Capital Advisors Group's Comments on the Recent Money Market Fund Reform Proposal by the Securities and Exchange Commission

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Summary Opinion

Institutional Shareholder Perspective: We commend the Commission for tackling the tremendous task of analyzing mountains of data before putting forth the reform alternatives for public comment. We seek to weigh in on the subject from the perspective of an institutional asset manager.

Penny Rounding for Shareholder Activities: We support the mandatory daily disclosure of market-based NAVs as the published share prices and penny-rounded NAVs for shareholder activities. In our opinion, floating NAVs provide no more informational value than market-based NAVs.

Managed Stable NAV: If the basis point rounded NAV approach is adopted, we propose a NAV stability band between $0.995 and $1.005 beyond which fees and gates may be imposed. This approach provides tax and accounting justification for maintaining the funds' current distinction and preserves some operational attractiveness.

Fees and Gates are a Non-Option: We view fees and gates as ineffective because of probable shareholder expectations that the tools will not be deployed due to fund sponsors' self-preservation motives.

Cost Plus Penalty Redemptions: We propose an emergency redemption price of market-based NAV plus a 1% liquidity fee when thresholds are breached (defined as weekly liquidity < 30% or market-based NAV < $0.995).

Gates Most Undesirable: We are strongly opposed to the use of gates. However, if gates must be implemented, we propose allowing redemptions of up to 50% of remaining balances.

Explicit Sponsor Support: We propose making sponsor support explicit, committed and disclosed prior to an event occurring.

Background and Scope

We welcome the opportunity to comment on the Securities and Exchange Commission's money market fund reform proposal. We express our thoughts from the perspective of an investment advisor that manages excess cash balances for more than 150 institutional and corporate accounts, the majority of which use money market funds as daily liquidity instruments. [1] As such, we limit our comments to matters concerning institutional prime funds, not retail, government or tax-exempt funds. We commend the Commission for covering the bases on many of the subjects we are about to discuss. For brevity's sake, we organize our views in a summary format without detailed reference to discussions in the proposal.

INSTITUTIONAL SHAREHOLDER CONCERNS

Capital Preservation: Most institutional investors use money market funds as cash management vehicles, and often consider them to be close substitutes for bank deposits without explicit government support.
Certainty Regarding Liquidity: Institutional investors tend to demand a very high level of certainty regarding available liquidity since the money market funds are the source of cash for expenditures.
Income is Incidental: While naturally desiring higher levels of income, institutional investors will not rationally violate the first two objectives of capital preservation and liquidity in pursuit of higher return potential.
Liquidity at a Cost: When the first two objectives cannot be satisfied simultaneously, investors may be willing to pay for liquidity, albeit reluctantly, under extreme market conditions. However, the costs must be commensurate with the expected returns of the associated instruments.
Game Theory and Agency Dilemma: The high concentration and interdependence of institutional shareholders requires an understanding of each shareholder's assessment of others' likely behaviors in times of market distress. They often are also cognizant of the potential for a fund advisor, as an agent, to place its self-preservation interests before the interests of shareholders – individually or collectively.

OBJECTIVES FOR ADDITIONAL MONEY MARKET FUND REFORM

2010 Reform was Successful: We think that the credit, liquidity and other measures enacted following the 2010 amendment are generally adequate for normal to moderately stressed market conditions. Additional reforms should primarily address emergency situations.
Systemic, Not Shareholder Interest: We believe that the Commission's primary objective should be the stability of the short-term financing market. Shareholder or sponsor interest is secondary.
Contagion Risk, Not Stopping the Runs: Runs in a single fund from idiosyncratic causes should not be the primary reform objective. Instead, preventing runs in other funds should be the focus.
No New Systemic Risk: We think that lower systemic risk in money market funds should not result in higher systemic risk elsewhere, including in less regulated private liquidity funds or more concentrated fund sponsors.

Expectations and Behavior: We agree with the Commission that influencing shareholder expectations and behavior is important, but we believe the proposed changes are too stringent.

Imperfect Choices: We recognize that the final rule revisions likely will be imperfect, as there are pros and cons for all conceivable alternatives. The final rule should represent the best balance between long-term funding market stability and the utility of money market funds.

