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PERSPECTIVES ON MONEY MARKET MUTUAL FUND REFORMS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE HEALTH AND STABILITY OF MONEY MARKET MUTUAL FUNDS

JUNE 21, 2012

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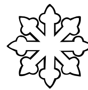

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PERSPECTIVES ON MONEY MARKET MUTUAL FUND REFORMS

THURSDAY, JUNE 21, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order. Today we will examine the health and stability of money market mutual funds, the impact of 2010 reforms, and the potential positive and negative consequences of additional proposed reforms from the perspectives of the industry's regulator, the industry itself, users of the industry's products, and an academic expert. I look forward to hearing the testimony and recommendations as the Committee continues its oversight of the financial markets.

Because we are anticipating a series of 11 votes starting in an hour, we are going to forgo opening statements from the Committee's Members in order to begin the questioning of our witnesses. I will remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit. I will also ask everyone to stick to 5 minutes for your questions.

On today's first panel we have the Chairman of the Securities and Exchange Commission, Chairman Mary Schapiro. Chairman Schapiro, please begin your testimony.

STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to testify about money market mutual funds and the continuing risks they pose to our financial system.

As we all know, during the financial crisis a single money market fund known as the "Reserve Primary Fund" broke the buck, triggering a run not only on that fund but on funds across the market. Within a matter of days, investors had withdrawn about $300 billion from prime money market funds, or 14 percent of those funds' assets. It was one of several destabilizing events during the crisis.

To meet their customers' redemption demands, money market funds began selling portfolio securities into markets that were already under stress, further depressing the value of those securities and creating a vicious cycle. Soon, other funds holding those same securities were struggling to meet the demands of their customers and found themselves at risk of breaking the buck.

The shock waves were widespread. Money market funds began hoarding cash and stopped rolling over existing positions in commercial paper and other debt issued by companies, financial institutions, and municipalities. This dramatically reduced the cash and liquidity available for those entities. In the final 2 weeks of September 2008, money market funds reduced their holdings of commercial paper alone by more than $200 billion.

The runs on money market funds ended only after the Treasury Department took the unprecedented step of using the Exchange Stabilization Fund to guarantee more than $3 trillion in money market fund shares. While this step dramatically improved the market, it also put U.S. taxpayers directly at risk for money market fund losses.

In the wake of the financial crisis, many have rightfully asked where were the regulators and why didn't they do more to address systemic risks. Having reviewed this issue closely and methodically since my arrival in 2009, I have come to understand that money market funds pose such a risk and others agree. Current and former regulators of both political parties have raised flags about the risks posed by money market funds and the need for reform, as has the Financial Stability Oversight Council.

Two years ago, we at the SEC passed a series of measures to increase the resiliency of money market funds by instituting liquidity standards, reducing maturities, and improving credit quality, all important reforms and one of the first significant responses to the financial crisis by any Government regulator. But while these steps have been widely hailed, I said then and still believe that more needs to be done. That is because the incentive to run clearly remains. And since Congress specifically prohibited the use of the Exchange Stabilization Fund to again guarantee money market funds, this core part of our financial system is now operating without a net.

There are several features of money market funds that can contribute to destabilizing runs. First, the stable $1 share price, together with a history of sponsor support, has fostered an expectation of safety. Based on a staff analysis since money market funds were first introduced, fund sponsors have stepped in with their own capital at least 300 times to absorb losses or protect their funds from falling below $1. When a sponsor does not or cannot support a fund, investors lose confidence and rush to redeem.

Second, because an early redeeming shareholder can receive their full $1, investors have an incentive to redeem at the first sign of problems in a fund. Because large, sophisticated institutional investors are more likely to be closely monitoring investments and can move large sums of money very quickly, the slower-moving retail investors and small businesses will bear the full loss.

And, third, if too many investors redeem at the same time, the fund can be forced to sell securities at fire sale prices, causing the

fund to break $1 and depressing the broader short-term credit market. This spreads the contagion to other funds.

It is for these reasons that I asked the staff to explore a number of structural reforms, including two in particular that may be promising. The first option would require money market funds, like all other mutual funds, to simply set their share prices based on the market value of the fund's underlying assets. But understanding that the dollar is important to investors who use this product, a second option would be to allow money market funds to maintain a stable value, as they do today, but require the funds to maintain a capital buffer to support the funds' stable values and to impose restrictions on redemptions.

On many occasions, Members of this Committee have appropriately noted the importance of capital buffers. Here, a capital buffer would increase money market funds' ability to suffer losses without breaking the buck and would permit, for example, money market funds to sell some securities at a loss to meet redemptions during a crisis. If a large credit event occurred, the buffer could help manage the loss, and additional redemption restrictions or fees could slow the run, possibly supplement the capital and dramatically reduce the contagion to other funds and the system.

These ideas and others are the subject of continuing analysis and discussion at the Commission. Of course, if the Commission were to propose reforms, there would be an opportunity for public consideration and comment. That would trigger a meaningful and informed public debate on this critical issue for the Nation's investors, taxpayers, and the financial system at large. It is essential that we address this risk now rather than waiting until the middle of the next crisis.

Thank you, and I am, of course, pleased to answer your questions.

Chairman JOHNSON. Thank you, Chairman Schapiro.

We will now begin the questions. Will the clerk please put 5 minutes on the clock for each Member's questions?

Chairman Schapiro, as a result of the 2010 reforms, funds now publish the assets they hold in their portfolios. What does the SEC know about money market funds that they did not know before the crisis? How has this new information informed the SEC's views on the risk of money market funds?

Ms. SCHAPIRO. Senator, I would say that the transparency initiatives that the SEC undertook in this connection have been extremely useful to us in monitoring the risks that money market funds are taking. I will also say anecdotally that every morning when I pick up the newspaper and read about an earthquake in Japan or problems in European financial institutions, the first question I ask our staff is: What is money market fund exposure to these incidents and to these institutions?

What the data has done is it has given us a window into those exposures in a much more granular way, but it also helps us understand the risks that exist within fund portfolios. We have, in fact, hired a former money market fund portfolio manager to help us work through this data.

I will say, we have noticed some interesting things, such as some fund managers are taking on significantly greater risk than others,

although all their share prices are still priced at $1. We have also learned that while most funds significantly reduced their exposures to European banks in light of all the problems in the eurozone, some funds did not. These funds were actually able to capture higher yields, which is very enticing to investors but, again, shows you that the $1 share price can be a little bit misleading.

The risks that funds are taking are not prohibited by our rules, but it is very important, obviously, for us to have a good handle on what those risks are. So we look at the data very carefully, and we worry about some of it.

Chairman JOHNSON. Which one or two provisions in the 2010 reforms do you believe have been most beneficial? What analysis has the SEC conducted on the full impact and effectiveness of the 2010 reforms? And has such analysis informed your view on what worked well?

Ms. SCHAPIRO. Sure. Well, of course, we have studied the 2010 reforms very carefully. I would say from my perspective, the most valuable reforms have been the liquidity requirements—the requirement for 10 percent daily liquidity and 30 percent weekly liquidity, which are, in fact, exceeded on average by funds. But those have been the most helpful in meeting redemptions, particularly high numbers of redemptions that we saw, for example, this past summer.

We have analyzed the 2010 reforms carefully. We believe they have served their purpose quite well. They do not solve for the problem we are most concerned with right now, which is the potential for a money market fund to suffer a severe loss as a result of a credit event and not be able to absorb that loss, and the propensity for there to be runs on money market funds. But that said, we think the 2010 reforms were extremely positive, and if we put out a release recommending further reforms, we will include in that a careful analysis of the 2010 reforms and why we believe we need to go further.

Chairman JOHNSON. There are pros and cons with any policy proposal. What would be the impact of additional reforms such as floating net asset value, capital buffer, or redemption restriction on those who use and rely on money market funds, including municipalities, companies, and retail investors, if implemented? And do you agree with some who have suggested that additional reforms may cause investors to move assets out of the money market funds?

Ms. SCHAPIRO. Well, Senator, that is a question that I could answer over a very long period of time, but I think clearly additional reforms in this area will have costs associated with them, and we would intend in our release to fully analyze not just operational administrative costs, which could come from systems programming or other kinds of changes, but also competitive issues and opportunity costs and the full range of costs and benefits.

But I believe the costs would be far, far outweighed by the benefits of forestalling another potentially devastating run, as we saw in 2008 when Reserve broke the buck. We will also try to measure the 2008 costs, but they are the costs of damaged investor confidence. They are the costs of funds frozen in order to liquidate and investors not having access to their accounts during that period.

They are the costs of a short-term credit market freezing up and public companies and others not being able to issue commercial paper or have their commercial paper rolled over. They are the costs of small businesses and individuals not being able to access their cash management accounts and make payrolls or tuition payments.

The implications of another run for our economy are very broad and very deep, and so those are costs we need to take into account as well as the costs, of course, of any proposed changes, whether it is floating NAV or capital.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

Chairman Schapiro, in your written testimony, you mention, and I will quote you, "runs with potential systemic impacts on the financial system" as a justification for additional money market fund regulation. Has the Financial Stability Oversight Council designated any money market funds or activities as "systemically important"?

Ms. SCHAPIRO. Senator, as you know, in the annual report of the Financial Stability Oversight Council, money market funds were discussed at length as a weakness and potential systemic risk for the U.S. financial system. The FSOC has not designated any institutions at this point as systemically important financial institutions.

Senator SHELBY. Yesterday the *Wall Street Journal* reported that a new SEC study has found that money market mutual funds received financial support from their sponsors more than 300 times since the 1970s, and that is about 100 more times than previously reported. Did the Commission, Madam Chairman, review or approve this study? And if so, could you provide a copy of the study to this Committee? And how many times, if I could add, have money market funds required sponsor support since the 2010 reforms? Is that too much? That is a lot.

Ms. SCHAPIRO. It tests my ability to remember, but I hope that you will remind me of any pieces of this that I have forgotten.

Senator, the staff did a tabulation, essentially—not really a study—a tabulation of occasions where sponsor support has been given to money market funds. It does not even include all kinds of sponsor support, so I actually believe that the number may be conservative. But essentially it is a tabulation of many instances where people came to us in order to get authority to do sponsor support because what they wanted to do was an affiliated transaction, which would be a violation of the SEC rules.

I would be more than happy to provide the information to the Committee. As I said, it is likely a conservative number because those instances that came to the Commission staff's attention because relief was sought or we were notified about the support that was given.

I believe that Moody's reported a number somewhere in the vicinity of 200, and I do not know exactly what data looked at and over what period of time. I know our staff reviewed everything back to the inception of money market funds in the 1970s.

I will say, just as an example that our staff may have had a different baseline at Moody's, that Moody's reported that during the

financial crisis, 62 money market funds required support from their sponsors, but they looked only at the 100 largest funds as an example. Our staff looked at everything back to the inception of money market funds in the 1970s.

Senator SHELBY. Madam Chairman, did the SEC work with the Federal Reserve in developing the 2010 money market fund reforms? And if so, would you explain to us the Fed's involvement, if any?

Ms. SCHAPIRO. Senator, I would be happy to supplement the record with the specific but I am not sure to what extent the staff consulted with or talked with the Federal Reserve Board staff with respect to the 2010 reforms. They may well have. I just do not know the extent of it.

Senator SHELBY. Is the SEC currently working with the Federal Reserve in developing further reforms?

Ms. SCHAPIRO. Yes, our staffs have had lots of conversations about the potential reforms.

Senator SHELBY. OK. Chairman Schapiro, multiple Fed officials have included discussions of the risks posed by money market funds in recent speeches on shadow banking. Are money market funds so-called shadow banks?

Ms. SCHAPIRO. I am not a big fan of the expression "shadow banks." I would say money market funds——

Senator SHELBY. How do you define it, too, right?

Ms. SCHAPIRO. Right, exactly. I would say that money market funds are hugely important and popular investment products in our economy, and they are important for millions of investors, and they have generally been well and responsibly managed. So this is not in any way about "shadow banks" or negative connotations. This is about my belief that their structure presents systemic risk that, as Chairman of the SEC, I think it is important we talk about and debate openly and publicly.

Senator SHELBY. Should the Fed be the primary regulator of money market funds?

Ms. SCHAPIRO. I think the SEC is a fine regulator of money market funds. I think they are at the end of the day—and this is part of what is lost in this discussion—investment products. And the SEC is truly the Federal Government's expert on investment products.

The confusion or the complication is that their value does not fluctuate like investment products can, should, and do because we have the fiction of the stable net asset value.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you, Mr. Chairman. I want to commend you and Ranking Member Shelby for holding this hearing because, looking back over the last several years, there were many, many issues that had potential dire consequences to the financial system which were not examined, even though they were small risks, it appeared, but the consequences were, as we discovered in 2008 and 2009, extraordinary. So I think this is a very, very important topic.

Let me follow up a question that Senator Shelby posed; that is, the Financial Stability Oversight Council has not designated a mu-

tual fund as systemically important and subject to regulation, but they can do that. Is that correct?

Ms. SCHAPIRO. I believe that we could designate individual funds as systemically important or the activity of maturity transformation or credit intermediation or whatever as systemically important activities.

Senator REED. And that raises a possibility that if the SEC does not promulgate a rule which would apply to all mutual funds, then the FSOC could pick out, presumably, the largest funds and impose restrictions or impose operating procedures on them under their authority. Is that a fair estimate?

Ms. SCHAPIRO. I think that is right. We are working to refine what criteria would be used for asset managers in designating them as systemically important. But I believe that is right.

Senator REED. So you could have essentially a system in which some are regulated and some are not. I would presume anything the SEC did under the Investment Act would apply to every mutual fund equally.

Ms. SCHAPIRO. It would apply to all 2a-7 money market funds, and the risk of having some designated and some not designated is that, of course, a run can start on a particular fund, but the contagion spreads it very quickly across many money market funds because, frankly, there is no incentive not to run. If you can get your dollar out as an early redeemer, why would you take the chance and stay in a fund and potentially have to bear the losses?

Senator REED. And as you point out, most of the institutional investors have the most connectivity to the fund, they monitor it on an individual basis, unlike retail investors, and they typically under the present rules could withdraw their funds at the full NAV, the dollar NAV, and then at the end of the line, others might get less. Is that correct?

Ms. SCHAPIRO. That is right. The tendency is for the losses to be concentrated in the remaining or the slower-moving shareholders, which are always retail investors and, small businesses, not the largest institutions, that are, in fact, monitoring their funds.

Senator REED. One of the issues that was also raised by Senator Shelby is that your testimony about 300 essentially situations where the sponsor of the fund stepped in and provided capital, which raises the issue, if that is the norm, if they have both the intent and the capability of doing that, then essentially the funds can police themselves. But that raises another issue about both the capacity of these funds and their willingness. And perhaps the notion in terms of the—is there any consideration to—I know stress-testing of the financial companies are popular now, but looking at the capacity of funds to be able to support—or sponsors to be able to support their funds as something that you would consider?

Ms. SCHAPIRO. We do have stress-testing now as part of the 2010 reforms, but it is really stress-testing the portfolio of the funds as opposed to testing their capacity and willingness to step in and support a fund that is in danger of breaking the dollar.

The real concern about that is not that it is necessarily a bad thing to have sponsor support and prevent a fund from breaking the dollar. It is that there will come a time when a fund will not have, as you say, either the capacity or the willingness to step in

and support its fund, and investors believe that there will be support because history has shown us that in hundreds of instances funds have stepped in to do that. And, of course, history has shown us that when things got very bad, the Federal Government stepped in to do that. So experience is trumping their theoretical understanding that these are at risk.

Senator REED. A final question. I am concerned about the impact on municipal participants. Many municipalities, State and local governments, use money market funds in a very efficient way to manage their case. Are you looking seriously at any impact that that could have on municipalities, particularly at a time when, frankly, they are all under real siege because of the local and national economy?

Ms. SCHAPIRO. Absolutely. We obviously have concerns. We have listened carefully to State and local governments and their concerns about money market funds. It has really come from two perspectives. One is that they use them as cash management vehicles and they need a stable-value product to do that, which is one reason we have an option for capital which would allow the product to stay a stable-value product. Their other concern is whether money market funds will continue to exist and be able to buy municipal securities.

I would note that only about 10 percent of the total municipal securities are held by money market funds. It is a larger percentage for very short-term paper, but I believe money market funds will continue to exist, and they will continue to invest in municipal securities. But if a municipal treasurer cannot bear the risk of loss of even a penny a share in their cash management account, one has to wonder whether a money market fund really is the right place for them to be in the first instance because they do have that risk if the fund breaks the buck.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and I, too, would like to thank you for having this hearing, and the Ranking Member as well. This certainly is a very, very important topic, and I appreciate the chance to have this discussion.

Thank you, Madam Chairman, for being with us today. In a footnote on the first page of your testimony, you acknowledge that the views of your testimony are your views and not the views of the Commission.

Ms. SCHAPIRO. That is right.

Senator TOOMEY. Is it fair to say that the views that you have expressed, in fact, do not represent the majority of the Commission?

Ms. SCHAPIRO. Senator, I guess I would not say that. Clearly the Commission as a whole has not joined me in this testimony. I think that some would tell you that they still have open minds and they want to engage with the document from the staff when it is circulated, see what the proposals are, see what the cost/benefit and other analyses are. But you are right that some of them have expressed their views that nothing more needs to be done, that the

2010 reforms were sufficient. But I am hopeful that we will have the debate that I think we need to have.

Senator TOOMEY. I will go out on a limb. It seems to me that there is a majority on the Commission that does not share your view on this. But we will see how this develops.

I also want to make the point that the disclosure that there were 300 instances in which there was some voluntary support succeeded in getting some sensational stories written. But the fact that it came without the accompanying analysis and without the accompanying data so that people really cannot evaluate is it pretty unfortunate because there are—I have seen articles in which people leap to conclusions that may not be supported by the data. And I would like to drill down a little bit into this topic since you have raised this and seem to be making this an important basis for suggesting that we need some really extraordinary new regulations.

The Boston Federal Reserve Bank recently cited that there were 47 instances of direct support between 2007 and 2010. In a recent speech, Federal Reserve Governor Tarullo referred to around 100 instances between 1989 and 2003. Moody's reported in 2010 that there were 181 cases between 1980 and August of 2009.

My first question is: Is everybody using the same definition of what constitutes support?

Ms. SCHAPIRO. They may not be, and they may not also be looking at the entire universe of money market funds, as I said earlier.

Senator TOOMEY. Right. OK. So could you tell us what is the definition that you have used to define an instance of this voluntary support that gets you to this count of 300?

Ms. SCHAPIRO. Yes, I believe we have used, a pretty conservative evaluation, looking at those instances for example where money market funds came to the staff of the SEC and sought authority to essentially violate the affiliated transactions rules by making a contribution to the fund. We have generally talked about it as buying out distressed paper, entering into a capital support agreement, or a letter of credit. We did not count renewals of capital support agreements, and we did not count other types of potential contributions.

Senator TOOMEY. OK. So a credit agreement is essentially a conditional support. If that was never drawn on, does it still count toward the 300?

Ms. SCHAPIRO. Yes, because it still shows up as a liability on the balance sheet.

Senator TOOMEY. OK, but there was no credit event that occurred, there was no adverse outcome for the fund; it was simply an arrangement that was made and was never used in that case.

Another question: Do you distinguish between significant and de minimis amounts of support?

Ms. SCHAPIRO. No, and I do not actually think that it is necessarily relevant to distinguish between them. If a fund is going to break the buck, it is going to break the buck, and capital support is there. It contributes to the understanding of investors.

Senator TOOMEY. Well, I mean, if it is a de minimis arrangement, then it is not clear that the consequence would be breaking the buck. But let me ask another question.

In the event that a sponsor had an agreement to purchase securities and the securities eventually paid in full, would that still count as one of these instances?

Ms. SCHAPIRO. Yes, it would.

Senator TOOMEY. OK. How about the number of instances since the 2010—precisely how many of the 300 occurred after the new regulations were imposed in 2010?

Ms. SCHAPIRO. My understanding is that since 2010 there have been three sponsor support occasions that were necessary because of the downgrade of a foreign bank. I believe it was a Norwegian bank.

Senator TOOMEY. But it is very hard for us to evaluate when you say "necessary" without—I mean, we just went through a number of examples in which support is defined in ways that certainly would not suggest to me or I think to many people that there was any real danger. And my concern is that this is the impression that is being created, that these are all instances about which we should be very concerned, when, in fact, it sounds as though many of them are not terribly disturbing.

Ms. SCHAPIRO. Senator, as I said, I am more than happy to provide the background information to you, but I think it is also important to note that money market funds come to us and ask us for the authority to enter into these arrangements. So these are not generated by the SEC. These are generated——

Senator TOOMEY. No, I understand. They are heavily regulated, and they are forced to come to you for permission to do many things. But that does not mean the thing they are forced to request permission for are necessarily disturbing or evidence that there is a problem here.

So you will give us public release of all the data and the analysis that accompanied it. When do you expect we would be able to get a chance to look at that?

Ms. SCHAPIRO. I would endeavor to get it to you as quickly as possible, in the next couple weeks.

Senator TOOMEY. OK. I just would like to make the general point and just wrap up my time. Your testimony, which I read closely, in my view you are portraying an industry that is extremely vulnerable, that has all these risks of runs, and I really find that extraordinary in light of the actual history. When you think of the way this industry has thrived for decades, that have seen so many extraordinary events, serious recessions, bouts of inflation, the crash of the S&L industry, all kinds of devastating natural disasters, 9/11, all the while prior to the financial crisis of 2008 there were thousands of bank failures, individual years in which hundreds of banks failed, and during all that time one money market fund broke the buck. There was no run, there was no contagion, and investors got 96 cents out of every dollar.

Then along comes the financial crisis. It is the worst since the Great Depression. Investment banks go down in smoke. Commercial banks crumble. An entire industry is wiped out. The big wire house broker-dealers no longer exist, all either forced to be bought or convert their charter. And while the entire financial services sector is virtually collapsing and seizing up, the panic that seized this whole sector did, in fact, affect some of the money market funds

somewhat; one of them broke the buck, extraordinary measures were taken. I understand all that.

And then you impose new regulations that you talked about: liquidity and maturity and credit enhancement and more transparency. And since then, we have had another round of real stresses, you know, an ongoing terrible recession, European credit crisis, downgrade of the U.S. Government, considerable redemption pressure, and not a single problem in this whole industry. No one gets in trouble. And now without having had a chance to look at this data that you cite and citing the very characteristics that have been in place from the very first day of this industry, you are telling us that this is a very vulnerable industry and there are great threats of a run and using that to justify regulations that I think threaten the very existence of this industry.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Madam Chair, thank you for your service. I am not sure which analysis you are referring to that you are going to make public, because I had a line of questions about your analysis process, and for which reforms are you talking about?

Ms. SCHAPIRO. Sure. I was asked by Senator Shelby and Senator Toomey to provide the background on the 300 occasions where there has been capital support provided to money market funds.

Senator MENENDEZ. OK. So my question then is: Have you at the SEC studied the impact of the SEC's 2010 changes on money markets?

Ms. SCHAPIRO. Yes, we have. And in the release, if we publish one, laying out potential further reforms, we would, of course, lay that full analysis out. But I will tell you we believe the 2010 reforms worked extremely well for what they were designed to do, which is to assure that there is sufficient liquidity in money market funds to meet heavy redemptions. And as we saw through last summer in Europe when there was a period of extraordinary redemptions, they performed very well. But even during that 3-week period from June 14th on, about $100 billion was withdrawn from money market funds. That compares to $300 billion withdrawn from money market funds in just a few days after Reserve broke the buck.

So I would disagree that there was no run. There was clearly a run in 2008. The goal here is to not demonize an industry. As I said, this is an industry that has performed very well, has structural weakness——

Senator MENENDEZ. I do not want to spend my time with you answering Senator Toomey.

Ms. SCHAPIRO. I am sorry. I apologize.

Senator MENENDEZ. I appreciate that you want to do that, but that is good for Presidential debates.

[Laughter.]

Senator MENENDEZ. Let me ask you this: Are you going to release the impact of the 2010 changes before you move on to your next set of reforms? I mean, I think some of us would like to know what in essence those 2010 changes did before you move on to a next set of reforms to get a sense here of the impact? For example,

you know, how much have they reduced systemic risk, the 2010 reforms? Have they reduced systemic risk? And if so, by how much?

Ms. SCHAPIRO. We could certainly do that, and as the Chairman has said, the record will be open for a period after the hearing. We could provide that in the form of a response on the record.

Senator MENENDEZ. OK.

Let me ask you this: Have you done an analysis of your proposed reforms that are coming down the pike that you can share with us?

Ms. SCHAPIRO. Well, that would be in the form of a proposed rule recommendation with lots of alternatives and options and lots of questions. That would include a compliance cost/benefit analysis of the proposed options, floating net asset value or capital buffer with redemption restrictions, and also a cost/benefit analysis compared to what the costs are of a run to our economy, and all the alternatives, where money might flow if it were to flow out of money market funds as a result of any reforms.

So we have quite a detailed cost/benefit and economic analysis in the proposing release.

Senator MENENDEZ. In that analysis, are you going to define the reforms both on safety and soundness but also on whether investors will be willing to invest in these funds?

Ms. SCHAPIRO. Yes, we would look at what the competitive impacts might be of any reforms.

Senator MENENDEZ. And do you believe—I have heard some criticism that there is not a wide enough array of options being considered.

Ms. SCHAPIRO. Well as you might recall, the President's Working Group in 2010 published a report that laid out more than half a dozen options for reform, including capital and floating NAV, but also a liquidity facility, converting money market funds into special-purpose banks, and there were four or five other recommendations there.

Senator MENENDEZ. Well, I am concerned about the net asset value of fluctuation, and that is one that I think is problematic, and I think we have written to the Commission, along with others, expressing that view.

How much would capital buffers cost, and how much would they reduce systemic risk?

