash management deposit products and that such a shift would have a negative financial impact on commercial paper issuers of approximately \$2 to \$11 billion per year due to a reduction in the availability of commercial paper funding.⁷³

3. Alternative 1 Will Not Achieve the Benefits Sought by the Commission, and There is a More Benign Means to Obtain the Desired Benefits

The Proposal stated that Alternative 1 is “designed primarily to address the incentive for shareholders to redeem shares ahead of other investors in times of fund and market stress.”⁷⁴ It further stated that Alternative 1 is also intended to improve the transparency of funds’ investment risks through more transparent valuation and pricing methods, suggesting that investors in floating NAV MMFs should become more accustomed to, and tolerant of, fluctuations in MMFs’ NAV and thereby less likely to redeem shares in times of stress.⁷⁵

Thus, Alternative 1 appears to seek to provide a benefit of reducing the likelihood of runs on money market funds by removing what it considers to be a first mover incentive and to accustom former stable value investors to accept declines in NAV without redeeming shares. However, adoption of Alternative 1 is not necessary to achieve any such benefits, and indeed the harmful incentives the Commission is hoping to avoid would actually be exacerbated by Alternative 1. In reality, the benefits the Commission seeks can be fully realized through the disclosure of a “shadow NAV” by an institutional prime money market fund, and the disclosure of a shadow NAV will not generate the harmful consequences that would flow from a

⁷³ Angel Report at 23.

⁷⁴ 78 Fed. Reg. at 36901.

⁷⁵ *Id.*

floating NAV. The Proposal's failure to consider the more benign alternative of disclosing the shadow NAV as the best means to achieve the desired benefits is another reason why the Proposal falls short of satisfying the requirements of section 2(c) of the ICA.

According to the Proposal, four features of money market funds create a supposed incentive for shareholders to redeem shares rapidly in periods of financial stress, and it is through the supposed suppression of these incentives that the Commission believes Alternative 1 would produce meaningful benefits.⁷⁶

1) Incentives Created by MMFs' Valuation and Pricing Methods

The Proposal stated that if an MMF's shadow prices deviate far enough below its stable \$1.00 value, investors may have an incentive to redeem shares because if the shadow value falls even more and the MMF breaks the buck, remaining shareholders will receive less than \$1.00 for their shares.⁷⁷

2) Incentives Created by MMFs' Liquidity Needs

The Proposal contended that the incentive for MMF shareholders to redeem shares ahead of other shareholders can be heightened by investor concerns about diminishing liquidity of an MMF following a period of redemptions.⁷⁸

3) Incentives Created by Imperfect Transparency, Including Sponsor Support

The Proposal stated that a lack of investor understanding and complete transparency can exacerbate the foregoing concerns.⁷⁹ The Proposal stated that MMF investors may not know an MMF's shadow price or its current holdings. It also noted that investors may not be aware of financial support provided by fund sponsors.

⁷⁶ See *id.* at 36837.

⁷⁷ See *id.* at 36838.

⁷⁸ See *id.* at 36839.

⁷⁹ See *id.*

4) Incentives Created by MMF Investors' Desire to Avoid Loss

Finally, the Proposal noted that many investors use MMFs for principal preservation and as a cash management tool, and, as a result, are unwilling or unable to tolerate even small losses.⁸⁰ The Proposal stated that such investors may seek to minimize possible losses, even if this means foregoing higher returns. It further stated that the considerations applicable to such investors may create incentives for them to redeem and would be expected to persist, even if valuation and pricing incentives were addressed.

In reality, however, these grounds cited by the Proposal do not support the purported benefits of Alternative 1, and, in any event, the benefits the Commission hopes to obtain can be achieved by alternative approaches that would not have the negative impacts on efficiency, competition, and capital formation that would result from Alternative 1.

Incentives Related to Valuation and Pricing. The Proposal appears to take the position that MMF shareholders are incentivized to engage in rapid redemptions based on an apprehension that if they delay such redemptions their MMF will “break the buck” and they will receive less than \$1.00 for their shares. However, the Proposal does not provide any support for this theory, and CCMC believes there is no sufficient basis for such an assumption.

First, there have only been two identified instances when a money market fund actually “broke the buck.” Alternative 1 is based on the idea that MMF investors are poised to respond to a possibility that has been almost nonexistent throughout the course of history. In fact, the Proposal stated that “it is not possible to state with certainty what would have happened if money market funds had operated with a floating NAV” during 2008.⁸¹ The Proposal further conceded that “a floating NAV would not have prevented redemptions from money market funds that were driven by certain other investment decisions, such as a desire to own higher quality assets . . . or not to be invested in securities at all . . .”⁸² From a cost-benefit analysis standpoint, a

⁸⁰ See *id.* at 36841.

⁸¹ *Id.* at 36850.

⁸² *Id.*

decision to eliminate the utility and benefits of a major short-term cash management vehicle for what is a highly speculative and unsupported theory is deeply flawed.

Second, the Commission has failed to explain how adopting Alternative 1 would diminish the likelihood of rapid runs, and such logic is not evident. The Proposal suggested that certain MMF investors will act quickly to redeem shares based on the remote possibility that they might experience a loss on their shares. To combat this concern, the Proposal would replace this situation with a floating NAV under which an MMF investor would immediately experience a *real* rather than a highly unlikely potential loss. If the Commission is correct in believing that certain investors will be incentivized to avoid the remote potential for losses on their MMF investments, then presumably such investors upon experiencing even a small reduction in NAV would be motivated to redeem their MMF shares in order to avoid the possibility that their NAV will experience a further reduction that would result in greater *real* losses.

Professor Angel's Report explains in detail why floating NAVs will increase, not decrease, the propensity for rapid redemptions by stable value-oriented MMF shareholders. He describes why small decreases in a floating NAV can be expected to trigger rapid redemptions when experienced by stable value oriented investors.⁸³

Third, to the extent the Commission believes that investor knowledge of the value of an MMF will discourage rapid redemptions triggered by a fear that the MMF will "break the buck," the Proposal itself acknowledges a far less costly means of achieving this benefit: the daily disclosure of shadow prices. This alternative would provide investors with the very same information that they would receive from the use of a floating NAV under Alternative 1 but without requiring a fundamental restructuring of MMFs.

Agency consideration of costs and benefits must evaluate whether there is an alternative means of achieving the benefits that the agency is seeking that results in lower costs. In this instance, the agency's Proposal to mandate disclosure of shadow pricing achieves the objective of providing important information to MMF investors. Thus, unlike Alternative 1, the provision calling for disclosure of shadow NAVs is not

⁸³ Angel Report at 24–27.

designed in a manner that would cause the dramatic outflow of funds from floating NAV MMFs that would have substantial adverse impacts on efficiency, competition, and capital formation in the short-term cash management market and the commercial paper market.

Incentives Stemming from Liquidity Needs. The liquidity concern cited by the Commission is similar to the concern that a money market fund might experience a run if investors fear that the fund will “break the buck.” Under this aspect of the Proposal, the Commission similarly assumed that investors will precipitate a run based on concerns that the MMF will not have sufficient funds to fulfill redemption requests. The Proposal does not provide any indication that MMF shareholders, outside of the context of the two money market funds that broke the buck, have been unable to obtain their funds because of a lack of liquidity. It is therefore unclear why the Commission believes that any such incentive would exist and would be a motivating factor for investor behavior.

To the extent investors are motivated by concerns that an MMF will have insufficient liquidity, such liquidity-based concerns would not be addressed by moving to a floating NAV. If a MMF were required to operate with a floating NAV, the incentive identified by the Commission for the fund’s investors to rush to redeem their shares to avoid a loss of liquidity would likely increase, not decrease, as the investors watch the floating NAV drop, because the actual loss of net asset value represented by the declining NAV would only heighten liquidity concerns for investors and make those concerns more acute.

Moreover, the Proposal offered a much more direct means of addressing issues relating to any investor concerns regarding MMF liquidity. Alternative 2 is specifically focused on addressing potential liquidity concerns by providing for liquidity fees and allowing an MMF’s board to impose redemption gates. Alternative 2, unlike Alternative 1, does not involve regulatory action that would fundamentally undermine the benefits that stable NAV MMFs provide to U.S. businesses. In this instance, to the extent that the Commission seeks to address investor concerns regarding liquidity, a weighing of costs and benefits clearly calls for the Commission to address those concerns through Alternative 2, not Alternative 1.

Incentives Related to Imperfect Transparency. The Proposal suggested that rapid redemption pressures may be exacerbated by inadequate disclosures regarding a range of matters related to a particular money market fund, including the fund's shadow price, its portfolio holdings, and any instances of sponsor support.

The Proposal included a set of enhanced disclosure requirements. These requirements would directly and fully address the Commission's concerns about inadequate disclosures, and the availability of effective disclosure options renders Alternative 1 unnecessary. If there is a regulatory approach that will achieve the benefits the Commission seeks to obtain while avoiding or minimizing the costs and burdens that a proposed rule change would otherwise generate, the cost-benefit calculus mandated by section 2(c) requires the Commission to adopt the less costly option, unless the Commission provides a reasonable analytical basis to conclude that the option would not be as effective or feasible to implement. No such conclusion is available here.

Incentives Stemming from Investors' Desire to Avoid Losses. The Proposal observed that since many investors use MMFs to achieve stable value and for cash management purposes, MMFs can attract investors who are unable or unwilling to tolerate even small losses. The Proposal then acknowledged that such investors may seek to minimize possible losses, even if this means forgoing higher returns. The Proposal stated that the risk averseness of these investors "may create incentives for money market investors to redeem and *would be expected to persist, even if valuation and pricing incentives were addressed.*"⁸⁴

Moreover, the Proposal admitted that the change to a floating NAV would not prevent any redemptions that are driven by a shift in investment goals, like the desire to own higher quality assets, to avoid investments in securities, or to hold assets in another form, such as insured cash deposits. The Proposal stated:

The floating NAV alternative is not intended to deter redemptions that constitute rational risk management by

⁸⁴ 78 Fed. Reg. at 36842 (emphasis added).

shareholders or that reflect a general incentive to avoid loss.⁸⁵

Therefore, by the Commission’s own reckoning, Alternative 1 would have no impact on—and thus produce no benefit from preventing—any supposed inclination for rapid redemptions by MMF investors motivated by a “flight to quality.”⁸⁶

4. *The Commission May Not Adopt Alternative 1 Without First Preparing a Rigorous and Detailed Economic Analysis of Its Costs, as Required by Section 2(c), and Providing the Public an Adequate Opportunity to Comment on that Analysis*

In response to the analytical deficiencies described above, and in order to meet its obligations under section 2(c) of the ICA, the Commission must conduct a rigorous cost-benefit analysis of Alternative 1 and must provide the public an adequate opportunity to review and comment on that analysis before the Commission may adopt Alternative 1. The Commission cannot present an inadequate analysis in a proposal and then issue a final rule with a more extensive cost-benefit analysis on which the public has no opportunity to comment.

The approach taken by the Proposal is not consistent with the Commission’s own internal guidance regarding economic analysis in SEC rulemaking from the Commission’s Office of General Counsel and Division of Risk, Strategy, and Financial Innovation (“RSFI”) (now the Division of Economic and Risk Analysis) (“Memorandum”).⁸⁷ The Memorandum calls for rule-writing staff to work with RSFI economists to quantify expected costs and benefits of the proposed rule and alternative regulatory approaches, to the extent possible.⁸⁸

⁸⁵ *Id.* at 36850.

⁸⁶ The Proposal suggested that, by moving to a floating NAV, investors should become accustomed to, and more tolerant of, fluctuations in MMFs’ NAVs and that investors may be less likely to redeem shares in times of stress. *See id.* at 36851. CCMC believes that Alternative 1, when applied to investors who are highly focused on stable value, will increase the likelihood of redemptions by such investors when they experience real losses as their MMF’s NAV decreases.

⁸⁷ *See* Memorandum to Staff of the Rulewriting Divisions and Offices from RSFI and OGC regarding Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012).

⁸⁸ *See id.* at 9.

The Memorandum makes it clear that the Commission cannot simply end its analysis by merely taking the position that it does not know what will happen if a proposal is adopted. The Memorandum stated:

Even without hard data, quantification may be possible by making and explaining certain assumptions. For example, if proposed rules would enable the operation of a new trading system, it may be reasonable to assume the system will attract a percentage of all market volume (*e.g.*, one percent). *With that assumption, the cost-benefit analysis could then estimate a distributional effect of a certain magnitude.* It is important to make assumptions (and the rationales for the assumptions) explicit and where alternative assumptions are plausible, to include analysis based on each.⁸⁹

The Memorandum then noted that:

Court decisions addressing the economic analysis in Commission rules have likewise stressed the need to attempt to quantify anticipated costs and benefits, *even where the available data is imperfect and where doing so may require using estimates (including ranges of potential impact) and extrapolating from analogous situations.*⁹⁰

Finally, the Memorandum stated that a proposing release should include a substantially complete analysis of the most likely economic consequences of the proposal.⁹¹

The application of the directives contained in the Memorandum with respect to Alternative 1 is clear. The two critical issues under Alternative 1 are (i) the extent to which businesses will shift funds out of floating NAV MMFs to alternative stable

⁸⁹ *Id.* at 12-13 (emphasis added).

⁹⁰ *Id.* at 13 (emphasis added) (footnote omitted).

⁹¹ *Id.* at 16.

value cash management vehicles, and (ii) the extent to which such funds are placed in either stable value MMFs or bank cash management deposit products.

The Memorandum and the court decisions it cites indicate that the Commission must develop reasonable assumptions or ranges of assumptions in order to permit an analysis of economic effects resulting from such assumptions. Such assumptions and their results must be presented for public comment in a proposed rule. In the case of Alternative 1, the Proposal does not currently meet these requirements.

