Statement at Open Meeting Regarding a Rule Proposal on Money Market Fund Reform

by

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U.S. Securities and Exchange Commission

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Thank you, Chair White.

The Commission, given its experience, expertise, and mission, is best positioned to shape the regulation of money market funds. The Commission has continued to consider additional money market fund reforms beyond those we adopted in 2010 before Dodd-Frank was even enacted. We have made good progress since last summer because of the hard work of the Commission staff,[1] and I believe that the Commission would have moved forward with a rulemaking even without FSOC's intervention.

I join my colleagues in thanking the staff — most notably those from the Division of Investment Management and the Division of Risk, Strategy, and Financial Innovation ("RSFI") — for your professionalism and dedication. I am especially pleased that the robust study that the economists in RSFI undertook to answer a series of questions that were posed has revealed new insights and allowed us to better root this rulemaking in economics and data.[2] This economic study facilitates the kind of rigorous cost-benefit analysis that is needed to determine the regulatory approach that will most effectively lessen the susceptibility of money market funds to heavy redemptions during a period of market stress, halt a run if one starts, and preserve the benefits of money market funds.

Two alternatives are at the core of the proposal before us. Either alternative could be adopted by itself, or a combination of the two could be adopted. The first alternative would require institutional prime money market funds to float their net asset value (their "NAV").[3] The second alternative would permit money market funds to continue transacting at a stable $1 share price, but would require a fund to impose a liquidity fee on redeeming investors if the fund's weekly liquid assets drop below 15% of its total assets, unless the fund's board determines that imposing the fee is not in the fund's best interest. Under the second alternative, a fund's board would also be permitted to suspend redemptions temporarily — that is, to "gate" the fund — if the 15% liquidity threshold is crossed.[4]

Each alternative calls for several significant disclosure enhancements, such as requiring a fund to disclose any sponsor support it receives, to disclose its liquidity in more detail, and to disclose additional information about its portfolio holdings. Other disclosures would explicitly warn that investors can lose money when investing in a money market fund. Under the fees and gates alternative, although a fund's NAV would not float, a fund would have to disclose its market-based "shadow" NAV on a daily basis, a practice that many funds have already begun.[5]

I support the staff's recommendation. That said, to be clear, at present, I remain unconvinced that floating the NAV is justified on a cost-benefit basis. But floating the NAV is just one of the proposed alternatives. It is particularly important to me that liquidity fees and gates are being proposed as a separate, standalone alternative so that, if appropriate, this alternative can be adopted by itself without requiring money market funds to float their NAVs. Indeed, Commissioner Gallagher and I have pressed for gates since last year, but it was not until this recommendation took shape that gates were included on a standalone basis in a proposal for the Commission to consider.[6]

Because the proposing release is so thorough, instead of engaging the proposal's many details, the balance of my remarks this morning will summarize my current take on the two proposed alternatives, realizing, of course, that the Commission will receive many thoughtful comments. In evaluating each alternative, I have tried to keep my eye on a simple question: "What are we solving for and does the alternative solve for it at an acceptable cost?" An alternative that does not sufficiently reduce the incentive to redeem at a time of stress, such as during the recent financial crisis, may not be worth pursuing, especially if the alternative could jeopardize the benefits that money market funds afford both investors and issuers.

This takes me to the first alternative, requiring institutional prime money market funds to float their NAV.

The animating purpose behind floating the NAV is to address the incentive to redeem that the stable $1 share price can create. Simply put, an investor may be motivated to exit a fund if the investor can get out at $1 when the fund's shadow price is less than $1. If the NAV floats, then by definition there can be no deviation between a fund's NAV and its shadow price for an investor to take advantage of by selling ahead of others.[7]

The floating NAV alternative is also designed to make the risk of money market funds more transparent. The proposing release explains, "Our floating NAV proposal is designed to increase the transparency of risks present in money market funds. By making gains and losses a more regular and observable occurrence in money market funds, a floating NAV could alter investor expectations by making clear that money market funds are not risk free and that the funds' share price will fluctuate based on the value of the funds' assets." The release continues, "Investors in money market funds with floating NAVs should become more accustomed to, and tolerant of, fluctuations in money market funds' NAV and thus may be less likely to redeem shares in times of stress."[8]

Even if floating the NAV would affect investors in these ways, would it be enough to solve for the kind of widespread redemptions that came about during the upheaval of the financial crisis? As the proposing release acknowledges, money market fund investors may redeem for many reasons that are unrelated to the stable NAV.[9] These other incentives to redeem — which persist even if a money market fund's NAV floats — can result in flights to liquidity, transparency, and quality that manifest as heavy redemptions. Flights to liquidity, transparency, and quality stem from a common source: investors' need or desire to avoid losses. Because investors routinely use money market funds as cash management vehicles, a loss of any size may be intolerable. The bottom line under a floating NAV, then, is that when investors see signs of stress, they will have an incentive to redeem sooner rather than later before the NAV floats downward. At a time of stress, even investors that are accustomed to seeing a fund's NAV fluctuate may redeem if they expect the fund's price to fall.