Ms. SCHAPIRO. Well, it depends on obviously how you structure a capital buffer. I think that a quite small capital buffer coupled with limitations or fees on redemptions would permit you to have a small buffer, and yet require redeeming shareholders to bear the loss, some of the loss, some of the costs of their redemptions. At the same time, the small buffer would allow you to have fluctuations that could be absorbed on a day-to-day basis. So we will try to cost out in our release what the cost of capital would be.

Senator MENENDEZ. But right now you cannot tell us how much that would reduce systemic risk, what you are proposing?

Ms. SCHAPIRO. Well, I think that is part of our analysis, but I think a capital buffer would allow the money market fund to maintain the stable value, as it does today, but support it through the absorption of relatively small mark-to-market losses that occur without breaking the buck.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. And, Chairman Schapiro, I want to follow up a little bit on Senator Menendez's questions about the analysis that you have made. It is my understanding that if money market funds were forced to float their net asset value, there is a great concern about the fact that the flow of hundreds of billions of dollars of both corporate and municipal financing would be severely disrupted.

Have you or your staff undertaken any studies as to how the reforms that you have floated might affect the ability to investors to continue to use money market funds as an effective cash management tool?

Ms. SCHAPIRO. Absolutely, part of our analysis is the impact on State and municipal governments' use of money market funds for cash management, and we understand that many of them operate under legal requirements to utilize a stable-value product. That is one reason we are proposing alternatives. If you need to use a stable-value product, then there is a capital alternative that would allow the money market fund to still price at $1. But we will look at the cost implications for municipalities of both the cash management aspect of money market funds but also their capacity to buy State and local paper.

Senator CRAPO. But at this point have you reached any conclusions as to what kind of disruption might be caused in the economy if you—in the development of capital in this context?

Ms. SCHAPIRO. We have obviously had conversations with State and local governments. We held a roundtable last year where we had participation from State and local governments talking about the issues and their concerns. Will they need to have additional staff? Will they have to change their programs?

Senator CRAPO. And what conclusions have you come up with from those conversations?

Ms. SCHAPIRO. Well, part of our release is to seek specific economic data about what those costs would be and then be able to compare those costs against the costs of the potential for a run that freezes money market funds, suspends redemptions, and gives them no access whatsoever to their cash management vehicle.

Senator CRAPO. OK. In April, a committee of the International Organization of Securities Commissions issued a report on the money market funds that included proposals to float the net asset value or imposed other varieties of capital buffers. Three of the five SEC Commissioners issued, I think, a rare statement that said that that report does not reflect the views and input of a majority of the Commission.

My question is: Who at the SEC did provide the input on this report? And were the three dissenting Commissioners consulted?

Ms. SCHAPIRO. The staff works with IOSCO on an IOSCO committee that was dealing with these issues. The Commissioners did disagree with the conclusions. Those disagreements were registered at the highest levels of IOSCO. The paper was published prematurely, quite honestly, through a genuine miscommunication in the process at IOSCO, before the Commission was able to register that there was not a majority of the Commission's support. But I

should emphasize this was a consultative staff paper seeking comment on a broad range of potential options.

Senator CRAPO. All right. Thank you.

Professor James Angel from Georgetown University makes the point that it is extremely important to distinguish between a destabilizing run and an orderly walk. In a run, apparently, as he says, the funds are forced to sell assets at potentially distressed prices, potentially destabilizing money markets. In a walk, the funds can be used in a normal cash-flow manner from maturing assets to meet redemptions.

Are you focusing on that kind of distinction? Do you agree with that distinction in the first place? And do you think that the reforms that you are talking about properly take into account that kind of distinction?

Ms. SCHAPIRO. I think the reforms do take into account that kind of distinction. Our concern is the propensity to run. Our concern is not to keep money market funds in business or to limit people's ability to withdraw and move their money from fund to fund, but our concern is the destabilizing run such as we saw in 2008. And we are very focused on that. We have had a number of our staff look at Professor Angel's report. I think it contains assertions and conjectures and, frankly, qualitative statements, but not the kind of quantitative data and analysis that we would expect to include along with our reform proposals.

Senator CRAPO. So although you may disagree with his analysis, you do agree with the distinction that there is a difference between a run and an orderly walk, as the term has been used?

Ms. SCHAPIRO. I think when a fund breaks the buck, it is very hard to have an orderly walk because a fund is likely to suspend redemptions, which freezes everybody in place, including people who need access to their funds for cash management purposes—payrolls, tuitions, mortgage payments. And so my concern is about the potential to break the buck because of the brittleness of the $1 value and that leading to a run.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. Let me also thank you and the Ranking Member for holding this hearing.

I want to go back to some of the comments that Senator Reed and Senator Toomey made. You know, I share, Chairman Schapiro, your concern that if you have got to have an intervention and whether that intervention is de minimis or larger, if it is breaking the buck, it has the potential of starting and unraveling.

The interesting thing, though, is that when we look at the FSOC, normally we go after the largest systemic important institutions. My sense is—and I am anxious to see the data as well—that the largest money market funds are probably the safest in terms of shoring up if they get into this gray area, and it really is the smaller ones, the ones on the fringe that may be providing the most threat to the system. And I guess this again goes back to—I want to comment a little bit more about Senator Reed's questions about—and I know there is not an equivalency of some type of stress test or analysis. Could you speak to that a little bit more?

Ms. SCHAPIRO. Sure. I think the stress test is an interesting idea, the stress test with respect to the capacity to provide capital. I think the problem is if there is going to be capital support, it ought to be explicit capital support. Investors ought to be able to know that it will be there when it is needed, not be left to wonder whether the sponsor is still capable of providing that support, or still willing to provide that support. And I think that is why my view is that we need to move forward with a rule that would require either a floating net asset value or a capital buffer coupled with some kind of redemption fee or limitation in order to ensure that those who redeem early are bearing some of the costs——

Senator WARNER. So in a sense no differentiation between those money market funds who have had long, stable relations, everybody would be in the same pot, right?

Ms. SCHAPIRO. Well, I think——

Senator WARNER. And with the capital buffer, if we are going to go on the capital buffer, would the capital buffer be for, you know, a Lehman-style collapse? Or would the capital buffer be just kind of in the normal course to have a small reserve here so that if there was something that kind of got you near that de minimis cushion?

Ms. SCHAPIRO. I think one of the——

Senator WARNER. Or would that be part of the review and analysis you are trying——

Ms. SCHAPIRO. Well, that is certainly part of the analysis, the Reserve Fund was about a $62 billion fund, but I do not believe a household name. They held only about 1.2 percent of their assets in Lehman paper, a $785 million investment. When they broke the buck, yes, admittedly it was at a time of general crisis in the economy, but it spread rapidly to many, many other money market funds. And if you read former Secretary Paulson's book, he talks about really standing on the edge of the cliff, hearing from money market fund managers who just did not know what was going to happen to them because redemptions were going through the roof. And if they were going to have to sell securities into this very depressed market in order to meet redemptions, they were going to create this spiraling down that would be very, very difficult to stop, which is why Treasury did step in and, to the tune of more than $3 trillion, guarantee all money market funds.

Senator WARNER. But if you had to put a capital buffer to be in place for that level of potential contagion, wouldn't you potentially really disrupt this whole——

Ms. SCHAPIRO. I think a capital buffer to contain that level would be prohibitively expensive and probably does not make sense, which is why you could have a much smaller capital buffer if it is coupled with some kinds of limitations on redemptions so that at least the losses are borne by all redeemers, not just those who are left at the end of the day.

Senator WARNER. But, again, your notion here on these reforms would be systemwide, not with some analysis of those funds that are graded stronger versus those that are more on the periphery?

Ms. SCHAPIRO. I think it needs to be explicit. I think investors need to understand will the capital be there or will it not be there, and a uniform capital requirement or capital buffer or NAV buffer has that benefit to it. Just to assume that because a sponsor never

had to support its money market fund in the past means it never will in the future would be very concerning to me because, in fact, that is what——

Senator WARNER. Let me just ask one last question. Is there any sense of—since you have seen improvements since the 2010 reforms, have you looked at other things in terms of additional liquidity requirements as opposed to some of the reforms you are looking at? Are there other ways to get at this protection without looking at the two options you have looked at so far?

Ms. SCHAPIRO. We have. As I said, the President's Working Group published a paper that laid out lots of different options: a liquidity facility, converting these to bank products, special-purpose banks, a two-tiered money market fund structure where you would have tighter restrictions on a stable value fund and less tight on a floating rate fund. There were several other alternatives. We took comment on those. We also held a roundtable on those. And we are open—and I should say this adamantly—we are open to continuing to discuss options. We have had lots of very constructive conversations with industry, but I think we have to get at the structural weakness, and I am not sure just enhanced liquidity requirements going to 50 percent weekly liquidity, for example, rather than 30 percent would get us there.

But, again, if we can put a release out, we can have this discussion in far more concrete and specific terms with some economic analysis to accompany it.

Senator WARNER. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and I thank you and the Ranking Member for having the hearing. And, Madam Chairman, it is nice to see you again. Thank you for your service.

I have actually lived this as a former school superintendent. I have seen the huge importance of money market funds to school districts and to municipalities, both for cash management but also for financing. And I also saw the challenges that arise when there is a run, and it is hair raising.

But I think we need to be really cautious about this because I think the costs are potentially very real and very large for municipalities, for school districts, for local government, and there has been a lot of general talk about that today. I wonder, have you done specific analysis yet on the potential costs to these local governments?

Ms. SCHAPIRO. Yes, our release will talk about, to the extent we have data on the potential costs to municipalities and State issuers, as well as on them and their capacity using these vehicles for cash management. But we will also seek additional data and input on those very issues. We recognize this is not a costless proposition by any means. I spent time with a number of members, from Colorado in particular, but other States as well, after Reserve broke the buck and I was brand-new at the SEC, and those members were frantic because their local governments could not access their accounts at Reserve.

Senator BENNET. I was there and I know it, and so having lived it, I have seen it, and still I am deeply worried about the unintended consequences that might arise here, because what I know

in our case is that the financing we were able to do dramatically improved the conditions for kids in the Denver public schools who for the first time actually in our history are seeing resources added back to their classrooms, while districts around us are having to cut back. And had the transaction not been one that we could have done, that would not be the case today.

So I guess my plea as you go forward is one for precision and for paying very close attention to what effect this might have on liquidity at the local level, not for the municipalities themselves, not for the school districts themselves, but for the people that we serve in those places.

Ms. SCHAPIRO. Absolutely. We recognize that these are incredibly valuable tools, and our goal is to make them stronger and better able to withstand——

Senator BENNET. I wanted to ask a question that I heard a little earlier, maybe in a different way, and it is a hard one, sort of, because it asks you to look back. But if you look back to—you know, had the Dodd-Frank Act law been in place and had the 2010 reforms been in effect 4 years ago, what do you think the likelihood is that the Reserve Fund would have broken the buck? Is it possible that requirements under Dodd-Frank would have reduced the likelihood that Lehman Brothers, in which the Reserve Fund was heavily invested, would have been in such terrible shape? Would the liquidity requirements and improved credit standards in the 2010 reforms have affected the wherewithal of the Reserve Fund under such circumstances?

Ms. SCHAPIRO. I do not know that the 2010 amendments would have been enough. I think they have been very valuable. I think they have contributed to the resiliency of money market funds. But they do not address a sudden credit event that causes a loss, which is what we had in Reserve when Lehman declared bankruptcy and the paper was valued at zero. Those reforms, while they require more liquidity, they require shorter maturities, they require higher quality, they do not address a sudden credit event. They really do not address or alter the incentive a shareholder has to run if they even fear losses because there is no penalty to getting out quick. There is a real penalty to hanging around, potentially.

I do not think they address the unfair results that can occur when a sophisticated institutional investor gets out quickly and losses are concentrated with retail investors or retail investors are left in a frozen fund and cannot access their liquidity.

So I do not think they would have been enough, and that is really why we are here today.

Senator BENNET. Thank you, Mr. Chairman.

Chairman JOHNSON. Any additional questions for Chairman Schapiro can be submitted for the record. You may be excused.

I will now ask the witnesses of the second panel to quickly take their seats. We welcome you and thank you for your willingness to testify before this Committee.

The Honorable Nancy Kopp is the treasurer of the State of Maryland.

Mr. Paul Schott Stevens is the president of Investment Company Institute, the national association for investment companies.

Mr. Christopher Donahue is the president, CEO, and director of Federated Investors.

Mr. Bradley Fox is vice president and treasurer of Safeway.

And, finally, we have with us Professor David Scharfstein, the Edmund Cogswell Converse Professor of Finance and Banking at Harvard Business School.

Because we are running short on time, we are going to move right to questions of our second panel. Each of our witnesses statements will be submitted for the record.

I will ask the clerk to put 5 minutes on the clock for each Member's questions.

Professor Scharfstein, please describe the causes of the run on money fund in September 2008 and the reasons why after the 2010 reforms you recommend further reforms to preserve financial stability?

Mr. SCHARFSTEIN. Thank you, Senator. The run on the money funds in September of 2008 was triggered by the failure of Lehman Brothers. Actually, in the months—in the year, actually, leading up to the failure of Lehman Brothers, recent research shows that not just their Reserve Primary Fund but a whole host of other funds took the opportunity to increase risk in their portfolios. There were stresses in those markets at the time, increased yields on various forms of paper that was issued by financial institutions, and those funds increased—not all but quite a few—the risk of their portfolios.

And so there was a lot of exposure to risky paper in those funds, and so when Lehman failed, there was a run on the Reserve Primary Fund. Institutional investors—the run basically occurred by institutional investors, not retail investors—pulled their funds out.

The 2010 reforms are desirable. They go some of the way. But I would say that they are not enough, and I think if you look at the recent experience with the European sovereign debt crisis, what we saw was a similar event that happened—not as extreme. The run was not as quick. It was more a trot. What we saw, though, was, again, funds increasing their risk and their exposure to euro zone banks, and when the crisis escalated last summer, what we saw was large withdrawals from those funds. Those had implications for foreign banks, which are the main users of the money funds. They are the main issuers into the money funds as the foreign banks. And that created a dollar funding problem for them, which spilled over and I think has affected the ability of those banks to make loans to U.S. firms and other companies that need dollar funding.

I would also say that the liquidity requirements as part of that fund also kind of get in—are at cross-purposes with other efforts that are in place to try to get U.S. banks to fund themselves in a more long-term basis. If you require money funds to hold short-term paper, that means that banks are going to be issuing more short-term paper, and part of what we are trying to do is get banks to fund themselves in a more stable way as well.

Chairman JOHNSON. Ms. Kopp and Mr. Fox, what impacts have the 2010 SEC reforms had on users of money market funds such as State Governments and companies? Ms. Kopp, please begin.

Ms. KOPP. Thank you, Senator. As you know, the States and local governments—and I am here representing 13 organizations of State, local, and municipal governments—use money market funds for liquidity, for money management, as well as for financing. And the fact is that the increased tightening of the credit standards, the shortening of the duration, the enhanced disclosure of having on the Web site the total portfolio has made it more possible for us to compare the sites, to compare the funds, and to go where we have to go. But as you know, we use these funds for daily liquidity, for managing our money, and that is our main concern.

It has made it simpler. We think they have been very important. We think there has not been a lot of time since 2010 to measure all of the impact. But what the professor called a trot and the Senator called a walk, both I think are testament to the fact that we have not had runs.

Chairman JOHNSON. Mr. Fox, what are your views?

Mr. FOX. I would agree as well. I think the money market funds have been extremely efficient allocators of capital from investors to borrowers. In the corporate marketplace, some 40 percent of all corporate commercial paper is purchased by 2a-7 money market funds. The improvements and the reforms from 2010 in liquidity, safety, and transparency have only enhanced the role that they play in the marketplace, and, you know, I think that is shown with the fact that there are $900 billion invested currently in prime money market funds, 2a-7 prime money market funds from institutional investors. So they have proven very resilient in the face of very serious global market turmoil from the European debt crisis.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I will direct this question to Mr. Stevens and Mr. Donahue. Some have argued that a product that seeks to maintain a stable net asset value while investing in instruments that can decline in value is essentially maintaining a fiction. Is the stable net asset value money market fund a fiction? Mr. Stevens. And if it is not, why not?

Mr. STEVENS. It is clearly not, Senator.

Senator SHELBY. OK.

Mr. STEVENS. We have actually done a considerable amount of empirical analysis of the variability of funds' net asset values per share over extended periods of time. The degree to which they fluctuate is really quite marginal. You can look at it in periods of stress. You can look at it over long periods of time.

Senator SHELBY. Does it depend on what you are investing in?

Mr. STEVENS. Well, we invest—you are absolutely right. We invest only in the shortest, highest-quality paper that is available.

Senator SHELBY. And that is the protection, is it?

Mr. STEVENS. That is what under the structure of Rule 2a-7 permits funds to keep their net asset value per share with a great deal of precision around $1.

Senator SHELBY. Mr. Donahue, do you have any comment?

Mr. DONAHUE. We had a hearing back with the SEC, an administrative law hearing, in the late 1970s on this exact subject, and it was the same issues and the same question. The SEC is in effect looking for a redo here. But the reason that the NAV is solid at

a dollar and not a gimmick or whatever is precisely because of the portfolios and the credit work to hold the maturity and all of the enhancements that were added in 2010, like Know Your Customer. So it is a solid thing that has gone a great thing for the American public.

Senator SHELBY. Ms. Kopp and Mr. Fox, have the disclosure requirements improved your ability to manage cash? And would your ability to manage cash, which is very important, be further improved if the information was provided in real time or near real time?

Ms. KOPP. Well, if you are talking, Senator, of going to a floating rate NAV——

Senator SHELBY. Right.

Ms. KOPP. ——when you are talking about real time, let me just make it clear that, first of all, throughout the country there are laws and ordinances, particularly with local government, that require a stable-value vehicle. So they would have to change all of those laws to pull out—or pull out their money.

Last week, the GFOA, which met—the local finance people met in Chicago, and there was a clear consensus, almost unanimous, that they would simply be forced to move out, A, because of the law; and, B, because their accounting systems simply do not allow them to go to that system. So they would have to go to banks, presumably, which are less transparent and not safe.

Senator SHELBY. Do you agree with that, Mr. Fox?

Mr. FOX. I think from a systems standpoint, it would be very difficult to monitor a floating net asset value from money market funds, and corporations would simply not use them as investment vehicles. The transparency from the 2010 reforms has been very helpful. We look at these portfolios. We understand where they are invested, and we are comfortable with the stable $1 net asset value.

Senator SHELBY. I will direct this first to Professor Scharfstein. What should be done to decrease the expectation of another taxpayer-funded bailout of the money market fund industry? Is it more capital? And how much capital?

Mr. SCHARFSTEIN. I would say it is more capital, and I think that is the proper lens—I think it should be more capital. I think that is the proper lens to look at this through. You know, there was extraordinary support for these funds during the crisis and the Treasury guarantee. You know, calibrating the exact amount of capital is difficult. I do not think it is going to be nearly as costly as people say. In fact, if the industry is correct and there is not that much risk in the funds, then having a subordinated share class, as has been proposed, should really not be very costly at all.

Senator SHELBY. Is the bigger the fund, the larger the fund, the less likelihood of visiting the taxpayers? In other words, you have got a lot of small money market funds that operate everywhere, and some of them operate very well. But in a time of crisis, do the big ones as a result have more potential to save themselves than others?

Mr. SCHARFSTEIN. Well, certainly sponsors' support, you know, is important, and that can be helpful. But I think clear capital that is set aside in advance would be better.

Senator SHELBY. What would you suggest about capital? Have you got a figure in mind? We are talking about a lot of money out there.

Mr. SCHARFSTEIN. That is right. I think if you had a subordinated share class, you know, on the order of 3 percent, I do not see that as being particularly difficult to do or particularly costly.

Senator SHELBY. Mr. Donahue?

Mr. DONAHUE. That just will not work. The math does not work. The reason you do not hear proposals——

Senator SHELBY. Tell us why it will not work.

Mr. DONAHUE. I will tell you. We have a $2.5 trillion industry, and so if you say 3 percent of capital, that is $75 billion of capital. I do not know where you are going to get $75 billion of capital. But assuming you can, that demands a return on capital. Our cost of capital is like 11 percent. Let us use 10 percent. It is easier numbers. That means you have got to earn $7.5 billion to pay for the $75 billion. Where are you going to earn that? From the $2.5 trillion in the industry. That is 30 basis points. In today's way, it does not work.

We as an adviser in good times have revenues of 15 basis points, so the numbers just do not work.

Senator SHELBY. I understand to some extent the interest of people and the use of money market funds. You know, it works well. But I also sitting up here as a Senator want to make sure that the taxpayers do not have to bail out anybody. We have done that. We have been down that road. That is a bad road to go down, as you well know.

Mr. DONAHUE. Senator the best part of Dodd-Frank is that part that says you are not allowed to redo the insurance thing for money funds, which we did not ask for and did not want.

Senator SHELBY. Thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you.

Mr. Donahue, implicit in a lot of the questions and in the operation of the funds is that the funds are prepared and have the capacity to, at least on a temporary basis, go up and maintain the dollar NAV. Is that a fair assumption?

Mr. DONAHUE. The way I would put it is because of the construct of their portfolio, they are able to maintain a $1 NAV. But if they blow a credit and it is a franchise issue, then it is not going to be a $1 NAV. Then you are going to have the suspension of redemption and the orderly liquidation of the fund. But notice you do not have a run because you suspend the redemptions, the people do not run, and you have an orderly liquidation, which is not what happened in the Reserve case and which was improved in the 2010 amendments.

Senator REED. But here is the situation. You have a prominent fund that miscalculated, in the case of the experience in 2008 where it held assets, Reserve had assets in Lehman which were rated, I think, AAA 24 hours before they went bankrupt. So, you know, they looked pretty good. And because of the notoriety and also, I think, because of the assumption that people have that a lot of mutual funds are basically sort of—you know, their portfolios are fairly similar, that there was this run.

So, I mean, your presumption would be that in a situation, which might happen, that one fund could, in fact, break the buck, stop redemptions, and that would have no spillover effect on the funds. Is that the presumption? I just want to understand.

Mr. DONAHUE. No. What I am saying is that because of the 2010 amendments, you will not have a run in the fund that breaks the buck because you have got this other——

Senator REED. Right.

Mr. DONAHUE. Now, what has happened in the 2010 amendments is that you have more cash in the system. We are required to maintain 30 percent weekly cash when 15 percent went out and everybody is maintaining about 40. You have transparency, which is the questions you have been asking already. People know what is in the portfolio. They know whether you have this stuff. And we have a Know Your Customer requirement, which means you have got to know who is coming in and who is going out.

But more important than that, the key is do you have liquidity in the system. The problem in 2008 was there was no liquidity in the system. And when there was a deviation of net asset value in 1994, it was no harm, no foul. Why? Because there was liquidity in the system and things could work out. But when the marketplace was shut down, you had a problem.

Senator REED. But here, again, I think Senator Shelby's comments go right to the heart of what our job is. We have to contemplate, particularly after 2008, things that seem so far removed from the day-to-day practice. There is a possibility, given all these rules, that there could be a liquidity problem in the overall system, not emanating from what you are doing, but, you know, take a case where a European banking system, where political and economic problems collide, and liquidity starts freezing up, then it is not the question of how much liquidity you are holding. You just cannot get access to a sufficient liquidity to redeem, not in one fund or any fund.

Is that a possibility?

Mr. DONAHUE. That is a possibility, and specifically it is addressed by Congress in Dodd-Frank, which directs the Fed, as soon as practicable—I do not think it has been practicable yet. They are supposed to come up with rules and regulations to govern emergency lending that is supposed to "add money and liquidity to the financial system," not allowed to aid an individual company or failing financial company, and it has to be done in a way where they do not lose money, and it has to be exited quickly. P.S., that is exactly what they did with the AMLF which money funds back at that time.

Senator REED. But that essentially—I mean, we are getting to sort of what this all might ultimately rest upon—is the Federal Reserve stepping in and declaring that this is not—we know you cannot do it for an individual company, but that the potential impacts of a failing fund could trigger failures in other well-run funds; therefore, we are stepping in and using Federal resources to support. Is that, Mr. Stevens—I am just trying to figure out, you know, what is the assumption underlying——

Mr. STEVENS. Senator, if I might, what Chairman Schapiro's testimony invites is to look at all 300 of those events through the lens

of what happened in September 2008. It is true Reserve had a contagion effect on other money market funds, but it had that effect in the context of a raging epidemic in the banking system. And looking at it from the point of view of 2008, you can also look at it from the point of view of 1994. That is the only other time a fund broke a dollar. Actually, money fund assets grew that month, and the world yawned. It did not have a knock-on effect.

So I would invite you to scrutinize whether it is likely, particularly with the enormous natural liquidity in these funds today—prime money funds have today $600 billion in assets that they can liquidate within a week to meet redemptions. Whether we have done what the industry thinks we have to address in any reasonable term the kind of crisis that we might meet without—and, Senator Shelby, I agree with you—without any prospect of our going to the taxpayer again, although taxpayers paid nothing on that guarantee program, and they made a billion and a quarter.

Senator REED. But, again, I think your point is extremely well taken. You know, we cannot ignore 1994, but we cannot ignore 2008. We have to look at both.

Mr. STEVENS. Agreed.

Senator REED. We have to assess a probability. And then we also have to, I think, probe, as I have tried to do—and thank you, Mr. Donahue; you have been extremely helpful—what are the underlying assumptions if we get into a 2008. Because in the 1994 situation, the markets sort of moved forward on their own, and we just looked and nodded approvingly. But in the 2008 situation, I think we have to be very careful of probing what are the assumptions, and getting back to Senator Shelby's point, if there is one assumption that is worst, worst, worst, worst, worst, worst case, 0.000001 probability, the Fed has this general authority to come in now and move resources, at least we have to have that on the table. I think that has to be acknowledged.

