MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

PUBLIC INTEREST COMMENT

MONEY MARKET FUND REFORM; AMENDMENTS TO FORM PF

Hester Peirce
Senior Research Fellow, Mercatus Center at George Mason University

Robert Greene
Research Associate, Mercatus Center at George Mason University

Securities and Exchange Commission, Investment Company Act Release No. 30551
Comment Period Closes: September 17, 2013

INTRODUCTION

We appreciate the opportunity to comment on the Securities and Exchange Commission's June 13, 2013 notice of proposed rulemaking "Money Market Fund Reform; Amendments to Form PF" (SEC 2013 MMF Proposals). The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and advancing knowledge about the effects of regulation on society. Thus, this comment does not represent the views of any particular affected party or special interest group but is designed to assist the Securities and Exchange Commission (SEC) as it seeks to amend of the regulatory structure governing money market funds (MMFs).

The alternatives the SEC proposes are, in the commission's own words, designed "to address money market funds' susceptibility to heavy redemptions, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, the benefits of money market funds."[1] The commission's proposed reforms do not effectively achieve these objectives.

The SEC proposes three potential alternatives: (1) floating the net asset value (NAV) of prime institutional MMFs, (2) allowing MMFs to impose emergency liquidity fees and redemption gates, and (3) some combination of the first two options. Switching to a floating NAV would bring some benefits, but they would be outweighed by the costs. While the SEC's second alternative is a step in the right direction, we encourage the SEC to adopt instead a new rule that permits MMF boards, subject to certain protective conditions, to impose redemption gates as needed. This approach would be a natural extension of the duties with which

1. SEC 2013 MMF Proposals, 76 Fed. Reg. 36,834, 36,834 (June 19, 2013).

The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

boards of directors are currently entrusted and would be more effective in achieving the SEC's stated objectives than the proposed reforms.

THE NEED FOR REFORM

Under rule 2a-7, investors generally can withdraw one dollar for every dollar they put in to a MMF.[2] As a consequence, MMFs have become a popular cash management tool for retail and institutional investors. They have also become a major source of short-term funding for governments and corporations. Until the most recent crisis, MMFs had not attracted much attention from those looking for trouble in the financial system. They were widely viewed as safe, low-risk investments. The events of the financial crisis shook this perception.

One MMF broke the buck during the crisis, and other funds also experienced problems, including rapid and voluminous redemptions and the need for emergency sponsor support. It is important to note, however, that MMFs were not uniformly affected by the market strains of fall 2008. Institutional funds were more affected than retail funds.[3] According to economists Kacperczyk and Schnabl, "funds with more money fund business and funds that took more risks before Lehman's default experienced larger runs."[4] Funds with less liquid portfolios experienced more run behavior.[5]

In response to the redemption pressures on MMFs and the resulting pressures in the short-term funding markets, the Department of the Treasury implemented a temporary guarantee program for MMFs, and the Federal Reserve created several programs to support the commercial paper markets. The crisis and the dramatic government rescue programs understandably inspired a rethinking of MMFs' regulatory structure. In March 2010, the SEC adopted a set of money market fund reforms.[6] The 2010 reforms tightened restrictions on MMFs' portfolio holdings and expanded disclosure. The SEC also authorized MMF boards to suspend redemptions, but only in conjunction with a fund liquidation.[7] These reforms, however, were viewed by the SEC and others as a precursor to more fundamental changes, such as those included in the SEC 2013 MMF Proposals.[8]

DRAWBACKS OF THE SEC'S PROPOSED REFORM ALTERNATIVES

The SEC's floating NAV proposal is "designed primarily to address the incentive of MMF shareholders to redeem shares in times of fund and market stress based on the fund's valuation and pricing methods."[9] If

