M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: September 13, 2013

Subject: September 18, 2013 Subcommittee on Capital Markets hearing on "Examining the SEC's Money Market Fund Rule Proposal"

The Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on "Examining the SEC's Money Market Fund Rule Proposal" at 10:00 am on Wednesday, September 18, 2013, in Room 2128 of the Rayburn House Office Building. This will be a one-panel hearing with the following witnesses:

- The Honorable Steven N. McCoy, Treasurer, State of Georgia, on behalf of the National Association of State Treasurers
- The Honorable Sheila Bair, Chair, Pew Charitable Trusts, Systemic Risk Council
- Ms. Marie Chandoha, President and Chief Executive Officer, Charles Schwab Investment Management Inc.
- Mr. James Gilligan, Assistant Treasurer, Great Plains Energy, on behalf of the U.S. Chamber of Commerce
- Mr. Paul Schott Stevens, President & CEO, Investment Company Institute

This hearing will review the proposal put forth by the Securities and Exchange Commission (SEC) on June 5, 2013, to further reform the regulation of money market mutual funds (MMFs). Among the reforms proposed is a requirement that "prime" MMFs adopt a "floating" net asset value (NAV) per share instead of a stable $1.00 share price and a proposal to allow MMF directors to impose liquidity fees and redemption gates in times of market stress.

"Prime" MMFs invest in high-quality, short-term instruments issued by corporations and banks, as well as repurchase agreements, certificates of deposit, and asset-backed commercial paper. By contrast, "government" MMFs invest in obligations of the U.S. government, the U.S. Treasury or federal agencies and instrumentalities, as well as repurchase agreements collateralized by government securities. During the financial crisis, "prime" MMF experienced heavy redemptions while "government" MMFs experienced heavy inflows.

Background

MMFs are a type of mutual fund developed in the early 1970s that allow investors to purchase a pool of securities that generally provide higher returns than interest-bearing bank accounts.[1] Unlike mutual funds, whose share price can fluctuate daily, MMFs seek to maintain a stable NAV, typically $1.00 per share. MMFs are also generally redeemable on-demand, and pay dividends reflecting prevailing short-term interest rates, which make them a popular cash management tool for both retail and institutional investors. These features, as well as the stable share prices, have caused some investors to mistakenly view MMFs as equivalent or substantially similar to interest-bearing bank deposit accounts. Unlike bank deposit accounts, however, MMFs are not insured by the Federal Deposit Insurance Corporation (FDIC).[2]

MMFs must register with the SEC under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) and are regulated by the SEC under Rule 2a-7. SEC Rule 2a-7 requires, among other things, that MMFs invest only in low-risk, high-quality, short-term eligible securities, or in debt instruments issued by the U.S. government, U.S. corporations, and local governments.

Each share in an MMF represents an investor's proportionate ownership of the fund's portfolio and income. MMF shares are "redeemable," which means that investors can sell their shares back to the fund or to a broker acting for the fund at the current NAV per share, minus any fees such as deferred sales loads or redemption fees. Unlike other mutual funds, MMFs try to maintain a stable NAV, typically $1.00 per share. MMFs are able to maintain a stable NAV in large part because their portfolios of short-term, high-quality debt securities generally do not experience large fluctuations in value during normal market conditions. In addition, Rule 2a-7 allows MMFs to value their portfolio securities using the "amortized cost" method of valuation and to use the "penny-rounding" method when pricing their shares.[3] Together, these valuation and pricing mechanisms create a "rounding convention" that allows MMFs to sell and redeem shares at a stable NAV notwithstanding small variations in the value of the underlying portfolio securities. An MMFs' NAV may fall below $1.00, however, if the fund's portfolio performs poorly.[4]

In exchange for the ability to use the "amortized cost" method of valuation and the "penny-rounding" method of pricing, Rule 2a-7 imposes certain requirements on MMFs in order to reduce the deviations between a fund's $1.00 share price and the market value of the fund's portfolio securities. For example, Rule 2a-7 requires that MMFs hold a sufficient

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[1] *See* SEC Fact Sheet, Reforming Money Market Funds (June 5, 2013), available at http://www.sec.gov/News/Article/Detail/Article/1365171576956 .
[2] *See* U.S. Securities and Exchange Commission, Money Market Fund Reform; Amendments to Form PF, Release No. 33-9408 (June 5, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9408.pdf. MMFs should not be confused with money market deposit accounts which are bank deposit accounts insured by the FDIC.
[3] The "amortized cost" method of valuation allows an MMF to value portfolio securities at cost plus any amortization of premium or accumulation of discount, instead of at their value based on current market factors. The "penny rounding" method of pricing allows an MMF to round the fund's NAV to the nearest one percent (*i.e.*, the nearest penny) when pricing its shares. *See id.*
[4] *See id*.