Mr. STEVENS. The Fed has on numerous occasions taken steps to make sure the commercial paper markets in the United States are functioning effectively. That is its job for the future as well.

Senator REED. I just want to make sure that we all understand that it is explicit, it is not implicit, because down the road, you know, if the Fed does take a move like this, you know, I do not—I think we all want to have said, well, we knew we had that authority and this is not one of these unauthorized bailouts, et cetera. But thank you. Your testimony has been extremely helpful.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you very much, Mr. Chairman.

I would like to direct several questions to Mr. Donahue. Thanks to all of you for being here today. But the first question would be in response to Chairman Schapiro's points.

You know, one of the central arguments that she seems to be making is that the past instances in which sponsors provided some degree of voluntary support to their money funds means that these funds are not as safe as they appear. I think that is one of her central arguments. Could you respond to that premise?

Mr. DONAHUE. Yes, Senator. We create a lot of funds. I am one of 13 kids. I have eight of my own. And we create a lot of children, too, and you are forever supporting them. And so the idea that you

support funds—and you look at any other kind of products. People are supporting their products. What are they trying to do? They are making independent, voluntary, marketplace analysis and judgments about what to do with the product.

So, you know, I do not know anything about the 300 or the 200. None of that really matters. What matters is that you have good, solid people deciding whether or not and what to do to help shareholders. And I think that what the support shows is the inherent resiliency of the funds. When you have $2.6 trillion in these funds with no interest and lots of regulatory abuse, that is really an accomplishment. And it is because the people want the cash management system.

And if you talk about support in terms of what was done that the Chairman was talking about, how about the support that every single one is doing 100 percent on waiving investment advisory fees in order to keep the funds going during these low-interest times?

So I look at support as something that is not unlike having a family. You birthed the fund. Well, what are you going to do about keeping it going?

Now, we also merge funds out of existence. We buy other funds and put them out of existence. But, overall, we are trying to enhance the relationship with the clients, some of whom are at this table, in the way they deal in the marketplace.

Senator TOOMEY. So would it be fair to say that in many instances, these—many of the instances that she is citing are really manifestations of the strength of an industry rather than weakness?

Mr. DONAHUE. They are manifestations of the strength and they are manifestations of the judgment people make about why to do something. For example, there may be a reputational issue. The customers may be somewhat uncomfortable with a name, even though it is going to pay off on time and in full. There may be questions that you want to improve things. So there could be a lot of reasons. You may have individual customers that you are trying to deal with. And so there are a lot of reasons other than you had to buy the Lehman paper out for doing that. And there are different elements to it. But I think it shows a strong dynamism in the industry to be able to see the variety of moves that people have made to support these strong products.

Senator TOOMEY. The same question I have also for Mr. Donahue is that some have suggested that having a fixed net asset value is somehow unfair to investors because investors do not really understand and they think that this is really akin to a bank deposit and a guaranteed thing. That strikes me as a rather surprising argument, but it appears frequently. I think a variation on that is in Chairman Schapiro's testimony. What is your reaction to that?

Mr. DONAHUE. We have 5,000 institutional clients and millions of individual investors behind that. Most of our institutional investors deal with us in one account. I assure you they understand what a money market fund is. And if there was any good thing to come out of Reserve Fund, which there really was not, the one good thing is they realized that the investors bore the loss and there was no bailout of a money fund.

So people understand it. Fidelity has run a good survey of their retail base and said they understand what the lay of the land is. And I think one of the things about all this regulatory noise on money funds has done is re-emphasize what we put on the front page of every prospectus and every annual report, that these things are not guaranteed, they are not backed by the FDIC, and you may lose money.

Senator TOOMEY. Thanks very much. Mr. Chairman, I would just like to ask unanimous consent to submit for the record a statement from the Financial Services Institute.

Chairman JOHNSON. Without objection.

Senator TOOMEY. Thank you very much.

Ms. KOPP. Mr. Chairman, could I just add on behalf of many of the investors—we do represent millions—we do read the prospectus, and we know it is an investment. It is not a savings account. And the reforms of 2010 and the experience of 2008 I think has brought that home very clearly. So I think treating us sort of like children is really not appropriate.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. I want to be succinct. I would have so many questions for all of you, but the vote is going to expire that is presently going on. So let me concentrate on two, Mr. Donahue, that you raise in your testimony which caught my attention as I was reading it. And I am going to give you the headings, and I would like you to give me the why you make that proposition.

On page 11 [Page 116 below], you say, “Reforms currently under consideration are fundamentally at odds with the nature of money market funds and the needs of their shareholders.” Why?

Chairman JOHNSON. Excuse me. My staff is informing me that we are all needed on the floor for the first vote. Because of this, I will remind my colleagues if they have more questions for our witnesses, they can submit them for the record.

I apologize to panel two that we were unable to finish. I want to thank our witnesses for their thoughtful testimony today and their cooperation in answering the written questions that my colleagues will be sending them.

This hearing is adjourned.

[Whereupon, at 11:26 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

Today, we are here to review the current state of regulations responsible for providing stability to the money market mutual funds and protecting investors. More than 50 million municipalities, companies, retail investors, and others use money market mutual funds. There are $2.6 trillion invested in these funds, which are often viewed as convenient, efficient, and predictable for cash management, investment, and other purposes. With Americans so heavily invested in these funds this Committee has a responsibility to conduct oversight to see to it that the Securities and Exchange Commission is doing its part and has the resources and authority necessary to effectively regulate this critically important financial market.

Market uncertainty during the financial crisis in 2008 destabilized the money market mutual fund industry, prompting the Treasury Department to temporarily guarantee funds' holdings. That 1-year guarantee prevented a potential systemic run on the money market mutual fund industry.

In response, the SEC adopted significant new rules in 2010 designed to increase the funds' resilience to economic shocks and to reduce the risks of runs. The key reforms required funds to shorten maturities of portfolio holdings, increase cash holdings, improve credit quality, and report their portfolio holdings on a monthly basis.

The adoption of these rules has no doubt improved investor protection, but questions still remain about what risk the funds present to investors and the American economy, and whether more action needs to be taken to address that risk.

Some regulators and economists have raised concerns that money market funds pose significant risks to financial stability, and have argued for further structural changes in addition to the 2010 reforms. They have proposed floating the net asset value, requiring a capital buffer and imposing redemption restrictions.

At the same time, some funds and users, including municipalities, corporations and retail investors, have urged caution, arguing that further reforms should wait until the impact of the 2010 reforms can be more fully studied. They have raised concerns that new regulatory changes might increase risks or disrupt or damage their operations.

Recognizing the diversity of views on this topic, today's hearing is an opportunity to examine the SEC's current regulation of the funds, including the impact of the 2010 reforms, and to better understand whether additional regulations are needed.

Our witnesses today represent many interested parties and a broad range of perspectives, including the industry's regulator, the industry itself, users of the industry's products, and an academic expert.

I hope to hear from our witnesses about the health and stability of money market funds today, the impact of the 2010 reforms, the potential positive and negative consequences of the additional proposed reforms, and how funds have performed during recent severe economic events such as the European debt crisis.

I look forward to hearing their testimony and recommendations as we continue our rigorous oversight of the financial markets.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you, Mr. Chairman.

Today the Committee will hear a range of perspectives on money market fund reform.

Since their introduction 40 years ago, money market funds have been an important source of short-term financing for businesses, banks, and State and local governments.

Money market funds have offered investors a low-cost means to invest in money market instruments and provided them with an efficient cash management vehicle.

But, unlike other mutual funds, money market funds are permitted by the SEC to maintain a stable net asset value (NAV).

The stable NAV feature of money market funds offers investors the convenience and simplicity of buying and selling shares at a constant one-dollar per share.

However, because the market value of the instruments held by the funds can decline, the stable NAV gives the impression that money market funds are without risk and guaranteed to never "break the buck."

Indeed, investment management firms have intervened several times with capital contributions and other forms of support to prevent their money market funds from breaking the buck.

According to the SEC, U.S. money market funds received financial support from their sponsors hundreds of times before the financial crisis. During the crisis, firms provided financial support dozens of times.

One notable exception is the Reserve Primary Fund, which broke the buck in September 2008 because of its exposure to Lehman Brothers.

Shortly thereafter, the Treasury Department and the Federal Reserve, concerned about runs on money market funds, put the U.S. taxpayer in the position of guaranteeing that no other money market fund in the country would break the buck.

The Treasury Department instituted a temporary guarantee program and the Federal Reserve opened emergency lending facilities to help money market funds meet their redemption requests.

These actions have increased the expectation that the Federal Government will support the money market industry again with taxpayer dollars in times of crisis.

In 2010, the SEC adopted several rules to reduce the risk of runs on money market funds.

The rules imposed minimum liquidity requirements, higher credit quality limits, and shorter maturity limits. The SEC also imposed new stress test requirements and disclosure requirements to improve the transparency of fund portfolio holdings.

By all accounts, money market funds, thus far, have been able to withstand the ongoing European crisis without any risk of runs.

For this reason, some say that the SEC's 2010 money market reforms are sufficient.

I look forward to hearing from the two industry witnesses and the two treasurers representing users of money market funds on why they believe that additional reforms are not warranted.

Others, including Chairman Schapiro, say that the SEC's 2010 money market reforms have not gone far enough.

I would like Chairman Schapiro to tell us what analysis the SEC has done to conclude that additional reforms are necessary, and how the SEC determined that the three proposals currently under consideration—a floating NAV, redemption restrictions, and a capital buffer—are the right solutions for the problems they are intended to solve.

I also look forward to hearing from Professor Scharfstein regarding his academic group's capital buffer proposal.

The loudest voices advocating additional money market fund reforms, however, have come from inside the Federal Reserve.

Fed Chairman Bernanke, Fed Governor Tarullo, and multiple regional Fed Presidents have given speeches in which they raise the issue of so-called "structural vulnerabilities" to highlight the need for additional reform.

Further, according to the minutes of the Financial Stability Oversight Council (FSOC) meeting held last February, Fed staff participated with SEC staff in a discussion of money market funds.

Unfortunately, the Fed is not represented in today's important hearing and they should be.

Perhaps, Mr. Chairman, we can leave the record open and give the Fed an opportunity to submit testimony for the record. I would be very interested in learning what analysis it has done to conclude that additional money market reforms are necessary.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF MARY L. SCHAPIRO

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

JUNE 21, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee: Thank you for the opportunity to testify about the Securities and Exchange Commission's regulation of money market funds.[1] The risks posed by money market funds to the financial system are part of the important unfinished business from the financial crisis of 2008. One of the seminal events of that crisis occurred in September, after Lehman Brothers filed for bankruptcy and the Reserve Primary Fund "broke the buck," triggering a run on money market funds and freezing the short-term credit markets. Although the Commission took steps in 2010 to make money market funds more resilient, they still remain susceptible today to investor runs with potential systemic impacts on the financial system, as occurred during the financial crisis just 4 years ago. Unless money market fund regulation is reformed, taxpayers and markets will continue to be at risk that a money market fund can

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission.

"break the buck" and transform a moderate financial shock into a destabilizing run. In such a scenario, policy makers would again be left with two unacceptable choices: a bailout or a crisis.

My testimony today will discuss the history of money market funds, the remaining systemic risk they pose to the financial system even after the 2010 reforms, and the need for further reforms to protect investors, taxpayers and the broader financial system.

Background

Money market funds are important and popular investment products for millions of investors. They facilitate efficient cash management for both retail and institutional investors, who use them for everything from making mortgage payments and paying college tuition bills to the short-term investment of cash received through business operations until needed to fund payrolls or pay tax withholding. Money market funds bring together investors seeking low-risk, highly liquid investments and borrowers seeking short-term funding. With nearly $2.5 trillion in assets under management, money market funds are important and, in some cases, substantial providers of credit to businesses, financial institutions, and some municipalities who use this financing for working capital needs and to otherwise fund their day-to-day businesses activities.

Money market funds are mutual funds. Like other mutual funds, they are regulated under the Investment Company Act of 1940. In addition, money market funds must comply with Investment Company Act rule 2a-7, which exempts money market funds from several provisions of the Investment Company Act—most notably the valuation requirements—to permit them to maintain stable net asset values per share (NAV), typically $1.00. Under this special rule, money market funds, unlike traditional mutual funds, can maintain a stable value generally by using an "amortized cost" accounting convention, rather than market values, when valuing the funds' assets and pricing their shares. The rule essentially permits a money market fund to "round" its share price to $1.00, but requires a money market fund to reprice its shares, if the mark-to-market per-share value of its assets falls more than one-half of one percent (below $0.9950), an event colloquially known as "breaking the buck."

The Commission adopted rule 2a-7 in 1983 with the understanding that the value of the short-term instruments in which the funds invest would rarely fluctuate enough to cause the market-based value of the fund's shares to deviate materially from a fund's typical $1.00 stable value. Rule 2a-7 limits money market funds' investments to short-term, high-quality securities for this very purpose.

Despite these risk-limiting provisions, money market funds can—and do—lose value. When, despite these risk-limiting provisions, money market fund assets have lost value, fund "sponsors" (the asset managers—and their corporate parents—who offer and manage these funds) have used their own capital to absorb losses or protect their funds from breaking the buck. Based on an SEC staff review, sponsors have voluntarily provided support to money market funds on more than 300 occasions since they were first offered in the 1970s.[2] Some of the credit events that led to the need for sponsor support include the default of Integrated Resources commercial paper in 1989, the default of Mortgage & Realty Trust and MNC Financial Corp commercial paper in 1990; the seizure by State insurance regulators of Mutual Benefit Life Insurance (a put provider for some money market fund instruments); the bankruptcy of Orange County in 1994; the downgrade and eventual administrative supervision by State insurance regulators of American General Life Insurance Co in 1999; the default of Pacific Gas & Electric and Southern California Edison Co. commercial paper in 2001; and investments in SIVs, Lehman Brothers, AIG and other financial sector debt securities in 2007–2008. In part because of voluntary sponsor support, until 2008, only one small money market fund ever broke the buck, and in that case only a small number of institutional investors were affected.

The amount of assets in money market funds has grown substantially, and grew particularly rapidly during recent years from under $100 million in 1990 to almost $4 trillion just before the 2008 financial crisis. This growth was fueled largely by institutional investors, who were attracted to money market funds as apparently riskless investments paying yields above riskless rates. By 2008, more than two-thirds of money market fund assets came from institutional investors, which could wire large amounts of money in and out of their funds on a moment's notice. Some

[2] Forms of sponsor support include purchasing defaulted or devalued securities out of a fund at par/amortized cost, providing a capital support agreement for the fund, and sponsor-purchased letters of credit for the fund. Sponsor support does not include a sponsor taking an ownership interest in (i.e., purchasing shares of) a money market fund.

of these institutional assets were what are known in the business as "hot money"—assets that would be quickly redeemed if a problem arose, or even if a competing fund had higher yields. To compete for that money, some money market fund sponsors invested in new, riskier types of securities, such as "structured investment vehicles." The larger amount of assets in money market funds contributed to the likelihood that a credit event would create stresses on one or more funds, and that fund sponsors would not have access to a sufficient amount of capital to support the funds.

The 2008 Financial Crisis

Implicit sponsor support as a mechanism to maintain a stable $1.00 share price increasingly came under strain as the size of money market funds grew into a several trillion dollar industry. The Reserve Primary Fund broke the buck after it suffered losses its sponsor could not absorb. The Reserve Primary Fund, a $62 billion money market fund, held $785 million in Lehman Brothers debt on the day of Lehman Brothers' bankruptcy and immediately began experiencing a run—shareholders requested redemptions of approximately $40 billion in just two days. The Reserve Primary Fund announced that it would reprice its shares below $1.00, or break the buck.

Almost immediately, the run on the Reserve Primary Fund spread, first to the Reserve's family of money market funds, and then to other money market funds. Investors withdrew approximately $300 billion (14 percent) from prime money market funds during the week of September 15, 2008. Money market funds met those redemption demands by selling portfolio securities into markets that were already under stress, depressing the securities' values and thus affecting the ability of funds holding the same securities to maintain a $1.00 share price even if the other funds were not experiencing heavy redemptions. Money market funds began to hoard cash in order to meet redemptions and stopped rolling over existing positions in commercial paper and other debt issued by companies, financial institutions, and some municipalities. In the final two weeks of September 2008, money market funds reduced their holdings of commercial paper by $200.3 billion, or 29 percent.

Money market funds were (and are) substantial participants in the short-term markets—in 2008 they held about 40 percent of outstanding commercial paper. The funds' retreat from those markets caused them to freeze. During the last 2 weeks in September 2008, companies that issued short-term debt were largely shut out of the credit markets. Cities and municipalities that rely on short-term notes to pay for routine operations while waiting for tax revenues to be collected were forced to search for other financing. The few companies that retained access to short-term credit in the markets were forced to pay higher rates or accept extremely short-term—sometimes overnight—loans, or both. All of this occurred against the backdrop of a broader financial crisis, which was exacerbated by the growing credit crunch in the short-term markets.

More than 100 funds were bailed out by their sponsors during September 2008. But the fund sponsors were unable to stop the run, which ended only when the Federal Government intervened in an unprecedented manner. In September 2008, the Treasury Department temporarily guaranteed the $1.00 share price of more than $3 trillion in money market fund shares and the Board of Governors of the Federal Reserve System created facilities to support the short-term markets. These actions placed taxpayers directly at risk for losses in money market funds but eased the redemption pressures facing the funds and allowed the short-term markets to resume more normal operations. Because the Federal Government was forced to intervene we do not know what the full consequences of an unchecked run on money market funds would have been.

The experience of shareholders of the Reserve Primary Fund, however, is instructive about the impact of an unchecked run on investors. While some observe that shareholders in the Reserve Primary Fund ultimately "lost" only one penny per share, this ignores the very real harm that resulted from shareholders losing access to the liquidity that money market funds promise. They were left waiting for a court proceeding to resolve a host of legal issues before they could regain access to their funds. In the meantime, their ability to make mortgage payments, pay employees' salaries and fund their businesses was substantially impaired, and Reserve Fund investors were left in a sea of uncertainty and confusion. Some of their money is still waiting to be distributed.

The next run might be even more difficult to stop, however, and the harm will not be limited to a discrete group of investors. The tools that were used to stop the run on money market funds in 2008 are either no longer available or unlikely to be effective in preventing a similar run today. In September 2008, the Treasury Department used the Exchange Stabilization Fund to fund the guarantee program, but

in October 2008 Congress specifically prohibited the use of this fund again to guarantee money market fund shares.[3] The Federal Reserve Board's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), through which credit was extended to U.S. banks and bank holding companies to finance purchases of high-quality asset backed commercial paper (ABCP) from money market funds, expired on February 1, 2010. Given the significant decline in money market investments in ABCP since 2008, reopening the AMLF would provide little benefit to money market funds today. For example, ABCP investments accounted for over 20 percent of Moody's-rated U.S. prime money market fund assets at the end of August 2008, but accounted for less than 10 percent of those assets by the end of August 2011.

The 2010 Reforms

Shortly after I joined the Commission in 2009, I asked the Commission's staff to prepare rulemaking designed to address concerns about money market funds revealed by the 2007–2008 crisis. The staff, with assistance from a report prepared by the money market fund industry, quickly identified some immediate reforms that would make money market funds more resilient. I am proud of this initial reform effort, but it is important to recognize what it did and did not do. The initial reforms, adopted and implemented in 2010, were designed to reduce the risks of money market funds' portfolios by reducing maturities; improving credit standards; and, for the first time, mandating liquidity requirements so that money market funds could better meet redemption demands. The new reforms also required money market funds to report comprehensive portfolio and "shadow NAV" information to the Commission and the public.

The 2010 rules made money market funds more resilient in the face of redemptions by requiring them to increase the liquidity of their portfolios. But the amendments did not (1) change the incentives of shareholders to redeem if they fear that the fund will experience losses; (2) fundamentally change the dynamics of a run, which, once started, will quickly burn through the additional fund liquidity; (3) prevent early redeeming, often institutional investors from shifting losses to remaining, often retail investors or (4) enable money market funds to withstand a "credit event" or the loss in value of a security held by a money market fund, precisely what triggered the run on the Reserve Primary Fund.

That money market funds were able to meet redemptions last summer when the markets were under stress suggests the 2010 reforms have helped address the risks they were designed to address. However, the reforms were not designed to address the structural features of money market funds that make them susceptible to runs, and the heavy redemptions of 2011 were (1) substantially less than in 2008, (2) made over a longer period of time, and (3) not accompanied by losses in fund portfolios. During the 3-week period beginning June 14, 2011, investors withdrew approximately $100 billion from prime money market funds. In contrast, during the 2008 financial crisis, investors withdrew over $300 billion from prime money market funds in a few days. These are significant differences. If there had been real credit losses last summer, the level of redemptions in some funds could very well have forced a money market fund or funds to break the buck, leading to the type of destabilizing run experienced in 2008.

The events of last summer demonstrate that money market fund shareholders continue today to be prone to engage in heavy redemptions if they fear losses may be imminent. About 6 percent of prime fund assets were redeemed during a 3-week period beginning June 14, 2011, and one fund lost 23 percent of its assets during that period even though the funds involved had not experienced any losses. The incentive to run clearly remains in place notwithstanding the 2010 reforms.

Susceptibility to Runs

Money market funds are vulnerable to runs because shareholders have an incentive to redeem their shares before others do when there is a perception that the fund might suffer a loss. Several features of money market funds, their sponsors, and their investors contribute to this incentive.

Misplaced Expectations. The stable $1.00 share price has fostered an expectation of safety, although money market funds are subject to credit, interest-rate, and liquidity risk. Recurrent sponsor support has taught investors to look beyond disclosures that these investments are not guaranteed and can lose value. As a result,

[3] *See,* Emergency Economic Stabilization Act of 2008, Public Law 110-343, 122 Stat. 3765 §131 ("The Secretary is prohibited from using the Exchange Stabilization Fund for the establishment of any future guaranty programs for the United States money market mutual fund industry.").

when a fund breaks a dollar, investors lose confidence and rush to redeem. Not only did large numbers of investors redeem their shares from The Reserve Primary Fund that held Lehman Brothers commercial paper, they also redeemed from other Reserve money market funds that held no Lehman Brothers paper, including a Government fund.

First Mover Advantages. Investors have an incentive to redeem at the first sign of problems in a money market fund. An early redeeming shareholder will receive $1.00 for each share redeemed even if the fund has experienced a loss and the market value of the shares will be worth less (e.g., $0.998). By taking more than their pro rata share of the assets, these redemptions at $1.00 per share concentrate losses in the remaining shareholders of a fund that is now smaller.[4] As a result a small credit loss in a portfolio security, if accompanied by sufficient redemptions, can threaten the fund with having to break the buck.

Moreover, early redeemers tend to be institutional investors with substantial amounts at stake who can commit resources to watch their investments carefully and who have access to technology to redeem quickly. This can provide an advantage over retail investors who are not able to monitor the fund's portfolio as closely. As a consequence, a run on a fund will result in a wealth transfer from retail investors (including small businesses) to institutional investors. This result is inconsistent with the precepts of the Investment Company Act, which is based on equal treatment of shareholders.

Mismatch of Assets and Liabilities. Finally, money market funds offer shares that are redeemable upon demand, but invest in short-term securities that are less liquid. If all or many investors redeem at the same time, the fund will be forced to sell securities at fire sale prices, causing the fund to break a dollar, but also depressing prevailing market prices and thereby placing pressure on the ability of other funds to maintain a stable net asset value. A run on one fund can therefore create stresses on other funds' ability to maintain a $1.00 stable net asset value, prompting shareholder redemptions from those funds and instigating a pernicious cycle building quickly towards a more generalized run on money market funds.

Given the role money market funds play in providing short-term funding to companies in the short-term markets, a run presents not simply an investment risk to the fund's shareholders, but significant systemic risk. No one can predict what will cause the next crisis, or what will cause the next money market fund to break the buck. But we all know unexpected events will happen in the future. If that stress affects a money market fund whose sponsor is unable or unwilling to bail it out, it could lead to the next destabilizing run. To be clear, I am not suggesting that any fund breaking the buck will cause a destabilizing run on other money market funds—it is possible that an individual fund could have a credit event that is specific to it and not trigger a broad run—only that policy makers should recognize that the risk of a destabilizing run remains. Money market funds remain large, and continue to invest in securities subject to interest rate and credit risk. They continue, for example, to have considerable exposure to European banks, with, as of May 31, 2012, approximately 30 percent of prime fund assets invested in debt issued by banks based in Europe generally and approximately 14 percent of prime fund assets invested in debt issued by banks located in the eurozone.

Additional Needed Reforms

The Commission staff currently is exploring a number of structural reforms, including two in particular that may be promising. The first option would require money market funds, like all other mutual funds, to buy and sell their shares based on the market value of the funds' assets. That is, to use "floating" net assets values. Such a proposal would allow for public comment on whether requiring money market funds to use floating NAVs would cause shareholders to become accustomed to fluctuations in the funds' share prices, and thus less likely to redeem en masse if they fear a loss is imminent, as they do today. It would also treat all investors more fairly in times of stress.

A second option would allow money market funds to maintain a stable value as they do today, but would require the funds to maintain a capital buffer to support

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[4] Assume, for example, a fund with 1,000 shares outstanding with two shareholders, A and B, each of which owns 500 shares. An issuer of a security held by the fund defaults, resulting in a 25 basis point loss for the fund—a significant loss, but not one that is large enough to force the fund to break the buck. Shareholder A, aware of a problem and unsure of what shareholder B will do, redeems all of his shares and receives $1.00 per share even though the shares of the fund have a market value of $0.998. The fund now has only 500 shares outstanding, but instead of a 25 basis point loss has a 50 basis point loss and will have broken the buck. Shareholder A has effectively shifted his losses to Shareholder B.

the funds' stable values, possibly combined with limited restrictions or fees on redemptions. The capital buffer would not necessarily be big enough to absorb losses from all credit events. Instead, the buffer would absorb the relatively small mark-to-market losses that occur in a fund's portfolio day to day, including when a fund is under stress. This would increase money market funds' ability to suffer losses without breaking the buck and would permit, for example, money market funds to sell some securities at a loss to meet redemptions during a crisis.