In this regard, we note that the House Appropriations Committee has expressed similar concerns regarding the cost-benefit analysis of Alternative 1 that is contained in the Proposal. The Committee in its report on the Financial Services and General Government Appropriations Bill stated:

Impairing or restricting the use of money market funds could potentially result in a decrease in the ability of these products to provide liquidity, potentially resulting in hundreds of market participants issuing longer-term debt, significantly increasing their funding costs, slowing expansion rates, and depressing job and economic growth. The Committee believes before final rules are promulgated . . . *rigorous economic analysis should be conducted*. Specifically, the final rules should carefully consider how any proposed changes would affect: (1) investor returns and cash management efficiencies; (2) the borrowing costs for businesses and governments that access money markets for financing purposes; (3) the concentration and capacity among providers of short-term financing; and (4) efficiency, competition, and capital formation.⁹²

⁹² H.R. Rep. No. 113-172 at 68 (emphasis added).

I. Concerns Regarding Removal of the Amortized Cost Method of Valuation Exemption

CCMC also has serious concerns about the Commission's proposal to remove the amortized cost method of valuation exemption that is currently relied upon by all MMFs pursuant to Rule 2a-7 under the ICA. As the Commission is aware, MMFs currently use the amortized cost method of valuation exemption provided under Rule 2a-7 to value portfolio securities at cost plus any amortization of premium or accumulation of discount, rather than at their value based on current market factors. Other mutual funds not regulated by Rule 2a-7 under the ICA must calculate their daily NAVs using market-based factors with certain exceptions. One of these exceptions allows a mutual fund to value a debt security that matures in 60 days or less using the security's amortized cost, if the fund's board determines, in good faith, that the fair value of the debt security is its amortized cost. Under the Proposal, MMFs would be permitted to use the amortized cost method of valuation only to the same extent as other mutual funds (*i.e.*, for debt securities with remaining maturities of 60 days or less).

In the Proposal, the Commission noted that the stable \$1.00 share price calculated using the amortized cost method of valuation provides a close approximation to market value under normal market conditions. However, the Proposal stated that differences may exist because market prices adjust to changes in interest rates, credit risk, and liquidity. The Proposal concluded that investors may have an economic incentive to redeem MMF shares when the market prices of an MMF's portfolio securities deviate from their amortized cost value.

CCMC has considered MMFs' use of amortized cost and believes that it is an accurate and appropriate valuation method for MMFs due to the characteristics of typical holdings of money market funds. In fact, CCMC issued a report authored by Dennis R. Beresford entitled "Amortized Cost is 'Fair' for Money Market Funds" ("Beresford Report"), which demonstrated that the use of amortized cost by MMFs is supported by more than 30 years of regulatory and accounting standard-setting consideration.⁹³ The Beresford Report illustrated that available data indicate that

⁹³ Dennis R. Beresford, *Amortized Cost is "Fair" for Money Market Funds* (Fall 2012). The Beresford Report is attached as Appendix C to this letter.

amortized cost does not differ materially from market value of investments industry wide. The report concluded that amortized cost method of valuation is appropriate for MMFs because of MMFs' high-quality holdings and is consistent with applicable accounting guidance.

Among other things, the amortized cost method of valuation exemption allows MMFs to execute same day and intra-day settlements in a cost-effective way for the benefit of U.S. businesses. Without the ability to use the amortized cost method of valuation, an MMF would be required to obtain market prices. However, as Professor Angel has noted, short-term securities held by MMFs are not actively traded on organized exchanges with publicly observable prices and, in fact, some short-term securities even lack CUSIP numbers.⁹⁴ As a result, pricing vendors typically base a short-term security's price on models, rather than actual market transactions or quotations.⁹⁵

By removing the amortized cost method of valuation, MMFs would therefore be relying on pricing information from pricing vendors, which, as Professor Angel explains, may not be more accurate than amortized cost.⁹⁶ Moreover, pricing services may not be able to provide pricing multiple times throughout the day (and, even if they are able to do so, those prices may not always be accurate and MMFs would still need to confirm those prices and calculate their NAVs). As a result, MMFs may not be able to provide same day and intra-day settlements in the same efficient manner as they do today.

Corporate treasurers value the ability to have rapid access to corporate funds. If this were lost, they would move to competitive short-term investment products that do offer such a feature. This would likely result in a substantial movement of corporate funds currently placed with MMFs to bank deposit products for the reasons discussed above. Such an effect would, as with a move to a floating NAV, have a negative impact on efficiency, competition, and capital formation, as discussed above. For these reasons, CCMC has significant concerns regarding the removal of the amortized cost method of valuation exemption currently available to MMFs.

⁹⁴ Angel Report at 28.

⁹⁵ *Id.* at 27.

⁹⁶ *Id.* at 28- 29.

II. Support for Enhanced Disclosures by MMFs

Investors would likely benefit from the Commission's recommendations to enhance MMF disclosures. The Proposal would provide MMF investors timely and valuable information regarding the condition and operations of an MMF. In particular, the Commission proposed a broad array of new advertisement, website and registration statement disclosure requirements. Among other things, the enhanced disclosures would provide more timely information regarding an MMF's: (i) daily and weekly liquidity levels; (ii) daily current NAV per share; (iii) inflows and outflows; and (iv) portfolio holdings.

As the Commission noted in the Proposal, many MMFs are (or will be) voluntarily providing some of this information in response to requests from their investors to provide more information relating to the MMFs' marked-to-market NAVs and other risks.⁹⁷ In addition, as evidenced in surveys conducted by Fidelity Investments, corporate treasurers and retail investors are aware of the investment considerations related to investing in MMFs.⁹⁸ Nevertheless, more detailed and consistent disclosure will allow U.S. businesses and other investors to be better informed as they decide whether to make new, or retain current, investments in an MMF.

While CCMC generally supports the Proposal's enhanced disclosures, the Commission should take into consideration that certain of the proposed disclosures will be costly and time-consuming for MMFs to implement. With respect to the website disclosure requirements, internal systems and software would need to be upgraded or, for those MMF managers that do not have existing systems, third-party service providers would need to be engaged. The costs (which ultimately would be borne by investors through higher fees or lower yields) could potentially be significant to an MMF and higher than those estimated in the Proposal.⁹⁹

⁹⁷ See *id.* at 36853.

⁹⁸ See Letter from Scott Goebel, Senior Vice President and General Counsel, FMR Co., to Elizabeth Murphy RE: File No. 4-619; Release No. IC-29497 *President's Working Group Report on Money Market Fund Reform* (Feb. 3, 2012), available at <http://www.sec.gov/comments/4-619/4619-116.pdf>.

⁹⁹ See Proposal at Sections III.F.2 and III.F.3 for the Commission's estimates of these costs.

Further, certain disclosures may cause investor confusion. For example, the new disclosures regarding financial support provided to MMFs may cause unnecessary investor concern if the definition is too broad and covers events that are not material to the performance and viability of the MMF. CCMC urges the Commission to consider carefully the comments from money market funds, MMF advisers, and other industry participants on these points to ensure that the benefits of each specific change will outweigh the costs.

Overall, as with the majority of the changes adopted in the 2010 Amendments that CCMC supported, CCMC believes that the enhanced transparency and disclosure reforms set forth in the Proposal are generally prudent regulation. This type of regulatory action is consistent with the Commission's mission to ensure that investors have access to important information, while avoiding regulatory action that would effectively deprive investors of a valuable investment option. For the reasons set forth above, CCMC generally supports the Commission's recommendations to enhance the disclosures required to be made by MMFs.

III. Potential Role for Liquidity Fees and Redemption Gates

CCMC believes that the Commission's enhanced disclosure proposals are the appropriate response to concerns regarding MMFs. However, to the extent that the Commission believes that additional actions should be taken, CCMC believes that the Commission's Alternative 2 may provide the basis for a workable regulatory scheme, although we do not believe the liquidity fees and gates are necessary. Nevertheless, unlike a floating NAV, they do not, if properly designed, present the existential threat to MMFs, or virtually ensure an upheaval in business cash management systems or the commercial paper markets.

The Proposal indicated that the Commission is seeking to reduce widespread redemptions of MMF shares during times of stress. Unlike with Alternative 1, which, for all of the reasons discussed above, clearly does not address this concern, CCMC believes that giving the board of an MMF the power to impose liquidity fees and gates under Alternative 2 could provide these boards with a precision instrument for managing large-scale redemptions. In addition, because liquidity fees and gates would likely be introduced only when there is a severe market dislocation, shareholders could continue to enjoy many of the important features that are provided by MMFs today—

their stable value, liquidity, investment diversification and, during a normal interest rate environment, return features.

A liquidity fee would introduce a cost to redeeming shareholders for liquidity. As the Commission noted in the Proposal, redemptions may be caused by liquidity concerns of an MMF. However, if shareholders were to be charged a fee when an MMF's liquidity costs are at a premium, they may be discouraged from redeeming their shares at that time, which would have the effect of slowing redemptions in the MMF.

Likewise, a redemption gate would also address concerns of substantial redemptions. In fact, a redemption gate would stop a "run" in tracks, because shareholders would be prohibited from redeeming their shares while the gate is in place. As noted in the Release, a redemption gate also gives an MMF time for issues in the market to subside and for securities in the portfolio to mature, which would increase the MMF's liquidity levels. In addition, unlike with the current conditions of Rule 22e-3 under the ICA, a redemption gate would allow the MMF to remain in operation after the gate is lifted. This, in turn, will provide MMF investors with comfort regarding the ultimate redemption of their investment and make any large-scale redemptions less likely.

In reviewing the Proposal, CCMC believes that, rather than imposing a specific regulatory mandate, Alternative 2 should empower boards of MMFs to exercise their business judgment to determine the appropriate response to market and specific MMF conditions. In particular, in the event that the Commission decides to adopt Alternative 2, CCMC believes that the Commission should not establish any specific liquidity threshold at which liquidity fees and redemption gates could become applicable. Rather, the approach should be modified to provide MMF boards with broad discretion to tailor the specific terms of any liquidity fees and/or redemption gates to the circumstances of a particular MMF, its investors and the market events, without any regulatory trigger for imposing such fees or gates. Such an approach would give boards an important tool to respond to extraordinary circumstances in a manner that takes into account the unique characteristics and circumstances of a particular MMF. Empowering boards is also consistent with the spirit of the ICA and rules thereunder, which have provided fund boards with an important and active role to oversee funds. A flexible approach will not only empower those best positioned to

understand the circumstances facing the MMF, it will not incentivize investors to redeem like a hard-line mandate might.

The 15 percent weekly asset threshold may not always be the most important measure of an MMF's viability. Indeed, there may be other circumstances that could require an MMF board to consider imposing a liquidity fee or redemption gate and these circumstances may be context-specific and may not be easily determinable in advance. Rather than focusing on a rigid 15-percent weekly asset liquidity threshold, the imposition of a liquidity fee or gate should be based on a finding by the MMF's board that the MMF is experiencing circumstances that threaten the ability of the MMF to continue to maintain its stable share price and/or meet redemptions.

Under a tailored approach, a MMF board could impose greater restrictions on shareholders seeking to redeem large amounts during periods of market turmoil. A MMF board also could analyze a MMF's portfolio maturity structure and implement a schedule for redemptions based on the amounts being redeemed. For example, shareholders who are redeeming smaller amounts could be provided their full redemption proceeds while shareholders who are redeeming larger amounts could be provided part of their redemption proceeds upon request and the remaining amount on a delayed basis.

Some contend that liquidity fees and gates may increase the risk of preemptive redemptions from shareholders who could be motivated to sell shares before such fees and gates are triggered. CCMC believes that an approach that relies on a board's judgment rather than a specific trigger based on liquidity would eliminate any concerns with preemptive redemptions. Further, consistent with CCMC's support of the proposed enhanced disclosures, CCMC believes that MMFs should include prominent prospectus disclosure of a board's powers and flexibility in this area, which may serve to emphasize further the nature of MMFs as investments subject to risks.

Overall, while CCMC believes that the Commission's enhanced disclosure proposals are the appropriate response to concerns regarding MMFs, for the reasons set forth above, there could be some merit to the Commission's Alternative 2, if boards of MMFs are granted broad discretion to impose liquidity fees and redemption gates.

IV. Combination of Alternatives 1 and 2

In the Proposal, the Commission seeks comment on the potential combination of a floating NAV requirement under Alternative 1 and liquidity fees and gates under Alternative 2. Although CCMC believes that enhanced transparency and disclosure requirements alone are sufficient and has serious concerns with the floating NAV requirement under Alternative 1, if the Commission determines to adopt both Alternatives, CCMC would not oppose providing MMF boards with the authority to choose to have the MMFs that they oversee operate under *either* Alternative 1 or Alternative 2. CCMC strongly opposes requiring MMFs to operate under *both* alternatives.

The ICA and the rules thereunder give boards an important and active role in overseeing funds. If the Commission ultimately determines to adopt both alternatives, an MMF board should be empowered to decide under which alternative the MMF will operate. A board would make that determination in consultation with the MMF's investment adviser and would base the decision on the best interests of the MMF. In this regard, a board would examine the shareholders in the particular MMF and the costs of operating under either alternative to determine the most appropriate regulatory structure for that MMF. Once a board determined under which alternative an MMF would operate, the board would provide shareholders and potential investors advance notice in order to provide those shareholders and investors with the opportunity to determine whether to invest in the MMF.

Conclusion

Because of the vital and beneficial role that MMFs play, CCMC is very concerned that Alternative 1 would seriously compromise the benefits that MMFs provide to U.S. businesses and the economy. Moreover, CCMC believes that the Commission can address its concerns regarding the transparency of MMFs by adopting the Proposal's provisions with respect to enhanced disclosure.

Ms. Elizabeth Murphy
September 17, 2013
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We urge the Commission not to take any action that could cause serious and unwarranted harm to U.S. businesses and the economy. Rather, the Commission should first conduct a thorough cost benefit analysis, examining the impact on all stakeholders. The Commission should consider the impact of the Proposal in the context of other financial regulatory initiatives underway such as the Volcker Rule, the Basel III capital rules, and derivatives rules that will impede capital formation and commercial lending. Doing so will ensure that any regulatory changes proposed by the Commission meet its statutory responsibility to promote efficiency, competition, and capital formation while strengthening MMFs without significantly compromising the benefits that MMFs have long provided to investors and issuers of commercial paper.

