MONEY MARKET MUTUAL FUND "REFORM": THE DANGERS OF ACTING NOW

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Dr. Jim began his professional career as a rate engineer at Pacific Gas and Electric, where he worked on FERC and CPUC related issues. Along the way he has also worked at BARRA (now part of Morgan Stanley) where he developed equity risk models. He has also served as a Visiting Academic Fellow in residence at the National Association of Securities Dealers (NASD – now FINRA) and also as a visiting economist at the Shanghai Stock Exchange. He has also been chairman of the Nasdaq Economic Advisory Board and a member of the OTC Bulletin Board Advisory Committee. He currently serves on the Boards of Directors of the DirectEdge stock exchanges.

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Abstract

In the wake of the 2008 financial crisis, one Money Market Mutual Fund ("MMMF") "broke the buck" as investors followed a flight to safety.[1] The federal government took actions to create a temporary backstop to prevent a run. In 2010, the Securities and Exchange Commission ("SEC") promulgated regulations to increase liquidity for MMMF's in order to prevent a run.

Recently, a number of high-ranking regulators have announced a desire for additional "reforms" intended to reduce the chance of runs on money market mutual funds (MMMFs). Several of these proposals could result in a major shrinkage or elimination of the MMMF industry as we know it. This could severely damage the municipal finance and commercial paper markets along with the governments and businesses that rely on those markets for funding. Additionally, shrinking the MMMF sector would, paradoxically, increase systemic risk in the financial system as a whole by concentrating more assets in highly leveraged too-big-to-fail banks, and place further strain on bank capital adequacy.

Imposing major structural experiments on such a vital part of our economy is particularly dangerous at this time, given the current state of anemic economic growth and continued failure to resolve the European sovereign debt crisis. Now is not the time to raise borrowing costs for businesses and governments, nor is it the time to concentrate risk within the banking system and strain capital adequacy. Ultimately, increasing the costs of operating MMMFs in the current low-yield environment will likely drive many funds out of business, compounding the damage to the economy.

This paper can assist policymakers in assessing the costs and risks to the economy from shrinking the MMMF sector through a proper cost-benefit analysis of proposed reforms. Any such cost-benefit analysis must reflect implementation costs of new rules and increased costs to municipal and

[1] The clients of the Reserve Fund received over 99 cents on the dollar. Additionally, over 400 banks failed as the result of the financial crisis.

corporate borrowers that rely upon MMMFs for funding, along with the resulting consequences on economic growth and job creation. Furthermore, MMMF investors will experience decreased yields and will be tempted to shift money into riskier assets.

MMMFs exist for the ease of short-term cash management and investment that provide economic benefits for investors, governmental entities and businesses. Recent reforms have already reduced the risk of destabilizing runs; even large shifts of assets are now more properly seen as orderly "walks," thus obviating the need for additional restrictions. It would therefore seem prudent for regulators to first study how the recent reforms have reacted to market stress and if they have achieved their purpose.

If the recent MMMF reforms are working, then it would seem that this is not the right time to consider MMMF reforms that may be harmful to the investors and businesses that use the product.

MONEY MARKET MUTUAL FUND "REFORM":
The Dangers of Acting Now

Introduction

A number of regulators have recently expressed a desire for immediate and radical changes to the regulation of money market mutual funds (MMMFs). SEC Chairman Mary Schapiro, for instance, has publicly called for further regulation of these funds and is pushing for SEC action. Federal Reserve Chairman Ben Bernanke recently said at an Atlanta Federal Reserve conference that "[a]dditional steps to increase the resiliency of money market funds are important for the overall stability of our financial system and warrant serious consideration."[2] His colleague at the Boston Federal Reserve, Eric Rosengren, called the current state of MMMF regulation "unacceptable" just two years after the implementation of sweeping industry reforms. Media reports indicate that three broad categories of reform are under consideration:

1) Abolish the product in its current form by prohibiting the constant $1.00 net asset value (NAV) that is the essence of a money market fund.
2) Reduce the essential liquidity feature of MMMFs by placing restrictions on investor withdrawals even in normal times.
3) Substantially increase the cost of operating MMMFs by requiring the sequestration of a large capital "buffer" against potential losses.