As described above, many money market funds effectively already rely on capital to maintain their stable values: hundreds of funds have required sponsor bailouts over the years to maintain their stable values. Requiring funds to maintain a buffer simply would make explicit the minimum amount of capital available to a fund. Today, in contrast, an investor must wonder whether a sponsor will have the capital to bailout its fund and, even if so, if the sponsor will choose to use it for a fund bailout.

Limits on redemptions could further enhance a money market fund's resiliency and better prepare it to handle a credit event. Restrictions on redemptions could be in several forms designed to require redeeming shareholders to bear the cost of their redemptions when liquidity is tight. Redemption restrictions could be designed to limit any impact on day-to-day transactions.

These ideas and others are the subject of continuing analysis and discussion at the Commission. If the Commission were to propose further reforms, there will, of course, be an opportunity for full public consideration and comment. In addition to a detailed release seeking comment on the likely effectiveness and impacts of the proposed reforms, the proposal will also include a discussion of their benefits, costs, and economic implications.

Conclusion

In closing, money market funds as currently structured pose a significant destabilizing risk to the financial system. While the Commission's 2010 reforms made meaningful improvements in the liquidity of money market funds, they remain susceptible to the risk of destabilizing runs. Thank you for the opportunity to testify on this important issue. I am happy to answer any questions that you might have.

PREPARED STATEMENT OF NANCY KOPP

TREASURER, STATE OF MARYLAND

JUNE 21, 2012

Introduction

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for providing the National Association of State Treasurers (NAST) the opportunity to testify on the issue of money market mutual funds (MMFs). It is an honor and a privilege to be here today. I am Nancy Kopp, the Treasurer for the State of Maryland and chair of the NAST Legislative Committee.

NAST is a bipartisan association that is comprised of all State treasurers, or State finance officials with comparable responsibilities, from the United States, its commonwealths, territories, and the District of Columbia.

I appreciate this timely hearing appropriately named "Perspectives on Money Market Reforms" as I can assure you State Treasurers have a unique perspective given their important role within the States of ensuring proper cash flow management.

The Importance of Money Market Funds to the States

MMFs are a vital cash management tool for State Governments, their political subdivisions, and their respective instrumentalities, all of which rely upon them to manage short-term investments that provide ready liquidity, preservation of capital, and diversification of credit. There are few options that have the multiple features of safety, return, liquidity and stable market history as MMFs and that is why so many States and local governments choose this product for their short- and mid-term investing and cash management needs. Additionally, States rely on MMFs to buy short term securities issued by States, local governments, and authorities. MMFs are by far the largest purchasers of these bonds, and if capitalization requirements and other restrictions put limits on their investment capital their demand for these bonds will decrease, and costs to issue these bonds—borne at the expense of taxpayers—would rise.

NAST Support for SEC Changes to Rule 2a-7 in 2010

Before the proposed SEC regulations are discussed, it is important to note that NAST is on record supporting the amendments to Rule 2a-7 adopted by the SEC in 2010. The regulation of MMFs was brought under scrutiny by regulators following the Reserve Primary Fund's NAV dropping below $1.00, or "breaking the buck", during the global financial crisis of 2008. The SEC appropriately responded by amending Rule 2a-7 which strengthened MMFs by increasing liquidity and credit quality requirements, enhanced disclosures to require reporting of portfolio holdings monthly to the Commission, shortened portfolio maturities, and permitted a suspension of redemptions if a fund has broken the buck or is at imminent risk of breaking the buck.

NAST believes the Commission's amendments to Rule 2a-7 finalized on May 5, 2010, have made MMFs more transparent, less subject to interest rate risk, more creditworthy and less susceptible to redemption demand pressure during periods of stress in the financial markets. However, we are concerned that some Commissioners and members of the staff, as well as other Federal regulators and officials, have publicly indicated support for further amending Rule 2a-7 without taking into consideration the effectiveness of the 2010 amendments. Such potential changes to Rule 2a-7 that have been discussed recently include restrictions on the redemption of MMF shares by investors, requiring MMFs to adopt a floating daily net asset value (NAV), and/or mandating that MMFs hold levels of capital similar to banking institutions.

In March 2012 at the NAST Federal Affairs Conference, NAST passed its Federal Securities Regulation of Money Market Mutual Funds Resolution which is included as an attachment to this testimony. Specifically, there are three purported proposals from the SEC that cause us concern:

Changing From a Stable NAV to a Floating NAV Feature

State Treasurers recognize that a floating NAV would increase accounting work tremendously because it would require the daily booking of the mark-to-market value of each fund. Being able to currently book the value of the fund as a dollar in equals a dollar out without having to note the daily fluctuations of its worth, is invaluable. When many Governments are hard pressed to hire teachers and public safety officers, it is difficult to see how States would be able to appropriate funds for more accountants to do this work, which in the end, would be of no value to the overarching issue as to whether it would prevent a run on these funds. If the stable NAV is changed to a floating NAV, we will have to look to other investment products to avoid unnecessary accounting burdens. It is important to note that a floating NAV would have negligible day-to-day changes, but the accounting for these changes is significant. In addition, many government jurisdictions are required by statute to invest only in products with a stable NAV like MMFs. If the SEC changes the NAV to a floating feature, these jurisdictions would be forced to find alternative investments that are not as attractive as MMFs for a variety of reasons discussed in this testimony.

The Importance of Liquidity

Another important feature of these funds is their liquidity. Often State and local governments receive payments that can be placed in a fund, sometimes as briefly as one night, because the funds are needed in the morning. This feature allows State and local governments to place these monies in a safe environment while still earning interest for the taxpayers. Often payments come in later in the day and no other product offers the ability to make an investment later in the day, including bank deposits. It is this key cash management tool, which attracts so many Governments—and other businesses—to these funds.

Placing Capital Requirements on Funds

The SEC is also looking at the possibility of placing capital requirements on MMFs to be held against a possible run on MMFs. Again, Treasurers are concerned that the additional costs of MMF operations could result in lower yields—or eliminate these funds altogether—and would push Treasurers into using other less attractive investment alternatives. It is also unlikely that placing capital requirements on these funds will actually prevent a run on these products, or otherwise truly benefit the market.

Placing Redemption Requirements on Funds

As discussed previously, Treasurers use MMFs to move money in and out on a daily basis in order to meet their cash management needs. Requirements that would limit the amount that could be withdrawn from a Government's MMF account would be highly disruptive. If money is held back or delayed, State Treasurers

would have to then create a system and use precious resources to track these holdbacks and have to plan for the future accordingly. If this becomes a requirement, Treasurers will seek other investments to find more reliable forms of liquidity. Additionally, this could be especially problematic for smaller Governments whose investments may not be large enough to buffer these requirements, and who need access to the full value of their account in order to make various payments, including payroll.

State and Local Governments Organizations Standing Together

On March 8, 2012, NAST joined 13 other organizations representing State and local governments in a joint letter to each of the SEC Commissioners expressing concern over potential regulations presently being considered. These organizations include the:

- American Public Power Association
- Council of Development Finance Agencies
- Council of Infrastructure Financing Authorities
- Government Finance Officers Association
- International City/County Management Association
- International Municipal Lawyers Association
- National Association of Counties
- National Association of Health and Educational Facilities Finance Authorities
- National Association of Local Housing Financing Agencies
- National Association of State Auditors, Comptrollers and Treasurers
- National Association of State Treasurers
- National Council of State Housing Agencies
- National League of Cities
- U.S. Conference of Mayors

The letter was intended to make clear to the SEC how vital MMFs are for members of the listed organizations who utilize MMFs on a daily basis. The cosigners also supported the changes to SEC Rule 2a-7 in 2010 and would support initiatives that would strengthen MMFs and ensure investors are investing in high-quality securities. However, these State and local organizations all recognized that if the discussed SEC regulations were to require a floating NAV, it very well could preclude State and local governments' ability to invest in these securities. As the cosigning organizations include issuers of municipal securities, a further concern that the SEC regulations would "dampen investor demand for the bonds we offer and therefore increase costs for the State and local governments that need to raise capital for the vital infrastructure and services."

A letter to this Committee, outlining our concerns about possible changes to MMFs from the State and local government community, including NAST, is also included in this testimony.

Effect on the Municipal Securities Market

Money Market Mutual Funds are by far the largest purchaser of short term municipal debt. If investors no longer use MMFs, then these funds will not have the same purchasing power to buy our debt. That would create a negative situation for State and local governments—a decrease in demand for our debt means the cost of issuing that debt will increase, on top of the likely increase in fees that would occur if Governments would no longer be able to use MMMFs for their investment and cash management purposes.

Finding Alternative Investments if MMFs Are Not Viable

One question that must be answered is why State Treasurers utilize MMFs rather than bank deposits or investing directly in commercial paper. First, Treasurers, as financial stewards of their respective States, have been able to use the well regulated MMFs to improve return. Banks are paying very little on deposits and deposits are only insured up to $250,000. First tier commercial paper that is not asset-backed pays slightly more than deposits, but less than MMFs. Commercial paper also has transaction costs, custodial fees, less flexibility, and importantly lacks the liquidity of MMFs as it does not have an active secondary market. Finally, one critical distinction to be made between MMFs and commercial paper is that MMFs allow for greater diversity of exposure and lower credit risk. The same cannot be said of commercial paper since it is an individual security with risked based on that security alone. If, for example, a State had purchased Lehman Brothers commercial

paper in 2008 as an alternative to MMFs, it would have had to absorb the entire loss of that particular holding.

Treasurer Kopp, State Treasurer of Maryland, Utilization of PMMF's

As Treasurer of Maryland I would like to convey how important MMFs are to States that utilize MMF's by showing how MMFs are used in my State. The State of Maryland uses MMFs to achieve the most efficient liquidity while earning a modest return like most other governmental entities throughout the Nation. The State of Maryland averages between $250 and $350 million in MMFs deposits on a daily basis for the operating fund depending on the fiscal year cycle. The State Debt and Lease programs average an additional $100 million invested in MMFs. The Maryland Local Government Investment Pool (LGIP) averages between $250 and $350 million in MMF deposits on a daily basis depending on the total size of the pool which varies from $2.5 billion to $3.5 billion, again depending on fiscal year cycle and available competing options. The Maryland State Retirement System had $1.569 billion of the $36.2 billion invested in MMFs as of May 31, 2012. Through the years the State has relied on MMFs for a safe place to put unexpected deposits that arrive late in the day until a more appropriate investment can be purchased and for daily liquidity for unexpected outflows or to cover failed delivery of expected incoming funds.

In 2008, the State of Maryland had over $230 million invested in The Reserve Primary Fund. As we monitored the economic conditions and the Reserve Prime Fund Portfolio, we determined that the risk of the Primary Fund was more than we desired. So we transferred our investment into the Reserve Government Fund. When the Reserve Primary Fund "broke the buck" on September 16, 2008, our funds were safely invested in the Government Fund. We had read the prospectus and knew that MMFs had the option to delay return of investments in dire economic circumstances. Therefore, we were prepared to wait for our investment to be returned. Our total Reserve Government Fund investment was returned January 21, 2009, with interest. We had invested in the fund that matched our risk tolerance.

The 2010 SEC reforms to MMFs were most welcome and thorough. Our research of MMF portfolios (we are always looking for better investment opportunities) has shown that since the implementation of the enhancements overall, MMFs are safer and the participants are more aware of the risks as well as the benefits of investing in these instruments. While recognizing the importance of preventing systemic and or idiosyncratic events, the stable NAV is critical to State and local government participation. As Washington State Treasurer James Mcintire pointed out in his letter to the SEC on November 15, 2011, "Many local communities and special districts lack the financial management and accounting resources to properly equip them to invest in floating NAV funds." During the Government Finance Officers Association's Conference in Chicago last week, the almost unanimous consensuses was that if MMFs have floating NAVs most Government entities will have to pull their money out. All are struggling with budget issues and do not have the resources to enhance personnel or systems to accurately account for a floating NAV. This will put further strains on their cash management. Furthermore, the banking system is not prepared to accept these additional deposits.

Conclusion

NAST believes that any of the suggested reforms mentioned above may further lead to a contraction in the availability of short-term financing and adversely affect the investment choices of public funds and the continued ability of State Governments, their political subdivisions and their respective instrumentalities to obtain financing to support the implementation of a wide variety of public initiatives. In effect, these regulations will increase costs and will not have the intended effect of making MMFs more stable. Of course, additional costs will be paid by investors and issuers alike, including the States and their taxpayers.

Many State Treasurers also manage LGIPs, which are pooled investment funds operated for the benefit of State or local government units. By pooling assets from numerous State and local government entities, LGIPs offer economies of scale, liquidity, and diversification, thereby reducing costs for them and ultimately for taxpayers. While LGIPs are not governed by Commission and Rule 2a-7, the investment guidelines for LGIPs typically track the Rule 2a-7. Therefore, any changes to MMF rules would also impact the governmental entities that invest in LGIPs.

As State Government officials, State Treasurers have enormous respect for and appreciate the responsibilities facing Government officials and regulators. No investor or Government official wants to again go through an experience as challenging as the financial crisis in 2008. However, the rationale for changing MMF regulation should be informed by the effectiveness of the amendments to Rule 2a-7 adopted in

2010 as well as the impact such changes may have on State and local governments. We are also concerned about how the changes would impact the ability of States to manage LGIPs.

These changes would simply increase costs to taxpayers by both taking away a key investment and cash management tool used by thousands of Governments, and possibly curtailing or eliminating the largest purchaser of short term municipal debt. Both of these scenarios would be the outcome of changing the stable NAV to a floating NAV, and one the National Association of State Treasurers would hope leaders in Washington, would try to avoid.

FEDERAL SECURITIES REGULATION OF MONEY MARKET MUTUAL FUNDS

WHEREAS, State governments, their political subdivisions and their respective instrumentalities rely upon money market mutual funds to manage short-term investments that provide ready liquidity, preservation of capital, and diversification of credit exposure; and

WHEREAS, State governments, their political subdivisions and their respective instrumentalities rely upon money market mutual funds to purchase municipal securities to provide financing to nonprofit and for profit private corporations for the purpose of funding actions by such private corporations that implement a wide variety of public policies (e.g. economic development, education, healthcare, housing, and transportation); and

WHEREAS, money market mutual funds regulatory structure were brought under scrutiny by regulators following the Reserve Primary Fund's net asset value dropping below $1.00 or "breaking the buck" during the global financial crisis of 2008 as liquidity pressures and investor anxiety spread across the financial markets and led to large redemptions from money market mutual funds; and

WHEREAS, the Securities and Exchange Commission (the "Commission") acted in response by amending rule 2a-7 (Release No. IC-29132; File Nos. S7-11-09, S7-20-09) ("Final Rule") under the Investment Company Act of 1940, effective May 5, 2010 to include requirements that money market mutual funds hold 10% of assets in daily liquid securities, hold 30% of assets in weekly liquid securities, shorten weighted average maturity from 90 days to 60 days, create a weighted average life for securities of no more than 120 days, hold no less than 97% of assets in first tier securities, hold no more than 5% of assets in illiquid securities, disclose holdings monthly to the Commission and to a publicly available website; and

WHEREAS, Several Commissioners and members of the staff have publicly indicated support for further amending rule 2a-7 to include consideration of new regulations that would impose restrictions on the redemption of money market mutual fund shares by investors, require money market mutual funds to adopt a floating daily net asset value, or mandate that money market mutual funds hold high levels of capital similar to banking institutions; and

WHEREAS, many of the suggested reforms would adversely affect the investment capabilities of public funds and the continued ability of State governments, their political subdivisions and their respective instrumentalities to obtain financing to support the implementation of a wide variety of public initiatives and may further lead to a contraction in short-term financing capabilities; and

WHEREAS, State Treasurers manage State Pooled Investment Funds and Local Government Investment Pools and if required to comply with new requirements and incur additional costs of compliance such costs would be paid by the states or passed on to the local governments.

WHEREAS, certain State Treasurers who manage 2a7-like State Pooled Investment Funds and Local Government Investment Pools would be required to comply with new requirements and incur additional costs of compliance and such costs would be paid by the states or passed on to the local governments.

NOW, THEREFORE BE IT RESOLVED, by the National Association of State Treasurers:

1. NAST believes the Commission's amendments to rule 2a-7 finalized on May 5, 2010 have made money market mutual funds more transparent, less subject to interest rate risk, more creditworthy and less susceptible to redemption demand pressure during periods of stress in the financial markets and ***supports*** the Commission's preservation of a stable $1.00 net asset value money market mutual fund; and

2. NAST ***opposes*** additional regulatory changes to money market mutual funds that would alter the structure of the product in such a way that would result in less liquidity, less diversification of holdings, increases in fund administration costs, decreases in net yield, or would prevent public investors from utilizing money market mutual funds with stable net asset values; and

3. NAST ***opposes*** additional regulatory changes to money market mutual funds that would destabilize financial markets, and lead to large outflows from money market mutual funds which in turn would increase the concentration of risk among fewer institutions as well as result in an increase in financing costs for issuers of municipal securities; and

4. NAST ***opposes*** additional regulations that would adversely affect the operation of 2a7-like State Pooled Investment Funds and Local Government Investment Pools by requiring a floating net asset value with the consequence for shareholders being the uncertainty of daily liquidation value or by promulgating other requirements resulting in additional compliance costs, those costs having to be paid by state governments or passed on to local governments and political subdivisions.

Approved this 19 Day of March, 2012, by the
National Association of State Treasurers

Hon. Kate Marshall
NAST President
Nevada State Treasurer

THE BOND BUYER

THE DAILY NEWSPAPER OF PUBLIC FINANCE

Treasurers: Proposed SEC Money Fund Regs Bad For Municipalities

Tuesday, May 29, 2012

By Kate Marshall, Manju Ganeriwala and Richard Ellis

As stewards of our states' coffers, state treasurers are tasked with managing and protecting the financial resources of our taxpayers.

In carrying out these responsibilities, like many individuals and families in this country, we rely heavily on money market mutual funds. We use money funds because they are an important investment tool as they provide ready liquidity, preservation of capital and diversification of credit exposure.

That is why state treasurers are so concerned about proposals in Washington that would sharply reduce the ability of money market funds to help manage our states' day-to-day finances, and could spell the end of this product.

In 2010, the Securities and Exchange Commission adopted regulations that enhanced the liquidity of money market funds while greatly reducing interest rate and credit risks. The National Association of State Treasurers applauded these changes as appropriate in the wake of lessons learned from the financial crisis.

However, recent reports indicate the SEC may issue additional proposals that would change the nature of money market funds by mandating that the funds adopt a daily floating net-asset value rather than the current stable $1 per share value.

Money market funds are able to maintain this $1 per share stable value by making a wide range of very low risk, short-term investments whose value is unlikely to decrease.

But under the SEC's proposal, money funds would be required to "float," or modify the price of the funds every day, so with a $100 investment, on some days you may get a little bit less than $100. While the variations would be small – less than half a penny per dollar – it would cause most investors who rely on getting every dollar back to stop using money funds.

Simply put, this proposal could have very negative consequences for already cash-strapped state governments.

The stable net-asset value is a fundamental feature of money market funds that lets us know that practically speaking, for each dollar we place in these funds we will get at least $1 back when we withdraw public monies. This simple and direct valuation method has made money market funds a critical investment tool for state treasurers and U.S. investors for more than four decades.

A second SEC proposal would require holding back some of the taxpayers' funds invested in money market funds for 30 or more days before we could retrieve those funds. We move money in and out of money market funds on a daily basis. A required hold-back of invested funds reduces or eliminates the efficiency of these as an investment tool and would impose significant accounting and regulatory burdens while offering no further reduction in the risks of money market funds.

Many state treasurers also manage state pooled investment funds and local government investment pools, which resemble money market funds and function as safe and essential short-term investment of funds for

both state and local governments. If these funds are required to conform to new regulations, the additional costs of compliance will be borne by the states or passed on to local governments.

If adopted, these proposed changes may well shrink the money fund industry and the participants who rely on it due to the uncertainties of daily mark to market and full liquidity.

If so, an important part of the investing and financing market will disappear, with investors left to search for other, perhaps riskier alternatives and borrowers forced to obtain credit at more expensive rates.

We appreciate the continual efforts to learn from and work to avoid a repetition of all aspects of the 2008 financial crisis. But we have an obligation to speak out when regulation goes too far.

For these reasons, at its 2012 Legislative Conference in Washington, D.C., the NAST unanimously adopted a resolution opposing these additional changes and will continue to work with the SEC to support appropriate regulation of money market funds.

We fully supported the 2010 regulations that helped make these investment vehicles the highly regulated, low-risk products that they are today. Those reforms fostered transparency, mandated higher credit quality and enhanced liquidity, thereby ensuring funds can weather periods of extreme market turbulence. In so doing, the new regulations have already achieved the effect of minimizing pricing fluctuations due to changes in interest rates and credit quality.

The proposed changes by the SEC add nothing to this but an undue regulatory burden.

Kate Marshall is the treasurer of Nevada and president of the National Association of State Treasurers. Manju Ganeriwala is the treasurer of Virginia and senior vice president of NAST. Richard Ellis is the treasurer of Utah and secretary-treasurer of NAST.

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American Public Power Association
Council of Development Finance Agencies
Council of Infrastructure Financing Authorities
Government Finance Officers Association
International City/County Management Association
International Municipal Lawyers Association
National Association of Counties
National Association of Health and Educational Facilities Finance Authorities
National Association of Local Housing Financing Agencies
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National Council of State Housing Agencies
National League of Cities
U.S. Conference of Mayors

March 8, 2012

The Honorable Mary L. Schapiro
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: SEC Activities related to Money Market Mutual Funds

Dear Chairman Schapiro:

The organizations listed above representing state and local governments would like to bring to your attention the vital role money market mutual funds (MMMFs) play for our members. As we have stated in previous comments to the Securities and Exchange Commission, notably to proposed changes to SEC Rule 2a-7 in 2010, we support initiatives that would strengthen money market funds and ensure investors are investing in high-quality securities. However, we are alarmed by recent reports that the SEC may alter the nature of these products and eliminate or impede state and local governments' ability to invest in these securities. As issuers of municipal securities, we also are concerned that such changes would dampen investor demand for the bonds we offer and therefore increase costs for the state and local governments that need to raise capital for the vital infrastructure and services they provide to their citizens.

The possibility of changing the stable net asset value (NAV) – the hallmark of money market funds – to a floating net asset value greatly concerns us. Such a move would be very harmful to state and local governments and the entire MMMF market. The fixed NAV is the fundamental feature of money market funds. Forcing funds to float their value likely would eliminate the market for these products by forcing many investors, including state and local governments, to divest their MMMF holdings, and discouraging others from using these funds.

As investors, many state and local governments look to MMMFs as an integral part of their cash management practice. In the third quarter of 2011, state and local governments held $86 billion in MMMFs. The Government Finance Officer Association's Best Practice "Using Mutual Funds for Cash Management Purposes" encourages governments to look to money market funds for short-term investments, with appropriate cautions. Many governments have specific policies or statutes that mandate investing in financial products with stable values, and

money market funds are the investments used to ensure compliance with these state and local laws and policies. MMMFs are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked. If the SEC were to adopt a floating NAV for MMMFs, we expect that most if not all of our organizations' members would divest a significant percentage of their investments in MMMFs and would be forced to look at competing products that could be more susceptible to market conditions, more difficult to account for and manage, and may pose market risk. That would contrast sharply with the SEC's goals, particularly since many of those competing products don't provide investors with the same transparency and comprehensive regulatory protections as MMMFs.

In addition to their important investment purpose, MMMFs also are related to the municipal bond market. Money market funds are the largest investor in short-term municipal bonds: with $288 billion in assets, tax-exempt money market funds hold 57% of all outstanding short-term municipal debt. Changing the NAV from fixed to floating would make MMMFs far less attractive to investors, thereby limiting money market funds' ability to purchase municipal securities. Such a decrease in demand would lead to higher debt issuance costs for many state and local governments across the country.

Any effort by the SEC to fundamentally change the DNA of MMMFs would have an extremely disruptive effect on the investing market as well as the municipal bond market. This ultimately could cost state and local governments millions of dollars, as they would have to turn to more costly – and/or more risky – investments as well as face higher costs for issuing debt due to shrinking demand for the market.

We hope that you and other members of the Commission will carefully weigh the negative effects that fundamental changes to MMMFs would have on the various markets. We hope you will also consider the effects of the comprehensive amendments to Rule 2a-7 adopted in January 2010, because the enhanced liquidity and transparency fostered by these changes appear to have helped MMMFs weather recent periods of market turbulence without incident or systemic risk. It is difficult to understand why the SEC, having already completed comprehensive reforms of Rule 2a-7 that enhanced the value of MMMFs to investors and the economy, would now consider additional changes that would have such a disruptive effect for so many, including state and local governments.

If you have any questions about this letter, please contact Susan Gaffney, Director of the Government Finance Officers Association's Federal Liaison Center at 202-393-8468.

Sincerely,

American Public Power Association, Amy Hille
Council of Development Finance Agencies, Toby Rittner
Council of Infrastructure Financing Authorities, Rick Farrell
Government Finance Officers Association, Susan Gaffney
International City/County Management Association, Beth Kellar
International Municipal Lawyers Association, Chuck Thompson
National Association of Counties, Mike Belarmino
National Association of Health and Educational Facilities Finance Authorities, Chuck Samuels
National Association of Local Housing Financing Agencies, John Murphy
National Association of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou
National Association of State Treasurers, Jon Lawniczak
National Council of State Housing Agencies, Garth Rieman
National League of Cities, Lars Etzkorn
U.S. Conference of Mayors, Larry Jones

PREPARED STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT AND CHIEF EXECUTIVE OFFICER, INVESTMENT COMPANY INSTITUTE

JUNE 21, 2012

Opening Statement

Good morning, Chairman Johnson, Senator Shelby, and Members of the Committee. I very much appreciate the opportunity to appear today to offer ICI's perspective on the State of the money market fund industry.