Sincerely,

A handwritten signature in black ink that reads "David Hirschmann". The signature is written in a cursive, slightly slanted style.

David Hirschmann

Impact of the SEC's Proposed Changes to Money Market Mutual Fund Regulation on Efficiency, Competition, and Capital Formation.

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I wish to thank the U.S. Chamber of Commerce for providing financial support for this project. All opinions expressed herein are my own and do not necessarily reflect those of the University of Pennsylvania, Georgetown University, or the U.S. Chamber of Commerce.

Executive Summary

The U.S. Securities and Exchange Commission has recently proposed changes to the regulations governing money market mutual funds.¹ The proposals include, among other things, 1) requiring institutional prime funds to switch to a floating Net Asset Value (“NAV”), 2) requiring funds to use “market-based” estimates of prices to calculate the floating NAV, and/or 3) impose restrictions on redemptions during times of panic such as liquidity fees or “gates.” As there are nearly \$1 trillion in assets in institutional prime MMMFs along with literally thousands of affected corporations, the proposed changes will be costly and have large impact on the economy. The initial upfront costs of increases in required bank capital along with system upgrades to handle floating NAVs range from \$13.7 billion to over \$90 billion, and the ongoing annual costs between \$4 billion and \$23 billion.

The floating NAV proposal destroys the benefits of money market funds for non-retail users. The uncertainty added by a floating NAV reduces the utility of money market funds for cash management purposes. A large fraction of institutional money market fund users will stop or reduce using money market funds. The reduction in institutional prime money market fund assets could range from approximately \$200 billion to over \$950 billion if the floating NAV proposal is adopted.

The floating NAV proposal and elimination of amortized cost accounting will cause significant reductions in competition, both in the money market fund sector, in the banking sector, and between the money market fund sector and the banking sector. Approximately half of the existing institutional prime money market funds will be forced to close in the most likely scenario due to the outflow of assets.

The shrinkage of institutional prime money market funds will lead to net inflows of institutional cash ranging from \$105 billion to \$792 billion into the banking system. Most of it will likely go to the largest banks able to deal with large fluctuating institutional deposits, further increasing concentration and decreasing competition in the banking sector. This cash is likely to reside in the banking system in normal times and flee to safety during a financial crisis, thus increasing systemic risk and the likelihood of bank runs in a future financial crisis. These inflows will require the banking system to raise between \$11.9 billion and \$89.5 billion in additional capital, adding additional stress on an already stressed banking sector still recovering from the financial crisis. The sequestration of this capital in the banking system will reduce capital available for investment in other productive sectors of the economy and thus reduce economic growth.

The floating NAV proposal and the elimination of amortized cost accounting will damage capital formation by raising the cost of funding to issuers of commercial paper that rely upon money market funds to purchase the paper. The floating NAV proposal will increase funding costs for issuers from between \$2.3 billion to \$12.8 billion per year. These costs are summarized in the following table:

¹ United States Securities and Exchange Commission, Release 33-9408; IA-3616; IC3051; File No. S7-03-13, Money Market Fund Reform, Amendments to Form PF, 78 Federal Register 36834 – 37030, also available at <http://www.sec.gov/rules/proposed/2013/33-9408.pdf>, hereafter referred to as the “Release.” These funds are mutual funds that generally invest in short-term financial instruments and seek to maintain a stable Net Asset Value (NAV) of \$1.00 per share. MMMFs are currently regulated under SEC Rule 2a-7, 17 CFR 270.2a-7, and are often referred to as “2a-7 funds”.

Table 1 Summary Costs of Floating NAVs \$ Billions		
Initial One-Time Costs		
	One-Time Costs \$ Billions	
	Low	High
Required Increases in Bank Capital	\$ 11.9	\$ 89.5
System Upgrades	\$ 1.8	\$ 2.0
Total Initial Costs	\$ 13.7	\$ 91.5
Recurring Annual Costs		
	Annual Costs \$ Billions	
	Low	High
Reduced Yields to MMMF Investors	\$.26	\$ 1.17
Reduced Interest Paid to Bank Depositors	\$ 1.1	\$ 4.6
Increased Capital Costs for Banks	\$ 1.0	\$ 7.2
Increased Interest Costs to Commercial Paper Issuers	\$ 2.3	\$ 10.5
Maintenance Costs for System Upgrades	\$.2	\$.25
Total Recurring Annual Costs	\$ 4.86	\$ 23.72

The floating NAV proposal and the elimination of amortized cost accounting will seriously damage the efficiency of the U.S. capital markets by forcing investors to use less efficient means to manage their short-term cash balances and by forcing issuers to use less-efficient means of raising capital.

The notion that a floating NAV will reduce a money market fund's susceptibility to heavy redemptions in a time of panic is based on several false premises. These include 1) that the proxies used for "market" value reflect the fundamental value of the assets better than amortized cost, 2) that all market participants believe that funds' published floating NAVs are accurate in a time of disorderly markets, and 3) that market participants believe that there is no serial correlation in asset prices as well as published floating NAVs. Relaxing these false assumptions shows that the floating NAV proposal will increase, rather than decrease, the propensity for investors to flee in a panic. Investors will have an incentive to run even in cases where the likelihood of an issuer default is remote, but the possibility of a decline in the noisy NAV may be much higher.

The use of "market-based" values instead of amortized costs for valuing money market fund assets is based on the unproven assumption that some proxy for the "market-based" value is a better measure of the fundamental value of a non-impaired money market instrument than its amortized cost. First,

“market-based” prices are ill-defined, as short-maturity money market instruments are not designed to be traded in a secondary market. Indeed, the majority of prime money market fund assets are categorized as Level II assets for which readily available market prices are not available. Funds today generally rely upon commercial pricing vendors that use, not real transaction prices or even dealer quotes, but models to estimate prices. Even market quotes may be very inaccurate during a market panic, as indicated in the SEC’s no-action relief during the financial crisis of 2008.

The price at which a money market fund instrument can be liquidated is only relevant when the fund has to sell securities. Funds with sufficient daily and weekly liquidity need not sell assets, and the gates or liquidity fees can be used in a panic to eliminate any need to sell assets into a distressed market. The use of noisy proxies for market value combined with the elimination of rounding to the nearest penny will inject unnecessary noise into the daily pricing of fund shares with serious undesirable consequences. This noise will destroy the utility of prime money market funds for a large number of users and lead to a substantial shrinkage of the money market fund industry.

The notion that a floating NAV will reduce runs is also based on an extreme belief that noisy NAVs will “acclimatize” the most risk-averse investors and make them so risk tolerant of frequent changes in the NAV that they will not run in a panic when the NAV decreases. It is more likely that they will flee the entire sector if floating NAVs are instituted.

1. Introduction

The U.S. Securities and Exchange Commission has proposed changes to the regulation of money market mutual funds (“ MMMFs”). Among other things, the proposals call for:

- MMMFs would no longer be permitted to use amortized cost accounting for money market fund assets.²
- Institutional MMMFs would be required to transact at floating NAVs, rounded to one basis point or four decimal places (e.g. \$1.0000). Retail funds (defined as MMMFs that restrict redemptions to no more than \$1 million per day) and government funds would still be allowed to transact at a constant NAV rounded to the penny (e.g. \$1.00).
- Alternatively, or in combination with the floating NAV, funds other than government MMMFs would be required to impose redemption restrictions when the Weekly Liquid Assets fall below 15% of total assets.³ These restrictions include a 2% redemption fee. The MMMF would also be able to temporarily suspend redemptions, known as imposing a “gate”. A fund’s board of directors could determine that the restrictions would not be in the best interest of the fund and not impose the restrictions.
- Additional disclosures are required, including disclosing transaction prices for the sale of fund assets and sponsor support.
- MMMFs would be required to conduct more stringent stress tests.
- Large private funds that act like MMMFs would also be required to provide information to the SEC in order to facilitate monitoring by the Financial Stability Oversight Council (“FSOC”).

This study examines the impact of the proposed changes on money market fund industry and its impact on efficiency, competition, and capital formation. In order to examine these impacts, it is important to first estimate the impact of the proposals on the total assets under management in institutional prime money market funds, and then to estimate how investors will invest the assets that are transferred out of institutional prime money market funds. This study then examines the impact of the proposed reforms on systemic risk and the overall economy. The study concludes with a summary of the impact on efficiency, competition, and capital formation.

² Specifically, the proposal eliminates the special treatment for MMMFs in Rule 2a-7 that permits the use of amortized cost accounting. MMMF assets would presumably be treated the same as other mutual fund assets and valued under Rule 2a-4, which does permit the use of amortized cost accounting for assets that mature in 60 days or less.

³ Weekly Liquid Assets consist generally of cash and assets that will mature within five business days, in addition to various government securities and securities with a demand feature that is exercisable and payable within five business days. See SEC Rule 2a-7(a)(32).

2. Impact of floating NAV on MMMF assets.

The bulk of the impact of the proposal on efficiency, competition, and capital formation will be a function of the impact on the total assets of institutional prime money market funds. The stable value of a constant NAV is at the heart of the MMMF product. It is extremely attractive to very risk-averse investors who seek a safe haven for short-term funds that passes on current market rates to investors.

A floating NAV seriously reduces the utility of MMMF investing. A floating NAV will create frequent, albeit small, losses or gains even when there have been no credit events in the underlying portfolio. Adding even small amounts of noise to the transaction price of a MMMF causes serious accounting, tax, and operational complexities. Accounting systems at the MMMFs and the thousands of users of MMMFs would have to be upgraded, which is an expensive and time consuming process. Every transaction potentially creates taxable gains and losses that must be tracked, adding to more complexity. Corporate cash investment policies and, in some cases, state laws need to be changed to permit investment in floating NAV funds. The lack of a stable NAV will reduce the ability of funds to provide intraday redemptions, impairing the liquidity which is one of the core value propositions of MMMFs.

It is clear that eliminating the most basic attribute of the product, its stable value, will cause investors to shift to other products. Behavioral economists have documented that people prefer certainty.⁴ In order to examine the impact of this shift on efficiency, competition, and capital formation, it is necessary to estimate how much money will flow out of the MMMFs and where the money will go.

The proposal only calls for a floating NAV for institutional funds. Although it is difficult to predict the exact amount of the outflows, there is very good evidence that there will be substantial outflows from the institutional MMMFs if the floating NAV is mandated. Numerous comment letters from users of MMMFs have stated that they will curtail their use of MMMFs if the constant NAV is eliminated.⁵ Instead of attempting a point estimate of the impact, this study examines several different plausible scenarios:

Outflow Scenario 1: Complete Elimination of Institutional Prime MMMFs

In this scenario, the utility of institutional prime funds has been so diminished that the industry effectively ceases to exist. Even though some institutional investors may at first choose to remain in institutional money market funds, the exodus of assets from the industry causes a death spiral in this scenario. The remaining assets are too small to support the overhead costs of running the funds, and the bulk of funds close. Even those institutional that would have chosen to remain in floating NAV funds find that their preferred funds have closed, and the reduced number of remaining funds are unappealing. The desire to not be different from other institutional managers, along with the reduced number of available funds, causes a herding effect, and those managers exit the product as well. All \$974 billion of the assets in the

⁴ For example, see Daniel Kahneman and Amos Tversky, 1979, Prospect Theory: An analysis of decision under risk, *Econometrica* 47(2) 263-292.

⁵ Many of these are cited in the Release. See for example Release footnote 567, 78 FR 36915.

institutional prime funds flow out of those funds into other alternatives, including banks and Treasury funds.⁶

Outflow Scenario 2: Survey-based Estimate of Asset Outflows

One of the most straightforward methods of estimating how large institutional, corporate, and government investors would respond to a floating NAV is to ask them. As those investors do not operate MMMFs themselves, their answers are likely to be unbiased estimates of how they would react to a floating NAV. This is the best method in the circumstances, and generates the most likely scenario. This is exactly what Treasury Strategies, Inc., did in its 2012 survey of 203 such investors, the majority of whom manage more than \$100 million in short-term assets.⁷

The Treasury Strategies survey indicates that these institutional investors would reduce their MMMF holdings by approximately 61% if a floating NAV were enacted. This is comparable to other surveys that show similar magnitudes of reduction, and is consistent with the hundreds of comment letters from users of money market funds.⁸ This 61% reduction indicates that approximately \$594 billion of assets will leave institutional prime money market funds.

⁶ The \$974 billion in institutional prime money market fund assets is as of February 28, 2013 from the Release, 78 FR 36916.

⁷ To be precise, the question posed was:

There is a proposal to change MMFs from a constant \$1 net asset value (NAV) to a floating net asset value. Under typical market conditions, it is anticipated that the share prices would fluctuate within a very narrow range.

Proponents say this will ensure everyone pays and receives a price that automatically reflects any gains or losses and that it reduces the potential for runs on MMFs during adverse situations.

Opponents argue that a floating NAV would impair the use of funds as a liquidity instrument, as well as cause other legal, accounting, tax, and market disruptions.

If the floating NAV proposal were enacted, what action would your organization most likely take?

- A. Increase use of MMFs
- B. Continue using MMFs at current level
- C. Decrease use of MMFs
- D. Stop using MMFs entirely

The study is available at <http://www.sec.gov/comments/4-619/4619-166.pdf>

⁸ See, for example, the 2013 Liquidity Survey from the Association of Financial Professionals, and the numerous comment letters submitted to the SEC in response to this release which can be found in File S7-03-13 at <http://www.sec.gov/comments/s7-03-13/s70313.shtml>.

Outflow Scenario 3: Average of Scenarios 2 and 4

This scenario is halfway between Scenario 2 and the conservative lower bound on outflows from Scenario 4 which is described below. In this scenario, approximately 42% of the assets, or \$404 billion, will leave institutional prime MMMFs.