amount of liquid assets to meet investor redemption demands, and to invest in securities that meet specific credit quality, maturity, and diversification requirements.[5]

In addition to the investment features, MMFs pay dividends that reflect short-term interest rates and offer check-writing redemption features. As a result of their principal stability, liquidity, and payment of short-term yields, MMFs have become popular cash management tools for both retail and institutional investors. As of February 28, 2013, there were approximately 586 money market funds registered with the SEC with collective holdings totaling more than $2.9 trillion of assets.[6]

MMFs and the Financial Crisis of 2008

On September 16, 2008, the Reserve Primary Fund — an MMF that had invested heavily in short-term debt issued by the investment banking firm Lehman Brothers — "broke the buck," meaning that its NAV fell below a par value of $1 per share. When Lehman Brothers filed for bankruptcy on September 15, shares of the Reserve Primary Fund fell to 97 cents after it wrote off debt issued by Lehman Brothers. Because many investors in MMFs had believed their investments to be safe, the collapse of the Reserve Fund shook their confidence in the soundness of all MMFs and set off a run on MMFs, as investors attempted to withdraw an estimated $250 billion, even from funds without any exposure to Lehman Brothers. Although the Reserve Primary Fund was the only prime reserve fund to "break the buck" during the 2008 crisis, research suggests that a total of 31 prime MMFs would have fallen below a $1 NAV if they had not received direct or indirect support from their sponsors between 2007 and 2011.[7]

To stop the run on MMFs, in September 2008, the Treasury Department—without seeking Congressional authorization—announced that it would use its Exchange Stabilization Fund, an emergency reserve typically used to intervene in foreign exchange markets, to guarantee the "share price of any publicly offered eligible money market mutual fund" that applied for and paid a fee to participate in the program. The program expired in September 2009. Treasury has reported that no MMF that participated in the program failed, that the program had guaranteed over $3 trillion in assets, and that it had collected $1.2 billion in fees to pay for the guarantee.[8] The Emergency Economic Stabilization Act of 2008 required that the Treasury reimburse the Exchange Stabilization Fund for any funds used related to Treasury's guarantee of MMFs, and prohibited the Treasury from using the Exchange Stabilization Fund in the future to guarantee MMFs.[9]

2010 SEC Reforms to Rule 2a-7

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[5] *See id.*

[6] *See id.*

[7] "Sponsors" consist of an MMFs' asset management firms, parents and affiliates, and support may come in the form of cash contributions, the purchase of distressed assets at above-market prices, or guarantees. *See* Federal Reserve Bank of Boston, The Stability of Prime Money Market Funds: Sponsor Support from 2007 to 2011 (Aug. 13, 2012), available at: http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1203.pdf.

[8] *See* U.S. Department of the Treasury, Treasury Department Releases Text of Letter from Secretary Geithner to Hill Leadership on Administration's Exit Strategy for TARP (Dec. 9, 2009), available at http://www.treasury.gov/press-center/press-releases/Pages/tg433.aspx.

[9] *See* Section 131 of P.L. 110-343

To improve the liquidity of MMFs, on January 27, 2010, the SEC adopted changes to Rule 2a-7 that require MMFs to maintain a minimum daily and weekly percentage of their assets in highly liquid securities so that those assets can be readily converted to cash to meet redemption requests by shareholders.[10] Under the new rule, all taxable MMFs must keep at least 10 percent of their assets in cash, U.S. Treasury securities, or other securities that can be converted into cash within one day. On a weekly basis, at least 30 percent of an MMF's assets must be in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that can be converted into cash within one week.

The SEC also reduced the amount that MMFs can invest in lower quality illiquid securities, or a security that cannot be sold or disposed of within seven days, from 5 percent of a fund's assets to 3 percent. In addition, the SEC limited the ability of MMFs to invest in long-term floating rate securities, and required MMFs to conduct periodic stress tests. The SEC also gave MMF boards of directors the authority to suspend fund redemptions if the fund is about to "break the buck," and the SEC allows the fund to liquidate. Previously, the SEC had to issue an order to an MMF to suspend redemptions.

Finally, in its 2010 release adopting the amendments to Rule 2a-7, the SEC indicated its intention to propose further reforms to MMF regulation in recognition of the possibility that additional changes might be necessary to prevent runs on MMFs. Among these possible changes was requiring MMFs to adopt the "floating NAV" standard used by other open-end investment companies.