For almost 5 years, ICI has been deeply engaged in analysis and discussion of events in the money market and the role of money market funds. We take pride in the fact that our engagement helped produce the first comprehensive regulatory reforms for any financial product in the wake of the crisis—five months before the Dodd-Frank Act was passed.

The reforms for money market funds in 2010 benefit investors and the economy by raising credit standards and shortening maturities for funds' portfolios.

They remove incentives for investors to redeem rapidly, by increasing transparency of fund holdings and authorizing an orderly liquidation if a fund risks breaking the dollar.

And those reforms sharply reduce the spillover effects of money market fund redemptions on the broader markets. As of December 2011, prime money market funds held $660 billion in assets that would be liquid within a week—more than twice the amount that investors redeemed from prime funds in the week of September 15, 2008. Today, prime funds keep more than 30 percent of their assets in liquidity buffers composed primarily of Treasury and Government securities and repurchase agreements—precisely the instruments investors were seeking in 2008.

We didn't have to wait long to put these reforms to the test. In the summer of 2011, markets were rattled by three significant events: the eurozone crisis; the showdown over the U.S. debt ceiling; and the historic downgrade by Standard & Poor's of U.S. Government long-term debt.

Money market funds did indeed see large redemptions. From early June to early August, investors withdrew 10 percent of their assets from prime money market funds—$172 billion in all. During the debt-ceiling crisis, prime and Government funds together saw an outflow of $114 billion in just 4 trading days.

But this withdrawal from money market funds had no discernable effects at all—either on the funds or on the markets. From April through December, prime money market funds kept their daily liquidity at more than twice the required level, and weekly liquidity stayed one-third to one-half higher than required.

Among the prime funds with the greatest exposure to European financial institutions, the average mark-to-market price of their shares fell by nine-tenths of a basis point. On a $1.00 fund share, that's nine one-thousandths of a penny.

It's clear from this experience that the reforms of 2010 have worked—and that money market funds today are a fundamentally different product than in 2008.

Unfortunately, that message hasn't gotten through to the regulatory community. They tell us that money market funds are "susceptible" to runs. They're worried that the Government can't "bail out" these funds in a future crisis.

Both of these statements are based in myths.

Let's look at September 2008. Regulators talk about the "contagion" from Reserve Primary's failure. But Reserve Primary broke the dollar in the middle of a raging epidemic of bank failures. In the turmoil, banks were refusing to lend to each other, even overnight.

Two things stand out. First, Reserve Primary's breaking the dollar did not trigger the tightening of the commercial paper market—investors of all types began abandoning that market days before Reserve Primary failed. Second, investors did not flee from the money market fund structure. Rather, they fled from securities of financial institutions and sought the refuge of U.S. Treasury securities—by buying shares in money market funds invested in Government securities. Assets of taxable funds—prime and Government—declined by only 4 percent in the week of September 15.

The Treasury and the Federal Reserve stepped in to restore the financial markets. Let me be clear: money market funds received no financial support from the Federal Government. The Treasury guarantee program never paid a dime in claims—instead, it collected $1.2 billion for the taxpayers. It's quite a stretch to call that a "bailout." The Federal Reserve's facilities were designed to use money market funds to access the markets and pump in needed liquidity. That's Central Banking 101.

Our shareholders realize that money market funds are investments—and they bear the risk of loss. No one in the investment community believes that these funds

carry a Government guarantee—and no one in our industry wants one. Period—full stop.

In conclusion, let me address the issue of sponsor support for funds. Since the 1970s, advisers to money market funds have on occasion chosen to address credit or valuation issues in their portfolios and support their funds. They did so with private resources—not taxpayer dollars. And they did so for business interests—to protect their brand or preserve their fund's rating.

The SEC hasn't released any data to back its claims about sponsor support. We can say, however, that we know of only one instance of sponsor support since the 2010 reforms, and that in that case the security in question was in no danger of defaulting.

Yet the SEC suggests that every case of sponsor support should be seen as a repeat of September 2008. They suggest that without sponsor support, money market funds would have triggered runs.

Decades of experience with these funds suggest just the opposite. Before the latest financial crisis, there was only one occasion when a money market fund broke a dollar, in 1994. The world yawned.

Persistently viewing money market funds through the narrow prism of 2008, the SEC clings to plans to impose structural changes that would destroy money market funds, at great cost to investors, State and local governments, business, and the economy. That is an outcome that we must avoid.

Thank you, and I'm happy to take your questions.

TESTIMONY OF

PAUL SCHOTT STEVENS
PRESIDENT AND CEO
INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ON

"PERSPECTIVES ON MONEY MARKET MUTUAL FUND REFORMS"

JUNE 21, 2012

EXECUTIVE SUMMARY

- Money market funds are one of the most significant financial product innovations of the past half century. With $2.6 trillion in assets, money market funds today serve over 57 million retail investors, as well as corporations, municipalities, and other institutional investors as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability of principal, and a market-based yield. They are an important source of direct financing for state and local governments, businesses, and financial institutions, and indirect financing for households.

- Contrary to the suggestions of critics and some policymakers, a careful review of market events demonstrates that money market funds did not accelerate the financial crisis of 2007-2008. Like other market participants, money market funds were directly affected by enormous scale and duration of the crisis, and by the lack of coherent, consistent government policy responses. In contrast to massive failures in the bank sector, a single money market fund could not return the full $1.00 share price to investors after an unprecedented set of failures, including that of Lehman Brothers. The events of 2007-2008 are in stark contrast to those of 1994—the *only other time* a money market fund ever "broke a dollar."

- Even as investors lost confidence in the markets and in government policy during the 2007-2008 financial crisis, they remained invested in money market funds, shifting their assets from "prime" money market funds to Treasury and government and agency money market funds. Assets of money market funds achieved an all-time high of almost $3.9 million by February 2009.

- Since the crisis, much progress has been made toward the objective of preserving the benefits that money market funds provide to the economy and to investors, while making them more resilient in the face of severe market stress. Most notably, drawing upon recommendations from ICI's Money Market Working Group, in early 2010 the Securities and Exchange Commission approved rule amendments designed to strengthen money market funds against certain short-term market risks and provide greater protections for investors in a fund that is unable to maintain a stable net asset value ("NAV") per share. These rule changes proved their value in the face of significant market turmoil last summer, calling into question the need for further reforms.

- Any additional reforms must preserve the fundamental characteristics of money market funds—such as a stable NAV and ready liquidity—and ensure a continued robust and competitive money market fund industry. Unfortunately, some regulators continue to view money market fund reform through the outdated lens of 2008. They are considering structural changes that would alter the characteristics that investors deeply value and reduce competition by driving fund sponsors out of the business. These changes would destroy money market funds, at great cost to investors, state and local governments and the economy.

I. Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

I very much appreciate the opportunity to appear before the Senate Committee on Banking, Housing and Urban Affairs and offer our perspectives on the state of the money market fund industry. Money market funds, which date back to the early 1970s, are one of the most significant and successful financial product innovations of the past half century. Today, over 57 million retail investors, as well as corporations, municipalities, and other institutional investors, rely on the $2.6 trillion money market fund industry as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability of principal value, and a market-based yield. Money market funds also serve as an important source of direct financing for state and local governments, businesses, and financial institutions, and of indirect financing for households. Without these funds, financing for all of these institutions and individuals would be more expensive and less efficient.[1]

Money market funds owe their success, in large part, to the stringent regulatory requirements to which they are subject under the federal securities laws including, most notably, Rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"). The regulatory regime established by Rule 2a-7 has proven to be flexible and effective in protecting investors' interests and maintaining their confidence in money market funds. The Securities and Exchange Commission ("SEC") deserves tremendous credit for crafting these requirements and administering them in a manner that has allowed money market funds to thrive and to serve so many investors. The SEC also has modernized and strengthened the rule from time to time as circumstances warranted (most recently in 2010, as discussed below).

In recognition of the importance of money market funds to the global economy and to investors, ICI and its members have devoted significant time and effort to considering how to make money market funds more robust under even the most adverse market conditions—such as those caused by the widespread bank failures in 2008. Over the past few years, the SEC and the fund industry have made a great deal of progress toward their shared goal of strengthening the resiliency of money market funds. Taking the initiative to respond quickly and aggressively to the events of fall 2008, ICI formed a Money Market Working Group to study the money market, money market funds and other participants in the money market, and recent market circumstances.[2] The March 2009 *Report of the*

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[1] An overview of the importance of money market funds as financial intermediaries within the broader money market is attached as an appendix to this letter.

[2] A copy of the press release announcing the formation of the Working Group is available on ICI's website at https://www.ici.org/policy/regulation/products/money_market/08_news_mm_group.

Money Market Working Group addressed these topics and advanced wide-ranging recommendations for the SEC to strengthen money market fund regulation.[3]

In 2010, with the industry's strong support, the SEC approved far-reaching rule amendments that incorporated many of the MMWG Report's recommendations and enhanced an already-strict regime of money market fund regulation.[4] The amended rules make money market funds more resilient by, among other things, imposing new credit quality, maturity, and liquidity standards and increasing the transparency of these funds. In the event a money market fund proves unable to maintain a stable $1.00 net asset value ("NAV") per share, the fund's board of directors is empowered to take prompt action to assure an orderly liquidation of the fund and equitable treatment for all shareholders. These reforms proved their value last summer when money market funds—without incident—met large volumes of shareholder redemptions during periods of significant market turmoil, including a credit event involving the historic downgrade of U.S. government debt.[5] Indeed, so far-reaching were these reforms that today's money market fund industry is dramatically different from that of 2008. Yet, the calls for further reform continue.

Regulators reportedly are pursuing flawed proposals that will harm investors, damage financing for businesses and state and local governments, and jeopardize a still-fragile economic recovery.[6] Indeed, the ideas under consideration will drive funds out of business, reducing competition and choice, and alter the fundamental characteristics of money market funds—such as a stable NAV and ready liquidity—thereby destroying their value to investors and the economy. Rather than making our economy and financial system stronger, such reforms have the potential to increase systemic risk by driving investors into less-regulated, less-transparent products. In a recent survey by Treasury Strategies, Inc., four out of five institutional investors said they would reduce or eliminate their use of money market funds if those funds are subjected to a floating NAV requirement or redemption restrictions.[7] Based on these investors' estimates, institutional assets in money market funds would decline by 60 percent or more.[8]

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[3] *See* Investment Company Institute, *Report of the Money Market Working Group* (March 17, 2009) ("MMWG Report"), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[4] *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010) ("MMF Reform Adopting Release"). The current regulatory requirements for money market funds are discussed in greater detail in Section IV, below.

[5] *See infra* Section IV.F.

[6] Despite public comments from three SEC commissioners questioning the need for further reform, SEC Chairman Mary Schapiro and SEC staff have continued to press their reform agenda, indicating that capital buffers combined with redemption restrictions and/or requiring money market funds to float their NAV are the proposals under consideration. *See, e.g.*, Mary L. Schapiro, Chairman, Securities and Exchange Commission, Remarks at the Society of American Business Editors and Writers (SABEW) Annual Convention (March 15, 2012) ("Schapiro March 2012 Remarks," available at http://www.sec.gov/news/speech/2012/spch031512mls.htm and SEC Chairman Mary L. Schapiro, Remarks at SIFMA's 2011 Annual Meeting (November 7, 2011), available at http://www.sec.gov/news/speech/2011/spch110711mls.htm.

[7] ICI commissioned Treasury Strategies, Inc. to conduct a study to help understand the effects of various SEC reform concepts on money market fund investors. The report, *Money Market Fund Regulation: The Voice of the Treasurer*, is

For our part, ICI has consistently supported exploring reasonable options to make money market funds even more resilient while preserving the fundamental characteristics of these funds. ICI's views on possible additional money market fund reforms also have evolved in recent months, for several reasons. First, as mentioned above, we have had the opportunity to observe the success of the SEC's 2010 amendments in helping money market funds withstand market stress, which strongly calls into question the need for additional reforms. Second, we have concluded that reform options reportedly under the most serious consideration are severely flawed and would prove extraordinarily detrimental to investors, issuers of short-term debt, and the country, not to mention the industry.

We remain committed to working with regulators on this important issue, but we submit that this process should be guided by two principles. First, we should preserve those key features of money market funds (including the stable $1.00 per-share NAV and ready liquidity) that have made them so valuable and attractive to investors. Second, we should preserve choice for investors by ensuring a continued robust and competitive global money market fund industry. Unfortunately, the proposals we understand some regulators currently are considering are altogether at odds with these principles.

Our comments below begin with a discussion of the events of 2007 to 2008—including the tumultuous weeks during September 2008 after Lehman Brothers failed—to correct the false narrative espoused by some policymakers and critics that money market funds were responsible for accelerating the financial crisis (Section II and Appendix A). Next, we describe efforts undertaken by the regulators and the industry to strengthen money market fund regulation in response to the financial crisis (Section III). We then examine how money market funds are regulated today under the new, stricter SEC amendments and how those new requirements helped position the money market fund industry to successfully weather recent market challenges (Section IV). Finally, we discuss our deep concerns with the policy options the SEC is considering: requiring money market funds to let their share prices float; requiring the funds or their advisers to maintain explicit capital; and implementing permanent restrictions on shareholders' ability to redeem all of their shares on demand (Section V). To better explain the singular benefits money market funds provide to investors and the economy, we also provide an overview of the money market itself, including its structure and participants and the key characteristics of money market funds (Appendix B).

II. Understanding Money Market Fund Developments in the Financial Crisis

Critics of money market funds often argue that the financial crisis of 2007-2008 demonstrated that money market funds are particularly "fragile" or "susceptible" to runs. They contend that if any

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available on ICI's website at http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf ("TSI Survey"). Treasury Strategies surveyed 203 unique corporate, government, and institutional investors between February 13 and March 6, 2012, asking 31 questions regarding their cash pools, investment objectives, and three SEC concepts for money market fund reform—floating NAVs, capital buffers, and redemption restrictions. Treasurers are significant users of money market funds: institutional share classes account for $1.7 trillion, or 65 percent, of the $2.6 trillion in U.S. money market fund assets.

[8] *Id.*

one money market fund today were to "break a dollar" (*i.e.*, fail to maintain a $1.00 NAV) shareholders of other funds would redeem *en masse*. We strongly disagree.

Federal Reserve Chairman Ben Bernanke characterized the market events in the fall of 2008 as "the worst financial crisis in global history, including the Great Depression."[9] He went on to say that "[i]f you look at the firms that came under pressure in that period...only one...was not at serious risk of failure. So out of maybe the 13, 13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two."[10] The events of 2007-2008 were, to be sure, highly unusual. They appear all the more so when compared with the only other time a money market fund broke a dollar, and the differences vividly illustrate the importance of the state of the overall financial economy to investor reaction. How investors are likely to react in the very rare event that a money market fund is unable to return a full $1.00 per share critically depends, in our judgment, on the financial environment—*i.e.*, whether and to what degree there are adverse financial market developments that precede and surround that occurrence.

A. Market Events Leading Up to September 2008

Money market funds were not the cause of the financial crisis, but were directly affected by its enormous scale and duration, and by the lack of coherent, consistent government policy responses.[11] Like many market participants, money market funds were hit by a global crisis that began to take hold long before September 2008.

Much of this history is familiar, but the parts of it that relate to money market funds may be less so. It deserves careful review, in light of critics' broad claims about the experience of money market funds in the crisis. The financial crisis was, first and foremost, a crisis in the real estate markets and the "originate to distribute" model that developed.[12] Over the period from 2004 to mid-2006, originations of subprime and other low-documentation mortgage loans soared.[13] Many subprime borrowers had taken out deeply-discounted adjustable-rate mortgages or mortgages with negative amortization features,[14] partly on the belief that house prices would continue to rise and allow them to refinance on

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[9] U.S. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (January 2011) ("FCIC Report"), available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, at 354.

[10] *Id.*

[11] For a timeline of major developments in the financial crisis, *see* Appendix A.

[12] *See generally* FCIC Report, *supra* note 9.

[13] The number of subprime and other low-documentation mortgage originations doubled from 1.4 million in 2003 to 3 million in 2005 and then leveled off in 2006. These mortgages represented more than 30 percent of the total dollar amount of mortgage lending in 2005, up from only 10 percent in 2003. *See* Chris Mayer, Karen Pence, and Shane Sherlund, "The Rise in Mortgage Defaults," *Finance and Economics Discussion Series*, Federal Reserve Board (November 2008).

[14] Generally, negative amortization occurs when a borrower's payment for a period is less than the interest assessed during that period, resulting in an increase in the borrower's loan balance.

more favorable terms in the future. Over the same period, however, short-term interest rates rose sharply, as monetary policy sought to dampen inflation.[15] The rapid increase in short-term interest rates fostered a slowing of the economy, job losses, and a rise in the cost of new mortgage borrowing. Appreciation of house prices moderated and then faltered. In the face of these developments, subprime borrowers began to default on their mortgages.

Difficulties in the subprime mortgage market began to spill over into the short-term and credit markets by mid-2007. Increasingly, lenders had financed subprime and other mortgages by packaging them into structured products, which were then sold into the financial markets. In some cases, such mortgages were used to back asset-backed commercial paper ("ABCP") or were channeled into structured investment vehicles ("SIVs") that then issued commercial paper. In June and July 2007, credit rating agencies began to downgrade many of the assets (such as SIVs and ABCP) that were backed either directly or indirectly by subprime mortgages. This caused difficulties for investment pools that held subprime mortgages, or ABCP and SIVs backed by subprime mortgages, and the auction rate securities market,[16] which were impacted because of spillover effects.

The banking crisis that followed was catastrophic. At least 13 major institutions went bankrupt, were taken over, or were rescued in the 12 months before Lehman Brothers failed. Lehman's failure was an especially difficult shock for the market because it represented an abrupt reverse in direction by the U.S. government from its previous decisions to intervene and rescue the smaller Bear Stearns, and Fannie Mae and Freddie Mac.

By contrast, money market funds received a strong vote of confidence. Over the 13 months from the end of July 2007 through August 2008, money market funds absorbed almost $900 billion in new cash, boosting the size of the money market fund industry by more than one-third. Eighty percent of this vast inflow (more than $700 billion) was directed to institutional share classes, as institutional investors, such as corporate cash managers and state and local governments, sought a safer haven for their cash balances.[17]

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[15] From June 2004 through June 2006, the Federal Reserve, seeking to forestall inflationary pressures and return short-term interest rates to a more normal level, raised the federal funds rate by 425 basis points, from 1 percent to 5.25 percent, and kept the overnight rate at that level until September 2007.

[16] Several factors have been identified as contributing to the seizing of the ARS market. Monoline insurers, which provided insurance for many ARS, were downgraded due to losses on mortgage-backed bonds that they had insured. These downgrades made investors less willing to come into the ARS market. The number of investors seeking to sell their ARS holdings outpaced the number of investors bidding in the auctions, requiring broker-dealers to step in absorb the excess supply. Ultimately, however, pressures on broker-dealers' balance sheets (*e.g.,* write downs due to the subprime mortgage crisis) led to broker-dealer firms abruptly ending their participation in the market.

[17] This vote of confidence reflected a number of factors. First, compared to other short-term investment pools, money market funds, under the strictures of Rule 2a-7 and with the overall protections of the Investment Company Act, had portfolios with shorter maturity, greater liquidity, higher quality, more diversification, and more transparency, and with no leverage. Second, to the extent that money market funds were indirectly exposed to subprime mortgages through ABCP or SIVs, they had been rapidly divesting themselves of such holdings. Third, in cases where money market funds had not

B. Key Market Events—September 2008

The financial crisis reached a critical stage during September 2008, which was characterized by severely impaired liquidity in the global credit markets and insolvency threats to numerous investment banks and other financial institutions. In contrast to massive failures in the bank sector, a single U.S. money market fund (Reserve Primary Fund) could not return the full $1.00 NAV per share to investors after Lehman failed. Lehman's sudden failure and widespread uncertainty about the government's stance towards other troubled institutions[18] had severe impacts on markets and market participants. Certain money market funds and many other money market participants were hit by a severe liquidity freeze. Banks, seeking to preserve their liquidity, refused to lend to one another. Investors lost confidence in the markets and in government policy.

Following the events of September 15-16, concerns rapidly spread in the financial markets that the debt of other large investment banks (The Goldman Sachs Group, Inc. and Morgan Stanley) and certain large commercial banks (Wachovia Corporation, Washington Mutual, and Citigroup) presented much greater risk than previously thought. The government's policy on rescuing troubled institutions also caused significant confusion, as many in the market had expected Lehman to be rescued, following the precedent the government set with its actions toward Bear Stearns, Fannie Mae, and Freddie Mac. Reflecting these concerns, the cost of insuring against defaults by these institutions rose dramatically and deepened the credit freeze. At the time, Federal Reserve officials seem to have been surprised by the severity of the market's reaction. For example, in Congressional testimony on September 23, Federal Reserve Chairman Ben Bernanke noted that:

> [t]he failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized—as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps—that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.
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> While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development . . . of extraordinarily turbulent conditions in global financial markets.[19]

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divested themselves of ABCP or SIVs and the market prices of those securities had the potential to put the $1.00 NAV of those money market funds at risk, their sponsors stepped in to purchase or otherwise support the distressed assets.

[18] One day after Lehman was allowed to fail and the same day the Reserve Primary Fund broke a dollar, the government again switched course and agreed to lend American International Group, Inc. (AIG) up to $85 billion and to take a nearly 80 percent stake in the company, reversing an earlier indication that it would not participate in a rescue of the insurance giant.

[19] Statement of Chairman Ben S. Bernanke, "U.S. Financial Markets," before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (September 23, 2008), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=bbba8289-b8fa-46a2-a542-b65065b623a1, at 3.

Even in these extreme conditions, however, investors remained invested in money market funds—they shifted their assets from prime money market funds, which held financial institutions' securities, to Treasury and government and agency money market funds, which did not. About $300 billion flowed out of prime money market funds; for every dollar that left these funds, however, 61 cents flowed into Treasury and government and agency funds. Indeed, investors did not abandon money market funds; they reacted to their concerns about the financial health of banks, the U.S. government's unpredictable response to financial institutions' collapses, and concerns about whether in such an environment prime money market funds could continue to sell assets into a frozen commercial paper market.

Following these events, the Federal Reserve and U.S. Treasury Department announced a series of broad initiatives designed to stabilize the market, which had ceased to function even for very short-term, high-credit securities. One of these programs was the Temporary Guarantee Program for Money Market Funds.[20]

Although the steps taken by the Federal Reserve and the Treasury Department helped to stabilize the commercial paper market and thereby moderate outflows from money market funds, investors continued to pull back from riskier credits and sought refuge in the U.S. Treasury market. The 4-week and 3-month Treasury bill yields remained well under 1 percent on most days during the first half of October. Issuance in the commercial paper market was heavily weighted to paper with 4 days or less to maturity, and the total amount of commercial paper outstanding contracted through the middle of October. Financial issuers of commercial paper were particularly hard hit, and most issuers were unable to issue paper much beyond a month. For example, in the four weeks after Lehman collapsed, on average, only 12 issues of financial paper with maturities beyond 40 days reached the market each day, compared with a daily average of 140 in early September. The daily dollar volume of new financial paper issuance with these maturities was equally impaired, averaging $117 million, compared with $2.9 billion during the first half of September. Issuance did not pick up until after the Federal Reserve launched the previously announced Commercial Paper Funding Facility ("CPFF") program in late October.

C. Money Market Funds Were Not the Primary Source of Pressure in the Commercial Paper Market

The FCIC Report and the Federal Reserve suggest that money market funds were the primary source of pressure in the commercial paper market.[21] The data simply do not support this conclusion. In fact, pressures in these and other short-term markets were driven by a wide range of investors pulling back, not just money market funds. Money market funds were simply the most visible and easily observable market participants.

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[20] *See* Appendix A. No claims were made on this program and taxpayers received an estimated $1.2 billion in premiums. The program expired on September 18, 2009.

[21] *See* FCIC Report, *supra* note 9, at 354.

A careful examination of the data shows that by the end of September, the decline in commercial paper outstanding was not primarily from money market funds. Outstanding commercial paper declined by $185 billion during the month of September.[22] ICI data show that money market funds reduced their holdings of commercial paper by $164 billion in September; however, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF") program also held $152 billion in commercial paper as of October 1, all of which arose from money market fund sales to commercial banks. Hence, money market funds' net reduction (after adjusting for sales to the AMLF program) amounted to $12 billion or about 6 percent of the $185 billion decline in outstanding commercial paper.[23] Other investors clearly were pulling back from commercial paper issuers in a stressed market. Data for other investors is not available specifically for September, but the Federal Reserve's Flow of Funds Accounts show that funding corporations, foreign investors, state and local governments, and the household sector (which includes hedge funds and nonprofit organizations) were significant sellers of commercial paper in the third quarter of 2008.[24] It would appear that much of the selling by these investors occurred during September.[25]

Furthermore, prime money market funds became net buyers of commercial paper in October, and by the end of that month had increased their holdings by $43 billion. Again, factoring in the AMLF program, the $250 billion decline in commercial paper outstanding in September and October resulted from other investors reducing their holdings. Through the end of 2008, prime money market funds steadily increased their holdings of commercial paper and time deposits as inflows to these funds lifted their overall assets by $412 billion.

Apart from the commercial paper market, there is additional evidence that a variety of market participants were pulling back their exposures to financial institutions, particularly banks, during the fall of 2008. Borrowing from the Federal Reserve's discount window, excluding the commercial paper programs and lending associated with AIG and Bear Stearns, rose from $170 billion as of September 10, 2008 to $587 billion as of December 17, 2008 and remained at that level through the end of 2008.[26] Much of this increase was through the Term Auction Facility, which held biweekly auctions of term funds to depository institutions against collateral that could be used to secure loans at the discount

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[22] Federal Reserve Commercial Paper report.