We do not know for sure why investors left money market funds during the financial crisis. The data we do have, however, is consistent with the view that investors predominantly left in search of safety and that investors would have done so even if NAVs floated. First, European floating value money market funds experienced significant redemptions during the financial crisis. Second, U.S. ultra-short bond funds also saw heavy redemptions.[10] Third, even as institutional investors exited from prime money market funds in 2008, significant sums flowed into institutional government money market funds, further suggesting that investors were reallocating their investments to the highest quality assets they could find.

All of this is to say that the floating NAV alternative suffers from a fundamental limitation. Because money market fund investors will always prefer to exit at a higher price instead of a lower one, even if NAVs float, plenty of reasons will remain for investors to redeem, particularly during a period of financial turmoil when investors seek out quality and as much certainty as they can find.[11] Moreover, if a run does start, a floating NAV is unable to stop it.

If, in fact, floating the NAV does not stave off heavy redemptions, then one has to question whether abandoning the stable NAV is justified given the significant costs and burdens that investors and issuers would have to bear if a floating NAV undercuts the usefulness of money market funds as a cash management vehicle. In this case, what would the Commission have solved by floating the NAV?

Let me now turn to make four observations about the fees and gates alternative, which I favor.

First, regardless of the reasons investors might redeem, liquidity fees can discourage them from doing so. By requiring redeeming investors to pay for the liquidity they take, liquidity fees reduce the incentive to redeem, whether the incentive is created by the stable NAV or an overarching desire to avoid risk and any chance of loss. Investors may stay put when they have to internalize at least some of the fund's liquidity costs. If some investors nonetheless opt to exit, then the liquidity fees they pay can help shore up the fund's net asset value to the benefit of the remaining investors. The result, according to the proposing release, is that "[the] explicit pricing of liquidity costs in money market funds could offer significant benefits to such funds and the broader short-term financing market in times of potential stress by lessening both the frequency and effect of shareholder redemptions."

Second, gates halt runs.[12] Investors' incentive to redeem can be reduced but not eliminated. There are times, for example, when investors are simply intolerant of risk and pull back from holding anything other than the highest quality assets they can find, such as treasuries. September 2008 comes to mind as such a time. If this occurs and money market funds come under pressure as their liquidity is depleted, fund boards may decide to halt redemptions under the fees and gates alternative. When investors cannot redeem, they cannot run. While a fund's gate is down, the fund's liquidity buffer has time to replenish, its manager and board have time to decide how best to meet redemptions, and fund investors have time to reassess.

It has been suggested that some investors might redeem preemptively before a fee is imposed or a gate comes down. I think that this concern is overstated. Boards have discretion over whether a fee or gate will be instituted. Because fund investors do not know what the board will decide, they may find it difficult to redeem preemptively with any confidence that their timing is correct. In any event, to reduce the potential skittishness of investors, fund managers have an incentive to operate money market funds even more conservatively than Rule 2a-7's risk-limiting conditions require. On the remote chance that preemptive redemptions are heavy enough to stress a fund, then the liquidity fee would be triggered and the board could decide to gate, the corrective effects of which I just described.

Third, the prospect of having to pay a fee to redeem or of being prohibited from redeeming makes the risk of investing in money market funds more transparent to investors. The fees and gates alternative, therefore, advances the objective of the floating NAV alternative to sensitize investors to the fact that money market funds are not risk free.[13] Facing the possibility of fees and gates, investors should come to further appreciate the risk of money market funds even if the stable NAV is maintained.