2012 MMF Regulatory Reform Proposals

SEC Regulatory Reform Proposal

On April 25, 2012, in testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises, then-SEC Chairman Mary Schapiro testified, "I have asked Commission staff to prepare recommendations on structural reforms to money market funds to lessen their susceptibility to runs and to enhance the protections afforded investors. These reforms would supplement the rules limiting the portfolio risk in money market funds that the Commission adopted in FY 2010."[11] The staff proposal would have required, among other things, that all MMFs adopt a "floating NAV" and use mark-to-market valuation for portfolio securities, and implement a capital buffer combined with a minimum balance at risk requirement in times of market stress.

On August 22, 2012, Chairman Schapiro issued a statement indicating that a majority of the SEC's commissioners had declined to support the staff proposal and for that reason the proposal would not be voted on.[12] The following day, SEC Commissioner Luis

[10] *See* SEC Approves Money Market Fund Reforms to Better Protect Investors (Jan. 27, 2010), available at http://www.sec.gov/news/press/2010/2010-14.htm.
[11] *See* Testimony of SEC Chairman Mary L. Schapiro on "SEC Oversight (April 25, 2012), available at http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489436#.UjDTjqDD9kg.
[12] *See* Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), available at http://www.sec.gov/news/press/2012/2012-166.htm.

Aguilar, who had opposed the proposal, responded to the Chairman's comments, stating "that there is much to be investigated related to the cash management industry, as a whole, before a fruitful discussion can be initiated as to whether additional structural changes should be made to only one segment of the cash management industry—SEC-registered money market funds."[13] Commissioner Aguilar expressed concern that the Chairman's proposal would "be a catalyst for investors moving significant dollars from the regulated, transparent money market fund market into the dark, opaque, unregulated market."[14]

On August 28, 2012, SEC Commissioners Dan Gallagher and Troy Paredes, who also had opposed the proposal, issued a joint statement responding to the Chairman's comments.[15] Commissioners Gallagher and Paredes stated that the proposed regulatory changes backed by Chairman Schapiro "were not supported by the requisite data and analysis, were unlikely to be effective in achieving their primary purpose [*i.e.*, to prevent future runs on MMFs in times of market stress], and would impose significant costs on issuers and investors while potentially introducing new risks into the nation's financial system."[16] They added that a proposal should be considered that would permit money market fund boards, in their discretion and consistent with their fiduciary obligations, "to 'gate' redemptions to stave off a run and to allow the fund manager time to mitigate the concerns of investors who otherwise may be inclined to redeem."[17]

Given their concerns with Chairman Schapiro's reform proposal and in order to gather data regarding the effect of potential changes to the regulatory regime governing MMFs, Commissioners Gallagher, Paredes, and Aguilar posed a series of questions regarding MMFs to the staff of the SEC's Division of Risk, Strategy, and Financial Innovation (now called the Division of Economic and Risk Analysis).

The FSOC's Regulatory Reform Proposal

In November 2012—following SEC Chairman Schapiro's failed attempts to gain the support of a majority of Commissioners for her regulatory reform proposal and while the SEC staff was conducting its study on MMFs—the Financial Stability Oversight Council (FSOC) invoked its authority under Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to recommend that the SEC proceed with structural reforms of MMFs.[18] The FSOC's reform proposals mirrored those offered by Chairman Schapiro, including alternatives requiring the adoption of a "floating NAV"; a stable NAV with a capital buffer and a minimum balance at risk requirement; or a stable NAV with a capital buffer and other measures, such as more stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements.

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[13] *See* Statement Regarding Money Market Funds by Commissioner Luis A. Aguilar (Aug. 23, 2012), available at http://www.sec.gov/news/speech/2012/spch082312laa.htm
[14] *Id.*
[15] *See* Statement by Commissioners Daniel M. Gallagher and Troy A. Paredes (Aug. 28, 2012), available at http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm.
[16] *Id.*
[17] *Id.*
[18] *See* Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (Nov. 2012), available at http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

SEC Staff Study

In December 2012, the SEC's Division of Risk, Strategy, and Financial Innovation published the study requested by Commissioners Aguilar, Gallagher and, Paredes. As requested by the three Commissioners, the staff study primarily addressed the causes of investor redemptions in "prime" MMFs during the financial crisis, certain characteristics of MMFs before and after the SEC's 2010 amendments to Rule 2a-7, and how future reforms might affect investor demand for MMFs and alternative investments.[19] The staff study found, among other things, that "[i]nvestor redemptions during the 2008 financial crisis, particularly after Lehman's failure, were heaviest in institutional share classes of prime money market funds, which typically hold securities that are illiquid relative to Government funds," while "institutional share classes of government money market funds, which include Treasury and government funds, experienced heavy inflows."[20] As described below, the staff study provided the foundation for additional reform measures proposed by the SEC in June 2013.