FLOATING NET ASSET VALUE (NAV)

All Proposals Require Floating NAV Treatment: The Commission's proposal made it clear that, with the end of the amortized cost accounting method, NAVs will float. While the so-called stable NAV (penny rounding) funds are less likely to have a NAV stray from a dollar than the so-called floating NAV (basis point rounding) funds, there is a possibility that they may float, as well.

Floating NAV Improves Transparency: We agree with the Commission that requiring market-based pricing of securities provides better risk signals to shareholders than amortized cost based pricing.

No More Informational Value than Shadow NAV: When all funds are required to disclose daily market-based NAVs, we see no more informational value from a floating NAV than from a market-based (shadow) NAV, which will be identical, in changing expectations and behavior.

Limited Incremental Transparency: The value of a floating NAV is further reduced by the mutual fund exemption allowing all securities with remaining maturities less than 60 days to use amortized costs as fair value. The current portfolio liquidity and duration restrictions significantly limit the portion of a fund subject to market-based pricing, thus offering diminished incremental informational value.

Published NAV vs. Transaction NAV: A procedure of publishing a daily basis point rounded NAV as the official share price and conducting shareholder activities with a penny-rounded NAV could achieve the floating NAV objective of influencing expectations without disrupting operational procedures.

Exaggerated First Move Advantage: We do not believe the incentive to rapidly redeem shares is resolved by a floating NAV fund. We think the first mover advantage of selling shares at a NAV higher than the intrinsic share price is exaggerated in some comment literature. The more relevant motivation is to escape from a potential liquidity trap and/or credit issues which are not yet manifested.

MANAGED STABLE NAV

Managed NAV Band: While the Commission intends to discourage managers from achieving NAV stability through risk limiting measures, we think that the practice should be encouraged, regardless of the rounding method being used. We propose that the band be kept at $0.995 to $1.005, and fluctuations outside of the band should result in the imposition of fees and/or gates.

Advantage over Constant NAV: Unlike the existing constant NAV approach which relies on amortized cost without regard to market risk and liquidity premium, the managed stable NAV reflects market discipline and reflects associated market, credit and liquidity risk.

Working with Floating NAV: With a stability band, the managed NAV approach provides the outer boundaries for a basis point rounding fund. Without the band, the NAV may drift away from a dollar over time, leading to the loss of money market funds' unique characteristics.

Preserving the Uniqueness of Money Market Funds: Even if basis point rounding is adopted, managed NAV stability offers an important benefit that will set money market funds apart from other variable NAV mutual funds. Shareholders may form reasonable expectations on the safety and stability of the funds since a NAV beyond the band will result in fees and/or gates. This approach also answers the Commission's question of when to impose fees and gates in a basis point rounded fund.

Reduced Tax and Accounting Complexity: We think that the NAV stability band will help resolve tax uncertainties and qualify the funds to receive cash equivalent treatment, two of the major obstacles for institutional shareholder acceptance of the floating NAV.

FEES AND GATES

Unimproved Risk Transparency: We do not think fees and gates will improve risk transparency or raise shareholder sensitivity to risk if shareholders do not believe that either will be used in practice.

Concerns with Discretionary Power: We are particularly concerned with the discretionary power of funds' boards of directors to impose fees and gates. Since these measures are designed for stressful market conditions, the discretionary power may result in the board not imposing fees and gates in order to prolong a failing enterprise rather than to protect the shareholders.

Shareholder Reliance: We also are concerned that, since the Commission continues to encourage voluntary, and therefore unreliable, sponsor support, shareholders may continue to believe that sponsors will support the fund rather than imposing fees and gates.

Negated Effects: When the two aforementioned concerns are combined, we think the deterring effect of fees and gates are negated by shareholder expectations that fund sponsors will not use the tools for self-preservation purposes. Because of the low likelihood of it actually being used in practice, we suspect this reform alternative essentially represents a non-option.

Mutually Exclusive Choices: We also note that fees and gates, as they currently are proposed, are mutually exclusive in practice, since redemptions will stop once the gates are implemented. However, we are in favor of fees and partial gates, a stance that will be discussed later.

The 15% Threshold is Too Low: We view the 15% weekly liquidity enforcement threshold as too low. The logical level should be 30%, which has been the regulatory minimum since 2010. Empirical evidence shows that when demand for liquidity is high, prudent fund managers customarily keep liquidity well above the required levels. Permitting liquidity to drop to 50% of the current regulatory minimum leaves little reserves for legitimate, non-panic induced redemptions. In effect, the proposed 15% threshold reduces the usefulness of the 30% regulatory minimum.