Each of these proposals could lead to the virtual elimination or at the very least a major shrinkage of the industry. The purpose of this paper is to highlight the extensive damage to the economy that such a shrinkage would entail. In short, MMMFs provide affordable financing to corporations and governments by investing in safe short-term securities such as commercial paper and tax anticipation notes. Eliminating or shrinking the MMMF industry will raise borrowing costs for governments and businesses to the tune of billions of dollars every year. These billions will be passed through to consumers and taxpayers. Higher borrowing costs will dampen investment and thus undermine any potential economic recovery. Given the current state of the economy, now is not the time to even consider actions that raise costs to consumers, raise costs to taxpayers, and slow the economy.

[2] Bloomberg News, "Fed Chief Seeks More 'Resiliency,'" Apr. 9, 2012, available at http://www.nytimes.com/2012/04/10/business/economy/fed-chief-call-for-bolstering-money-market.html?_r=1.

As the SEC considers potential rulemaking on MMMFs, they need to carefully weigh the costs and benefits of proposals. Culminating in a decision last year to throw out the SEC's Proxy Access regulations, the courts have held that the SEC must follow the law in weighing costs and benefits and insuring that rulemakings will promote market efficiency and capital formation.[3]

As a result, when drafting regulations, the SEC must engage in a comprehensive analysis that goes beyond simple compliance costs that are just the tip of the iceberg. The total costs to the economy include follow-on effects from the economic activity that is inhibited by the regulations. This would appear to mean that the SEC would have to look at the impacts of MMMF regulations on the commercial paper market and cash management by businesses as well as state and municipal governmental entities.

Background: The history and role of money market mutual funds

Money market mutual funds are mutual funds whose investment objective is to invest in safe and liquid short-term debt instruments and maintain a NAV of $1.00 per share. The U.S. MMMF industry plays a large role in the economy. As of February 2012, the industry had total assets of $2.6 trillion, down from a peak of $3.9 trillion in January 2009.[4] The economic significance of the MMMF industry is readily apparent when compared with the $7.3 trillion in deposits in U.S. commercial banks.[5] The sheer size of the industry necessitates that any major changes in its regulation be approached with the utmost caution.

The MMMF industry began in the high-interest-rate days of the 1970s as a reaction to Federal Reserve Regulation Q, a government price control on the interest rates banks were permitted to pay their customers. MMMFs permitted consumers to benefit from higher interest rates by investing in safe short-term instruments such as bank certificates of deposit (CDs), high-quality commercial paper, repurchase agreements, and short-term municipal and Treasury securities. As mutual funds, they could pass through all of the interest (less their expenses) to the investors. Because they invested in extremely safe, short-term assets, they could easily maintain a NAV of $1.00 per share, thus providing a safe and stable place for small and large investors to store funds for short periods of time.

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[3] *See Business Roundtable and Chamber of Commerce of the United States v. SEC*, USCA Case 10-1305, opinion date July 22, 2011, available at http://www.chamberlitigation.com/sites/default/files/cases/files/2011/Business%20Roundtable%20and%20Chamber%20of%20Commerce%20v.%20SEC%20(Decision).pdf.

[4] Investment Company Institute, Money Market Funds in 2012, available at http://www.ici.org/pdf/12_mmf_by_the_numbers.pdf.

[5] FDIC data as of June 30, 2011, available at http://www2.fdic.gov/sod/sodSumReport.asp?barItem=3&sInfoAsOf=2011.

Even after the demise of Regulation Q, investors and issuers found MMMFs to be a safe and beneficial addition to the financial landscape. Corporations found them to be extremely useful means of outsourcing their cash management. Instead of hiring specialized and expensive employees to evaluate and trade short-term financial instruments, it was far more cost-effective to "hire" MMMFs to perform the same function. The simplicity and transparency of MMMFs makes it easier for corporations to analyze the credit quality of MMMFs than that of banks. This is especially important because corporate cash balances routinely exceed the single-account limits insured by the Federal Deposit Insurance Corporation (FDIC).

MMMFs also have come to play an important funding role for federal, state, and local governments, as well as corporations. MMMFs are important buyers of U.S. Treasury bills that fund the federal government, as well as short-term paper from states and local governments.