Fourth, the fees and gates alternative preserves money market funds' utility and the benefits funds generate for investors as a cash management vehicle and for issuers as a key source of short-term financing. A floating NAV affects investors on a daily basis — indeed, on a transaction-by-transaction basis — and does so in a way that compromises a fundamental reason investors invest in money market funds, namely price stability. In contrast, although any redemption restriction is consequential, fees and gates are only triggered during a period of stress. During normal market conditions, which exist most of the time, fees are not imposed and redemptions are not suspended. At least to date, it seems like investors are more accepting of the remote chance that a fee or gate will be imposed than they are of an NAV that floats every day. Many institutional investors have indicated that they would decrease their investments in money market funds that have a floating NAV.

As Commissioner Aguilar has emphasized many times, to the extent investors withdraw from money market funds because the funds become less useful, we have to concern ourselves with where the money will go. To my mind, it would be regrettable if we instituted costly regulatory changes only to find out that the changes do not reduce systemic risk. If that were the result, what would we have solved for? It would be even more regrettable if systemic risk actually increased.

The sum effect of these observations leads me to think that the fees and gates alternative would more fully accomplish the goals of this rulemaking.

In conclusion, I want to thank the staff once again for all of your efforts. As always, I look forward to hearing from commenters.

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[1] In August 2012, it became apparent that an attempt to restructure money market funds, which differed in material respects from the proposal before the Commission today, would not garner majority support. Commissioner Gallagher and I issued a joint statement explaining our reasons for not supporting the earlier attempt at regulatory change. See Commissioner Daniel M. Gallagher & Commissioner Troy A. Paredes, U.S. Securities & Exchange Commission, Statement on the Regulation of Money Market Funds (Aug. 28, 2012), available at http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm

[hereinafter Gallagher & Paredes MMF Statement].

[2] Response to Questions Posed by Commissioners Aguilar, Paredes, & Gallagher, A Report by Staff of the Division of Risk, Strategy, & Financial Innovation (Nov. 30, 2012), available at

http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf [hereinafter RSFI Study].

[3] Government money market funds and retail money market funds would be exempt from the floating NAV requirement.

[4] Government money market funds would be exempt from the liquidity fees and gates requirement. Retail funds would not be exempt.

[5] In addition, the proposal increases the diversification of money market fund portfolios, requires more robust stress testing of money market fund portfolios, and obligates liquidity funds to provide additional information on Form PF.

[6] See Gallagher & Paredes MMF Statement, supra note 1 (explaining that the earlier attempt to restructure money market funds that failed to receive the support of a majority of the Commission “relegate[d] gating to a limited discussion of options that [were] implied to be inferior” to other alternatives and that “[g]ating [was] never considered as a standalone proposal, but instead [was] coupled with a capital buffer”).

[7] During normal market conditions, it would seem unlikely that a single fund’s “breaking of the buck” would spur heavy redemptions at other money market funds.

[8] This argument presupposes that investors mistake money market funds as being without risk. However reasonable it may be to conclude that retail investors do not fully understand the risk of money market funds, the redemption behavior of institutional investors during the financial crisis and more recently in 2011 would seem to indicate that institutional investors do understand the risk. If, in fact, institutional investors realize that money market funds are not risk free, then there may be relatively little to acclimate them to, thus eroding the transparency rationale for floating the NAV of institutional prime funds.

If institutional investors do not properly appreciate the risk of money market funds, the proposed disclosure enhancements should further sensitize them to the risk by highlighting that their investments are subject to loss. If the new disclosures were to alter investor expectations as intended, then insofar as increasing transparency is concerned, the marginal benefit of floating the NAV may not be appreciable because institutional investors would already realize the risks that floating the NAV is designed to make clear.

[9] See Proposing Release at § II.B; see also RSFI Study, supra note 2, at § 3.A.2.

[10] Investors in European floating value money market funds and in U.S. ultra-short bond funds presumably were acclimated to a fluctuating NAV and yet they still redeemed when such funds came under stress.

[11] The proposing release expresses it this way:

We recognize, however, that the [floating NAV alternative] does not necessarily address shareholders’ incentive to redeem from money market funds due to their liquidity risk or for other reasons… . In times of severe market stress when the secondary markets for funds’ assets become illiquid, investors may still have incentives to redeem shares before their fund’s liquidity dries up. It also may not alter money market fund shareholders’ incentive to redeem in times of market stress when investors are engaging in flights to quality, liquidity, and transparency and the related contagion effects from such high levels of redemptions.

[12] Whereas the floating NAV attempts to change behavior by changing incentives, gates directly change behavior by not permitting redemptions.

[13] The disclosure enhancements that are part of the fees and gates alternative have a similar effect. See supra note 8.