Outflow Scenario 4: Conservative Lower Bound on Outflows

The Association of Financial Professionals (“AFP”) conducts annual liquidity surveys of corporate treasurers. Its *2013 Liquidity Survey* indicates that if a floating NAV were imposed, 22% of the 885 respondents would stop investing and divest all holdings.⁹ This appears to present a conservative lower bound on the outflows that will occur from institutional prime money market funds if the floating NAV is imposed, and it ignores the 18% that said they would reduce but not eliminate their use of floating NAV funds. This 22% figure is more conservative than the approximately 35% that would stop altogether in the Treasury Strategies survey. One potential reason for the difference between the AFP survey results and the Treasury Strategies survey results is that the Treasury Strategies sample included institutional and governmental investors, compared with the AFP survey of corporate investors. Although the Treasury Strategies’ sample is probably more representative of the investors in institutional prime MMMFs, the lower AFP number is used here to provide a more conservative lower bound on the potential outflows. Unlike Treasury Strategies, the AFP survey did not attempt to estimate the total assets which would leave MMMFs if reforms were implemented.

The following table illustrates the total number of dollars, in billions, that will leave institutional prime money market funds under the four scenarios outlined above, based on the \$974 billion estimated to be in institutional prime money market funds as of February 28, 2013. This indicates that from \$214 to \$974 billion will flow out of institutional prime money market shares if the floating NAV proposal is implemented.

Scenario Number	1	2	3	4
Description	Complete Elimination	Survey-based	Mid-range	Conservative
Percentage outflow	100%	61%	42%	22%
Dollar outflow in \$ billions	\$ 974	\$ 594	\$ 404	\$ 214

⁹ Association of Financial Professionals, *2013 Liquidity Survey*, available at http://www.afponline.org/mbr/reg/pdf/2013_AFP_Liquidity_Survey.pdf

3. Substitutes for Institutional Prime Money Market Funds

One of the key issues in this analysis is how institutional investors will substitute other investments for the funds that flow out of institutional prime MMMFs. Institutional investors have a variety of alternatives, including:

- Bank deposits and other bank products
- Government MMMFs exempt from the floating NAV
- Direct investment in commercial paper and other money market instruments
- Separately managed accounts
- Private funds
- Offshore money funds
- Ultra-short bond funds or short-duration ETFs.

Again, since it is not clear exactly where the displaced assets will end up, it is useful to construct a variety of scenarios. One major uncertainty is the degree to which institutional investors will view Treasury and government money market mutual funds as substitutes for prime money market mutual funds. As Treasury and government funds will be exempt from the floating NAV requirement, they will continue to offer the advantages of a stable value, convenience, and liquidity. However, they traditionally suffer from the lower yields associated with the putatively less risky government securities. As prime money market mutual fund investors have specifically chosen higher yielding prime funds over government funds and direct investment in Treasury securities, it is likely that many of them will continue to choose alternatives to government- and Treasury-based products.

Substitution Scenario 1: 100% of Assets Leaving MMMFs Switch to Banks.

Although the unlimited FDIC insurance has expired, the latest AFP liquidity survey indicates that corporations have not materially reduced their cash holdings in banks.¹⁰ Although large deposits are not insured by the government, there is a perception that the largest banks currently have negligible counterparty risk. In this scenario, it is assumed that the institutional investors have already rejected government money market funds because of their lower yield, and transfer all of the assets that leave the institutional prime money market funds for bank products such as deposit accounts, bank money market accounts, and CDs. Investors also do not manage material amounts of the funds in house and buy money market instruments directly; the cost of hiring additional employees to do credit analysis and manage the money market instruments makes this alternative too costly for most MMMF clients. This is consistent with historical industry experience during periods of interest rate spikes when higher yields were available through purchasing money market instruments directly yet assets did not migrate to direct management.

¹⁰ The unlimited FDIC insurance on non-interest-bearing transactions accounts expired on December 31, 2012. See <http://www.fdic.gov/deposit/deposits/changes.html>.

Substitution Scenario 2: Assets Leaving MMMFs Are Invested Pro Rata Over Other Assets Not Including Government MMMFs at Historical Ratios.

Another scenario is that the assets are distributed across all of the other possibilities pro-rata in accordance with their historical behavior. In other words, investors in the aggregate will invest the cash taken out of prime money market funds in the same proportion as they invest the rest of their cash. From the Federal Reserve Flow of Funds Table L.102, one can derive the market shares of various cash management alternatives from looking at how nonfinancial corporations have managed their financial assets over the last several years:

Type of Investment	2007	2008	2009	2010	2011	2012	2007-2012 average
Foreign Deposits	3.8%	1.9%	2.1%	2.7%	2.3%	0.8%	2.3%
Bank Products	43.6%	31.0%	43.6%	52.5%	55.8%	58.1%	47.4%
Money Market Funds	40.9%	56.8%	44.3%	33.5%	31.0%	29.5%	39.3%
Commercial Paper	5.2%	4.5%	3.8%	4.6%	4.6%	4.0%	4.4%
Treasuries, Agencies and Municipal Securities	6.0%	5.2%	5.7%	5.9%	5.4%	6.9%	5.9%
Repurchase Agreements	0.6%	0.6%	0.5%	0.8%	0.8%	0.7%	0.7%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total without MMMF	59.1%	43.2%	55.7%	66.5%	69.0%	70.5%	60.7%

Source: Derived from Federal Reserve Flow of Funds Table L.102¹¹

This table shows that, on average over the last 5 years, the average nonfinancial corporation kept 47.4% of its short-term financial instruments in bank products such as deposit accounts and CDs. If one assumes that, without money market funds, the available cash will be spread across the other available alternatives in the same proportion as before, we get the following table:

¹¹ Available at <http://www.federalreserve.gov/releases/z1/current/>

Table 4							
Nonfinancial Corporation's Allocation of Short-Term Financial Instruments Other Than Money Market Funds							
2007-2012							
Type of Investment	2007	2008	2009	2010	2011	2012	2007-2012 average
Foreign Deposits	6.3%	4.5%	3.8%	4.1%	3.4%	1.2%	3.9%
Bank Products	73.7%	71.7%	78.2%	78.9%	81.0%	82.4%	77.7%
Commercial Paper	8.8%	10.4%	6.8%	6.9%	6.6%	5.6%	7.5%
Treasuries, Agencies and Municipal Securities	10.1%	12.1%	10.2%	8.9%	7.8%	9.8%	9.8%
Repurchase Agreements	1.0%	1.3%	1.0%	1.2%	1.2%	0.9%	1.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Using the five-year average as an estimator, 77.7% of the assets leaving institutional prime money market funds will end up in bank products, 7.5% in commercial paper, 9.8% in U.S. Treasuries, GSE's and municipal securities, and 1.1% in repurchase agreements.

Substitution Scenario 3: Assets Leaving MMMFs Are Invested Pro Rata Over Other Assets Including Government MMMFs at Historical Ratios.

This scenario also assumes that the assets leaving institutional prime MMMFs are spread pro-rata across all the other remaining asset classes. Only now, government money market funds are included as one of the other classes. As the Federal Reserve data does not break out government MMMFs from prime MMMFs, the percentage of assets in government money market funds is estimated by using the proportion of institutional government funds from the ICI data.¹²

¹² This was calculated by multiplying the holdings of money market funds in the Federal Reserve data by the ratio of (Net Assets of Institutional Government Funds) divided by (Net Assets of Institutional Government Funds plus Net Assets of Institutional Prime Funds). Data were obtained from the ICI Factbook, http://www.icifactbook.org/pdf/13_fb_table39.pdf.

Table 5 Nonfinancial Corporation's Allocation of Short-Term Financial Instruments Including Government MMMFs 2007-2012							
	2007	2008	2009	2010	2011	2012	2007-2012 average
Foreign Deposits	5.1%	2.6%	2.8%	3.4%	2.8%	1.0%	3.0%
Bank Products	59.6%	42.3%	58.2%	66.0%	66.9%	69.7%	60.4%
Government Money Market Funds	19.2%	41.0%	25.6%	16.4%	17.4%	15.4%	22.5%
Commercial Paper	7.1%	6.1%	5.0%	5.7%	5.5%	4.8%	5.7%
Treasuries, Agencies and Municipal Securities	8.2%	7.1%	7.6%	7.4%	6.4%	8.3%	7.5%
Repurchase Agreements	0.8%	0.8%	0.7%	1.0%	1.0%	0.8%	0.9%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Using the five year average as an estimator, 22.5% of the assets leaving institutional prime money market funds will switch to government funds, and 60.4% will end up in bank products.

The following tables display the dollar value of assets leaving institutional prime money market funds in each scenario, along with their destinations.

Table 6 Institutional Prime MMMF Asset Movements to Banks Floating NAV						
			Fund Outflow Scenario			
			1	2	3	4
			Complete Elimination	Survey-based	Mid-range	Conservative
Percentage of Assets Leaving Institutional Prime MMMFs			100%	61%	42%	22%
Dollars Leaving Institutional Prime MMMFs:			\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario		Bank%	\$ Billions			
All Bank	1	100.0%	\$ 974	\$ 594	\$ 404	\$ 214
Pro-rata without Government Funds	2	77.7%	\$ 757	\$ 462	\$ 314	\$ 167
Pro-rata with Government Funds	3	60.4%	\$ 588	\$ 359	\$ 244	\$ 129

Table 7 Institutional Prime MMMF Asset Movements to Government Funds Floating NAV						
			Fund Outflow Scenario			
			1	2	3	4
			Complete Elimination	Survey-based	Mid-range	Conservative
Percentage of Assets Leaving Institutional Prime MMMFs			100%	61%	42%	22%
Dollars Leaving Institutional Prime MMMFs:			\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario		% Government Funds	\$ Billions			
All Bank	1	0.0%	\$ -	\$ -	\$ -	\$ -
Pro-rata without Government Funds	2	0.0%	\$ -	\$ -	\$ -	\$ -
Pro-rata with Government Funds	3	22.5%	\$ 219	\$ 134	\$ 91	\$ 48

Table 8 Institutional Prime MMMF Asset Movements to Foreign Deposits Floating NAV						
			Fund Outflow Scenario			
			1	2	3	4
			Complete Elimination	Survey-based	Mid-range	Conservative
Percentage of Assets Leaving Institutional Prime MMMFs			100%	61%	42%	22%
Dollars Leaving Institutional Prime MMMFs:			\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario		% Foreign Deposits	\$ Billions			
All Bank	1	0.0%	\$ -	\$ -	\$ -	\$ -
Pro-rata without Government Funds	2	3.9%	\$ 38	\$ 23	\$ 16	\$ 8
Pro-rata with Government Funds	3	3.0%	\$ 29	\$ 18	\$ 12	\$ 6

Table 9 Institutional Prime MMMF Asset Movements to Commercial Paper Floating NAV						
			Fund Outflow Scenario			
			1	2	3	4
			Complete Elimination	Survey- based	Mid- range	Conservative
Percentage of Assets Leaving Institutional Prime MMMFs			100%	61%	42%	22%
Dollars Leaving Institutional Prime MMMFs:			\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario		Commercial Paper %	\$ Billions			
Bank	1	0.0%	\$ -	\$ -	\$ -	\$ -
Pro-rata without Government Funds	2	7.5%	\$ 73	\$ 45	\$ 30	\$ 16
Pro-rata with Government Funds	3	5.7%	\$ 56	\$ 34	\$ 23	\$ 12

Table 10 Institutional Prime MMMF Asset Movements to Treasuries, Agencies, and Munis Floating NAV						
			Fund Outflow Scenario			
			1	2	3	4
			Complete Elimination	Survey- based	Mid- range	Conservative
Percentage of Assets Leaving Institutional Prime MMMFs			100%	61%	42%	22%
Dollars Leaving Institutional Prime MMMFs:			\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario		% Treasuries, Agencies, and Munis	\$ Billions			
Bank	1	0.0%	\$ -	\$ -	\$ -	\$ -
Pro-rata without Government Funds	2	9.8%	\$ 96	\$ 58	\$ 40	\$ 21
Pro-rata with Government Funds	3	7.5%	\$ 73	\$ 45	\$ 30	\$ 16

Table 11 Institutional Prime MMMF Asset Movements to Repurchase Agreements Floating NAV						
			Fund Outflow Scenario			
			1	2	3	4
			Complete Elimination	Survey-based	Mid-range	Conservative
Percentage of Assets Leaving Institutional Prime MMMFs			100%	61%	42%	22%
Dollars Leaving Institutional Prime MMMFs:			\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario		% Repurchase Agreements	\$ Billions			
Bank	1	0.0%	\$ -	\$ -	\$ -	\$ -
Pro-rata without Government Funds	2	1.1%	\$ 11	\$ 7	\$ 5	\$ 2
Pro-rata with Government Funds	3	0.9%	\$ 8	\$ 5	\$ 3	\$ 2

4. Impact on Competition in the Money Market Mutual Fund Industry

The floating NAV proposal will reduce competition in the MMMF industry by severely reducing the number of funds. The floating NAV proposal will lead to a massive outflow of assets from institutional prime MMMFs ranging from \$214 billion to \$974 billion. This outflow will reduce the size of the remaining funds substantially. If one assumes that a fund needs to generate \$1 million in management fees to cover its expenses, and use the current average expense ratio for institutional prime funds of 19 basis points, this implies that the minimum sustainable size for an institutional prime money market fund is 1/.0019, or approximately \$526 million.¹³ If one applies the shrinkage pro rata across all funds as a percentage of assets, we see that many funds will shrink below the long-term sustainable level.

This outflow will force many institutional prime funds to close. The following table shows the percentage of institutional prime funds which will close under each scenario. A sensitivity analysis is also presented with minimum fee levels of \$0.5 million and \$1.5 million.

¹³ Asset size and fee information taken from *Money Fund Intelligence Daily*, August 26, 2013.

Table 12 Closure rate of Institutional Prime Funds Floating NAV					
		Scenario			
		1	2	3	4
		Complete Elimination	Survey-based	Mid-range	Conservative
Fund outflow %		100%	61%	42%	23%
Minimum Fund Fees \$ millions	Sustainable Fund Size \$ millions	Percentage of Institutional Prime Funds Closing			
\$0.5	\$263	100%	40.5%	30.6%	27.3%
\$1.0	\$526	100%	52.1%	46.3%	41.3%
\$1.5	\$789	100%	57.9%	52.1%	46.3%

This reduction in the number of funds will reduce competition in the industry, leading to more concentration. This may increase the pricing power of the remaining funds and result in higher fees for investors.

