FedFin Client Report

Tuesday, July 23, 2014

Divided Commission Scrapes Together Sweeping MMF Rewrite

Client Report: **MMF13**

Executive Summary

After years of contentious debate, the SEC voted 3-2 on its own version of FSOC recommendations for new MMF rules (see FSM Report **MMF10**). With the Treasury and IRS set in parallel to issue proposals and guidance to resolve tax problems with floating NAVs, the Commission decided on requiring a floating NAV for prime, non-governmental MMFs (including tax-exempt ones) aimed at institutional investors. Retail non-governmental funds will be able to impose fees or gates to stem runs, with their flexibility here decreased in some respects to address FRB and other fears that retail investors would be more prone to run if access to investments were curtailed. The final rule drops the proposed capital buffer. This report analyzes the new regulatory framework and SEC action on it, noting that the rule will have significant market impact despite the two-year compliance period now provided for the MMF industry. Pressure now returns to the FRB for action on the overall short-term funding markets, with several SEC commissioners noting fears in areas like securities financing that require prompt attention by the FSOC and central bank.

Analysis

Chair White summarized the new floating NAV for prime funds and voluntary fees and gates for non-prime funds. She argued that both prevent first-mover advantage and widespread runs that result in contagion risk. Treasury will, as noted, release key tax guidance in proposed rules to simplify the tax method to calculate gains and losses in a fund, along with revenue procedures for wash transactions. Ms. White noted that the fees and gates have been preserved with revisions designed to prevent or dampen redemption runs through reducing the time a gate could be in place. She closed by committing herself to reform to the

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

short-term financing market outside the SEC's scope, presumably referencing ongoing FSOC and FRB work in areas like universal margins.

Staff Discussion

Key provisions in the rule would:

- require floating NAVs for institutional, non-governmental prime funds, with pricing done to the fourth decimal place. Municipal MMFs in this institutional class would not be exempted, but the definitions of government and retail funds have been changed from the NPR to include a tight *de minimis* basket for exempt funds that would evade the floating NAVs and define exempted retail funds by investors, not redemption practice;
- provide non-governmental, retail MMF fund boards with greater powers during liquidity stress, including redemption fees and/or gates, with restrictions in the final rule eased to limit fees and shorten allowable gate periods. These funds could continue to price as they now do, not as proposed;
- increase portfolio diversity, including through new rules that treat affiliated parties as single issuers. ABS guarantors would also generally be treated as counterparties;
- require stress testing, with the final rule simply from the initial proposal; and
- improve disclosure, including at private liquidity funds similar in many ways to MMFs.

Staff also recommended re-proposal of a rule eliminating reliance on credit ratings, with this rule to be adopted well before the end of the MMF two-year compliance period. Guidance would also be issued on factors to determine portfolio risk.

Commission Discussion

Luis Aguilar criticized former Chair Schapiro, arguing that the study since then about the impact of these reforms has led to a far better outcome. He noted fears at the Federal Reserve Bank of New York about run risk resulting from fees and gates, but Mr. Aguilar said that the final rule addresses them well. Despite continuing reservations, he supported the final rule. However, he remains

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

concerned with the heightened risk potential from the proposal on eliminating rating reliance, seeking views on objective risk criteria and the benefits of a more prescriptive approach.

Commissioner Gallagher applauded the removal of the SEC's proposal for capital buffers, emphasizing the differences between MMFs and banks and pushing foreign regulators to reflect this in pending action (see FSM Report **SYSTEMIC71**). He supported the rule on grounds that it ends any expectation of an implicit MMF federal guarantee. He also took on the FRB, arguing that the SEC should govern matters such as resolution for MMFs.

Commissioner Stein supported the rules in concept, but dissented due to the gates/fees provisions and pushed for extensive additional action, including broker-dealer capital, resolution, and margin rules. She also wants other regulators to take actions such as FRB regulation of short-term funding. Noting progress in tri-party repo reform, she pushed the Commission to get out of its "institutional silo," citing in particular fears about securities lending.

Commissioner Piwowar opposed the combined NAV and fee/gates provisions, supporting only fees and gates. He argued that any MMF risk derives from bank reliance on them and thus that this problem is for the banking agencies, not the SEC.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com