[23] Data from iMoneyNet show that money market fund holdings of commercial paper contracted before the AMLF program began during the week of September 22, and a special survey by the Financial Crisis Inquiry Commission of money market funds does show that money market funds reduced their holdings of commercial paper during the first week of the crisis. Hence, money market funds did contribute to the contraction of the market during the week of September 15, but were not the primary cause of the contraction in the market in September.

[24] Data from the Flow of Funds Accounts (not seasonally adjusted) show that these sectors combined reduced their commercial paper holdings on net by $131 billion in the third quarter of 2008.

[25] Confidential data submitted to ICI show that stock, bond, and hybrid funds lowered their holdings of commercial paper by $10 billion in September.

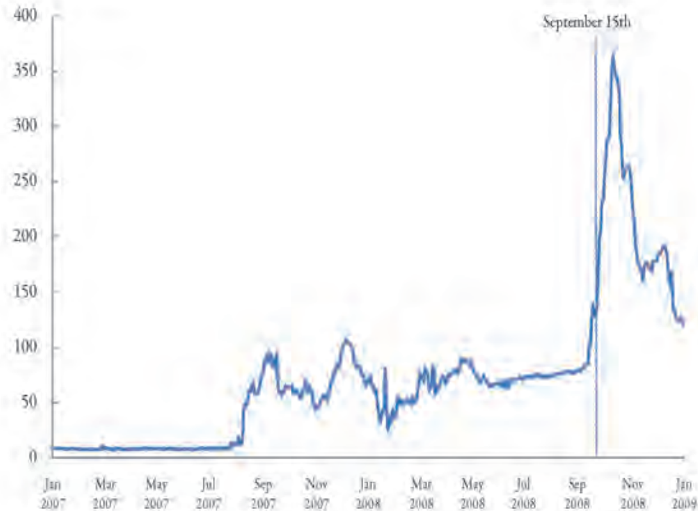
[26] *See* http://www.federalreserve.gov/releases/h41/20080911/ and http://www.federalreserve.gov/releases/h41/20081218/

window. At the same time, interbank lending by commercial banks fell more than 30 percent, or nearly $145 billion on a seasonally adjusted basis. The stress in the banking industry was reflected in the spread between the 3-month London Interbank Offered Rate (LIBOR) and the overnight index swap (OIS) rate which jumped from less than 100 basis points on September 12 to nearly 370 basis points one month later (Figure 1). The LIBOR-OIS spread is generally viewed as an indicator of the banking industry's financial health and a widening of the spread can be interpreted as a reluctance or unwillingness by banks to lend to other banks because of an increase in credit risk.

Figure 1

Spread Between Three-Month LIBOR and Overnight Index Swap Rate*

Basis points, daily



* 90-day LIBOR less the 90-day Overnight Index Swap (OIS) rate. An OIS is an interest rate swap with the floating rate tied to an index of daily overnight rates, such as the effective federal funds rate. At maturity, two parties exchange, on the basis of the agreed notional amount, the difference between interest accrued at the fixed rate and interest accrued by averaging the floating, or index, rate.

Source: Bloomberg

D. Aftermath

The U.S. government's programs were eventually highly successful in shoring up confidence in financial markets generally and money market funds specifically. By mid-October, the assets of prime money market funds began to grow and continued to do so into 2009, indicating a return of confidence by institutional investors in these funds. During this same time period, assets of Treasury and government-only money market funds also continued to grow, although at a much reduced pace.

By the end of February 2009, although assets of prime money market funds had not returned to the level seen at the beginning of September 2008, they had regained much ground. Perhaps more importantly, assets of money market funds had achieved an all-time high of just less than $3.9 trillion by February 2009, reflecting the renewed confidence in money market funds among both retail and institutional investors.[27]

In a speech at the Credit Markets Symposium on March 31, 2011, Federal Reserve Governor Daniel K. Tarullo characterized the experience of money market funds in the 2008 crisis as "a small money market fund's travails . . . provok[ing] a run on the entire industry."[28] Conspicuous by its absence is any mention by Governor Tarullo of myriad other events constituting what Federal Reserve Chairman Bernanke termed "the worst financial crisis in global history."

Clearly, "a small money market fund's travails" did *not* in themselves provoke the wholesale flight from financial assets to Treasury securities that ensued in September 2008. To suggest that they did is a disservice to any serious policy debate. Indeed, the events of 2007-2008 are in stark contrast to those of 1994—the ***only other time*** a money market fund broke a dollar.[29] At that time, the banking system was not in cataclysmic disarray. But the 1994 incident had no "systemic" consequences, it did not precipitate a run from other money market funds, nor did it have any adverse impact on other parts of the financial market. In fact, money market fund assets *grew* during the month after the fund broke a dollar. At that time, there was no reason for investors to lose confidence in the assets their funds were holding or in the financial system at large, as there was in 2008. As discussed above, the Reserve Primary Fund's failure in 2008 followed an unprecedented series of failures going back to the middle of 2007 involving major banks and other leading financial institutions around the world, and bewildering, inconsistent responses to these events by the U.S. and other governments.[30]

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[27] It should be noted that any investments made to money market funds *after* September 19, 2008 were not covered by the Treasury's Temporary Guarantee Program for Money Market Funds.

[28] *See* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm.

[29] Community Bankers U.S. Government Money Market Fund broke a dollar in September 1994 and ultimately paid investors $0.96 per share.

[30] Reserve Primary Fund ultimately paid investors $0.99 per share.

III. Industry and Regulators' Response to the Financial Crisis

ICI and its members have dedicated enormous effort, in collaboration with regulators, to preserving the benefits that money market funds provide to the economy and to investors, while making them more resilient in the face of severe market stress such as that which followed the collapse of Lehman Brothers. Since the crisis, both the SEC and the money market fund industry have made a great deal of progress toward this objective.

Beginning in the summer of 2007, early warnings began to surface that the mortgage lending crisis in the United States could have a detrimental effect on lenders. At that time, ICI began to analyze how those market conditions might affect money market funds, a process that continued and intensified over the ensuing twelve months.

Quickly following the events of September 2008, ICI formed the Money Market Working Group ("MMWG"), a panel of fund industry leaders with a broad mandate to develop recommendations to improve the functioning of the money market and the operation and regulation of funds investing in that market. Less than six months later, ICI issued the MMWG Report, an industry study of the money market that included wide-ranging recommendations for the SEC to enhance money market fund regulation.[31]

In early 2010, the SEC approved rule amendments to enhance an already-strict regime of money market fund regulation. The SEC designed the amendments to strengthen money market funds against certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable NAV per share.[32] The amendments, which are discussed in detail in Section IV, incorporated a number of the MMWG Report's suggestions, including minimum liquidity requirements, stress testing, shorter maturities, and increased disclosure.

The search for ways to make money market funds even more secure under the most adverse market conditions did not stop, however, with the adoption of the SEC's reforms. For example, for two years, ICI and several of its members were actively engaged in a task force sponsored by the Federal Reserve Bank of New York to strengthen the underpinnings of a vital portion of the money market—tri-party repurchase agreements ("repos"). During this time, task force members put in considerable time and effort to help bring about many improvements and to develop an improved understanding of what further changes are needed in the tri-party repo market.[33] Reforms in this market are significant not only to money market funds, which provide about one-third of the lending in the tri-party repo market, but to all participants in that market.

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[31] *See* MMWG Report, *supra* note 3, at 123-126.

[32] *See* MMF Reform Adopting Release, *supra* note 4, at 10060.

[33] *See* Final Report of the Task Force on Tri-Party Repo Infrastructure: Payments Risk Committee (February 15, 2012), available at http://www.newyorkfed.org/tripartyrepo/pdf/report_120215.pdf.

In June 2009, the Treasury Department issued a paper on financial regulatory reform.[34] The Treasury paper recommended that the President's Working Group on Financial Markets ("PWG") prepare a report assessing whether more fundamental changes were necessary to supplement anticipated SEC money market fund reforms.[35] The paper called for, among other things, exploring measures to require money market funds "to obtain access to reliable emergency liquidity facilities from private sources."[36] In response, ICI and its members developed a detailed framework for such a facility, including how it could be structured, capitalized, governed, and operated.[37]

In October 2010, the PWG issued its report discussing several options for further reform of money market funds and recommending that the Financial Stability Oversight Council ("FSOC") examine those options.[38] These options ranged from measures that could be implemented by the SEC under current statutory authorities to broader changes that would require new legislation, coordination by multiple government agencies, and the creation of private facilities, including a private emergency liquidity facility for money market funds as mentioned in the Treasury paper. In response to a request for comments on the report,[39] ICI, along with more than 100 other commenters, provided its views on the reform options outlined in the report.[40] There we described how an industry-sponsored emergency liquidity facility for prime money market funds could address policymakers' remaining concerns by serving as a liquidity backstop for those funds during times of unusual market stress. We also explained

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[34] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009) ("Treasury paper"), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[35] Notably, the Treasury paper urged caution in this effort. In particular, it recommended that the PWG carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as investor flight from these funds into unregulated or less regulated money market investment vehicles. *Id.* at 39.

[36] *Id.* at 38.

[37] For details concerning ICI's plans for a private liquidity facility to further strengthen "prime" money market funds, *see* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011) ("PWG Comment Letter"), available on ICI's website at http://www.ici.org/pdf/11_sec_pwg_com.pdf and http://www.ici.org/pdf/11_sec_pwg_deck.pdf (appendix). Prime money market funds are funds that may invest in a mix of high-quality, short-term money market instruments including Treasury and government obligations, certificates of deposit, repurchase agreements, commercial paper, and other money market securities.

[38] *See* Report of the President's Working Group on Financial Markets: Money Market Reform Options (October 2010) ("PWG Report"), available on the Treasury Department's website at http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

[39] *See* SEC Release No. IC-29497 (November 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. As a follow up to its request for comments, on May 10, 2011 the SEC hosted a roundtable on money market funds and systemic risk that consisted of SEC officials, representatives of the FSOC, and participants from ICI, the fund industry, academia, the business community, and state and local governments. Information about this roundtable is available on the SEC's website at http://sec.gov/news/otherwebcasts.shtml.

[40] *See* PWG Comment Letter, *supra* note 37. The PWG Report spawned a voluminous and still growing comment record that reflects not only many good faith attempts to respond to policymakers' concerns, but also a striking absence of consensus around whether further action is needed, and if so, how to proceed.

how the other options presented in the PWG Report, including forcing money market funds to abandon their objective of maintaining a stable $1.00 share price, would not solve the problem at hand, could increase rather than decrease systemic risk, would adversely impact the market, or would result in some combination of the foregoing. In many cases, we observed, transitioning to a new approach in and of itself would have systemic risk implications.

Throughout 2011, the money market fund industry continued to explore whether additional reform measures could improve upon the 2010 SEC amendments and still ensure a continued robust and competitive money market fund industry and preserve the value of money market funds for investors and the economy. For example, ICI hosted a "Money Market Funds Summit," which focused on important developments in the money markets since the financial crisis.[41] This high-level event brought together money market professionals, analysts, policymakers, investors, and issuers for an in-depth discussion and exchange of ideas.

To lend perspective and analysis, we examined a variety of proposals put forth by commenters to the PWG Report, including a proposal by a group of 14 economists, known as The Squam Lake Group, to require money market funds to create capital buffers by having funds sell subordinated securities in the market.[42] After considerable study, however, including in-depth analysis by capital markets experts,[43] ICI concluded that market-provided capital is not a feasible option for the money market fund industry.[44]

As aptly demonstrated by our actions since 2008, the Institute and its members remain committed to working with regulators on our shared goal of strengthening money market funds. We are deeply troubled, however, by recent statements from regulators suggesting that the money market fund industry is "working without a net" or "susceptible to runs" and therefore that the current and successful program of money market fund regulation should be replaced with a model that would fundamentally alter the product and/or impose inappropriate bank-like regulation on money market funds. Indeed, we believe such a model would not enhance the stability of these funds—or of our global financial system—and, in fact, could have the opposite effect of increasing risk worldwide. This rhetoric is particularly puzzling considering how, as discussed in detail in Section IV, money market funds operating under the SEC's 2010 reforms have demonstrated their resilience during periods of significant market turmoil, as was experienced last summer.

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[41] Information on this event is available at http://www.ici.org/events/highlights/conf_11_mmf_summit.

[42] *See* Letter from René Stulz, Everett D. Reese Chair of Banking and Monetary Economics, The Ohio State University, Fisher College of Business, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (January 14, 2011), available on the SEC's website at http://sec.gov/comments/4-619/4619-57.pdf.

[43] ICI engaged Sullivan & Cromwell LLP, PricewaterhouseCoopers, and Barclays Capital to analyze the potential for funds or advisers to raise capital through the capital markets.

[44] Our analysis of the feasibility of market-provided capital through the issuance of subordinated securities is discussed further in Section V.B.2, below.

We are actively analyzing the impact on investors, the economy, and the fund industry of certain proposals currently being considered by the SEC that would fundamentally alter the character of money market funds. For example, ICI commissioned Treasury Strategies, Inc. to conduct a survey of corporate treasurers and other institutional investors on their attitudes toward these proposals.[45] The survey asked more than 200 organizations how they use money market funds; what their views are on floating NAVs, capital requirements, and redemption holdbacks; and how those proposals would change their use of money market funds. Estimates based on the survey indicate that a floating NAV or a redemption holdback will drive 60 percent or more of institutional assets out of money market funds. The results show that imposition of capital buffers on money market funds will have a much smaller impact on institutional assets (a reduction of 13 percent) when the question omits mention of any loss of yield caused by the buffers. Follow-up questioning, however, shows that if a buffer reduced the yield of those funds by just 2 to 5 basis points, a large majority of the respondents would decrease their use or discontinue their use altogether. The survey provides the first clear analysis of the degree to which institutional investors would move their short-term investments away from money market funds if these SEC proposals are put in place.

ICI also has completed a study of the likely effects of capital requirements on money market funds or their advisers. The study indicates that, depending on the details, an SEC-required capital buffer could have profound effects on the money market fund product, the cash management business, and money markets themselves.[46] In addition, ICI has just issued a study of the operational implications and potential costs that would be associated with the SEC's proposed imposition of redemption holdback restrictions.[47]

For all of these reasons, and particularly in light of the demonstrated effectiveness of the 2010 amendments, the Executive Committee of ICI's Board of Governors issued a statement earlier this year reflecting its belief that the further changes in money market fund regulation now under consideration are neither necessary nor appropriate.[48] Although the industry remains open to exploring reasonable options to make money market funds even more resilient, such reforms must preserve the fundamental characteristics of these funds and ensure a continued robust and competitive money market fund industry.

IV. Today's Regulation of Money Market Funds

Today's money market funds are stronger and more resilient than the funds that were available in 2008, as amply demonstrated by the market events of last summer.

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[45] *See* TSI Survey, *supra* note 7.

[46] *See infra* Section V.B.

[47] *See infra* Section V.C.

[48] *See* Statement of ICI Executive Committee on Money Market Fund Regulation (March 14, 2012), available at http://www.ici.org/mmfs/background/12_new_mmf_st.

A. Overview

Money market funds, like all mutual funds, are regulated under all four of the major securities laws: the Securities Act of 1933, which requires registration of the mutual fund's shares and the delivery of a prospectus; the Securities Exchange Act of 1934, which regulates the trading, purchase and sale of fund shares and establishes antifraud standards governing such trading; the Investment Advisers Act of 1940, which regulates the conduct of fund investment advisers and requires those advisers to register with the SEC; and, most importantly, the Investment Company Act, which requires all mutual funds to register with the SEC and to meet significant operating standards.[49] Indeed, money market funds share key features with other mutual funds. They issue shares that are redeemable upon demand, invest in marketable securities, and, with one exception discussed below, adhere to the same rules and regulations that apply to all mutual funds.

One defining feature of money market funds is that, in contrast to other mutual funds, they seek to maintain a stable NAV or share price, typically $1.00 per share. As a result, money market funds must comply with an additional set of regulatory requirements in Rule 2a-7 under the Investment Company Act. Rule 2a-7 exempts money market funds from the valuation provisions generally applicable to all mutual funds and permits them to determine their NAV using the amortized cost method of valuation, which facilitates money market funds' ability to maintain a stable NAV. Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount.[50] The basic premises underlying money market funds' use of the amortized cost method of valuation are: (1) high-quality, short-term debt securities held until maturity will return to their amortized cost value, regardless of any temporary disparity between the amortized cost value and market value; and (2) while held by a money market fund, the market value of such securities ordinarily will not deviate significantly from their amortized cost value. Thus, Rule 2a-7 permits money market funds to value portfolio securities at their amortized cost *so long as* the deviation between the amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current NAV per share of the fund. In practice, the risk limiting conditions of Rule 2a-7 generally keep deviations between money market funds' per share market value and amortized cost extremely small.[51]

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[49] For an overview of the key principles of the Investment Company Act, *see* Appendix C to Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to the Secretariat of the Financial Stability Board, c/o Bank for International Settlements (June 3, 2011), Appendix C (regarding the FSB's directive to develop recommendations to strengthen the oversight and regulation of the "shadow banking system"), available at http://www.ici.org/pdf/25258.pdf.

[50] Rule 2a-7 also permits money market funds to use the penny rounding method of pricing. Under this method, share price is determined by valuing securities either at market value, fair value, or amortized cost, and rounding the per share NAV to the nearest cent on a share price of $1.00.

[51] *See infra* Section V.A.

B. Risk-Limiting Conditions

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, Rule 2a-7 contains a number of conditions that are designed to limit the fund's exposure to certain risks by setting minimum standards for the credit quality, liquidity, maturity, and diversification of a money market fund's investments.[52] These risk-limiting conditions, which were strengthened in 2010, include the following:

- *Credit quality*: Money market funds may only invest in high-quality securities that mature in 13 months or less (with exceptions for certain types of securities including variable and floating rate securities that have an interest rate reset of no more than 397 days or a demand feature), and that a fund's board of directors (or its delegate) determines present minimal credit risks. At least 97 percent of a fund's assets must be invested in securities held in U.S. government obligations or other securities that either received the highest short-term rating or are of comparable quality.

- *Liquidity*: Money market funds must maintain a degree of portfolio liquidity sufficient to meet reasonably foreseeable redemption requests. All taxable funds must maintain at least 10 percent of assets in cash, Treasury securities, or securities that convert into cash within one day ("daily liquid assets"). All funds must maintain at least 30 percent of assets in cash, Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week ("weekly liquid assets").

- *Maturity*: Money market funds must maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk.

- *Diversification*: Money market funds must maintain a diversified portfolio designed to limit a fund's exposure to the credit risk of any single issuer.

C. Transparency

Today, money market funds are one of the most transparent financial products in the United States. Like other mutual funds, every money market fund must deliver to investors either a summary prospectus or a long-form prospectus that describes, among other things, the fund's investment objectives, strategies, fees, and principal risks. More detailed information is included in the statement

[52] Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.

of additional information that a fund must make available to investors upon request.[53] Money market funds also are required to send annual and semi-annual reports to shareholders.

In addition to the risk disclosure that *all* mutual funds are required to provide in their prospectuses, money market funds must prominently disclose the following in their prospectuses and any advertisements:

> **An investment in the [f]und is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the [f]und seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the [f]und.**

Despite this disclosure, in the past, when a limited number of money market funds approached the point of deviating from their stable $1.00 NAV (*e.g.*, because of idiosyncratic credit events or valuation concerns), fund advisers have provided limited financial support to those funds through capital infusions, capital support agreements, or purchasing potentially troubled securities from a fund at amortized cost. Fund advisers took such actions to ensure that the fund operated as designed and to manage the sponsor's risk to its reputation in the marketplace. In most of these cases, fund advisers did not incur financial losses. Neither securities laws nor standard investment advisory contracts, however, require the adviser to guarantee or support the fund's stable $1.00 NAV.

In light of money market funds' experience during the financial crisis, the MMWG Report recommended that money market funds evaluate whether their disclosures, including advertising and marketing materials, and in particular their risk disclosures, fully capture the risks that money market funds may present and, if appropriate, revise their disclosures.[54] Although many money market fund complexes voluntarily have evaluated the adequacy of their own risk disclosures after the MMWG recommendation, the SEC did not adopt this recommendation as part of the 2010 rule amendments. Notably, recent research indicates that investors are well aware of the risks associated with money market funds.[55]

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[53] Funds that choose to deliver a summary prospectus must make the long-form prospectus and statement of additional information available on the fund's website and must furnish paper copies upon request.

[54] *See* MMWG Report, *supra* note 3, at 91-92.

[55] *See* Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (April 26, 2012), available at http://sec.gov/comments/4-619/4619-170.pdf. In particular, the research described in this letter found that 81 percent of Fidelity retail customers with money market funds indicate that they understand that the securities held by these funds fluctuate up and down daily in value; 75 percent of Fidelity customers know that the money market funds they invest in are not guaranteed by the government; only 10 percent believe the government would step in to prevent money market funds from breaking a stable $1.00 share price; and the majority of customers do not favor further regulation of money market funds, but instead would support additional investor education.

While the 2010 amendments did not change money market funds' narrative risk disclosure requirements, the SEC did make other important enhancements to money market fund disclosure requirements that substantially increase the transparency of money market fund portfolios for the benefit of investors and facilitate regulatory oversight. First, every money market fund is required to provide updated portfolio information on its website as of the end of each month. In addition, each month money market funds must file with the SEC new Form N-MFP, which contains detailed information about the fund and its portfolio, including the market value of each security held. The information provided in Form N-MFP becomes publicly available 60 days after the end of the month covered by the report.

D. Governance

Like other mutual funds, a money market fund is organized as a corporation or business trust governed by a board of directors or trustees, at least a majority of whom typically are independent from fund management. In practice, most fund boards have a far higher percentage of independent directors or trustees than the 40 percent minimum required by the Investment Company Act. According to a study of fund boards conducted by ICI and the Independent Directors Council, as of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes.[56] Independent board members play a critical role in overseeing fund operations and are entrusted with the primary responsibility for looking after the interests of fund shareholders.

Rule 2a-7 also includes certain procedural requirements overseen by the money market fund's board of directors. One of the most important is the requirement that the fund periodically compare the amortized cost NAV of the fund's portfolio with the mark-to-market NAV of the portfolio.[57] If there is a difference of more than ½ of 1 percent (or $0.005 per share), the fund's board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) $1.00 per share, an event colloquially known as "breaking a dollar." Regardless of the extent of the deviation, Rule 2a-7 also imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Moreover, all funds must dispose of a defaulted or distressed security (*e.g.*, one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.

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[56] *See* Overview of Fund Governance Practices, 1994-2010, available at http://www.idc.org/pdf/pub_11_fund_governance.pdf.

[57] As a result of Rule 2a-7's risk-limiting conditions, money market funds' underlying per-share market price on average deviates by only a few basis points from $1.00 in all but the most extreme market conditions. *See infra* Section V.A.

The SEC's 2010 amendments gave money market fund boards of directors, for the first time, the ability to suspend redemptions if a fund has broken or is about to break a dollar.[58] In contrast to the September 2008 experience of the Reserve Primary Fund, which did not have the ability to promptly suspend redemptions, this powerful new tool will help assure equitable treatment for all of the fund's shareholders, stem any flight from the fund, ensure an orderly liquidation of a troubled fund, and minimize the potential for disruption to other funds and the money market generally. Indeed, this capability, which is available only if the board has determined to liquidate the fund, would protect shareholders by ensuring that the actions of investors who exit a money market fund first under extreme circumstances do not harm those remaining behind. The rule recognizes that a money market fund's share price can decline in value, and provides for an orderly liquidation of the fund's securities in a manner that best serves the fund's shareholders by effectively negating any "first mover" advantage for a redeeming shareholder and by avoiding the liquidation of portfolio securities in a "fire sale."

E. Money Market Funds Are Far More Resilient Under SEC 2010 Amendments

The SEC's 2010 amendments to money market fund regulation have made these funds even more stable, liquid, and transparent than ever before. We urge regulators and other policymakers to avoid falling into the trap of looking at these funds and reform options as though it were still 2008, and instead to recognize that money market funds themselves, and the financial markets in which they operate, are meaningfully different today.

1. *Shorter Maturities*

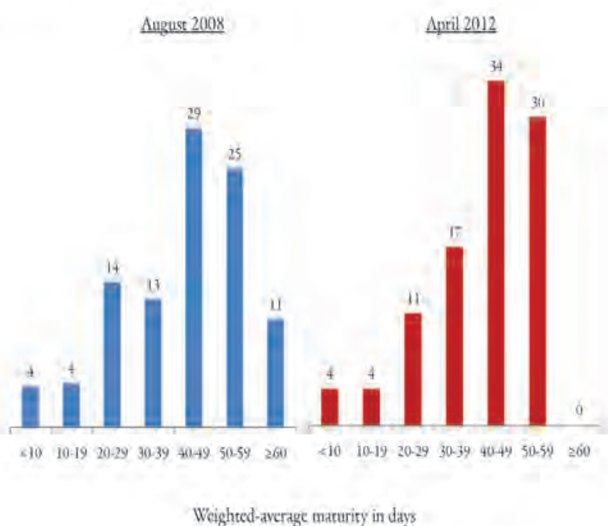
The SEC's 2010 amendments to Rule 2a-7 raised credit standards and shortened the maturity of money market funds' portfolios—further reducing credit and interest rate risk. For example, the maximum allowable weighted average maturity ("WAM") was reduced from 90 days to 60 days, which has lowered the average maturity of taxable money market funds (Figure 1). Preventing funds from holding a portfolio with a WAM in excess of 60 days also has reduced "tail risk"; this is seen in Figure 1 as a cutting off of the right-hand tail of the distribution of WAMs across taxable money market funds. This restriction has made money market funds more resilient to changes in interest rates that may accompany significant market shocks, and puts money market funds in a far better position to meet shareholder redemptions.