In addition, such a major contraction in the industry will result in less competition between institutional prime money market funds and banks. This may also lead to lower yields to investors and higher costs to borrowers.

5. Impact of Floating NAV on Total Bank Deposits

The floating NAV proposal will clearly cause a large transfer of assets from the money market mutual fund sector to the banking sector. However, the total increase in deposits and assets to the banking sector is not the same as the decrease in prime MMMF assets. It is necessary to adjust for the fact that some prime MMMF assets are invested in bank products such as deposit accounts and CDs. Although the MMMF shareholders will be increasing their deposits in banks, the MMMFs themselves will be decreasing the deposits held in the banks. Over the last 20 years, prime MMMFs invested an average of 18.7% of their assets in bank products.¹⁴ This historical average is used to estimate the future fraction of prime MMMF assets that would be invested in bank products. These investments in bank products need to be subtracted from the transfers by MMMF investors from MMMFs to bank products to determine the net inflows of deposits to the banking sector.

¹⁴ ICI 2013 Factbook, Table 44. Available at http://www.icifactbook.org/pdf/13_fb_table44.pdf

One could argue that a transfer of assets from MMMFs to banks would not change total deposits because the assets sold by the MMMFs will be paid for with deposits from the banking sector, leading to no net change in bank deposits. However, this is not the case. Historically, changes in MMMF assets and bank deposits have not offset each other on a one for one basis. As prime MMMF assets contract, the issuers of the assets held by the MMMFs have to replace their funding with other sources. For example, commercial paper issuers are likely to replace maturing commercial paper with bank loans, and the banks are likely to use their excess reserves to fund those loans. With over \$2 trillion in excess reserves, there is ample room for such deposit expansion.¹⁵ Similarly, securities dealers who use repurchase agreements to fund their inventories will likely replace maturing repo with repo from the banking system, again likely funded from excess reserves. Total deposits will thus increase as investors move funds from institutional prime money market funds to the banks.

The following table shows the net inflows to the banking sector under each of the four scenarios:

Table 13				
Net Increases in Bank Deposits				
Floating NAV				
	Fund Outflow Scenario			
	1	2	3	4
	Complete Elimination	Survey-based	Mid-range	Conservative
Percent of Institutional Prime Fund Asset Outflows	100%	61%	42%	22%
Outflows from Institutional Prime MMMFs (\$ billions)	\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario	Net Increases in Bank Deposits			
Bank	\$792	\$483	\$329	\$174
Pro-rata without Government funds	\$615	\$375	\$255	\$135
Pro-rata with Government funds	\$478	\$292	\$198	\$105

Note that bank deposits will increase from between \$105 to \$792 billion, an increase of from 1.0% to 7.3% in the \$10.8 trillion in total bank deposits.¹⁶

¹⁵ As of August, 2013 there were approximately \$2.1 trillion in excess reserves. See <http://www.federalreserve.gov/releases/h3/current/>.

¹⁶ Total bank deposits of \$10.8 trillion in active FDIC insured institutions as of June 30, 2013. Data from <http://www2.fdic.gov/idasp/main.asp>.

6. Impact on Competition in the Banking Industry

As demonstrated above, the floating NAV proposal will cause a large migration of assets from institutional prime MMMFs to banks. These will be large institutional flows far above the FDIC insurance limit from investors who are concerned about counterparty risk. Consequently, virtually all of these deposits will go to the largest banks that can handle large and volatile institutional deposits and are perceived to have negligible credit risks. In other words, the bulk of the deposit increase will likely end up in the 10 largest banks. These top-10 banks already hold approximately \$5.6 trillion, or 51.4%, of the total deposits in US banks. The following table demonstrates the increase in concentration that will occur under the floating NAV proposal assuming that all of the inflows go to the top-10 banks:

Table 14				
Change in Bank Concentration				
Floating NAV				
	Scenario			
	1	2	3	4
	Complete Elimination	Survey-based	Mid-range	Conservative
Percent of Institutional Prime Fund Asset Outflows	100%	61%	42%	22%
Percentage of Bank Deposits in Top 10-Banks Before Floating NAV	51.4%	51.4%	51.4%	51.4%
Substitution Scenario	Percentage of Bank Deposits in Top-10 Banks After Floating NAV (% Change)			
Bank	54.8% (3.3%)	53.5% (2.1%)	52.9% (1.4%)	52.2% (0.8%)
Pro-rata w/o Government funds	54.1% (2.6%)	53.1% (1.6%)	52.6% (1.1%)	52.0% (0.6%)
Pro-rata with Government funds	53.5% (2.1%)	52.7% (1.3%)	52.3% (0.9%)	51.9% (0.5%)

Notice that the ratio of total deposits in the 10 largest banks to total deposits will add between from 0.5% and 3.3% to the existing concentration of 51.4% of deposits in the 10 largest banks as a result of the floating NAV proposal. This will reduce competition in the banking industry.

7. Impact of Floating NAV on Yield to Investors

Investors who are forced out of institutional prime MMMFs will suffer a loss as they manage their funds in a less efficient manner. Although the bulk of assets are likely to flow into bank products, Treasury and government MMMFs will also be available. The yield spread between Treasury MMMFs and institutional prime MMMFs provides an upper bound on the losses to investors from lower yields. Some investors may switch to government MMMFs that invest in instruments issued by Government Sponsored Entities (“GSEs”) such as Fannie Mae and Freddie Mac in addition to U.S. Treasuries. Although government MMMFs usually yield slightly more than pure Treasury MMMFs, it is not clear how long this yield spread will last given the uncertainty over the future status of Fannie Mae and Freddie Mac. Other institutional investors may invest directly in money market instruments, although this requires hiring additional staff to conduct credit analysis and manage the instruments. It is reasonable to estimate the cost to investors of higher management costs and lost yield as approximately half the spread between yield on Treasury and prime MMMFs. At a representative yield spread of 0.24%, this results in an annual cost of decreased yield to investors of between \$260 million and \$1.17 billion dollars per year.

Table 15
Annual Cost to Investors of Lower Yield from Loss of Institutional Prime Funds
Floating NAV proposal

	Scenario			
	1	2	3	4
	Complete Elimination	Survey-based	Mid-range	Conservative
	100%	61%	42%	22%
Asset Outflows From Institutional Prime MMMFs \$ Billions	\$ 974	\$ 594	\$ 404	\$ 214
Half Yield Differential	0.12%	0.12%	0.12%	0.12%
Annual Cost \$ Billions	\$ 1.17	\$ 0.71	\$ 0.49	\$ 0.26

8. Impact of Floating NAV on Interest Paid to Bank Depositors

The large inflow of deposits into the banking system will put downward pressure on the interest that banks will pay their depositors. This will affect all bank depositors, not just those new deposits resulting from the contraction of the institutional prime funds. Although it is difficult to forecast the exact impact on rates, it is clear that there will be some impact. The following table illustrates the impact ranging from a single basis point on the average interest rate paid on all deposits in the most conservative scenario to four basis points in the complete elimination scenario. Reduced interest to depositors will total from \$1.1 billion to \$4.6 billion per year.

	Fund Outflow Scenario			
	1	2	3	4
	Complete Elimination	Survey-based	Mid-range	Conservative
Percent of Institutional Prime Fund Asset Outflows	100%	61%	42%	22%
Decrease in Average Interest Rate Paid on Deposits	0.04%	0.03%	0.02%	0.01%
Substitution Scenario	Decrease in Interest Paid on Deposits (\$ Billions)			
Bank	\$4.6	\$3.4	\$2.2	\$1.1
Pro-rata w/o Government funds	\$4.6	\$3.4	\$2.2	\$1.1
Pro-rata with Government funds	\$4.5	\$3.3	\$2.2	\$1.1

9. Impact on Bank Capital Requirements

The efficiency of the economy will be harmed by unnecessarily tying up huge amounts of capital in the banking sector. The large contraction in the size of institutional prime money market funds will lead to a large increase in deposits for the U.S. banking system. The banks will have to invest the additional deposits somewhere, and this will increase their total assets, assuming that other bank liabilities remain constant.

This significant increase in the size of the balance sheet of the US banking industry has serious implications for bank capital. Loans to former commercial paper issuers will increase the Risk Weighted Assets (“RWA”) of the banks. The volatility of the large institutional deposits will force banks to hold liquid assets against a possible runoff of the deposits, and the banks will not be able to count those

deposits as part of their stable funding, increasing required capital. With respect to the Basel standards for bank capital, the volatile nature of large institutional deposits will adversely affect the banks' Liquidity Coverage Ratios and Net Stable Funding Ratios.¹⁷

The banks will have to raise large amounts of capital to cover the inflows to their balance sheets, in addition to the capital they will have to raise to comply with the coming Basel III standards. Banks typically hold more capital than the minimum required by bank capital standards. U.S. banks as of 2012 have a capital to assets ratio of approximately 11.3% according to the World Bank.¹⁸ Applying this ratio to the expanded assets on bank balance sheets gives us the following table:

Table 17 Increased Capital Requirements for U.S. Banks Floating NAV Capital to Assets Ratio of 11.30%				
	Scenario			
	1	2	3	4
	Complete Elimination	Survey-based	Mid-range	Conservative
Percent of Institutional Prime Fund Asset Outflows	100%	61%	42%	22%
Outflows from Institutional Prime MMMFs (\$ billions)	\$ 974	\$ 594	\$ 404	\$ 214
Substitution Scenario	Required Additional Bank Capital (\$ Billions)			
Bank	\$89.5	\$54.6	\$37.1	\$19.7
Pro-rata w/o Government Funds	\$69.5	\$42.4	\$28.9	\$15.3
Pro-rata with Government Funds	\$54.0	\$33.0	\$33.0	\$11.9

Thus, banks will be required to raise between approximately \$11.9 billion and \$89.5 billion in new capital to support these net inflows. This is capital that will not be available for other productive uses in the economy, hurting economic growth and efficiency. To put this number into perspective, note that US venture capital firms raised \$20.6 billion in 2012.¹⁹ Thus, the amount of capital that will be sequestered by imposing a floating NAV on prime money market funds, even under the most conservative scenario, is comparable to the entire amount of money raised by venture capital firms last year.

¹⁷ For more information, see Bank for International Settlements, *International Regulatory Framework for Banks* (Basel III) <http://www.bis.org/bcbs/basel3.htm>.

¹⁸ The capital to assets ratio is the ratio of total capital to total assets. Capital is defined here by the World Bank as including common shareholder equity, various reserves, and some subordinated debt issues, so called Tier 1, Tier 2 and Tier 3 capital. For more details see <http://data.worldbank.org/indicator/FB.BNK.CAPA.ZS>

¹⁹ <http://thenextweb.com/insider/2013/01/07/mo-money-less-funds-182-us-based-vc-funds-raised-20-6b-in-2012-most-since-2008/>. The National Venture Capital Association reports that VCs invested \$27 billion in 2012. http://www.nvca.org/index.php?option=com_content&view=article&id=344&Itemid=103

In addition, this capital comes with an annual cost. Assuming an 8% cost of bank capital, this investment requires annual capital costs for the banks of \$1.0 to \$7.2 billion.

This analysis does not attempt to quantify the real but large impact on economic growth and employment from the crowding out of other more productive investment, which could be much higher. If one assumes that innovation and growth are the result primarily of venture capital investments, and that the net effect of this sequestration of capital in the banking sector crowds out about one year of venture capital investment, then the switch to a floating NAV could shave about one year of economic growth off of the U.S. economy.

10. Impact on Interest Costs to Commercial Paper Issuers

Capital formation will be harmed as the cost of capital will increase for businesses. Prime MMMFs have traditionally been large investors in commercial paper. Over the last 20 years, an average of 41.3% of their assets has been invested in commercial paper.²⁰ A contraction of the prime MMMF sector will likewise lead to a decline in the commercial paper market and force many commercial paper issuers to access other and more costly sources of funding. Some of the affected issuers will be able to issue commercial paper directly to investors. This is estimated by the institutional assets that move directly from institutional prime MMMFs under the floating NAV proposal to commercial paper as calculated above.

Businesses that cannot access the commercial paper market must pay much higher rates of interest in bank financing for their short-term financing needs, typically the prime rate or more. Currently, one month non-financial commercial paper carries a yield of 0.06% per year, while the prime rate is 3.25%.²¹

The following table demonstrates the impact of the floating NAV proposal on funding costs for commercial paper issuers who will have to switch to other sources of financing. Additional costs to issuers will range from \$2.3 billion to \$10.5 billion in pretax interest costs per year across the various scenarios.

²⁰ ICI 2013 Factbook, Table44. Available at http://www.icifactbook.org/pdf/13_fb_table44.pdf

²¹ <http://www.federalreserve.gov/releases/h15/current/default.htm>, accessed August 28, 2013

Table 18 Increase in Pretax Interest Costs to Commercial Issuers Floating NAV				
Scenario	1	2	3	4
	Complete Elimination	Survey-based	Mid-range	Conservative
Asset Outflows From Institutional Prime MMMFs	\$ 974	\$ 594	\$ 404	\$ 214
Commercial Paper %	41.30%	41.30%	41.30%	41.30%
Commercial Paper Not Purchased by Fund \$ Billions	\$ 402	\$ 245	\$ 167	\$ 88
Less: CP Still Directly Issued (Pro-rata without Government Funds Scenario)	\$73	\$45	\$30	\$16
Total Contraction in Commercial Paper Market	\$329	\$201	\$137	\$72
Prime Rate	3.25%	3.25%	3.25%	3.25%
Commercial Paper Rate	0.06%	0.06%	0.06%	0.06%
Difference	3.19%	3.19%	3.19%	3.19%
Annual Pretax Interest Cost Differential \$ Billions	\$ 10.5	\$ 6.4	\$ 4.4	\$ 2.3

11. Cost of System Upgrades

In addition to the abovementioned costs, converting the IT systems of numerous users to handle floating NAVs to four decimal prices requires quite extensive systems changes. Treasury Strategies Inc. has estimated these as having an initial cost of \$1.8 to \$2 billion. In addition, Treasury Strategies estimates that the changes will require \$200 to \$250 million per year for maintenance of the more complicated systems needed to handle floating NAVs.²²

12. Total Costs

The following table subtotals the initial and continuing costs to the economy of the floating NAV proposal that have been quantified in this paper. It does not include the costs that have not been quantified such as lost future economic growth.