Combination of Floating NAV and Fees and Gates: We recognize that when a floating NAV does not resolve the risk of runs, and fees and gates may be necessary reinforcement. Likewise, fees and gates cannot be adequately enforced unless they are under the floating NAV regime, as NAV volatility should be important input variables for fees and gates decisions.

FEES

Liquidity at a Cost: Viewing fees and gates separately, we think shareholders may accept a cost of liquidity in a stressful situation and will pay to redeem shares when the liquidity threshold is breached.

Basis Point Rounding of NAV: We believe that, regardless of the rounding convention that is adopted, shareholder activities should be conducted in basis point rounded NAVs when the liquidity threshold is breached. This approach provides the most realistic estimate of the value of the fund shares during the unusual periods when such measures become necessary.

Cost Plus Penalty: We propose that the redemption be conducted at basis point rounded NAV plus one percent (1%) in liquidity fees. Compared to a flat fixed NAV plus 2%, we believe this cost plus penalty approach to be a more reasonable and realistic way to pay for liquidity during a crisis. The value of fund shares conceivably may be more than a static 2% below the fixed dollar price during a crisis and potentially could hurt the remaining shareholders.

Exemption from Liquidity Fee: We propose to allow each shareholder, institutional or retail, a one-time opportunity to redeem up to $1 million for incidental expenditures without fees.

GATES

Gates are Incompatible with Cash Management: We consider gates to be the least attractive alternative for institutional shareholders. If gating is perceived as a likely reality, it may be prudent for cash management accounts to exit the product category. We think that even a small probability of losing 100% of one's liquidity renders the funds fundamentally incompatible with institutional liquidity accounts.

Cause vs. Effect: Gates merely address the effect, not the cause of an underlying problem. They may be useful in stopping runs in isolated cases in the short-term, but if the underlying problem is systemic, gates may paralyze the short-term funding market due to the contagion effect of gates at multiple funds at the same time.

Unfavorable Shareholder Treatment: The discretionary power to impose gates by the board of directors places shareholders in an unfavorable position when the fund sponsor holds all of the options. At a minimum, the sponsor should contribute capital or liquidity for the privilege of imposing gates. We believe it is difficult to discern the "best interest of the fund" motive during a crisis.

Partial Gates: We propose that if gates are adopted, the fund must allow shareholders to redeem at least 50% of their remaining balances at the then basis-point rounded NAV plus a 1% liquidity fee. We further propose that shares under the control of the sponsor's affiliated entities not be eligible for redemption while gates are in effect.

Additional NAV Threshold: We think it is necessary to add a market-based NAV to weekly liquidity as gating thresholds since a fund may incur losses before the liquidity threshold is breached. We propose to impose gates when liquidity drops below 30% or a NAV drops below $0.995, whichever occurs first.

Maximum Expected Maturity: The Commission's proposal did not discuss the situation of uncured liquidity when the gates are removed after 30 days. We propose allowing redemptions with fees to be partially financed by asset sales, with a terminal liquidation date of the fund within 183 days from the time the gates are established. This allows shareholders to understand a "maximum expected maturity" timeframe when gates are imposed.

SPONSOR SUPPORT ISSUE UNADDRESSED

Changing Expectations Starts with Sponsor Support: We think more is needed to address the risk of uncertain sponsor support, which we believe to be the primary factor of shareholder expectations and a major source of systemic risk. It is essential for shareholder expectations of sponsor support to evolve before fees and gates can truly become effective.

Enforcing Market Discipline: We believe that removing sponsor support uncertainty serves to enforce market discipline by refocusing shareholders' attention on factors intrinsic to money market fund portfolios rather than on external factors.

Explicit Sponsor Support: We are not proposing to eliminate sponsor support. Instead, we think support should be on a committed, ex ante basis. Sponsors may be allowed to enter into formula-based capital support agreements contingent upon the breach of certain liquidity or credit thresholds. The removal of support uncertainty will improve transparency of the fund sponsors' true capital costs of running the money market fund business. By comparison, the current proposal of requiring ex post disclosures does not reduce this uncertainty.

CONCLUSION

Institutional Shareholder Perspective: In conclusion, we commend the Commission for tackling the tremendous task of analyzing mountains of data before putting forth the reform alternatives for public comment.

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[1] Data as of 7/31/2013.

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