[58] *See* Rule 22e-3 under the Investment Company Act. Rule 22e-3 permits a money market fund to suspend redemptions and payment of redemption proceeds if (i) the fund's board, including a majority of directors that are independent of fund management, determines that the deviation between the fund's amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.

Figure 1

WAMs for Taxable Money Market Funds

Percentage of funds



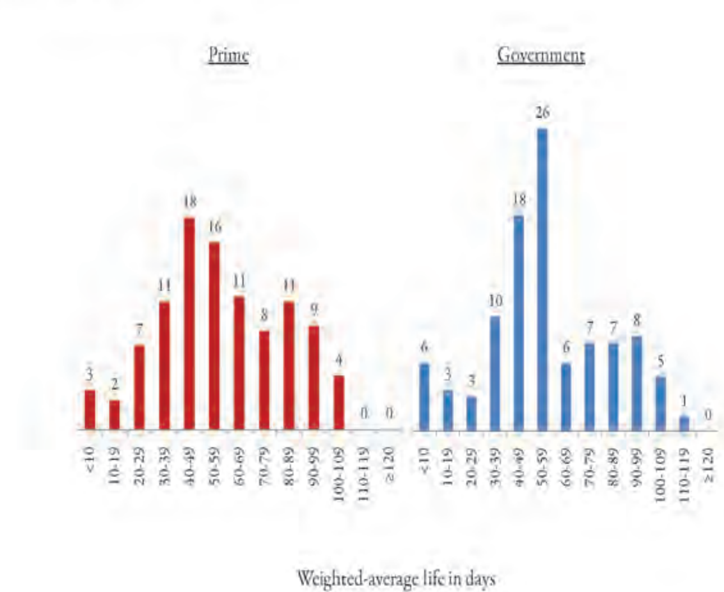
Source: Investment Company Institute

The introduction of a limit on money market funds' weighted average life ("WAL") also has strengthened the ability of money market funds to withstand shocks and meet redemption pressures. Unlike a fund's WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although data on WALs before November 2010 are not publicly available, publicly available data since then suggest that the new WAL requirement likely has bolstered the resilience of funds. Figure 2 depicts the distribution of WALs for taxable money market funds as of March 2012. The maximum allowable WAL is 120 days. Most funds are well below this, however, with the great majority having WALs in the range of 30 to 90 days. Only a very small proportion of funds have WALs in excess of 100 days.

Figure 2

WALs for Taxable Money Market Funds

Percentage of funds, March 2012



Source: Investment Company Institute tabulation of publicly available Form N-MFP data

2. *Daily and Weekly Liquidity Requirements*

The 2010 amendments directly and meaningfully addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. Under the new requirements, money market funds must maintain a sufficient degree of portfolio liquidity to meet reasonably foreseeable redemption requests. In addition, at a minimum, all taxable money market funds must maintain at least 10 percent of assets in daily liquid assets, and all money market funds must maintain at least 30 percent of assets in weekly liquid assets. The daily and weekly minimum liquidity requirements are measured at purchase. Thus, if a money market fund's holdings of daily liquid assets or weekly liquid assets fall below 10 percent or 30 percent of total assets, respectively, due to shareholder redemptions or redemptions in combination with changes in the value of portfolio securities, that will not violate these minimum requirements. Rather, Rule 2a-7 forbids the fund from acquiring anything other than a daily liquid asset or weekly liquid asset if, immediately after the acquisition, the fund would have invested less than 10 percent or 30 percent

(as applicable) of total assets in daily liquid assets or weekly liquid assets. The purchase by the fund of assets other than daily liquid assets or weekly liquid assets would trigger a violation.

The amendments also require funds, as part of their overall liquidity management responsibilities, to have "know your investor" procedures to help fund advisers anticipate the potential for heavy redemptions and adjust their funds' liquidity accordingly and to have procedures for periodic stress testing of their funds' ability to maintain a stable NAV.

Indeed, the new liquidity requirements have had a transformative effect on money market funds. As Figure 3 shows, as of March 2012, funds exceeded the minimum daily and weekly liquidity requirements by a considerable margin. For example, 29 percent of the assets of prime money market funds were in daily liquid assets and 44 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated $1.36 trillion in daily or weekly liquid assets, which includes an estimated $623 billion held by prime money market funds. In comparison, during the business week September 15, 2008 to September 19, 2008 (the week Lehman Brothers failed), prime money market funds experienced estimated outflows of $310 billion.[59] Accordingly, in March 2012, prime money market funds held daily and weekly liquid assets more than twice the level of outflows they experienced during the worst week in money market fund history.

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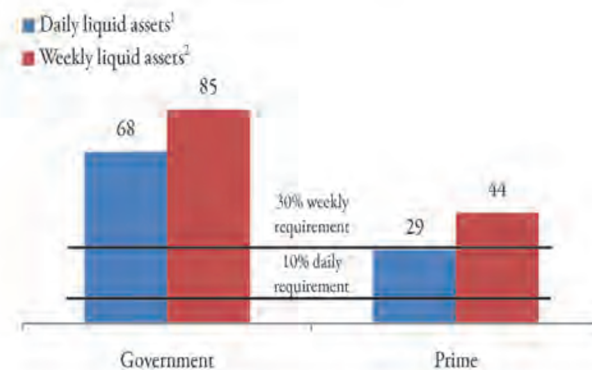
[59] *See* PWG Report, *supra* note 38, at 12.

Figure 3

Liquid Assets for Taxable Money Market Funds

Percentage of total assets, March 2012



[1]Daily liquid assets include securities with a remaining maturity of 1 business day, Treasury securities with a remaining maturity of 397 days or less, and securities with a demand feature that is exercisable within 1 business day. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for daily liquid assets.

[2]Weekly liquid assets include securities with a remaining maturity of 5 business days or less, Treasury securities with a remaining maturity of 397 days or less, agency securities with a remaining maturity of 60 days or less (regardless of whether those securities were initially issued at a discount), and securities with a demand feature exercisable within 5 business days. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for weekly liquid assets.

Sources: Investment Company Institute tabulation of publicly available Form N-MFP data

3. *Increased Disclosure*

By requiring more frequent and vastly more detailed disclosure of money market funds' holdings, the 2010 amendments have made money market funds likely *the* most transparent financial product in the United States. These funds now disclose every security they hold to the SEC each month (and publicly with a 60-day lag). They also disclose their mark-to-market NAV and other salient information. Regulators, analysts, and investors have been using this additional data to closely scrutinize fund portfolios. This heightened scrutiny has at times led regulators and analysts to highlight potential risks in particular fund holdings. The additional disclosure also has led certain advisers to avoid investments that, although exhibiting stable credit fundamentals, may raise investor concerns.[60]

[60] *See* N. Flanders, G. Fink-Stone, and V. Baklanova, *U.S. MMF Shadow NAV Volatility Declines Post-Crisis*, Fitch Ratings (January 18, 2012) ("Fitch Ratings' Special Report").

Thus, the discipline of far greater disclosure, consistent with the SEC's historical approach to protecting investors, in itself has had a strong palliative effect.

F. Recent Events in Financial Markets Underscore the Effectiveness of the 2010 Amendments

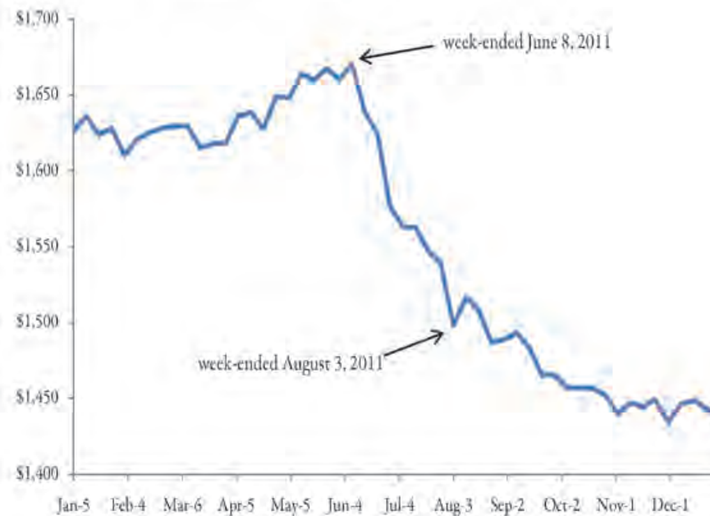
As a result of these regulatory changes, money market funds are much more resilient to economic and financial shocks. This is amply demonstrated by recent events. In 2011, money market funds weathered two financial market shocks attributable in large measure to government gridlock: the looming U.S. federal debt ceiling crisis in mid-2011 and deteriorating conditions in European debt markets throughout the year. Money market funds also had to contend with historically low interest rates and the U.S. federal government's extension of unlimited deposit insurance on non-interest bearing checking accounts, which provided depositors a guarantee on business checking account balances held at banks.[61]

[61] *See* Federal Deposit Insurance Corporation, *Deposit Insurance Regulations; Unlimited Coverage for Noninterest-Bearing Transaction Accounts*, 75 FR 69577 (November 15, 2010). As required by Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the unlimited insurance coverage became effective on December 31, 2010, and will expire on January 1, 2013. We are pleased that this program will expire in the near term, as we view it as having the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for these transaction accounts. Programs that create and sustain such moral hazard have no place in our markets. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (October 10, 2010), available at http://www.fdic.gov/regulations/laws/federal/2010/10c48AD37p.PDF.

Figure 4

Prime Money Market Funds Accommodated Large Outflows During U.S. Debt Ceiling and Eurozone Debt Crises

Assets, billions of dollars, 2011, weeks-ended Wednesday



Source: Investment Company Institute

Reflecting these circumstances, investors withdrew $213 billion from prime money market funds over the six-month period from June 2011 to November 2011 (Figure 4). To be sure, these outflows were smaller in dollar and percentage terms than the flows prime funds experienced during the worst months of the financial crisis in September and October 2008. Nevertheless, they were quite large, totaling 13 percent of the assets of prime money market funds as of May 2011. Moreover, the bulk of these outflows occurred in a very short time (the weeks ended June 8, 2011 to August 3, 2011) as the U.S. federal debt ceiling crisis came to a head. Over that eight-week period, outflows totaled $172 billion, or 10 percent of prime money market fund assets. Outflows in the month of June 2011 were the second largest on record, totaling $86 billion.

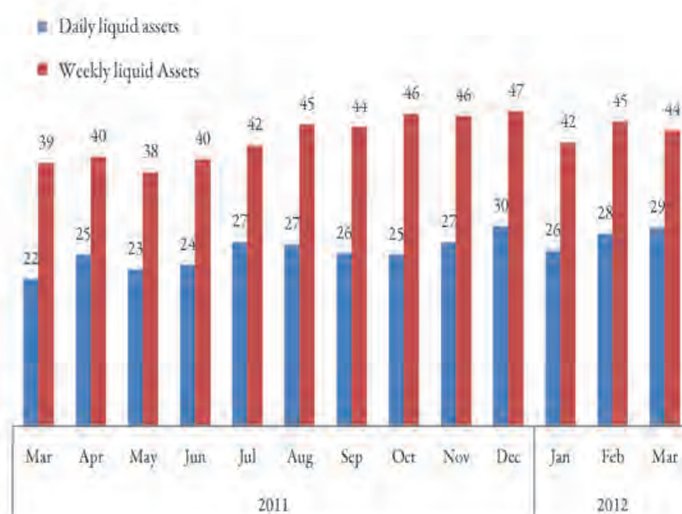
Prime money market funds accommodated these sizable outflows in an orderly manner. Funds had plentiful liquidity to meet redemptions. As of May 30, 2011, prime money market funds held an estimated $626 billion in daily and weekly liquid assets, well in excess of the outflows they experienced over the next several months. Moreover, the large outflows in the second half of 2011 had only a small

impact on funds' liquid asset ratios, which remained well above required minimum levels of 10 percent and 30 percent, respectively, for daily and weekly liquid assets (Figure 5).

Figure 5

Liquid Asset Ratios of Prime Money Market Funds, March 2011 to March 2012

Percentage of prime fund assets



Sources: Investment Company Institute tabulation of publicly available Form N-MFP data

In addition, despite the outflows and stresses in the market, money market funds' per-share market values were extremely stable. The average change in the mark-to-market value of prime funds between May and September 2011 was less than 1/100th of a cent. These findings are consistent with the findings of other analysts who note that the variability of prime money market funds' per-share market values has declined significantly since the 2007-2009 financial crisis, which they attribute in large measure to the revisions to Rule 2a-7 that went into effect in May 2010.[62]

V. Flawed Policy Options

ICI remains deeply concerned that regulators continue to consider policy options that would not strengthen money market funds but instead would alter their fundamental characteristics—such as a stable NAV and ready liquidity—thereby destroying the value of these funds to investors and the

[62] *See* Fitch Ratings' Special Report, *supra* note 60.

global economy. The contemplated changes also would reduce competition by driving fund sponsors out of the business. Moreover, if regulatory changes to money market funds alter those characteristics valued by investors, investors will move to less regulated, less transparent cash pools, increasing systemic risk. In this section, we highlight three such reforms that are under consideration at the SEC. First, we explore the proposition that all money market funds should let their share prices float—a structural change for the money market fund industry that would not reduce systemic risk but instead could increase it. Next, we discuss the idea that money market funds or their advisers should maintain capital against money market fund assets—an idea that not only alters the product but could cause significant industry contraction. Finally, we address the implementation of permanent redemption restrictions in the form of a "restricted share balance requirement"—a concept that not only would be prohibitively costly to implement, but also is contrary to the fundamental nature of a mutual fund.

A. Requiring Money Market Funds to "Float" Their NAVs

One proposal being advanced is eliminating the ability of money market funds to use the amortized cost method of valuation—forcing them to let their share prices fluctuate or "float." For example, those commentators who emphasize the liquidity, maturity, and credit transformation of money market funds[63] espouse a floating NAV. Opposed to this idea is a wide range of businesses, state and local government entities, financial services companies, and consumer organizations who argue that a floating NAV would destroy the convenience and simplicity of money market funds for investors, and compromise an important source of financing for many segments of the U.S. economy.[64] Also weighing in against a floating NAV are many individual investors who strongly oppose changing the fundamental nature of money market funds. Nevertheless, the option of requiring money market funds to float their NAVs remains a topic of discussion. This option would prohibit funds from using amortized cost to

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[63] This degree of transformation, in fact, is extremely modest, especially when compared to banks. As noted in Section IV, taxable money market funds are required to hold a minimum of 10 percent of their portfolios in daily liquid assets and 30 percent in weekly liquid assets. In addition, a money market fund's WAL cannot exceed 120 days. These requirements reduce liquidity and maturity transformation to very low levels, and in practice, money market funds exceed these requirements. For example, in March 2012, taxable money market funds held 45 percent of their portfolios in daily liquid assets and 60 percent in weekly liquid assets, far exceeding the minimum requirements. Furthermore, the average WAL in March 2012 was 66 days for government money market funds and 74 days for prime money market funds. Money market funds also are required to hold securities that pose minimal credit risk. As of December 2011, over 99 percent of money market fund portfolio assets received the highest short-term credit ratings. In addition, to the extent that a credit issue arises with a security, money market funds have clear rules to allow for the discontinuation of the amortized cost method of valuation and the repricing of the fund shares or suspension of redemptions and liquidation of the fund to ensure that there is no material dilution or unfair results to fund shareholders. These requirements ensure that existing fund investors share in the losses of a fund.

[64] The SEC received more than 60 comment letters in opposition to the concept of requiring money market funds to float their NAVs during its rulemaking on amendments to Rule 2a-7 in 2009. These letters came from a broad spectrum of businesses, governments, schools, retirement plans, consumer groups, and financial services firms. The list of these entities is available at http://www.ici.org/policy/regulation/products/money_market/10_mmfs_opposefloatingnav. In response to the SEC's request for comment on the PWG Report, ICI, along with over 100 companies or organizations, submitted letters to the SEC in opposition to the floating NAV concept. *See* PWG Comment Letter, *supra* note 37. These types of letters have continued to flow into the public comment file.

value portfolio assets, and from using the "penny rounding" method to determine the NAV of fund shares on a daily basis. Instead, money market funds would be required to mark all portfolio assets to market on a daily basis.

It is important to note that requiring the use of mark-to-market pricing in lieu of amortized cost pricing would not, under normal circumstances, cause a money market fund's share price to float. This is because money market funds have three characteristics that contribute to the stability of their share price. First, money market funds declare dividends on a daily basis so that income does not accumulate in the share values.[65] Second, money market funds hold very short duration portfolios with minimal credit risk, minimizing the effects of even large interest rate changes on the underlying value of the portfolio. For example, about 70 percent of money market funds had a WAM of 50 days or less at the end of April 2012. The third feature is the use of amortized cost combined with penny rounding.

The effects of the first two characteristics—daily declaration of income and short duration, high-quality portfolios—can be observed by examining money market funds' mark-to-market share prices. Data from a sample of taxable money market funds covering one-quarter of taxable money market fund assets show that the average per-share market values for prime money market funds varied between $1.002 and $0.998 during the decade from 2000 to early 2010 (*i.e.*, years prior to the implementation of the SEC's 2010 money market fund reforms).[66] More recently, using publicly available data from Form N-MFP reports that require money market funds to disclose their underlying mark-to-market share price, without using amortized cost pricing,[67] ICI calculated changes in prime fund share prices on a monthly basis for January 2011 to March 2012. Nearly all (96 percent) of the prime money market funds had an average absolute monthly change in their mark-to-market share prices of 1 basis point or less and all had an average absolute monthly change of less than 2 basis points. To make the NAV float, funds' NAVs would need to be changed to $100.00 a share (*e.g.*, through a reverse 1 for 100 share split).

The stabilizing effect of penny rounding is illustrated during periods of volatile interest rates. For example, assuming a $1.00 NAV, short-term interest rates would need to move by 3 percentage

[65] For example, income accrued daily, in the form of either coupon interest receivable or the increase in the amortized cost value of discount instruments, less fund expenses (*e.g.*, management fees), is recognized as net investment income. Each day's net investment income is distributed to shareholders through the daily dividend. While dividends are declared daily, cash distribution typically takes place monthly, and until that time the fund recognizes a liability for dividends payable. Accordingly, increases in assets (attributable to income accrual) are offset by recognition of a corresponding liability (for dividends payable) so that there is no increase in the fund's net assets or share price associated with accrual or collection of interest on the fund's investments.

[66] *See* Investment Company Institute, *Pricing of U.S. Money Market Funds* (January 2011), available at http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf, at 26.

[67] Share prices that excluded sponsor support were used for the calculation.

points (or 300 basis points) in one day to cause the typical money market fund's mark-to-market price to fall by one-half of one percent.[88]

As we discuss below, and as numerous investors and issuers already have advised the SEC, requiring money market funds to move to a floating NAV would be unlikely to reduce systemic risk and may, in fact, increase it. Furthermore, we have deep concerns about the impact such a change would have on financial markets, both during a transition period and afterward.

1. *Impact of a Floating NAV on Preventing Investor Runs*

Some have argued that requiring money market funds to float their NAVs will reduce the tendency of money market funds to experience large redemptions during periods of financial stress. Evidence from products with floating NAVs suggests this is incorrect.

For example, while ultra-short bond funds are not required to follow Rule 2a-7, they do invest in a portfolio of relatively short-dated securities. In contrast to money market funds, however, the NAV of an ultra-short bond fund fluctuates. Beginning in the summer of 2007, the average NAV on these funds began to fall (Figure 6). In February and March 2008, several ultra-short bond funds posted significant NAV declines, and the average NAV of these funds fell about 2 percent. This preceded a large outflow of assets from such funds; during a four-week period ending in early April 2008, these funds experienced cumulative outflows of 15 percent of their assets. By the end of 2008, assets of these funds were down more than 60 percent from their peak in mid-2007.

Thus, we remain doubtful that floating the NAV of money market funds would reduce risks in any meaningful way. Rather, prohibiting money market funds from maintaining a stable NAV likely would lead investors to abandon money market funds for less regulated products that seek to maintain a stable NAV, as discussed below, and therefore simply would shift risks to this less regulated and more opaque part of the market.

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[88] *See* Investment Company Institute, *Pricing of U.S. Money Market Funds* (January 2011), available at http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf, at 26.

Figure 6

Weighted Average NAV and Net New Cash Flow of Ultra-Short Bond Funds

Weekly

Sources: Investment Company Institute and Morningstar

2. *Investor Demand for a Stable NAV Fund Would Remain*

One very significant concern is whether investors would continue to use money market funds if the stable NAV was eliminated. For a substantial number of investors, the answer is a resounding no.

Many institutional investors that use money market funds would be unable to use a floating NAV fund. These investors often face legal or other constraints that preclude them from investing their cash balances in pools that do not maintain a stable NAV. For example, corporations may have board-approved policies permitting them to invest operating cash (balances used to meet short-term needs) only in pools that seek to maintain a stable NAV. Indentures and other trust documents may authorize investments in money market funds on a similar assumption. Many state laws and regulations also authorize municipalities, insurance companies, and other state regulated entities to

invest in stable NAV funds, sometimes explicitly including funds operating in compliance with Rule 2a-7. Thus, absent a stable NAV, many state and local governments no longer would be able to use money market funds to help manage their cash.[69]

Investors that do not face such constraints still may be unwilling to invest in a floating NAV product. For example, the $1.00 per share pricing is vitally important to the usefulness of money market funds to a variety of business applications involving automated accounting and settlement systems.[70] The use of amortized cost accounting and a stable NAV allow the efficient processing of cash balances through cash sweep programs in which customer cash balances are "swept" into investments in shares of money market funds that are owned by the customer but transacted through accounts registered to a broker-dealer or a bank. A stable NAV also offers significant convenience in terms of tax, accounting, and recordkeeping. For example, as discussed above, all of a money market fund's returns are distributed to shareholders as income. This relieves shareholders from having to track gains and losses, *including* the burden of having to consider the *timing* of sales and purchases of fund shares (*i.e.*, wash sale tax rule considerations). To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors make fewer purchases and sales from long-term mutual funds because they are used for long-term investing, not cash management. And in any case, many purchases (or exchanges) in long-term funds are made within tax-advantaged accounts (*e.g.*, 401(k) plans) where such issues do not arise.

A floating NAV also would reduce the value and convenience of money market funds to individual retail investors. For example, brokers and fund sponsors typically offer investors a range of features tied to their money market funds, including ATM access, checkwriting, electronic check payment processing services and products, and Fedwire transfers. These features generally are provided only for stable NAV products. In addition, money market funds typically offer investors same-day settlement on shares redeemed via "wire transfer" (where redemption proceeds are wired to an investor's bank account via Fedwire), whereas bond funds typically offer *next*-day settlement. Thus, elimination of the stable NAV for money market funds likely would force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

Proponents of eliminating the stable NAV state that there is no direct evidence regarding the likely effect of a floating NAV on the demand for money market funds. The current rate environment, however, has proven to be an important test of investor demand for stable NAV funds. Currently, yields on money market funds are on average 150 basis points below short-duration bond funds, and

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[69] *See* MMWG Report, *supra* note 3, at Appendix D.

[70] For a detailed description of the specialized business applications and automated systems that use stable NAV money market funds to hold temporary liquidity balances, *see* Letters from John D. Hawke, Jr, Arnold & Porter LLP, to Chairman Mary Schapiro, Chairman, Securities and Exchange Commission (December 15, 2011) and the Financial Stability Oversight Council (December 15, 2011) (regarding Federated Investors, Inc.'s comments on FSOC's rulemaking proposal to require supervision and regulation of certain nonbank financial companies), available at http://regulations.gov/comments/4-619/4619-112.pdf.

300 to 500 basis points below longer term bond funds.[71] Yet, assets in money market funds are roughly $2.6 trillion, *greater* than the assets held in money market funds prior to the start of the financial crisis in the summer of 2007.

Indeed, a diverse range of investors in money market funds previously have communicated their opposition to floating NAVs. In a letter to the SEC, a group of 36 North Carolina independent colleges and universities noted that "requiring a floating NAV would eliminate money market mutual funds as a stable option and as a reasonable investment for [colleges and universities to use] for cash management purposes."[72] The stable $1.00 NAV, as the Financial Services Institute told the Subcommittee on Capital Markets and Government Sponsored Enterprises of the U.S. House of Representatives' Committee on Financial Services in June 2011, provides "a high degree of liquidity, diversification, and convenience, along with a market-based yield" to investors.[73] In its comments to the Subcommittee, Financial Executives International noted that corporate treasurers "use money market funds as a diversification tool . . . [and] are not geared to mark-to-market on a daily basis and will have to pull out of money market funds if a floating NAV is adopted."[74]

Members of Congress also have communicated their concern regarding proposals that would require money market funds to float their NAVs. A bi-partisan letter to SEC Chairman Mary Schapiro from 33 former state and local government officials who now serve in Congress highlighted the importance of the stable $1.00 NAV to states, municipalities and towns as not only a cash management tool and short-term investment option, but also for "the issuance of debt to fund many [ ] critical public projects."[75]

Furthermore, surveys of money market fund investors indicate clearly that most of these investors do not want and would not use a floating NAV product. For example, a survey of corporate treasurers and other institutional investors indicated that nearly 80 percent of respondents would either decrease their use of money market funds or discontinue use of them altogether if money market funds

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[71] Investment Company Institute; Morningstar; iMoneyNet.

[72] *See* Letter from A. Hope Williams, President, North Carolina Independent Colleges & Universities, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (April 13, 2012), available at http://sec.gov/comments/4-619/4619-167.pdf.

[73] *See* Statement for the Record from the Financial Services Institute on behalf of the independent broker-dealers and financial advisors that they represent and the investors whom they serve, available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/07/FSIs-Statement-for-the-Record-on-Money-Market-Funds-07-14-11.pdf.