²² See *Costs and Operational Implications of a Floating NAV: Operational Implications of a Floating NAV across Money Market Fund Industry Key Stakeholders*, available at <http://www.sec.gov/comments/s7-03-13/s70313-43.pdf>

Table 19 Summary Costs of Floating NAVs \$ Billions		
Initial One-Time Costs		
	One-Time Costs \$ Billions	
	Low	High
Required Increases in Bank Capital	\$ 11.9	\$ 89.5
System Upgrades	\$ 1.8	\$ 2.0
Total Initial Costs	\$ 13.7	\$ 91.5
Recurring Annual Costs		
	Annual Costs \$ Billions	
	Low	High
Reduced Yields to MMMF Investors	\$.26	\$ 1.17
Reduced Interest Paid to Bank Depositors	\$ 1.1	\$ 4.6
Increased Capital Costs for Banks	\$ 1.0	\$ 7.2
Increased Interest Costs to Commercial Paper Issuers	\$ 2.3	\$ 10.5
Maintenance Costs for System Upgrades	\$.2	\$.25
Total Recurring Annual Costs	\$ 4.86	\$ 23.72

13. Floating NAVs will increase, not decrease, the propensity to run in a crisis

The argument supporting a floating NAV for institutional funds goes like this:

In the example given in the Proposing release, a fund suffers a loss and that causes the shadow NAV to fall from \$1.00 to \$.996.²³ The more observant investors notice this loss, and quickly redeem their shares at the rounded value of \$1.00 per share. This concentrates the loss on the remaining shareholders. If investors redeem one quarter of the shares, the NAV falls to \$.9947, forcing the fund to break the buck. The first investors who got out received \$1.00 per share, while the later investors received less. Indeed, in the case of the Reserve Fund, early redeemers did get \$1.00 per share. After the fund suspended

²³ Release, 78 FR 36838.

redemptions, the remaining investors eventually received about 99 cents per share.²⁴ Even though the absolute value of the loss is small, it still creates an incentive to run in a case similar to The Reserve Fund.

The proposing release, however, does not follow its own model to its logical conclusion. When the fund breaks the buck and then prices shares at the penny-rounded \$.99, the opposite occurs. The fund is now undervalued (since the shadow NAV is \$.9947), so the smart investors should stampede INTO the fund since they can buy \$.9947 worth of assets for only \$.99. Thus, the run under their theoretical model should be self-limiting and even reverses. That investors are unlikely to run into a fund that has just broken the buck is strong evidence that there are factors other than the shadow NAV at work in determining fund flows.

The floating NAV proponents postulate that a floating NAV will eliminate the incentive to run. Thus, the fund realizes a loss, and the floating NAV drops to \$.996. It is now too late to get out at \$1.00, so there is no incentive to run. The investors stay put and there is no run. This theory is based on several implicit assumptions. These assumptions include:

- 1) All market participants believe that the published floating NAVs are accurate.
- 2) Market participants do NOT believe that there is any serial correlation or momentum in published floating NAVs.
- 3) Market participants do NOT change their expectations of sponsor skill as a result of the change in floating NAV.
- 4) Remaining assets can be sold at the prices at which they are currently carried on the books of the fund.
- 5) Investors will become more “tolerant” of fluctuations in floating NAVs.

There are significant problems with these assumptions.

- 1) Some market participants are aware of the significant limitations in mechanical pricing models, and thus may question floating NAVs in a time of market panic.
- 2) Many investors believe that trends continue and that there is momentum in the markets. Given the natural lags that some mechanical pricing models may have in picking up changes in markets, it is natural for traders to expect there to be some lag in the published floating NAVs.
- 3) Market participants expect a certain level of skill in money managers in analyzing credit and selecting assets. A substantial loss in what is supposed to be a safe product damages the sponsor’s reputation for skill, leading investors to take their money elsewhere before more losses occur.
- 4) As the SEC has noted, funds tend to sell the more liquid assets first when forced to sell.²⁵ As more assets are redeemed, the remaining assets are less liquid and likely to receive larger haircuts if sold in a distressed market.
- 5) The stability of share price is one of the most attractive features of MMMFs. The notion that investors seeking a stable-value product will grow to tolerate fluctuations is unlikely. MMMF

²⁴ Release, footnote 80, 78 FR 36843

²⁵ Release, 78 FR 36879.

investors are among the most risk-averse investors around. The floating NAV proposal represents an ambitious attempt to change the behavior of investors during a financial crisis. Such an attempt at changing behavior by getting investors “accustomed to, and tolerant of fluctuations in money market funds NAVs” is unlikely to succeed because it goes against the basic nature of crowd psychology in a panic.²⁶

Let us use the same basic fact picture and see what is more likely to happen in real life with a floating NAV when we relax these assumptions:

The fund realizes a loss, and the NAV drops to \$.996. Some market participants suddenly realize that this manager is less skilled than other MMMF managers, and they rush to liquidate their remaining shares because the fund now appears less well managed than similar funds. Other market participants suspect that the NAV is overstated, either because of mechanical issues with the technology used by pricing vendors or by the human reluctance to recognize losses. They also rush to liquidate before the NAV falls further. Still others believe that the NAV, even if accurate, will continue to decline as momentum trading continues to push the estimated prices of the fund’s assets lower. They view the reduction in NAV as a harbinger of bad times and flee for the safety of other asset classes. Still others sell because they have lost faith in the skill of the fund managers and want to invest with managers that don’t make mistakes. The additional redemptions force the fund to sell its less liquid assets at a substantial haircut, leading to even more losses to shareholders.

In short, the investors will be even more likely to run when there is bad news, even with a floating NAV. Indeed, they will be more likely to run with a floating NAV even with small changes in NAV. Consider the following scenario:

The shadow NAV of a constant NAV fund falls to \$.999 due to jitters over the credit quality of some assets that lead to unrealized losses. The sponsor views the jitters as unfounded and believes the assets are of good quality. With a penny-rounded fund, the fund continues to transact at \$1.00 per share while it patiently looks for a way to bring the shadow NAV back to \$1.000.²⁷ Some investors redeem, but not enough to cause substantial dilution because the fund is widely regarded as well run. Perhaps the problem goes away as the jitters prove unfounded, the securities pay off at maturity, and the NAV returns to \$1.000.

Suppose instead that the fund was a floating NAV fund. Now the fall in the floating NAV to \$.999 raises serious questions among some investors. They suspect that the model prices of the fund’s assets have not yet caught up to the current state of the market, and they believe that the jitters will get worse. They thus pull out because they think the NAV will fall to \$.998 or lower. The visible reduction in NAV leads

²⁶ As stated in the Release, 78 FR 36851: “Investors in money market funds with floating NAVs should become more accustomed to, and tolerant of, fluctuations in money market funds’ NAVs and thus may be less likely to redeem shares in times of stress.”

²⁷ The Release (78 FR 36838, footnote 29) wrongly claims that reductions in shadow prices are permanent due to its interpretation of IRS regulations that force funds to distribute virtually all earnings. Fund managers can use gains to offset losses by selling securities upon which there is a temporary gain. For example, there may be some temporary gains on T-bills around the end of a quarter when other investors are eager to acquire T-bills for quarter-end reporting.

others to question the skill of the fund's management and pull out. Others note the outflows of assets from the fund and suspect that the other investors know something is wrong, so even more additional investors pull out.

This is not a farfetched scenario. The Association of Finance Professionals conducted a survey of its members and found that, if a floating NAV were imposed, 17% of the respondents would monitor the floating NAV and sell if the floating NAV dropped below \$1.00 per share.²⁸

Thus, a floating NAV will likely lead to more jittery investors running from money market funds to avoid small losses in times of uncertainty.

14. The removal of amortized-cost valuation injects noise into MMMF pricing.

Currently, MMMFs are permitted under the existing Rule 2a-7 to use amortized cost accounting for valuing the bulk of the instruments held by the funds.²⁹ In practice, this means that the funds value a security by taking the original purchase price and adding the interest that has been accrued since the purchase. Funds are also required to calculate their "shadow prices" under Rule 2a-7(c)(8)(ii)(A)(1) using "available market quotations (or an appropriate substitute that reflects current market conditions)." The extant rule and the Proposing Release provide little guidance on exactly how "available market quotations" are to be utilized. MMMFs generally use data vendors to provide prices, and those prices are frequently based on models, not actual market transactions or quotations.³⁰ These pricing models are designed to price thousands of securities quickly and cheaply. For these reasons, the bulk of prime MMMF assets are recorded in their financial statements as Level II assets lacking market prices.³¹

Short-term money market instruments are generally not actively traded like exchange-listed equities. They do not trade on organized exchanges with publicly observable prices. While a single share of stock may change hands hundreds or thousands of times over the life of a corporation, short-term money market instruments may never change hands at all. Many corporations sell their commercial paper directly to investors who hold the paper until maturity. Other commercial paper is sold through dealers, who are also willing to purchase and resell the instruments.

²⁸ Association of Finance Professionals, *2013 Liquidity Survey*

²⁹ The current Rule 2a-7(2) definition states: "*Amortized cost method* of valuation means the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors." § 270.2a-7(2) The Investment Company Act provides general guidance on the pricing of investment company shares. §2(a)(41)(B) of the Act states: "(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors;"

³⁰ The Release (78 FR 36837) states "Accordingly, most money market fund portfolio securities are valued largely through "mark-to-model" or "matrix pricing" estimates."

³¹ As stated in the Proposing Release "Level 2 measurements include: (i) quoted prices for similar securities in active markets; (ii) quoted prices for identical or similar securities in non-active markets; and (iii) pricing models whose inputs are observable or derived principally from or corroborated by observable market data through correlation or other means for substantially the full term of the security." Release, 78 FR 36942. See also Release, footnote 27 (78 FR 36837).

Indeed, many of the money-market instruments held by MMMFs even lack CUSIPs.³² The Proposing Release states that approximately 10% of the MMMF securities reported to the SEC on Form N-MFP lacked CUSIP numbers.³³ This is the rationale for the proposal to add the Legal Entity Identifier (LEI) of the issuer to the information required to be reported.³⁴ If these securities lack CUSIPs, how can there be any kind of market prices, let alone accurate ones? The proposing release presents no evidence, and indeed there is none, that shows that the mechanically mass produced model prices from data vendors produce better estimates of the fundamental value of money market holdings than amortized cost even in normal times, let alone in times of crisis that are most relevant for this proceeding.

The one advantage of model-based pricing over amortized cost is when market interest rates have changed subsequent to the purchase of the asset. This is quite important in the pricing of long-term bonds, which have a very high sensitivity to interest rates, known as duration. A 30 year Treasury bond will generally lose more than 15% of its value when the yield on the Treasury bond increases by 1%.³⁵ However, the very short duration of money-market instruments reduces their interest rate risk to very small levels. Furthermore, the Fed generally changes short-term rates by small amounts, and usually signals its intentions far in advance. The market generally takes these expected changes into account in setting yields and prices for money market instruments. The short duration of MMMF assets means that the losses from an unexpected increase in rates would be small. A fund with the maximum 45 day weighted average maturity (0.12 years) would lose approximately 3 basis points (.03%) from an unexpected increase of 0.25% in short-term rates.³⁶ This would decrease the shadow NAV from \$1.0000 to \$0.9997. Of course, any paper held by the fund would pay off 100 cents on the dollar as long as the issuer does not default, so the only “loss” to investors would be the opportunity loss from not earning the higher yield on newer instruments for a few days.³⁷ The fund would not realize any losses on any of its holdings unless it was forced to sell assets because net redemptions exceed the normal cash flows from maturing assets. As most funds have somewhat similar investment positions, it is unlikely that investors would stampede from one fund to another in such a situation.

³² CUSIP stands for Committee on Uniform Security Identification Procedures. The CUSIP number is a standard identifier number for securities in the United States.

³³ Proposing Release, footnote 755, 78 FR 36941.

³⁴ Release, 78 FR 36941

³⁵ For example, as of August 26, 2013, the 2.875% US Treasury Bond that matures on May 15, 2043 was trading to yield 3.813% at an ask price of 83.4063% of face value. (Source:wsjmarkets.com, accessed August 27, 2013). The bond has a modified duration of 18.6 years, meaning it will lose approximately 18.6% according to the duration model when rates rise approximately 1%. This will be offset somewhat by the bond’s convexity. Higher coupon bonds will have a somewhat lower modified duration and thus a somewhat lower sensitivity to interest rate changes. A 30 year 5% coupon bond trading at par has a modified duration of about 16 years.

³⁶ The Fed generally provides ample signaling of forthcoming interest rate changes, giving market participants the opportunity to position themselves accordingly, and these anticipated changes are often visible in the yield curve for short-term rates. It is thus unexpected changes that provide the most risk. The Fed has not raised its target of the Federal Funds rate by more than ¼% at a time since 2000. See <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html> for a history of Fed actions on interest rates. Even an unexpected 1% increase in short term rates would only cause a fund with a 45 day (.12 year) maturity to decline in value by 0.12%, a decline of 12 basis points pushing the shadow value to \$0.9988. This calculation stems from the well-known duration formula: %Change in Value ≈ - Modified Duration X Change in yield. See Berk, Jonathan and Peter DeMarzo, *Corporate Finance*, page 952.

³⁷ The Release recognizes that such losses are temporary as long as securities are held to maturity. 78 FR 36838

The use of “market-based” prices may appear theoretically appealing, but identifying the correct “market” price for a non-traded or thinly-traded instrument even in normal times, let alone in times of market stress can be quite difficult. If quotes can even be found, should the firm use the bid price at which they can liquidate the position, the offer or ask price at which they can buy more, the last sale price, the midpoint of the bid and ask, or some combination of the above?