---

2. 17 C.F.R. § 270.2a-7 (2013).
3. *See, e.g.*, Lawrence Schmidt, Allan Timmerman & Russ Wermers, *Runs on Money Market Mutual Funds* 3 (Working Paper, Jan. 2, 2013) (finding that "prime institutional funds exhibited much larger persistence in outflows than retail funds, although retail investors also exhibited some run-like behavior"), *available at* http://www.rhsmith.umd.edu/cfp/pdfs_docs/papers/WermersMoneyFundRuns.pdf; Patrick E. McCabe, *The Cross Section of Money Market Fund Risks and Financial Crises* 9 (Fed. Reserve Bd. Fin. & Econ. Discussion Series Working Paper, Sept. 12, 2010) (estimating that during the month starting September 10, 2008, institutional prime MMFs were depleted by thirty percent, compared to five percent for retail prime MMFs).
4. Marcin Kacperczyk & Philipp Schnabl, *How Safe Are Money Market Funds?*, Q. J. ECON. 1073, 1078 (2013).
5. Schmidt, Timmerman & Wermers, *supra* note 3, at 38 (finding "that runs were more pronounced among funds that had less liquidity, in terms of their lower holdings of securities that matured with seven days").
6. Money Market Fund Reform, Investment Company Act Release No. 29,132, 75 Fed. Reg. 10,059 (Mar. 4, 2010) (amending or adding 17 C.F.R. §§ 270.2a-7, 270.17a-9, 270.22e-3, 270.30b1-6T, 270.30b1-7 & 274.201).
7. 17 C.F.R. § 270.22e-3(c) (2013). A majority of directors, including a majority of independent directors, must approve the decision to suspend redemptions.
8. The 2010 amendments may have been a contributor to the need for, as well as a precursor of, further reforms as they further homogenized portfolio holdings across MMFs, which could increase the chance in a future crisis of problems at one fund spilling over to other funds. *See* Fin. Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69,455, 69,463 (Nov. 19, 2012) ("The similarity of portfolio holdings increases the contagion risk to the entire MMF industry and to the broader financial system in the event that one MMF encounters stress.").
9. SEC 2013 MMF Proposals, *supra* note 1, at 36,849.

portfolio securities were properly priced (which is not inevitable),[10] the floating NAV would temper the first-mover advantage. As discussed above, evidence suggests that investors run from funds that have taken on riskier assets or lack liquidity to meet redemptions. Even with a floating NAV, investors would have an incentive to run early from funds that they anticipated would later experience problems.[11]

The floating NAV option would fall far short of the SEC's goal of "preserving, as much as possible, the benefits of money market funds." It would impair the day-to-day utility of MMFs for many investors. It would require substantial operational and technology changes. It would eliminate the tax, accounting, recordkeeping and operational benefits provided by stable NAV funds.[12] The proposing release gives inadequate weight to these issues. Although it is encouraging that the SEC generally "believes that an investment in a money market fund with a floating NAV would meet the definition of a 'cash equivalent,'"[13] the SEC's beliefs in this regard are insufficiently concrete for MMF shareholders to rely upon. Likewise, it is heartening that the Internal Revenue Service (IRS) has taken steps since the SEC proposed its rules to alleviate tax concerns regarding wash sales.[14] However, that relief—which is conditional—has not been finalized. Moreover, as the SEC 2013 proposing release acknowledges, there are costs associated with tracking gains and losses for tax purposes brought about by a floating NAV regime that the IRS has not yet addressed.[15]

The proposing release explains that "the move to a floating NAV [which is not applicable to retail funds] would be designed to change the investment expectations and behavior of money market fund investors" and cites a survey of retail investors about their understanding of MMF risk and the availability of government assistance to show that MMFs' expectations need to be changed.[16] It is unclear how shifting institutional funds to a floating NAV and making related disclosure changes will assist retail investors in better understanding the risks of MMFs.

The SEC alternatively proposes to require MMFs to impose a liquidity fee of up to two percent if weekly liquid assets fell below a liquidity threshold of fifteen percent of total assets, unless the board determines that doing so would not be in the best interest of the fund. In addition, the SEC proposes to allow a MMF board to temporarily suspend redemptions if weekly liquid assets fell to the same trigger level and the board "determines that doing so is in the best interest of the fund."[17] A board could only gate for thirty days unless the fund's total weekly assets in liquid assets reach thirty percent before that, and a board may not gate for more than thirty days in any ninety-day period.[18]

This proposal has benefits, but its design interferes with those benefits. Liquidity fees would allow investors that wanted liquidity to pay for it by compensating remaining shareholders, which could help to mitigate

10. The Presidents of the Regional Federal Reserve Banks, who support a floating NAV, underscored the importance of proper pricing. Letter from Eric S. Rosengren, President, Federal Reserve Bank of Boston, et al. to Elizabeth M. Murphy, Secretary, SEC 3 (Sept. 12, 2013) ("The effectiveness of a floating NAV option depends on funds' ability to properly value money market instruments. To the extent that investors believe that a fund's 'true' market-based NAV is below its reported NAV, they will be incented to redeem before other investors.").

11. Patrick E. McCabe et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Funds* 1 (Fed. Reserve Bank of New York, Staff Report No. 564, 2012) (acknowledging that a floating NAV could contribute to fund stability, but noting that "investors in an MMF with a floating NAV would still face strong incentives to redeem shares quickly at the first sign of trouble—before other redemptions deplete the fund's most liquid assets").