Over the years, the industry has built up an impressive safety record. Prior to the recent financial crisis, only one fund actually "broke the buck," or failed to maintain a $1.00 NAV. During the 2008 financial crisis, in contrast to the failures of dozens of banks, only a single MMMF failed to return 100 cents on the dollar to its investors—and its investors ultimately received more than 99 cents.

During the 2010 period when Washington was responding to the 2008 financial crisis, the SEC conducted a rulemaking process leading to comprehensive reform of Rule 2a-7, the framework for the SEC's regulation of MMMFs. These reforms (1) tightened MMMF credit and liquidity standards; (2) required MMMFs to publicly disclose on a monthly basis their holdings and the "shadow" NAV to four decimal places, and (3) required MMMFs to perform periodic stress testing of their portfolios to validate their ability to maintain a stable NAV in the face of hypothetical events, including increases in short-term interest rates or shareholder redemptions, a security's downgrade or default, and the widening or narrowing of spreads between yields of an appropriate overnight rate benchmark and those of the fund's securities.[6]

These reforms have benefited MMMF investors and issuers, and over the past two years, the industry has prospered by continuing its 40-year track record of serving investors well. Despite this, discussion of more extensive and disruptive changes continues in the name of "systemic risk."

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[6] Mark Perlow, "Money Market Funds – Preserving Systemic Benefits, Minimizing Systemic Risks" (Spring 2011). http://www.law.berkeley.edu/files/bclbe/Money_Market_Funds__Preserving_Systemic_Benefits_Minimizing_Systemic_Risks.pdf

It is extremely important to distinguish between a destabilizing "run" and an orderly "walk." In a run, funds are forced to sell assets at potentially distressed prices, potentially destabilizing the money markets. In a "walk," funds can use the normal cash flows from maturing assets to meet redemptions. The recent reforms significantly increased the amount of "daily" and "weekly" liquid assets that MMMFs have to hold. The SEC reduced the maximum permitted weighted average portfolio maturity from 90 days to 60 days. Taxable MMMFs are now required to hold 10% of their assets in daily liquid assets (assets that mature in one day) and 30% in weekly liquid assets (assets that turn into cash within one week). This increase in required liquidity makes it much less likely that a fund will be forced to sell assets into a distressed market.

Because 10% of a MMMF's assets turn into cash every day even if it does nothing, a fund can withstand redemptions of at least 10% of its assets in a single day without having to sell anything. Most funds now hold significantly more than the 10% minimum. Furthermore, because MMMFs are now required to have at least 30% of their assets convert into cash each week, a fund could experience redemptions of 30% or more in a week without having to sell a single asset into a fragile market.

MMMF performance during the market's 2012 jitters over exposure to European bank paper provides some evidence that the reforms have achieved their goal. Funds reduced their exposure in an orderly way and market stability was maintained. Further changes to the industry should be made only after we have gained additional experience with the 2010 reforms. As 2008-style panics are fortunately extremely rare events, there is no need to rush into hasty and ill-considered reforms. We have the luxury of time to see how the recent reforms work.

This paper describes some of the most predictable and dramatic impacts of further restrictions should regulators decide to act now. Changes to MMMF operations would damage our economy, raising costs significantly and achieving no meaningful benefits for investors.

These proposals, if enacted, will shrink the MMMF industry.

It is highly likely that the MMMF industry will shrink dramatically if any of the discussed regulations are implemented. Many investors simply will not or cannot invest in floating NAV funds. For example, many corporations and state and local governments are subject to policies and legal restrictions permitting them to invest only in funds that do not fluctuate in value. Corporate cash management systems are not set up for floating NAV funds, and it is costly to upgrade systems. Each transaction in a floating NAV fund risks generating

minor taxable capital gains or losses, leading to nightmarish complexity for tax calculations. According to a survey of MMMF investors, more than half of institutional cash managers indicated that they would substantially decrease their use of MMMFs if the funds are required to have a floating NAV.[7]

Clearly, any regulations that reduce the economic usefulness of MMMFs will cause the industry to contract or disappear altogether. Although regulators are not expected to protect specific business models, a legitimate cost-benefit analysis must include the incidental and consequential economic costs resulting from the inevitable contraction or disappearance of this essential financing vehicle. Such an analysis would include a careful quantitative analysis of the impact of each component of proposed rules on total MMMF assets and the indirect impact of this shrinkage on the economy.