Thus, the widespread use of mechanical pricing models is likely to inject noise, not information, into the published NAVs of floating-NAV MMMFs.

Liquidation values are only relevant for assets likely to be liquidated.

The majority of MMMF assets are held to maturity and unlikely to be sold. Thus, a shareholder’s redemption generally does not trigger the sale of an asset under normal conditions, as the normal cash flows from maturing assets (combined with new cash coming into the fund) are usually sufficient to honor redemption requests. The situation is different for mutual funds that hold longer-lived assets, such as stocks. Those assets are likely to be sold at any time, so the market price is highly relevant.

Market prices may not be available in a crisis.

As money market instruments do not trade on exchanges, the market depends on dealers as intermediaries. They are an important part of the financial system, and in normal times their quotes can provide useful information about the value of financial instruments. However, in a financial crisis, dealers will be under considerable financial strain and may not have much, if any, financial capacity to purchase any more money market instruments, even high quality ones. Thus, they may fail to provide bid quotations when asked, or they may provide low bids that reflect not the value of the securities, but their own precarious financial position. Indeed, in the 2008 financial crisis the SEC staff provided no-action relief to the MMMF industry permitting the use of amortized cost instead of market quotes because of the turmoil in the market.³⁸ The no-action letter was based on representations that “...the markets for short-term securities, including commercial paper, may not necessarily result in discovery of prices that reflect the fair value of securities the issuers of which are reasonably likely to be in a position to pay upon maturity,” and “...pricing vendors customarily used by money market funds are at times not able to provide meaningful prices because inputs used to derive those prices have become less reliable indicators of price.”

Some market participants will question published floating NAVs in a crisis.

It is likely that some market participants will question the published floating NAVs in the next financial crisis. One of the hallmarks of a financial crisis is a loss of trust in information and institutions that are normally trustworthy, such as rating agencies and pricing vendors. Some market participants are aware of the tendency of humans in trouble to deny that they are in trouble, and thus lose faith in published pronouncements and financial statements. The unexpected financial difficulties facing financial and nonfinancial institutions leads to a loss of faith in the financial infrastructure, leading to a general loss of confidence in everything. A flight to quality is inevitable.

³⁸ Release, footnote 391, 78 FR 36887. The No Action Letter can be found at <http://www.sec.gov/divisions/investment/noaction/2008/ici101008.htm>.

The combination of noisy NAVs from mechanical pricing models and a lack of confidence in published NAVs during a financial crisis have serious consequences for the likelihood of a run on MMMFs. In a penny rounding world, the only thing that can lead to breaking the buck in a crisis is the unexpected default by a large issuer leading to a realized loss. As demonstrated from historical experience, this is an extremely low probability event. However, in a floating NAV world, skepticism over the true NAV may cause investors to run at the first sign of a decline in the published floating NAV, as they would expect the published floating NAV to continue dropping.

15. Summary and Conclusions

The proposal to require institutional prime money market funds to switch to floating NAVs will fail to achieve its primary objective of preventing runs on MMMFs in a financial crisis. Indeed, floating NAVs will actually increase the likelihood of runs in the next crisis by injecting noise into the system.

Institutional prime money market funds contain nearly \$1 trillion in assets. The initial upfront costs of a floating NAV range from nearly \$12 billion to over \$90 billion, and the ongoing annual costs range from nearly \$5 billion to over \$23 billion.

Impact on efficiency

The floating NAV proposal imposes significant costs on the economy with no corresponding benefit. This results in a loss of efficiency as resources are diverted away from productive uses and towards unproductive uses. The elimination of a convenient cash management product for investors will cause many investors to search for less convenient and less efficient substitutes. Investors are likely to either suffer a yield differential from using other higher cost and lower yielding alternatives, or else suffer increased risk from riskier investment alternatives. The flow of deposits into the banking system will depress yields paid to all depositors, not just former MMMF investors. Likewise, the elimination of a convenient and low-cost funding source for businesses will force them to use less efficient and more expensive substitutes.

The floating NAV proposal increases the risk of runs on money market mutual funds and the banking sector and thus increases systemic risk, a further drag on efficiency.

Impact on competition

The massive outflow of assets from institutional prime money market funds that will occur under a floating NAV will lead to a serious shrinkage of the institutional prime money market fund sector. The smaller assets under management will leave many funds so small as to be economically unviable, and the number of prime institutional MMMFs will shrink from anywhere between 27% and 100%. This will result in less competition and higher fees. Furthermore, the elimination of competition between banks and MMMFs will also result in less choice and higher costs to investors.

Impact on capital formation

The floating NAV proposal will have two major deleterious impacts on capital formation. First, the flow of assets into the banking sector will result in a massive increase in capital requirements for the banking sector ranging from \$11.9 billion to \$89.5 billion. This sequestration of capital in the banking sector will divert capital away from other uses, and thus reduce economic growth.

As institutional prime MMMFs are important purchasers of commercial paper, the contraction in the commercial paper market will force issuers into borrowing through other and more expensive channels. This will cause an annual increase in interest costs to borrowers of between \$2.3 billion and \$10.5 billion. This will increase the cost of capital to the private sector and thus lead to a decrease in investment and hence economic growth.

Amortized Cost is “Fair” for Money Market Funds

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Summary

Recent events have caused the U.S. Securities and Exchange Commission (SEC) to rethink the long-standing use of amortized cost by money market mutual funds in valuing their investments in securities. This practice supports the use of the stable net asset value (a “buck” a share) in trading shares in such funds. Some critics have challenged this accounting practice, arguing that it somehow misleads investors by obfuscating changes in value or implicitly guaranteeing a stable share price.

This paper shows that the use of amortized cost by money market mutual funds is supported by more than 30 years of regulatory and accounting standard-setting consideration. In addition, its use has been significantly constrained through recent SEC actions that further ensure its appropriate use. Accounting standard setters have accepted this treatment as being in compliance with generally accepted accounting principles (GAAP). Finally, available data indicate that amortized cost does not differ materially from market value for investments industry wide. In short, amortized cost is “fair” for money market funds.

Background

Money market mutual funds have been in the news a great deal recently as the SEC first scheduled and then postponed a much-anticipated late August vote to consider further tightening regulations on the industry.¹ Earlier, Chairman Mary Schapiro had testified to Congress about her intention to strengthen the SEC regulation of such funds, in light of issues arising during the financial crisis of 2008 when one prominent fund “broke the buck,” resulting in modest losses to its investors. Sponsors of some other funds have sometimes provided financial support to maintain stable net asset values. And certain funds recently experienced heavy redemptions due to the downgrade of the U.S. Treasury’s credit rating and the European banking crisis.

¹ This paper deals exclusively with the issue of accounting for money market funds’ investments in debt securities. It does not touch on other measures being considered by the SEC or others relative to liquidity of such funds, such as capital requirements or restrictions on the amounts that investors could withdraw.

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 \$1 per share pricing convention also conforms to the funds' accounting for their investments in short-term debt securities using amortized cost. This method means that, in the absence of an event jeopardizing the fund's repayment expectation with respect to any investment, the value at which these funds carry their investments is the amount paid (cost) for the investments, which may include a discount or premium to the face amount of the security. Any discount or premium is recorded (amortized) as an adjustment of yield over the life of the security, such that amortized cost equals the principal value at maturity.

Some commentators have criticized the use of this amortized cost methodology and argued for its elimination. In a telling example of the passionate but inaccurate attention being devoted to this issue, an editorial in the June 10, 2012, *Wall Street Journal* described this long-standing financial practice in a heavily regulated industry as an “accounting fiction” and an “accounting gimmick.”

This paper seeks to clarify the record on this matter and to inform the public discourse with (1) a factual and historical perspective on the application of amortized cost to securities held by money market mutual funds under GAAP, (2) an analysis of some of the most recent conceptual accounting thinking, and (3) some related matters.

The use of amortized cost to account for securities of money market mutual funds has been embedded in well-established GAAP for more than 30 years.

History

The use of amortized cost to account for securities of money market mutual funds has been embedded in well-established GAAP for more than 30 years. Both the SEC and the Financial Accounting Standards Board (FASB) have explicitly established or endorsed this

accounting. And the most recent conceptual thinking by accounting standard setters supports this approach as providing relevant information for the users of the entities' financial statements.

The first authoritative accounting guidance for all investment companies, generally, was in the 1973 "Industry Audit Guide on Audits of Investment Companies" (Guide), issued by the American Institute of Certified Public Accountants (AICPA). The Reserve Fund, established in 1971, was the first money market mutual fund, and only a few funds of this type were in operation in 1973. Accordingly, the Guide did not discuss such funds specifically. The Guide called for mutual funds to account for their investments in securities at market value for securities for which quotations were readily available and fair value as determined in good faith by the board of directors for other securities.

A few years later, money market funds had proliferated, and in late 1975 the AICPA drafted guidance to amend the Guide to cover such funds. After exposure for public comment, that guidance was finalized in April 1977 as AICPA Statement of Position (SOP) 77-1, "Financial Accounting and Reporting by Investment Companies." While dealing exclusively with money market funds, SOP 77-1 did *not* cover their use of amortized cost to value their investments. Rather, it covered distribution policies for dividends, the statement of changes in net assets, supplementary information, reporting gains and losses, and federal income taxes.

The first authoritative accounting guidance on accounting for investments in securities for money market mutual funds came from the SEC in May 1977, when it issued Accounting Series Release 219 (ASR 219) (also known as SEC Release IC-9786). It appears that before the issuance of this release, money market funds, still a relatively new type of fund, were applying amortized cost to all investments and sought to stabilize their net asset value. ASR 219 was an interpretation of a rule under the Investment Company Act. ASR 219 indicated that it would be appropriate for money market funds to determine the fair value of debt portfolio securities on an amortized cost basis, provided the securities had remaining maturities of 60 days or less. This release also articulated a materiality standard of \$.01 on a \$10.00 per share net asset value.

In September 1979, the FASB issued Statement 32, "Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting

and Auditing Matters.” It stated that the “specialized accounting and reporting principles and practices contained in the AICPA Statements of Position and Guides on accounting and auditing matters designated herein are preferable accounting principles for purposes of justifying a change in accounting principles as required by APB Opinion No. 20, Accounting Changes.” This Statement, therefore, effectively brought the accounting guidance in those AICPA SOPs and Guides under the umbrella of GAAP. The 1973 Investment Companies Guide and SOP 77-1 were among the AICPA pronouncements specifically cited by Statement 32. (This FASB action did not affect ASR 219, which remained the applicable guidance at that time.)

In February 1982 the SEC proposed and in July 1983 finalized Rule 2a-7, “Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds).” This Rule was issued following several years of SEC hearings and exemptive orders that permitted individual money market funds to use either penny-rounding or the amortized cost method to stabilize their share prices. The former was used in computing current price per share and the latter was used in both valuing portfolio instruments and computing current price per share. The exemptive orders required funds to adhere to limits on the maturity of their investments. These limits extended the maturity restrictions in ASR 219. In particular, money market funds were required to limit the weighted average maturity of the portfolio to 120 days and the maturity of all fund investments to one year. Rather than continuing to provide exemptive orders to individual funds, the SEC concluded that it should establish standards that all funds could follow that would permit use of these methods.

The Rule noted that it was designed to “limit the permissible portfolio investments of a money market fund seeking to use either penny-rounding or the amortized cost valuation method to maintain a stable price per share to those instruments that have a low level of volatility and thus will have a greater assurance that the money market fund will continue to be able to maintain a stable price per share that fairly reflects the current net asset value per share of the fund.” Accordingly, the Rule established maturity limitations that were consistent with the SEC’s exemptive orders as follows:

- The entire portfolio must consist of instruments with a maturity of one year or less.

- The dollar-weighted average maturity of the overall portfolio must not exceed 120 days.

The Rule also required that all investments must represent minimal credit risks and be rated “high quality” by a major rating service, or if unrated, determined by the board of directors to be of comparable quality.

Rule 2a-7 thus became GAAP for money market mutual funds as they applied the Rule’s requirements both in calculating their daily stable price per share and in reporting the value of their investments in their financial statements.

In November 1986 the FASB voted not to object to the issuance of a proposed revision of the 1973 Guide. This was the first time the FASB had formally exercised its oversight of the AICPA literature pursuant to Statement 32 with respect to investment companies. According to the minutes of the meeting at which the FASB voted not to object to the AICPA issuing the Guide, the FASB discussed a few specific accounting issues, but did not comment on the accounting for money market funds. That topic was covered in the Guide in paragraph 2.37, which referred to the SEC’s Rule 2a-7 permitting use of the amortized cost method of accounting for debt securities. Thus, this accounting treatment became part of the professional accounting literature, in addition to the SEC rules, through the inclusion of this information in the Guide and the FASB’s implicit endorsement thereof. While there were several amendments to the Guide between its early 1987 new issuance and the present, there has been little change in the attention given to money market mutual fund accounting for investments.²

As a result of events in the financial markets in 2008, the SEC revisited Rule 2a-7 through a proposal in July 2009 that was finalized in January 2010. The 2010 amendments shortened portfolio maturity and implemented specific liquidity requirements. The weighted-average maturity of the portfolio now cannot exceed 60 days, with no individual security’s maturity more than 13 months.³ The 2010 amendments require taxable funds to hold at least 10%

² However, in February 1991, the SEC amended Rule 2a-7 to, among other things, tighten the maximum weighted average portfolio maturity from 120 days to 90 days.

³ There are exceptions for certain types of securities—including variable- and floating-rate securities—that have a demand feature or an interest rate reset of not more than 397 days.

of their investments in cash, U.S. Treasuries, or securities that mature or are subject to a demand feature within one business day. And all funds must hold 30% of their investments in cash, U.S. Treasuries, other government securities with remaining maturities of 60 days or less, or securities that mature or are subject to a demand feature within one week or less. Also, the credit quality of permitted investments was further limited. Thus, the long-standing assumption of amortized cost closely approximating market value was strengthened by a substantial tightening of the conditions under which it is being applied—namely, shorter maturities and high credit quality.