12. *See, e.g.*, Letter from Paul Schott Stevens, President & CEO, Inv. Co. Inst., to Amias Gerety, Deputy Assistant Sec'y, Fin. Stability Oversight Council, *supra* note 208, at 62-67 (detailing the tax, accounting, recordkeeping, and operational advantages of a CNAV).

13. SEC 2013 MMF Proposals, *supra* note 1, at 36,869.

14. *See* Internal Revenue Serv., Notice 2013-48: Application of Wash Sale Rules to Money Market Fund Shares.

15. SEC 2013 MMF Proposals, *supra* note 1, at 36,868.

16. *Id.* at 36,874 & n.306.

17. *Id.* at 36,878 (discussing proposed alternative).

18. *Id.* at 36,884.

the severity of redemptions. The gating portion of the proposal would afford MMF boards additional flexibility in responding to a crisis situation. However, this proposal does not effectively meet the SEC's goal of curbing run risk and contagion. MMF shareholders could withdraw early in anticipation of a trigger being reached.[19] The proposing release recognizes this problem and cites research showing that triggers in other contexts can inspire anticipatory trading volume.[20] Establishing appropriate triggers and setting properly sized liquidity fees in advance are difficult and likely futile tasks. The SEC attempts to mitigate the concerns associated with predetermined triggers by allowing boards to decide not to implement a liquidity fee or to impose a reduced fee.[21] A better approach—the one to which we turn next—does not include a liquidity fee, but affords boards broad discretion to gate.

DISCRETIONARY GATING PROPOSAL

We propose to allow boards of directors to halt redemptions at any time and for any length of time without any conditions other than an affirmative board vote that suspending redemptions is in the best interests of the fund and is necessary to protect the fund's stable NAV and to ensure the equitable treatment of fund shareholders. The vote must include the majority of the fund's disinterested directors. There would be no requirement, as there is in existing rule 22e-3, that a fund's board have made an irrevocable decision to liquidate the fund—a condition that unnecessarily dissuades boards from using redemption suspensions.[22] A board's gating decision would take effect at the beginning of the next business day and would end as soon as the board determined that the conditions necessitating gating were no longer present. Boards could not delegate this responsibility. MMFs would be required to disclose the existence of the board's authority to impose gates and, if gates were imposed, to inform fund shareholders and the SEC promptly.

This proposal offers several important advantages. First, it is consistent with the existing roles and responsibilities of MMF boards of directors under state law,[23] the Investment Company Act, and rule 2a-7. As with other corporate directors, mutual fund directors must give the fund's interests preeminence over their own interests and those of other directors, persons, or entities.[24] In addition, Congress and the SEC have looked to fund boards to guide and protect the fund in many specific circumstances.[25] Independent directors play

---

19. *See, e.g.*, Patrick E. McCabe et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Funds* 58-59 (Fed. Reserve Bank of New York, Staff Report No. 564, 2012) (arguing that sophisticated investors will monitor MMFs and redeem preemptively before gates or fees are triggered).
20. *See* SEC 2013 MMF Proposals, *supra* note 1, at 36,881 n.361.
21. *Id.* at 36,881 (noting that "the opportunity for preemptive redemptions will decrease as a result of the amount of discretion fund boards would have in imposing liquidity fees and gates.").
22. In order to implement this proposal, the SEC could adopt a new rule under section 22(e) or amend existing rule 22e-3by removing the requirement that boards have voted to liquidate the fund before suspending redemptions and adding in conditions for the termination of the redemption suspension. If the SEC were to take the latter approach, the conditions under which the board could exercise its authority would be the existing conditions in the rule, namely, "The fund's board of directors, including a majority of directors who are not interested persons of the fund, determines pursuant to § 270.2a-7(c)(8)(ii)(C) that the extent of the deviation between the fund's amortized cost price per share and its current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) may result in material dilution or other unfair results to investors or existing shareholders."). 17 C.F.R. § 270.22e-3 (2013).
23. State law subjects directors to "duties of care and loyalty" to the fund, which require they act with diligence and care to pursue the fund's best interests. See 1 THOMAS P. LEMKE, GERALD T. LINS & A. THOMAS SMITH III, REGULATION OF INVESTMENT COMPANIES § 9.09 (2013). As the SEC has explained, "duty of care" requires "that directors act in good faith and with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position," and "duty of loyalty" requires "that directors exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization." *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083, 64 Fed. Reg. 59,877, 59,878 (Nov. 3, 1999) (citations omitted).
24. *See* LEMKE et al., *supra* note 23, at § 9.09.
25. *See, e.g.*, Arthur Levitt, Chairman, Sec. & Exchange Comm'n, Remarks Before the Second Annual Symposium for Mutual Fund Trustees and Directors, (Apr. 11, 1995) ("I would characterize the relationship between the SEC and fund directors as a partnership in the public interest. Your supervision complements our oversight -- in fact, the SEC's abilities as a watchdog pale in comparison with yours. You're in an ideal position to monitor new developments and trouble-shoot problems as they arise.").

a particularly important role in policing conflicts of interest.[26] Our proposed approach would require that a majority of the independent directors vote for redemption.

