SEC Money Market Proposal Will Harm State and Local Governments

Much Pain, No Gain in Forcing Tax-Exempt Money Market Funds to Adopt Floating NAVs

YOUR HELP IS NEEDED!

State and local entities across the United States benefit from the $2.6 trillion money market mutual fund sector. The Federal Reserve reports that as of the end of the first quarter of 2013 state and local governments hold over $120 billion of their short- and mid-term investments in money market funds. Beyond providing valuable cash management services for state and local governments, money market funds themselves are key purchasers of municipal securities. In fact U.S. money market funds are the largest investor in short-term municipal bonds, holding almost three-fourths of state and local short-term debt (72 percent as of April 2013).

A recent proposal from the Securities and Exchange Commission (SEC) would jeopardize those benefits by requiring a fundamental change to the key feature of these funds – from using a stable net asset value (NAV) to a floating NAV. The SEC's proposal could undermine the much needed and important role money market mutual funds play for states and municipal governments, both as cash management and investment tools and as purchasers of cities' and states' debt. These changes could cause governments to invest in less attractive and riskier products, and see an increase in debt issuance costs. Below is a brief summary of the potential impacts of this proposal.

State and local governments will face costly money management difficulties

As investors, state and local governments rely on money market funds as a flexible tool for investing in anticipation of short- and mid-term needs. For example, while state and local governments do not have a steady and predictable inflow of revenue (tax payments and payments from state and local governments are collected only at certain times of the year), the accounts payable – including payroll and general bill paying – is constant. Many governments invest in money market funds solely to be able to access their cash and pay bills when they are due. Money market funds offer a very manageable way to do this, and the stable NAV, liquidity and low risk of these products are the reasons why they are critical to the cash management needs of state and local governments.

The SEC's proposal to require these funds to determine a daily NAV that could "float" would remove the flexibility of these products and make them increasingly difficult to manage. Further, floating the NAV would confront state and local governments with new and costly cash management and accounting system needs, as state and local cash management systems are not equipped to handle such a change. While no official estimate has been generated to illustrate these cost increases, a recent report by cash-management consultants Treasury Strategies Inc. estimates that the total up-front costs for U.S. money market fund institutional investors to modify operations in order to comply with a floating NAV will be between $1.8 and $2 billion.

State and local governments will experience cost increases

Many state and local governments are subject to policies and legal restrictions permitting them to invest only in funds that do not fluctuate in value. If a floating NAV is imposed on money market funds, governments will be forced out of these funds and will have to look to other investment vehicles that have historically paid lower yields, or to other less secure products with equal or less liquidity than money market funds MMMFs. All of these potential scenarios would increase costs to state and local governments.

Using a floating NAV is also likely to drive away all types of money market investors. This would in turn dampen funds' interest in purchasing municipal securities and result in increased debt issuance costs for governments as demand for tax-exempt securities wanes. As money market funds are the largest purchaser of short-term municipal bonds, these projected outcomes will have enormous cost impacts on state and local governments.

The floating NAV requirement could adversely affect Local Government Investment Pools (LGIPs)

Many state governments operate Local Government Investment Pools (LGIPs), which are critical investment tools that must comply with standards set for them by the Government Accounting Standards Board (GASB). As GASB requires LGIPs to operate in a manner consistent with the SEC rule governing money market funds (Rule 2a-7), the SEC's proposal to modify this rule and institute a floating NAV would put many of these LGIPs out of compliance with GASB. GASB rules state that those LGIPs not complying with Rule 2a-7 must report to each participant its share of any unrealized gains or losses. Participants must also report these gains or losses on their balance sheets. Because this would not be an acceptable option for most states, many LGIPs will be faced with higher operational costs related to floating NAV compliance.

State and local financing should get the same treatment as federal government financing

The proposed SEC rule would allow money market funds that invest largely in Treasury and U.S. government agency securities to continue to offer a stable NAV. However, tax-exempt funds that invest in state and local government securities would be required to float their NAVs. That lopsided treatment favors financing for the federal government and its agencies over the funding needs of state and local governments, which are no less pressing or important to taxpayers. Municipal securities are the second safest investment, aside from U.S. Treasuries, with state and local governments having nearly a zero default rate. The SEC should not grant one level of government finance advantages over another in its rules.

The SEC should recognize the differences between tax-exempt and institutional prime money market funds in its reform proposals to prevent significant investor redemptions during times of fiscal stress

The SEC is proposing to impose floating NAVs on both institutional tax-exempt funds (which invest in municipal securities) and institutional prime money market funds (which invest in a wider range of securities). The proposals come as a further response to the heavy redemption pressure that institutional prime funds experienced during the financial crisis of 2008–2009. The change of the NAV should not apply to muni funds, as these funds did not show a heavy sell-off during the financial crisis. In fact, they behaved more like government money market funds and retail prime funds, which the SEC proposes to exempt from the floating-NAV requirement.

Further, with regard to the SEC's proposal to define retail money market funds as those which limit investor redemptions to no more than $1 million per business day, it is important to note that some state and local governments have money market fund cash flows that are greater than $1 million per business day. If the money market funds that these governments are invested in will no longer be permitted to use a stable NAV, then these governments will be forced to withdraw their funds. As a result governments will be forced out of these funds and required to look to other investment vehicles that have historically paid lower yields, or to other less secure products with equal or greater liquidity.

WHAT SHOULD YOU DO?

While GFOA and other state and local stakeholder organizations are weighing in with the SEC on this proposal, it is critical that you share your concerns as well. Please submit a comment letter to the SEC by September 17 that discusses the role money market funds play in your government's investment and cash management policies, and the problems associated with the SEC's proposal to change the rules governing money market funds from a stable to a floating NAV. The bolded concepts above should assist with developing your letter, but your communication to the SEC of your own specific money market fund needs and uses and the projected impacts on your communities are the best points to include. The SEC is accepting both electronic and paper comments, and you can view instructions on how to file your comments on page 2 of the SEC's proposal. Emailed comments should be directed to www.sec.gov/rules/proposed.shtml and paper comments to should be sent to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions must include File Number S7-03-13 in the subject line.