Issuers of commercial paper will pay significantly higher interest rates. Direct and indirect damage must be taken into account.

Currently, MMMFs purchase up to 40% of commercial paper, representing a significant and easily accessible source of funding for companies. In the current fragile economic environment, any damage to the commercial paper market can be expected to seriously hamper economic recovery. Congress recognized this principle in the recently enacted JOBS Act, which sought to ease the process of capital formation for small, entrepreneurial companies. Regulators should not then make obtaining short-term credit significantly more challenging for established companies and frequent issuers of debt by hobbling the MMMF industry.

Any regulations that shrink the MMMF industry will force some users of the commercial paper market to go elsewhere. In many cases, the immediately available alternative to issuing commercial paper is bank financing that may be hundreds of basis points more expensive than commercial paper. For example, as of this writing the prime rate in the U.S. is 3.25%, almost 14 times more than the six-month commercial paper rate of 0.24%. If the issuers of $400 billion of commercial paper were forced to moved to a prime rate funding source, their interest expenses would jump by as much as $12 billion, a roughly 1,400% increase. A precipitous increase of this magnitude might be absorbable in the deficit-financed world of Washington-style budgeting, but not in corporate America.

[7] Investment Company Institute, Submission to International Organization of Securities Commissions (Feb. 7, 2012), p. 31.

Banks also need more lead time to be able to offer financing to most corporate customers and may require such borrowers to hold the debt for a longer term. Transactional costs are higher, and fees and other expenses are usually involved. A properly functioning MMMF market, in sharp contrast, offers transactional simplicity and rapid access to funding impacts.

Higher borrowing costs result in higher hurdle rates for planned investments, and thus reduce the investments that companies undertake. This reduction in investment leads to fewer jobs and less economic growth. This impact must also be quantified and considered in the cost-benefit analysis. Curtailing access to commercial paper means that corporations will also have less flexibility to offer financing to customers, resulting in an even further permanent drag on economic recovery.

With further restrictions, corporate treasury departments also will lose significant flexibility in how they manage their cash. Damaging the industry would therefore mean the loss of a conservative investment vehicle for corporate treasurers, with no obvious alternative in sight. Corporations would either experience lower yields elsewhere or pay expensive in-house staff to run an inefficient internal equivalent of a money market mutual fund. These costs should be quantified.

State and local governments will face higher costs, pressuring them to increase taxes.

Further regulation would have significant impacts on another important type of issuer: state and local governments. MMMFs hold 60% of state and local short-term debt. Almost immediately, there would be a direct, negative impact on funding for local economic development at a time of great economic uncertainty.

The reason for the immediate fallout is clear. Rather, much of their revenue flows in at different times, such as when taxes are due. As the nonpartisan Congressional Research Service stated,

> Most governments issue short-term debt to finance current spending then use future revenue to repay this debt. These notes are called revenue anticipation notes or tax anticipation notes. It is important to note that almost every state and local government is required to maintain a balanced

> operating budget from fiscal year to fiscal year, so only in rare circumstances is short-term debt carried over into the next fiscal year….[8]

MMMF financing therefore helps governments smooth out revenue flows so they are not forced to take on excessive longer-term debt, and they can fund work on critical projects throughout the year while also providing a safe, reliable source of returns to holders of their short-term notes.

MMMFs are especially beneficial to state and local governments because the governments can pass through tax-exempt yields to investors, reducing their effective financing costs. The role of MMMFs here is irreplaceable; banks and other institutional lenders cannot offer this pass-through feature. In the alternative, states and municipalities would have to sell their obligations directly to investors, at greater cost and with less efficiency, to achieve the same objective.

Burdensome new regulations on MMMFs would amount to raising the cost of short-term lending to governments—in essence, increasing the costs to taxpayers and putting upward pressure on tax rates—for protection against a nonexistent risk. Higher funding costs for governments and higher taxes for citizens at this time would cause the teetering economy to contract even further.