The fund board makes key decisions with respect to the fund and monitors the fund's relationships with the adviser and other outside entities that provide services to the fund. Boards are responsible for "performance evaluation, contract approval, fee approval, pricing of fund shares, and oversight of portfolio management and compliance issues."[27] By our rough estimate, mutual fund boards have more than thirty separately identified tasks under the Investment Company Act and its implementing regulations. Rule 2a-7 adds another twenty-five unique responsibilities for MMF boards. One of these responsibilities is, in the event of a significant deviation from a $1.00 NAV, to determine "what action, if any, should be initiated."[28] Having boards to decide when and for how long to suspend redemptions is a natural extension of, and a facilitator of, these existing responsibilities. A decision of the magnitude of suspending redemptions properly resides with the board.

Second, boards in the midst of a crisis are better able to decide when gating is necessary than regulators who attempt to make that decision before a crisis occurs. Our proposal relies on boards to make fund-specific decisions based on current facts, rather than on regulators to implement technically difficult, industry-wide, ex ante decisions. They will be able to decide, based on the volume of redemption requests and a close consideration of their portfolios' liquidity, quality, and maturity, whether and for how long gating is necessary. Some might argue that boards would be conflicted, inadequately responsive, or irresponsible in their use of gates.[29] If accepted, these arguments would have broader implications for the entire mutual fund regulatory scheme, which is built upon the corporate structure of mutual funds with oversight by a board that acts in the best interests of the fund.[30]

Third, the prospect of discretionary gating would force MMFs to compete based on safety as well as on yield and would force MMF investors to balance yield and liquidity considerations. An analysis of hedge funds—which employ discretionary gating—reveals that more stringent restrictions on redemption requests are correlated with higher fund yields.[31] Introducing this trade-off to MMFs would mitigate the incentives of investors and funds to chase yields by forcing them to take into account the cost they might incur in terms of reduced liquidity. MMF shareholders would likely seek to diversify their holdings and more closely monitor investment risks. MMF sponsors would want to avoid a gating event because of the reputational consequences. Gating's remote, but real, liquidity risk could cause a subset of investors to leave MMFs. In fact, some could be compelled by their investment guidelines to leave. To the extent giving boards broad

---

26. *See*, *e.g.*, Burks v. Lasker, 441 U.S. 471, 484 (1979) (explaining that Congress chose to rely on independent directors as an independent check on mutual funds "in preference to more direct controls on behavior"); *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (1977) (independent directors should "act in the role of 'independent watchdogs' who would assure that, in accordance with the preamble of the Investment Company Act, mutual funds would operate in the interest of all classes of their securities holders, rather than for the benefit of investment advisers, directors, or other special groups."). *See also* Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,380 (Aug. 2, 2004) ("Fund independent directors play a central role in policing the conflicts of interest that advisers inevitably have with the funds they advise.").

27. JOHN J. BRENNAN, ET AL., REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS: ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS 14 (1999).

28. 17 C.F.R. § 270.2a-7(c)(8)(ii)(B) (2013).

29. For example, a director that sits on the boards of multiple funds might be tempted to gate one fund in order to prevent a fire sale of assets that another fund also has in its portfolio.

30. *See*, *e.g.*, DIVISION OF INVESTMENT MANAGEMENT, SEC. & EXCHANGE COMM'N, PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION 252 (1992) (explaining that the Investment Company Act "imposes requirements that assume the standard equipment of corporate democracy: a board of directors (forty percent of whom must be independent): whose function is to oversee the operations of the investment company and police conflicts of interest; and shareholder voting. . . ."), *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

31. *See* George O. Aragon, *Share Restrictions and Asset Pricing: Evidence from the Hedge Fund Industry* 83 J. FIN. ECON. 33, 56 (2007).

discretion to gate makes MMFs less attractive to these investors, it is a positive step toward helping them find appropriate investments for their needs.