2013 SEC Regulatory Reform Proposal for MMFs

On June 5, 2013, the SEC voted unanimously to propose additional reforms to the regulatory regime governing money market funds.[21] The 90-day comment period ended September 17, 2013. The SEC's proposal sets forth three primary reform alternatives:

1. *"Floating NAV" For Prime Institutional MMFs*: The first alternative would require only prime institutional MMFs to transact at a "floating NAV," rather than $1.00 per share, meaning that their share prices would fluctuate according to changes, if any, in the market-based value of their portfolio securities. This alternative would require prime institutional MMFs to drop "penny rounding" for "basis point-rounding," meaning that these MMFs would round their share prices to the nearest 1/100th of one percent (*i.e.*, the fourth decimal place for a fund with a $1.0000 share price). This proposal would not apply to retail[22] and government[23] MMFs.

2. *Liquidity Fees and Redemption Gates*: The second alternative would allow MMFs to continue to maintain a stable share price, but would require MMFs to (i) impose a 2 percent liquidity fee on investor redemptions if a fund's "weekly liquid assets" fall below 15 percent of total assets (half the required amount),

[19] *See* SEC Division of Risk, Strategy, and Financial Innovation, "Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher" (Nov. 30, 2012), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.
[20] *Id.* at 10.
[21] *See* SEC Proposed Money Market Fund Reform, Rel. No. 33-9408; U.S. Securities and Exchange Commission, Reforming Money Market Funds Fact Sheet (June 5, 2013), available at http://www.sec.gov/news/press/2013/2013-101.htm.
[22] The proposal defines a "retail" MMF as a MMF that does not permit a shareholder from redeeming more than $1 million in a single business day.
[23] The proposal defines a "government" MMF as a MMF that invest at least 80% of its assets in cash, government securities as defined in the Investment Company Act, or repurchase agreements collateralized by government securities. Government securities does not include securities issued by state and municipal governments.

unless the fund's board of directors determines that a liquidity fee would not be in the best interests of the fund; and (ii) if the 15 percent threshold is crossed, to impose a temporary (not longer than 30-day) suspension of redemptions, or "gate," in the discretion of the fund's board of directors. This proposal would not apply to government MMFs unless they opt into the new requirement.

3. *Combination of "Floating NAV" for Prime Institutional MMFs and Liquidity Fees/Redemption Gates*: The third alternative would combine a "floating NAV" requirement for prime institutional MMFs with liquidity fees/redemptions gates for all MMFs other than government MMFs (unless such funds chose to opt in).

In addition to the three primary reform alternatives, the SEC's proposal would also require additional disclosures relevant to assessing MMF risks on Form N-MFP and make Form N-MFP disclosures available to the public immediately upon filing. The SEC's proposal would also require advisers to large liquidity funds—essentially unregistered MMFs—to make substantially the same disclosures on Form PF that MMFs make on Form N-MFP. The SEC's proposal would also strengthen MMF asset diversification requirements, and enhance MMF stress-testing requirements.

Proposed Framework for the Regulation of European Money Market Funds

On September 4, 2013, the European Commission (EC) issued a proposed European framework aimed at enhancing the liquidity and stability of European MMFs during times of market stress. In contrast to the SEC's proposal, the EC's proposal requires European MMFs with a stable NAV to hold a 3% capital cushion or "buffer" that can be used to support stable redemptions when these funds' investment assets decline in value. The European Union (EU) has only a small amount of euro or sterling-denominated government MMFs (accounting for around 3% of assets managed by stable NAV funds). The EC's proposal does not differentiate between government and prime MMFs for purposes of the capital buffer requirement. Similar to the SEC's approach, the EC's proposal also requires certain daily and weekly levels of liquidity so that European MMFs are able to satisfy investor redemptions; clear labeling to differentiate short-term European MMFs from standard European MMFs[24], customer profiling policies to help anticipate large redemptions; and internal credit risk assessment by European MMF managers to avoid over-reliance on external ratings. The EC's proposal must be approved by the EU Council and the European Parliament, and is expected to be applied throughout the EU by the end of 2014.[25]

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[24] Short-term European MMFs hold assets with a residual maturity not exceeding 397 days compared to a residual maturity limit of 2 years for standard European MMFs.

[25] *See* European Commission Memo 13/764, New Rules for Money Market Funds Proposed – Frequently Asked Questions (Sept. 4, 2013), available at http://europa.eu/rapid/press-release_MEMO-13-764_en.htm?locale=en; Citizens' summary: The EU creates safeguards to avoid a new crisis on Money Market Funds (MMF), available at http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-citizens-summary_en.pdf.