Higher borrowing costs for corporations and governments will dampen economic recovery.

Clearly, higher borrowing costs motivate companies and governments to borrow less. Businesses will raise fewer funds to expand and hire new workers, and governments will spend less on infrastructure and other useful works. Any attempt to measure the costs of shrinking the MMMF industry must take into account the increase in unemployment (and the cost of unemployment benefits), along with follow-on impacts stemming from less investment in future economic growth.

Big banks will get bigger, increasing systemic risk and pressure on capital adequacy.

Eliminating the viability of MMMFs as sources of investment would not lessen corporations' need to manage their excess cash balances and obtain short-term cash financing. Nor would it lessen consumers' need to manage their cash efficiently. The money

[8] Congressional Research Service, "State and Local Debt: An Analysis," Apr. 14, 2011, available at http://www.fas.org/sgp/crs/misc/R41735.pdf.

must go somewhere—and the two most likely options at this time are banks and less regulated offshore funds.

Weakening MMMFs thus has the paradoxical effect of putting more pressure on the FDIC and bank regulators as more assets are shifted to banks, at the same time as the broad based FDIC insurance guarantees are withdrawn.[9] As this asset shift occurs, large banks will become bigger and more concentrated, expanding systemic risk concerns. This will put increasing pressure on bank regulators as their resources are spread thinly. This effect seems to come into direct conflict with the stated goal of the Dodd-Frank legislation of 2010,[10] which aimed to abolish the concept of "too big to fail." According to the logic underlying Dodd-Frank, as big banks become even bigger, there is an *increase* in systemic risk. Why, then, would financial regulators want to promote a migration from a safe form of financing into a much more vulnerable one?

Unlike MMMFs, banks are highly leveraged and make up a considerably less efficient "marketplace" for short-term credit. Banks would need to hold more liquid assets to prepare for the possibility of significant withdrawals of funds as corporations and others seek to manage their cash flow efficiently.

Given the likelihood that some of the funds currently invested in MMMFs would switch to banks, regulators should consider the impact of the Basel III capital adequacy standards (which provide, among other things, for a 7% common equity requirement, and eventually, a Tier 1 capital ratio of up to 8.5%). While the Federal Reserve is still determining final implementation of the standards for U.S. financial institutions, it is clear that in the context of a $2.6 trillion industry, billions of dollars would need to be held in increased capital reserves if assets invested in MMMFs were to migrate to the banking sector. If the banking sector adds $1 trillion of assets resulting from a reduction in the MMMF sector, the banking sector would have to raise $85 billion in additional capital.

This increased capital could be put to much better uses in the economy. A thorough cost-benefit analysis would quantify the gross domestic product impacts and jobs lost from such a fruitless misallocation of capital. Furthermore, bank equity capital is costly to raise, and the costs will be passed through to borrowers and thus to the rest of the economy. If banks are reluctant or, more likely, unable to dilute their existing shareholders by raising new capital, they may seek to meet expanded capital requirements by shrinking their balance

[9] Professor Jonathan Macey of Yale has made this point very clearly. See his "Reducing Systemic Risk: The Role of Money Market Mutual Funds as Substitutes for Federally Insured Bank Deposits" (2011), available at http://digitalcommons.law.yale.edu/fss_papers/2020.
[10] Pub. L. 111-203 (2010).

sheets in other ways that could harm the economy, such as by cutting lending to other borrowers. Again, a serious cost-benefit analysis must account for all of these effects.

Retail investors will suffer decreased yields.

Any serious analysis of the costs and benefits of additional restrictions on MMMFs must also quantify the specific impact on retail investors—the 56 million individual Americans who invest in MMMFs. Like their corporate counterparts, they would lose flexibility in cash management options. Retail investors have even fewer options for alternative investments than do corporations. To manage their cash, individuals would have to increase their deposits in banks, limiting their financing alternatives and losing the benefits of investing in short-term debt. According to the Investment Company Institute, since 1990, individual investors have gained $242 billion more in returns from MMMFs than they would have earned in competing bank products.[11]

A thorough analysis must also assess the penalties to investors from decreased yields that would inevitably result from a capital buffer requirement or any other operational change that increases the cost structure of managing a MMMF. A 10 basis point (0.10%) increase in the annual cost of operating money market funds (which translates to a 10 basis point reduction in yield to investors) on a $2.6 trillion industry becomes a $2.6 billion tax on money market fund investors *every year*. This is more than the total *cumulative* losses to MMMF investors in the entire history of the industry.