Fourth, discretionary gating would prevent runs and facilitate the equitable treatment of shareholders.[32] Funds would not need to resort to the sale of securities at fire-sale prices or the disposal of liquid assets to meet redemption requests. Gating would enable boards to prevent first movers from benefiting at the expense of a fund's remaining shareholders.[33] The absence of a specific, pre-defined trigger lessens the likelihood of anticipatory redemptions and gaming. To the extent one fund's suspension of redemptions triggered redemptions at other MMFs, their boards could use their discretion to gate.[34]

Fifth, discretionary gating would not affect the day-to-day operations of MMFs. As a consequence, costly and disruptive systems changes would be kept to a minimum. MMF shareholders' regular interactions with funds would remain largely unchanged. Although MMFs, their service providers, and intermediaries would have to be prepared in the event the board halts redemptions, the preparations these entities have undertaken in connection with existing rule 22e-3 may suffice.

Some may object to the microprudential focus of a gating approach.[35] In the event of large-scale gating across MMFs (as could happen in a crisis), the commercial paper market—especially for financial institutions—could be disrupted. However, the responsibility of MMF boards is to their funds—not to the vitality of the commercial paper market. As noted above, fund directors are responsible for looking out for the best interests of their fund, not for other funds, the counterparties of the fund, or the broader economy. Attempting to regulate MMFs in order to protect the financial institutions that depend on them for funding is a very indirect way to address concerns about financial firms' penchant for short-term financing.

ADDITIONAL MATTER: REFERENCES TO CREDIT RATINGS

The proposing release invited comments on the commission's prior proposal to remove references to credit ratings from rule 2a-7.[36] It would have been far better if the SEC had simply taken this opportunity to move forward with removing the references from rule 2a-7. Doing so would have brought rule 2a-7 into compliance with section 939A of the Dodd-Frank Act.[37] Instead, the proposed rule text is replete with references to credit ratings in direct contradiction to the statutory directive. Removing those references is admittedly a delicate task, but leaving them in perpetuates a harmful legacy of government-mandated reliance on the judgments of a handful of sanctioned firms.

---

32. Gates have worked to address runs in other sectors. *See, e.g.*, MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960 166-167 (1st paperback ed. 1971) (finding that gates mitigated the severity of runs on US commercial banks in the early 1900s).
33. *See, e.g.*, Daniel M. Gallagher & Troy A. Paredes, Comm'rs, Sec. & Exchange Comm'n, Statement on the Regulation of Money Market Funds, (Aug. 28, 2012) ("Discretionary gating directly responds, we believe, to run risk, both as to an individual fund and across multiple funds, as well as to the potential disparate treatment between retail and institutional investors.").
34. *See, e.g.*, MARK HANNAM, INSTITUTIONAL MONEY MARKET FUND ASS'N, MONEY MARKET FUNDS, BANK RUNS AND THE FIRST-MOVER ADVANTAGE 18 (2013) (explaining that "suspension of convertibility provides the best mitigation against a loss spiral in the event of a widespread run on banks and MMFs. If, as in September 2008, MMFs experience unusually large redemption demands, which in turn would require significant sales of assets in falling markets, and there is a risk of a significant amplification of market distress, the best option for MMF sponsors, MMF investors and regulators is an orderly, industry-wide suspension of convertibility."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2187818.
35. *See, e.g.*, Samuel G. Hanson et al., *An Evaluation of Money Market Fund Reform Proposals* 25 (Working Paper, Dec. 20, 2012) (objecting that "gating rules have an inherently micro-prudential focus.").
36. *See* SEC 2013 MMF Proposals, *supra* note 1, at 36,849. *See also* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29,592, 76 Fed. Reg. 12,896 (Mar. 9, 2011). For a discussion of credit rating agencies, *see generally* Lawrence J. White, *An Assessment of the Credit Rating Agencies: Background, Analysis, and Policy* (Mercatus Ctr. at George Mason Univ., Working Paper No. 13-16, Sept. 2013).
37. Dodd-Frank Wall Street Reform and Consumer Protection Act §939A [amending 15. U.S.C. § 78o-7].

CONCLUSION

Enabling MMF boards to discretionarily gate their funds—without predefined triggers or liquidity fees—is a simple approach compared to those outlined in the proposing release, but one that offers greater promise of addressing the objectives that motivate the SEC's proposals. Our recommended approach would address MMFs' susceptibility to heavy redemptions by giving boards a tool for immediately halting such redemptions. It would improve MMFs' ability to manage and mitigate potential contagion from such redemptions by enabling boards to readily respond at the first signs of contagion and to cease redemptions in order to avoid having to conduct asset fire sales, thus promoting the equitable treatment of shareholders. The prospect of a board's being able to gate would increase the transparency of MMF risks to shareholders and advisers alike. Finally, because discretionary gating would not affect the day-to-day functioning of MMFs, it would preserve, as much as possible, the benefits of MMFs.