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February 2, 2017

QUESTONS FOR THE RECORD
Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing entitled "The Impact of Regulations on Short-Term Financing"
Thursday, December 8, 2016

Thank you for the opportunity to supplement testimony from the hearing. In this letter, I address the specific question from Representative Rothfus regarding the recently implemented Money Market Fund (MMF) regulations and also fill in some blanks from the original hearing.

Overview

- New regulations which went into effect on October 14 will NOT achieve their stated objective of preventing bailouts and maintaining market stability, since **most money market assets are not subject to the rule**. The entire treasury and government MMF market, Local Government Investment Pools, retail MMFs of all types, and bank short term investment funds are all exempt. Of all the investors in the marketplace and all the investment options available (tens of trillions of dollars), the rule singles out just one segment – "non-natural persons" investing in Prime Funds and Tax Exempt Funds for draconian regulation.

- Prime money funds (PMMFs) are a key source of funding for the private sector. Both banks and corporations have relied upon Prime MMF funding for decades. Tax Exempt funds (TEMMFs) are a key source of funding for municipalities, universities and hospitals.

- \$1.17 trillion or 73% of the market has left PMMFs. \$130 billion or 50% of the market has left TEMMFs. So **the rule essentially eradicated the part of the market it tried to "improve", while leaving far larger segments of the market unaddressed**.

- One especially onerous part of the regulation prohibits the use of standard accounting methods (amortized cost) for funds with non-natural persons as investors. It was this broadly accepted accounting principal which enabled funds to maintain a constant net asset value (CNAV) of \$1.00 per share to investors. Because of this prohibition, the institutional Prime and Tax Exempt MMFs must now float their net asset values.

- **Reinstating amortized cost accounting for all MMF investors, both natural persons and non-natural persons, is such an obvious and benign remedy** for the deleterious \$1.3 trillion market shift we have just experienced, that it should be done immediately. Amortized cost accounting is an accounting principal used by almost all banks, almost all corporations and most other investors including all Treasury MMFs and all Government MMFs for their own portfolios.

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Institutional investors are sophisticated, NOT confused

- The underlying notion behind the regulation is that the $1.00 CNAV causes Prime and Tax Exempt MMF investors to be confused between MMFs and bank deposits. That is simply ludicrous. These institutional investors are sophisticated financial professionals, corporate treasurers, institutional money managers, and managers in bank trust departments. There is absolutely no evidence they are confused between MMFs and bank deposits.

- If they were confused, why would they not also be confused about government and Treasury MMFs, which continue to be priced the same way Prime Funds were? The fact that the SEC chose not to include government and treasury funds under the regulation, after their purported study, is evidence in and of itself that the SEC concluded there is no confusion at all among these investors.

- Similarly, if the floating NAV is needed for increased transparency, it makes no sense that this should be applied only to institutional funds and not retail funds as well. Again, **there is absolutely no evidence that institutional investors are less sophisticated than retail investors and require such protection**.

- Regarding the floating NAV making it less likely for an investor to redeem in a stress situation, and why this would also not be a relevant point for retail investors: not only are we unaware of any such evidence, we see evidence to the contrary. In a 2014 whitepaper, Treasury Strategies presented a comprehensive game theory analysis of investor behavior. It concluded that neither a floating NAV or fees and gates provide disincentive for mass withdrawals during financial stress.

Tax Exempt MMFs support long-term infrastructure projects

- Municipal debt is issued to finance long-term infrastructure projects. Many project financing bonds are issued as serial bonds with maturities across an entire term spectrum, so part of every issue may be short-term and thus MMF eligible.

- As long-term bonds approach their maturity dates, they become short-term, and are thus also eligible investments for MMFS.

- From a working capital perspective, municipalities regularly issue Tax Anticipation Notes (TANs) and other short-term obligations to meet their working capital needs.

- Thus, MMFs support both the short- and long-term financing needs of municipalities. The damage done by this new rule is of great concern to municipalities, cutting financing previously provided by MMFs in half and raising its cost.

Administrative requirements of the new regulations

- It is logical to ask if the administrative burdens of the new regulations can be addressed to reduce their negative impact. The answer is no. These burdens are a direct result of the floating NAV, which requires accounting and system changes, not only by intermediaries who operate the funds, but also by the investors.

- Our 2012 study examined the operational consequences of potential MMF regulation changes. We concluded then that although fund companies might undertake the accounting and system changes required, investors were more likely to exit the funds. Indeed, some investors might be prohibited from remaining in the funds at all.

- The floating NAV is categorically unsuitable for sweep account investments, and again there is no administrative fix. Relative to other constant NAV options such as Eurodollar funds, repurchase agreements or offshore deposits, the floating NAV fund is simply at an insurmountable disadvantage for sweeps.

- For fiduciary managers, the floating NAV's natural/non-natural person distinction is another administrative burden for which there appears to be no remedy. Our research showed that most fiduciaries (wealth managers, asset managers, and bank trust departments) invest through omnibus accounts. Such accounts aggregate funds from different kinds of investors (individuals, small business, family trusts, private partnerships, etc.). To comply with the regulation, the fiduciaries have to determine which of their hundreds or thousands of customers are natural vs. non-natural persons (an ambiguous distinction), and exclude non-natural persons from the omnibus accounts. They are simply not able to do this with a high degree of confidence. To avoid the risk and cost of misclassifying, they instead exit the investment category entirely as our study predicted.

Conclusion

While some are calling for further study before deciding how to proceed, others ask if there are some obvious fixes to implement immediately.

- As stated above, **immediately reinstating a constant NAV for all investors in all MMFs** is an obvious and benign remedy for these threshold issues.

- We continue to be concerned about the implementation of multiple simultaneous regulations affecting corporate finance and investment. We do believe **further study of the simultaneous impact is required**, but not at the expense of delaying the action recommended above.

With the regulatory-induced demise of Prime and Tax Exempt MMFs, the market has lost a $1.3 trillion shock absorber, and America's businesses and municipalities have lost a $1.3 trillion primary source of capital.

FSOC recently applauded itself for the orderly flow of funds out of Prime Funds as the October regulations took hold. But we observe with great concern that is hardly a market test of the implications of the rule. That test comes in some unknown future stress scenario, not during a transition which was signaled two years in advance.

Not until that next stress event occurs, will we be able to observe how markets react and adjust, absent the $1.3 trillion shock absorbing capacity of the MMFs that have disappeared.

Respectfully submitted,

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