[T]he long-standing assumption of amortized cost closely approximating market value was strengthened by a substantial tightening of the conditions under which it is being applied—namely, shorter maturities and high credit quality.

In May 2010, the FASB issued an exposure draft of a Proposed Accounting Standards Update, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.” While mutual funds and more specifically money market funds were not a principal focus of that exposure draft, it appears the draft could be read to change the accounting for money market funds through paragraph 26b, wherein it stated, “An investment company that is subject to the guidance in Topic 946 shall measure both its financial assets and its financial liabilities at fair value and include all changes in their fair

value in the net increase (decrease) in net assets for the period. Neither the option to report changes in the fair value of a qualifying financial asset or financial liability in other comprehensive income nor the amortized cost option for qualifying financial liabilities is available to an investment company.” That exposure draft, however, has not yet been finalized. And more recently, in an October 2011 exposure draft, “Financial Services—Investment Companies,” the FASB stated in paragraph BC29,

The FASB also concluded that money market funds, which currently report their investments at amortized cost, would be considered to be managing their investments on a fair value basis. This conclusion is based on money market funds being managed to minimize the differences between the carrying value and the fair value of their investments to maintain a constant net asset value.

Thus, both the SEC, from its initial action in 1977 through the latest revision of Rule 2a-7, and the FASB, from its 1986 endorsement of the AICPA Audit Guide through its latest thinking on this topic in 2011, have clearly articulated the amortized cost basis of accounting as being GAAP for investments of money market mutual funds.

Reasoning for Use of Amortized Cost

The FASB has been considering various aspects of the accounting for financial instruments for approximately 25 years. During that time it has issued standards on topics such as accounting for marketable securities, accounting for derivative instruments and hedging, impairment, disclosure, and others. Also, the FASB has issued standards or endorsed standards issued by the AICPA of a specialized nature applying to certain industry groups such as investment

companies, insurance companies, broker/dealers, and banks. Further, the FASB is presently involved in a major project that has encompassed approximately the past 10 years, whereby it is endeavoring to conform its standards on financial instruments to the related standards issued by the International Accounting Standards Board. Aspects of that project have stalled recently, and the two boards have reached different conclusions on certain key issues. Other aspects of that

project are moving forward.

[M]oney market fund investments are often held to maturity and any discount or premium in the purchase price is realized by the fund.

Over this 25-year period, probably the most controversial aspect of the financial instruments project has been to what extent those instruments should be carried at market or fair value in financial statements rather than historical cost. On several occasions the FASB

has indicated a strong preference for fair value as a general objective. But there has been a great deal of opposition from many quarters, and the FASB has tended to determine the appropriate measurement attribute for particular instruments (fair value, amortized cost, etc.) in different projects based on the facts and circumstances in each case.

The maturity, credit quality, and liquidity restrictions in SEC Rule 2a-7 ensure that the difference between market value and amortized cost generally is immaterial.

Mutual funds typically value their investments using readily available market quotes, or in the absence of such quotes, at an estimate of fair value. However, as noted above in the “History” section, the amortized cost convention has long been used by money market funds as they invest in short-term, high-quality instruments. The maturity, credit quality, and liquidity restrictions in SEC Rule 2a-7 ensure that the difference between market value and amortized cost generally is immaterial. Further, money market fund investments are often held to maturity and any discount or premium in the purchase price is realized by the fund. To consider the reasoning underlying money market funds’ use of amortized cost, it may be useful to look at one of the FASB’s recent documents.

Paragraphs BC69-BC80 of the FASB 2010 exposure draft on “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities” provide some of the latest thinking on the use of amortized cost as a measurement attribute for financial instruments. In particular, BC75 notes,

Preparers have generally favored the use of amortized cost for instruments that an entity intends to hold and realize its benefits through collection of contractual cash flows.

Because of the very short duration of the majority of their investments, money market funds generally intend to hold and realize contractual cash flows in order to achieve their primary earnings. Gains and losses tend to be immaterial.

Amortized cost accounting recognizes reported interest as the primary “earnings” of the entity and also places emphasis on the timing of the realization of changes in value by the entity rather than simply on the amount of the change in value. For example, an entity that is in the “spread” business is concerned about maximizing interest margin through collection of interest income and payment of interest expense while minimizing credit losses. Realizing temporary value changes is not the immediate goal of that business strategy.

Because of the very short duration of the majority of their investments, money market funds generally intend to hold and realize contractual cash flows in order to achieve their primary earnings. Gains and losses tend to be immaterial. Money market funds do not leverage

their investors' funds through borrowing, and realizing temporary value changes is not the goal of their strategy.

In paragraph BC79 of that same exposure draft, the FASB noted that "... amortized cost information may be relevant for certain financial instruments that an entity intends to hold for collection or payment(s) of contractual cash flows." But debt securities would have been accounted for at fair value according to the exposure draft, which also would have changed the specialized industry accounting for money market funds, as noted earlier. However, the extent of the use of fair value accounting was very controversial, as two of the five FASB members at that time dissented on that issue and comment letters on the exposure draft were largely negative, although for many reasons in addition to this issue.

Money market funds do not leverage their investors' funds through borrowing, and realizing temporary value changes is not the goal of their strategy.

It is also useful to consider the "primary perceived disadvantages of amortized cost" as cited by the FASB in paragraph BC78 of that exposure draft. The fact that those arguments are *not* relevant in the case of money market funds is another indication that amortized cost is an entirely appropriate valuation methodology for money market funds, assuming no credit impairment.

First, the FASB states that "Amortized cost reflects a historical transaction price that is not relevant for current investment decisions. For example, amortized cost does not reflect current market conditions such as interest rates and market prices. Some argue that an entity that relies on amortized cost measures may not fully understand the risks inherent in its financial instruments and may lose out on certain current opportunities as a result. Fair value would provide information about opportunity cost because it reflects current market conditions."

As noted by the FASB in its 2011 exposure draft on investment companies mentioned earlier, by reporting their investments at amortized cost, money market funds would be considered to be managing those investments at fair value. That is because they are being

managed to minimize the differences between the carrying value and the fair value of their investments to maintain a constant net asset value. In other words, the difference between amortized cost and fair value is purposely managed to be immaterial by rule. Further, any “opportunity cost” information is addressed by the market value information filed with the SEC monthly and made publicly available on a delayed basis.

Second, the FASB states that “Under amortized cost, an entity can change its intent and realize in net income short-term changes in value. Some view the use of amortized cost as

[T]he difference between amortized cost and fair value is purposely managed to be immaterial by rule.

delaying the recognition of economic gains and losses. An entity could sell assets that are performing favorably and hold on to underperforming assets to meet short-term market expectations.”

Given the current SEC liquidity requirements, this is relatively unlikely for most money market funds as a significant portion of the portfolio will be in securities that mature in a week or less and, thus, not subject to significant market fluctuations. Further, with a weighted average portfolio of 60 days or less, a high percentage of investments will be held to maturity and not sold to generate short-term gains or losses.

Third, the FASB states that “The use of amortized cost relies on complex impairment models. Estimating impairment losses and using valuation accounts are complicated and subjective and could create opportunities to smooth the recognition of income.”

According to Rule 2a-7, money market funds are required to determine net asset value per share based on market prices for their portfolio securities at appropriate intervals and promptly consider taking action should the market value based net asset value deviate from the amortized cost-based net asset value by more than ½ of 1%. They are also required to report market values (or estimates of fair value) for their portfolio securities to the SEC on a monthly basis. Impairment models are necessary mainly in situations where there are no market-based prices broadly available for assets, such as bank loans. Generally, fair values can be readily and objectively determined for the securities in which money market funds invest. In limited

instances, the fund may estimate the fair value of certain securities based upon procedures approved by the fund's board of directors. Accordingly, there is no need for money market funds to develop or employ complex impairment models.

The fourth and final point made by the FASB is that "Complex tainting rules may be necessary if some instruments are measured at amortized cost and others are measured at fair value with management's intentions used as the basis for determining which measurement basis should be used for a particular instrument."

That argument would only apply in a situation where an entity had a mixture of assets and liabilities with some of them carried at cost and some at fair value. That is not the case for money market mutual funds.

In addition to the conceptual arguments for using the amortized cost method of accounting for securities rather than market or fair value, it can be argued that for money market funds, amortized cost is materially the same as fair value in nearly all cases. FASB Concepts Statement No. 8, "Conceptual Framework for Financial Reporting," in Chapter 3, "Qualitative Characteristics of Useful Financial Information," defines materiality as follows:

Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

The SEC staff has issued similar guidance on accounting materiality in Staff Accounting Bulletin Nos. 99 and 108, which specify that materiality cannot be reduced to a numerical measure but must include qualitative considerations as well. However, it is reasonable to assume that amounts that are less than the $\frac{1}{2}$ of 1% of net asset value threshold at which directors must

take action to address a difference between fair value and amortized cost would not be considered material by most parties.

It should also be noted that many, if not most, of the securities owned by money market funds would be considered as “cash and cash equivalents” if they were owned by commercial entities. The FASB’s GAAP Codification in Section 305-10-20 defines cash equivalents as “short-term, highly liquid investments that have both of the following characteristics: a. readily convertible to known amounts of cash, and b. so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.” This would, of course, include investments in money market funds owned by commercial entities. In addition, the

[M]any, if not most, of the securities owned by money market funds would be considered as “cash and cash equivalents”

GAAP Codification gives examples of a three-month U.S. Treasury bill (T-bill), commercial paper, and federal funds sold.

T-bills are very common investments of money market mutual funds, as are short-term agency obligations. Other common money market mutual fund investments that would qualify as cash equivalents if held by commercial entities are commercial paper and repurchase agreements. Under current GAAP, all of these cash equivalents would be carried at cost in the financial statements of commercial entities because they are short-term highly liquid investments and are usually held to maturity—just like those that meet the requirements for the amortized cost method for investments of money market mutual funds.

It is also appropriate to consider the “going concern assumption.” As noted in FASB Concepts Statement No. 1, “Objectives of Financial Reporting by Business Enterprises,”

Investors and creditors ordinarily invest in or lend to enterprises that they expect to continue in operation—an expectation that is familiar to accountants as “the going concern” assumption. Information about the past is usually less useful in assessing an enterprise’s future if the enterprise is in liquidation or is expected to enter liquidation. Then, emphasis shifts from performance to liquidation of the enterprise’s resources and obligations.

Thus, absent evidence to the contrary, companies assume that the entity will continue in business and will carry out its operations according to the terms of understandings with customers, vendors, and others. An entity that is considered not to be a going concern would adopt liquidation accounting principles and assume that its assets would be sold immediately, for example. Market value accounting for money market fund securities would certainly be appropriate if a fund were not a going concern. But given that only one or two funds have liquidated due to breaking the buck in more than 40 years of operations for the industry, it seems that funds can reasonably assert that they are going concerns. And use of the amortized cost method is supported by the going concern assumption.

Related Matters

According to the SEC's regulations in Rule 2a-7, use of the amortized cost method of accounting for investments in securities by money market mutual funds must be justified on an entity-by-entity basis. Therefore, it may not be fully representative to evaluate the application of this method using broad industry data. However, it is still useful to know that, in general, such data show that deviations between money market funds' shadow prices and amortized costs are small. A January 2011 study issued by the Investment Company Institute noted the following for a sample of taxable money market funds covering one-quarter of industry assets.

Average per-share market values of all funds in the sample varied within a narrow range over the decade from 2000 to 2010—a period when financial markets experienced wide variations in interest rates and asset prices. Average shadow prices for funds in the sample ranged from \$1.0020 in 2001–2002, when the Federal Reserve reduced interest rates sharply, to \$0.9990 in the fall of 2008, at the peak of the financial crisis.

[I]n general, data shows that deviations between money market funds' shadow prices and amortized costs are small.

Average per-share market values for prime money market funds in the sample—those taxable funds that invest in corporate as well as government securities—varied between \$1.0020 and \$.9980 during the decade from 2000 to 2010.⁴

In spite of strict guidelines on the quality of individual securities that money market funds may purchase, it is inevitable, of course, that such funds will occasionally suffer credit losses. In many cases during the recent financial crisis, fund sponsors provided support to avoid losses to the funds through purchase at face amount of troubled securities or in other ways. According to a Federal Reserve Bank of Boston Working Paper by Brady, Anadu, and Cooper, “The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011” (August 13, 2012), at least \$4.4 billion was provided by sponsors of 78 funds. Another Federal Reserve Bank official, Eric Rosengren, presented remarks on April 11, 2012, at the Federal Reserve Bank of Atlanta’s 2012 Financial Markets Conference on “Money Market Mutual Funds and Financial Stability.” Using a different method of estimating sponsor support than the Brady et al. paper, Rosengren’s figure for the 2007 to 2010 period was at least \$3.2 billion

Accounting for investment securities by money market mutual funds appropriately remains based on amortized cost.

While these amounts are very large, it is important to keep them in perspective. These losses represent approximately one-tenth of 1 percent of total money market fund assets under management and occurred during a period of unprecedented market volatility. Of more relevance from an accounting standpoint is that occasional losses such as these do not negate use of the amortized cost method of accounting for securities. Providing for possible impairment is a necessary part of any accounting convention based on historical cost. Just a couple of examples of this are accounting for long-term debt investment securities under the hold-to-maturity method and accounting for loans. The board of directors’ regular review of the portfolio should ensure that prompt action will be taken to identify and account for securities with impaired values.

⁴ Given that this study covers a period prior to the 2010 SEC changes to Rule 2a-7, the magnitude of fluctuation in subsequent periods is nearly certain to be much smaller.

Conclusion

Accounting for investment securities by money market mutual funds appropriately remains based on amortized cost. The amortized cost method of accounting is supported by the very short-term duration, high quality, and hold-to-maturity nature of most of the investments held. The SEC's 2010 rule changes have considerably strengthened the conditions under which these policies are being applied. As a result of the 2010 SEC rule changes, funds now report the market value of each investment in a monthly schedule submitted to the SEC that is then made publicly available after 60 days. That provides additional information for investors. And the FASB's current thinking articulates this accounting treatment as GAAP.



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