Curtailing the industry will entice some retail investors to shift their assets into less effective substitutes for MMMFs, such as short-term bond funds. However, these funds have historically exhibited far more risks to investors than MMMFs. They also experienced significant outflows in the financial panic of 2008. A thorough analysis should quantify the projected losses to investors who are pushed out of MMMFs into riskier investments.

The Dodd-Frank regulatory traffic jam makes this the wrong time to consider additional reforms.

MMMF regulation does not exist in a vacuum. Regulators currently have their hands full implementing Dodd-Frank and Basel III. Indeed, it appears that the SEC may be more than a year late meeting congressional deadlines on some of the Dodd-Frank required rulemakings.[12] Given its limited human capacity, it is unlikely that the SEC will be able to

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[11] Paul S. Stevens, "Preserving the Value of Money Market Funds for Investors and the Economy," Mar. 12, 2012, available at http://www.ici.org/mmfs/iciperspective/12_pss_mmx.

[12] For example, see http://www.bloomberg.com/news/2012-03-06/sec-conflict-mineral-rule-may-miss-deadline-by-more-than-a-year.html.

conduct thorough economic analyses of MMMF proposals or any of the myriad issues on its plate. Regulators with an agenda to "get things done" before they leave office may well make hasty and ill-considered decisions.

Any changes in MMMF regulation must also consider the *cumulative* impact of adding this regulation on top of the other major changes currently being implemented in financial regulation.[13]

Under the Dodd-Frank legislation and other regulatory reform efforts such as the Basel III standards,[14] regulated financial institutions are digesting a large number of radical changes to their business models, governance, interaction with customers, and general operations. These major changes include the Volcker Rule, Basel III bank capital adequacy and market liquidity standards, changes in FDIC insurance and assessments on member institutions, changes in debit card fees under the Durbin Amendment to Dodd-Frank, the establishment of the Financial Stability Oversight Council and enhanced regulation of certain nonbank financial institutions, regulation of hedge funds, and many other matters. Implementing changes to MMMFs at the same time as other major changes in financial regulation would most likely heighten, not reduce, uncertainty and systemic risk. Simply put, there are dangers to acting now.

The most important regulations to consider in this context are the 2010 SEC rules that reformed the governance and structure of MMMFs. Taking further action before thoroughly studying the impact of the 2010 reforms makes no sense—particularly when the proposed actions pose a grave and immediate danger not merely to the MMMF industry but to the overall economy that relies on the MMMF's essential role in the process of short-term lending itself.

Conclusion

With the recent enactment of MMMF reforms, a regulatory log-jam created by the Dodd-Frank Act and potential harm investors and financing of businesses, it would appear that now would be an inopportune time to engage in MMMF reforms.

The costs of placing increased restrictions on MMMFs are considerable, to say the least. Depending on how draconian the restrictions are, costs could easily top many tens of

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[13] See generally Treasury Strategies, "Level-Setting the MMF Debate," Presented to the Securities and Exchange Commission, Apr. 5, 2012, p. 14.

[14] See generally http://www.bis.org/bcbs/basel3.htm?ql=1; Bank for International Settlements, "Basel III: International framework for liquidity risk measurement, standards and monitoring," available at http://www.bis.org/publ/bcbs188.pdf.

billions of dollars every year. These costs—lower returns to investors of all types, a higher cost of short-term financing for companies and government units, potential tax increases, larger, riskier banks, and the potential for money to flow offshore to less regulated markets—militate against regulatory action at this time. The impact of higher borrowing costs to business and governments is especially problematic during a period of persistent high unemployment, when we need to be putting more people to work. In the current near zero-yield environment, saddling MMMFs with unnecessary and excessive costs that will put many funds out of business will further compound the damage.

The costs are real; the purported benefits illusory at best. , Now is not the time to act.

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