[74] *See* Letter from Susan Stalnecker, Chair, Financial Executives International's Committee on Corporate Treasurers, available at http://financialservices.house.gov/UploadedFiles/112-42.pdf. Also available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/06/CCT_ltr_to_House_FSC_Money_Market_Fund_6-24-11_1309210528l.pdf

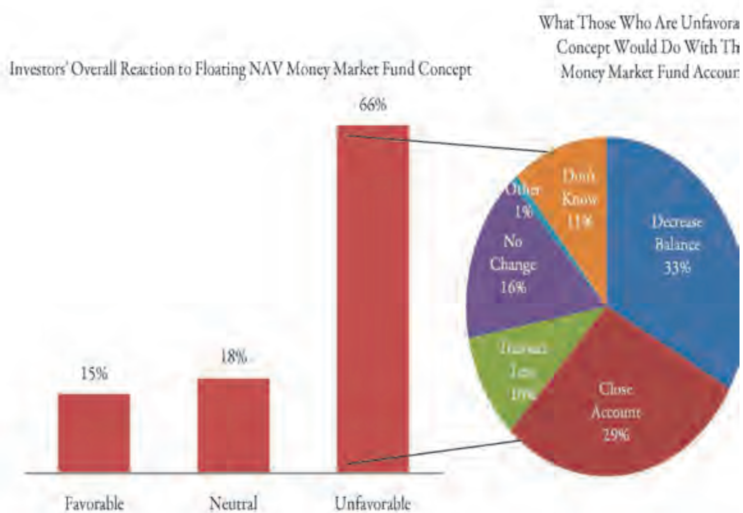
[75] *See* Letter to Mary Schapiro, Chairman, Securities and Exchange Commission (May 1, 2012), available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_1335965851l.pdf.

are required to have a floating NAV. Based on this response, over 60 percent of corporate money market fund assets would move to other investments if this concept were adopted.[76]

A survey of retail money market fund investors commissioned by T. Rowe Price and conducted online by Harris Interactive indicated much the same response (Figure 7).[77]

Figure 7

Retail Investors' Reaction to Floating NAV Money Market Funds



Source: Harris Interactive / T Rowe Price

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[76] *See* TSI Survey, *supra* note 7.

[77] Based on a study commissioned by T. Rowe Price and conducted online by Harris Interactive from August 31 to September 7, 2010 of 413 adults aged 35-75 who own money market funds outside of a retirement plan, who also own at least one long-term mutual fund, who invest directly with a mutual fund company, do not rely solely on the advice of an investment adviser, and have $100,000 or more in investable assets. The data are weighted to be representative of the adult population with $100,000 or more in investable assets. A full methodology is available upon request.

Two thirds of retail investors surveyed found the idea of a floating NAV money market fund unfavorable. Among those who reacted to the concept unfavorably, 72 percent indicated that they would use the product less, and that their most likely response would be to close their money market fund accounts (29 percent), decrease their money market fund balances (33 percent), or execute fewer money market fund transactions (10 percent). A third survey, conducted among both retail and institutional shareholders by Fidelity Investments, found much the same result.[78] This survey found that institutional investors overwhelmingly (89 percent) indicated a preference for keeping the stable NAV and more than half (57 percent) indicated they would use money market funds less or not at all if faced with the prospect of a floating NAV. Retail investors also disliked the floating NAV concept. Seventy-four percent of the retail investors surveyed also favored keeping the stable NAV and 47 percent of those surveyed said they would move all or some of their assets out of money market funds if funds changed to a floating NAV. In short, data on the subject demonstrate that investors do not want and likely would reject a floating NAV money market fund.

3. *Floating the NAV Would Harm the Market*

The principal impact of a floating NAV for money market funds will be a major restructuring and reordering of intermediation in the short-term credit markets. If assets move to less regulated and less transparent products or structures, risks in the financial markets will increase.

Assets in money market funds now total $2.6 trillion. As discussed above, money market fund investors of all types are unlikely to use a floating NAV product. Requiring these funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. This transition, in and of itself, could be destabilizing to the financial markets. It would require money market funds to shed hundreds of billions of dollars of commercial paper, bank CDs, Eurodollar deposits, repurchase agreements, and other assets. Even under the calmest of financial market conditions, this would be a highly tricky process. During a period of stress in the money market, such a transition could well set off the very kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs assuredly will shift credit intermediation from one type of product to others. There are a number of alternative products that money market fund investors could use, including enhanced cash pools, local government investment pools, and other vehicles that seek to maintain a stable unit price but are not regulated under the Investment Company Act.[79] Regulatory changes that push assets from regulated products (*i.e.,* money market funds) to less regulated and less transparent products arguably serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.[80]

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[78] *See* Fidelity Investments, *The Investor's Perspective: How Individual and Institutional Investors View Money Market Mutual Funds and Current Regulatory Proposals Designed to Strengthen Money Funds* (December 2, 2011).

[79] For an overview of some of these alternatives, *see* MMWG Report, *supra* note 3, at 41-46.

[80] *See* MMWG Report, *supra* note 3, at 62-64.

Many investors already have the ability through banks to select among various sweep arrangements that seek to offer a stable unit value, such as money market fund sweeps, repurchase agreement sweeps, commercial paper sweeps, and, importantly, sweeps into offshore (non-money market fund) accounts (*e.g.*, Eurodollar sweeps).[81] If a stable NAV is eliminated for money market funds, investors can migrate to these other kinds of sweep accounts, which in some cases (*e.g.*, Eurodollar sweeps) largely are beyond the jurisdictional reach of U.S. domestic regulators.

Even if investors shift their liquid balances to conventional bank deposits, corporate cash managers and other institutional investors would not view an undiversified holding in an uninsured (or underinsured) bank account as having the same risk profile as an investment in a diversified short-term money market fund. Such investors would continue to seek out diversified investment pools, which may or may not include bank time deposits. Insuring all these new deposits would entail a major increase (perhaps as much as $2 trillion) in the federal government's potential insurance liability and would result in a vast increase in moral hazard, a development that would simply increase systemic risk.

In addition, a shift to traditional banks would result in a significant reduction in the supply of short-term credit to corporate America unless banks raised significant amounts of capital to be able to support their expanded balance sheets. Even if they could raise the capital to support this expansion, the market would be less efficient and the cost of short-term credit would rise. Furthermore, municipalities would lose an important source of financing in the short-term markets because banks cannot pass through tax-exempt income and simply could not replace tax-exempt money market funds.

Not surprisingly, issuers of money market securities have expressed serious concerns about the disruptive effects in the market for their securities should regulatory reforms diminish the role played by money market funds. For example, in its letter to the House Subcommittee on Capital Markets and Government Sponsored Enterprises in June 2011, the Association for Financial Professionals warned that moving to a floating NAV would create "significant disruptions in the corporate funding market. . . . [because] many organizations issue commercial paper to meet their short-term financing needs, such as funding payroll, replenishing inventories, and financing expansion."[82] Similarly, a group of 12 state and local government groups representing both investors in money market funds and issuers of municipal securities that are purchased by money market funds expressed their views to the Subcommittee that mandating a floating NAV "would make [money market funds] far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing

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[81] For a general discussion of overnight sweep arrangements, *see* MMWG Report, *supra* note 3, at 43-44.

[82] *See* Letter from James A. Kaitz, President and CEO, Association for Financial Professionals, available at http://financialservices.house.gov/UploadedFiles/112-42.pdf. Also available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/06/AFP_Comments_on_MMF_Reform_-_June_2011_13089337503.pdf.

this vital investing power could lead to higher debt issuance costs for many state and local governments across the country."[83]

In sum, there is strong demand for a stable NAV money market fund or money market fund-like product. Many institutional investors will find a way to satisfy that demand, but at least in the short run, retail investors are not likely to be able to do so. And while new financial products eventually will develop, until that time there will be substantial market dislocations.

B. Capital Buffers

Recent comments by SEC officials and others have suggested that money market funds or their advisers be required to hold capital to provide a buffer protecting fund investors from potential future losses on their funds.[84] In a recent ICI study, we analyzed the likely outcomes of a capital buffer for the money market fund industry.[85] Our study considered several variations on the capital buffer idea, including requiring money market fund advisers to commit capital, requiring funds to raise capital in the market, or having funds build a capital buffer inside funds from fund income. A summary of our findings is provided below.

1. *Requiring Fund Advisers to Commit Capital*

Proposals requiring money market fund advisers to commit capital to absorb possible future losses in their funds would alter fundamentally the money market fund business model. A money market fund, like every other mutual fund, provides investors a pro rata interest in the fund, whereby fund investors share in the risks and rewards of the securities held by the fund. All of the fund's shares are equity capital. The default risk of diversified portfolios of securities held by money market funds is very low, and is shared by all fund investors, so the likelihood that an individual investor will experience a sizeable loss, or any loss at all, is remote.

Imposing capital requirements on a fund adviser would transform the essential nature of a money market fund by interposing the adviser between the fund and its investors. Currently, fund advisers do not allocate capital to absorb losses because investors bear the risks of investing in funds. To be sure, some money market fund advisers have at times voluntarily supported their funds. But these

[83] *See* Joint Letter of the American Public Power Association, Council of Development Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, International City/County Management Association, International Municipal Lawyers Association, National Association of Counties, National Association of Local Housing Financing Agencies, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National League of Cities, U.S. Conference of Mayors, available at http://financialservices.house.gov/UploadedFiles/112-42.pdf. Also available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/06/GFOA-Municipal_Groups_Statement_for_HFSC_062411_13089336282.pdf.

[84] *See, e.g.*, Schapiro March 2012 Remarks, *supra* note 6.

[85] *See generally* Investment Company Institute, *The Implications of Capital Buffer Proposals for Money Market Funds* (May 16, 2012), available at http://www.ici.org/pdf/ppr_12_mmfs_capital_buffer.pdf.

advisers did so as a business decision. Requiring all fund advisers to take on a first loss position would be radical departure from the current agency role that fund advisers play. The mutual fund structure, including that of money market funds, is designed so fund advisory fees compensate the adviser for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. Advisers are *not* compensated for bearing investment risks of the fund.

Shifting investment risks from fund investors to advisers would require advisers to dedicate capital to absorb possible losses of the funds that they manage. Some advisers would have to raise new capital in the market. Others could perhaps shift capital from other parts of their businesses. Either way, all advisers would have to earn a market rate of return on such capital. If they cannot earn that rate of return, they would seek better business alternatives, such as seeking to move investors to less-regulated cash management products where investors still must bear the risks of investing.

While the potential for losses is remote, the cost of providing capital likely would be significant. Under money market funds' current structure, small and highly infrequent losses are spread across a large number of fund investors and a large asset base. Under the structure being contemplated, small losses would be concentrated in a single investor (the adviser) and across a small asset base (the value of the capital). The adviser could face large *percentage* losses on its capital investment and thus would require a compensatory rate of return.

In theory, advisers could seek to pass along to investors the cost of providing the capital to absorb investment risks. As a practical matter, however, we doubt this is possible. Because of the very low interest rate environment, advisers at present have no ability to pass along cost increases; doing so would raise fund expense ratios, dropping net returns below zero. Even in a more normal interest rate environment, advisers would have difficulty passing the cost of the required capital on to fund investors. Rule 2a-7's risk-limiting provisions effectively place a ceiling on what a prime money market fund may earn. Yields on Treasury funds set a floor on the yields that prime funds may return to investors after expenses, which in turn limits the fees that prime funds may charge.

In addition, any proposed increase in a fund's advisory fees must be put to a shareholder vote. Shareholder votes can be costly to undertake and outcomes by no means would be guaranteed. Even if shareholders accepted a fee increase, the increase could be so large as to reduce the net yield on a prime fund below that of a Treasury-only money market fund. All else being equal, an increase in a fund's advisory fee will lower the fund's net yield. Any desire to offset the effect on the fund's yield by holding riskier and therefore higher yielding securities would be constrained by the risk-limiting provisions of Rule 2a-7 and, in any case, counterproductive to the goals of regulators. Presumably no investor would hold a prime money market fund that offered a return below that of a Treasury fund.

By far the most likely outcome is that advisers would have to absorb the cost of providing the capital buffer. Although outcomes depend on the particulars of any proposal, our analysis indicates that capital buffers in the range of 1.5 percent to 3 percent would cause advisers to reconsider the money market fund business model. There are various ways to illustrate this. In our recent study on capital buffers, we focused on two approaches: internal rate of return and payback period. The analysis

shows that it would require very sizable increases in the fees of prime money market funds for advisers to earn a reasonable rate of return on capital they might be required to pledge. For example, depending on how the capital requirement is calculated, prime money market fund fees might need to rise between 18 and 40 basis points for advisers to earn a 5 to 7 percent rate of return on invested capital.

Our analysis shows that under current fee structures and market conditions, capital buffers of 1.5 percent to 3 percent would absorb every dollar of advisers' net earnings from money market funds for 18 to 43 years, depending on whether only Treasury securities or both Treasury and agency securities are excluded from a capital assessment. Even under best-case assumptions, these buffer requirements would absorb at least 8 to 20 years of advisers' profits from operating money market funds.

For all of these reasons, it is foreseeable that many, if not most, fund advisers would make the business decision to change their cash management offerings radically. Some advisers may simply liquidate their funds and not offer alternative products. Others may refocus their efforts on alternative cash-like products that are less regulated and less transparent, thereby increasing risks in the financial markets.

2. *Requiring Funds to Raise Capital in the Market*

As an alternative to requiring fund advisers to commit capital, some have suggested requiring funds to raise capital in the market. As noted above, ICI engaged capital markets experts to help study this approach in depth.[86] We ultimately concluded, for several reasons, that market-provided capital is not a feasible option for the money market fund industry. Adding subordinated debt or equity would turn a rather simple product—the money market fund—into a considerably more complex offering. Small funds and small fund complexes likely would find it difficult and costly to issue and roll over subordinated securities, resulting in further industry consolidation and raising a barrier to entrants. The approach also would potentially create competing interests between the subordinated investors' desire to avoid losses and senior shareholders' (*i.e.,* traditional money market fund investors') tolerance for taking greater risks for greater yields.

A market-raised capital buffer would reduce the yield available to senior shareholders, and subordinated investors would have a highly levered—and hence potentially volatile—investment. The compensation subordinated investors would demand for assuming such volatility would reduce the yield available to the senior share class. A smaller capital buffer would further magnify losses to the subordinated investors. While the fund would be required to raise less capital, the resulting subordinated securities would be more levered, more volatile, and therefore more expensive and difficult to sell.

Other issues that could complicate the use of this structure include that, to be marketable, the subordinated securities would need to obtain a credit rating (and thus be structured as debt) but for

[86] *See supra* note 43 and accompanying text.

various reasons, credit rating agencies would not be likely to treat the securities as debt. The legal structure of the subordinated securities also would pose challenges—whether they are issued by the fund or issued by a special purpose bankruptcy remote entity. In addition, while in theory capital could be raised more quickly in the markets than through retained earnings, launching a new form of security is likely to be a complex and time-consuming process. And it might require more than 600 individual money market funds to enter the market seeking to raise capital simultaneously. Finally, it is unclear how well this structure would protect senior share class investors during times of market stress.

3. *Requiring a Within-Fund Capital Buffer*

Building a within-fund capital buffer would align more directly the costs of the buffer with the fund's beneficiaries: fund shareholders. Capital at this level would not absorb large credit losses, but it would provide funds somewhat greater flexibility in selling securities at a price below amortized cost. Legal and accounting considerations, however, would limit a within-fund capital buffer to 0.5 percent of a fund's total assets. Also, because of tax and economic considerations, a fund likely would need many years to build such a buffer. As the analysis shows, under plausible assumptions, building such a buffer might take a typical prime fund 10 to 15 years. The exact horizon depends on whether short-term interest rates rise somewhat more quickly than is currently expected, on how investors respond to a buildup of a within-fund capital buffer, and on the willingness of advisers to continue to absorb the cost of maintaining large fee waivers. In the best of circumstances, building a within-fund capital buffer of 0.5 percent likely would require at least five years.

C. Redemption Restrictions

The SEC is considering subjecting money market funds to "redemption restrictions" that would deny investors full use of their cash. It appears that regulators are looking at a variety of possible approaches that, in essence, would escrow a portion of a shareholder's money market fund account on an ongoing basis. The money held back from an investor's account due to redemption activity would be used to absorb first losses if a fund cannot maintain its $1.00 NAV.

Proponents of redemption restrictions believe that such restrictions can prevent or mitigate redemption pressure similar to that experienced by prime money market funds in 2008 by removing investors' incentives to be among the first to redeem (the so-called first mover advantage). They also believe that redemption restrictions will make explicit to investors that money market funds entail risk, which will be borne by investors in times of severe market stress.

The SEC's contemplated redemption restrictions for money market funds would permanently alter the ability of fund investors to redeem all of their shares on a daily basis. They apparently would apply to all funds and all investors at all times, under all market conditions. Simply put, they would impair a core mutual fund investor protection and reverse more than 70 years of SEC practice in fund regulation.

Under the Investment Company Act, one hallmark feature of mutual funds, including money market funds, is that they issue "redeemable securities," meaning that the fund stands ready to buy back

its shares at their current NAV. Section 22(e) of the Investment Company Act generally prohibits funds from suspending the right of redemption and from postponing the payment or satisfaction upon redemption of any redeemable security for more than seven days, except under extraordinary circumstances that are delineated in the statute or determined by SEC rule.[87] Under this authority, in 2010, the SEC adopted Rule 22e-3, which exempts money market funds from Section 22(e) to permit them to suspend redemptions and postpone payment of redemption proceeds—but only in very limited circumstances, *i.e.,* in order to facilitate an orderly liquidation of the fund.[88] By contrast, the redemption restrictions that the SEC is now contemplating would permanently alter the ability of money market fund investors to redeem all of their shares on a daily basis.

ICI opposes any sort of redemption restriction that would impair investor liquidity when liquidity is readily available within the money market fund. The SEC's contemplated redemption restrictions, if adopted, represent an experiment on the $2.6 trillion money market fund industry that could have harmful consequences for the broader financial markets, including financing for businesses and state and local governments.

These redemption restrictions also would create serious operational issues that would reduce or eliminate the usefulness of many services that money market funds and financial providers extend to investors. ICI recently issued a paper that focuses on the operational implications of the SEC's possible proposals for redemption restrictions.[89]

As discussed in our paper, throughout the 40-year history of money market funds, investors have benefited from the convenience, liquidity, and stability of these funds. Individual or retail investors use money market funds as savings vehicles to amass money for future investments or purchases; as transaction accounts; and as stable-value investments in their retirement or other investment portfolios. Institutional investors—which include corporations of all sizes, state and local governments, securities lending operations, bank trust departments, sweep programs, securities brokers, and investment managers—use money market funds as a cost-effective way to manage and diversify credit risk, while providing same-day liquidity with market-based yields.

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[87] Certain foreign regulatory regimes offer fund advisers mechanisms that, provided that the actions are in the interest of fund shareholders, give them significant discretion and flexibility to address extraordinary circumstances, such as an unexpected loss of liquidity in the markets, while also helping them stem an incipient run on a fund. For an overview of the various tools available to offshore funds, *see* MMWG Report, *supra* note 3, at 85–86.

[88] *See supra* Section IV.D. When it adopted Rule 22e-3, the SEC noted that the rule "is intended to reduce the vulnerability of investors to the harmful effects of a run on the fund, and minimize the potential for disruption to the securities markets." MMF Reform Adopting Release, *supra* note 4, at 10088. The SEC recognized, however, that permitting suspension of this statutory protection should be limited to extraordinary circumstances. "Because the suspension of redemptions may impose hardships on investors who rely on their ability to redeem shares, the conditions of the rule limit the fund's ability to suspend redemptions to circumstances that present a significant risk of a run on the fund and potential harm to shareholders. The rule is designed only to facilitate the permanent termination of a fund in an orderly manner." *Id.*

[89] The paper is available at: http://www.ici.org/pdf/ppr_12_operational_mmf.pdf.

To meet these shareholder needs, funds, intermediaries, service providers, and investors have developed a wide array of arrangements for distributing and using money market funds efficiently. Investors can purchase and redeem money market fund shares directly from fund sponsors or through a wide array of platforms, portals, and financial intermediaries such as broker-dealers and retirement plans. Money market funds are the primary investment for sweep accounts offered by broker-dealers and financial advisers. Investors also benefit from the convenience of check-writing or debit-card access to their money market funds. These offerings depend critically on an intricate and complex operational infrastructure created by the industry that allows investors to transact smoothly and efficiently, often with same-day settlement.

Implementing the SEC's proposed freeze on shareholders' assets would require changes to a myriad of systems that extend well beyond those under the control of the funds themselves. Fund complexes, intermediaries, and service providers have developed complex systems that allow them to communicate and process significant volumes of money market fund transactions on a daily basis through a variety of mechanisms on behalf of investors. To apply continuous redemption restrictions accurately and consistently across all investors in money market funds, each of these entities, including a host of intermediaries, would need to undertake intricate and expensive programming and other significant, costly system changes.

In many cases, daily redemption restrictions would simply render money market funds useless for offerings and services that investors and intermediaries value. Intermediaries and funds that can and choose to continue to provide money market funds would be required to make extensive and burdensome changes throughout their operational structure. Our analysis indicates, however, that the costs of these changes could be prohibitive and that the industry would be unlikely to undertake them, particularly if the SEC's changes result in shrinking the asset base of money market funds.

The SEC's suggested redemption restrictions would remove money market funds as a viable option in many instances. Fiduciaries, such as retirement plans, trustees, and investment advisers, may be legally prohibited from using money market funds with redemption restrictions for their clients, because such restrictions would impair clients' liquidity. Sweep programs, which rely upon the ability to move 100 percent of an investor's available cash on a daily basis, would not be able to employ money market funds if they are subject to a holdback of investor assets. Retail investors' ability to access their money market funds through checks and debit cards could also be impaired.

In other uses, funds, intermediaries, and institutional investors conceivably could restructure and reprogram operational systems to incorporate daily redemption restrictions. ICI's paper provides an overview of the systems and processes that would require modification by thousands of institutional investors, funds, intermediaries, and service providers. Based on ICI's cost-benefit analysis of a prior rule proposal requiring extensive systems and operational changes, it is reasonable to expect that requiring money market funds to adopt the SEC's contemplated restricted share balance concept would cost the industry hundreds of millions of dollars.[90] These costs are largely fixed and not scalable to the

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[90] Two years ago, ICI conducted a cost-benefit analysis of proposed changes to Rule 12b-1 under the Investment Company Act that would have required extensive systems and operational changes. The estimated costs for these changes were $231

size of the asset base. It would be difficult for intermediaries, in particular, to justify such expenses even if money market fund assets were to remain at their current level.

Investor reaction to the SEC's contemplated redemption restrictions, however, suggests that enactment of these proposals would greatly reduce investor use of money market funds. In a survey of corporate treasurers and other institutional investors, 90 percent of these investors indicated that they would reduce their usage or stop using money market funds altogether if the SEC's contemplated redemption restrictions were put in place.[91] Calculations based on these investors' responses suggest that institutional assets in money market funds would shrink by two-thirds if the restrictions were imposed. Retail investors also have indicated that they would limit their use of money market funds with redemption restrictions.[92] Investors that hold accounts directly with funds may choose alternative products that are less regulated, widely varying, and more opaque, but that would better meet their liquidity needs. This movement would seem unlikely to reduce systemic risk and, indeed, would be more likely to increase risk.

A sharp reduction in investors' use of money market funds would have severe consequences. Money market funds hold more than one-third of corporate commercial paper and about three-quarters of state and local government short-term debt. Shrinkage of money market fund assets would significantly disrupt the flow of short-term financing within the American economy.

The likely consequences of the SEC's contemplated redemption restrictions are thus mutually reinforcing. Fund complexes, intermediaries, and service providers will be hard-pressed to justify undertaking the significant costs of compliance with the restrictions in the face of the rapid shrinkage of money market fund assets predicted by investors' response to the proposals. We believe many intermediaries would make the business decision to migrate to unregulated or less-regulated money market investment vehicles or bank deposit products where possible, in lieu of implementing costly changes to their systems in order to continue to offer money market funds to a dwindling shareholder

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million for fund complexes only, not including additional costs that would have been incurred by intermediaries. *See* Investment Company Institute, *Cost-Benefit Analysis of SEC Rule 12b-1 Reform Proposal* (December 1, 2010), available at http://www.ici.org/pdf/10_12b1_sec_cba.pdf, at 11, Figure 4. We believe the changes that would be required to implement the SEC's redemption restrictions easily could meet or exceed this prior estimate.

[91] *See* TSI Survey, *supra* note 7. BlackRock Inc., in separate interviews of its institutional money market fund shareholders, found "virtually without exception" that redemption restrictions "would cause them to abandon [money market funds]." *See* BlackRock ViewPoint, *Money Market Funds: The Debate Continues—Exploring Redemption Restrictions, Revisiting Floating NAV* (March 2012), available at http://sec.gov/comments/4-619/4619-127.pdf.

[92] In a survey of its retail clients, Fidelity Investments found that about half of its retail clients would invest less or stop investing in money market funds with redemption restrictions regardless of whether the restrictions were continual or applied only during periods of market stress. *See* Fidelity Investments Letter from Scott C. Goebel, Senior Vice President and General Counsel, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (February 3, 2012), available at http://sec.gov/comments/4-619/4619-116.pdf.

base. The total effect would be to drive users away from money market funds, disrupt short-term financing for the economy, and increase use of less-regulated, less-transparent alternatives.

VI. Conclusion

We appreciate the opportunity to share our views with the Senate Committee on Banking, Housing and Urban Affairs. We look forward to working with Congress and regulators as they seek to address this important issue in the best possible way for millions of American investors who rely on money market funds as an effective cash management tool and as an indispensable source of short-term financing for the U.S. economy.

Appendix A

Timeline of Major Developments in the Financial Crisis[1]

VII. Key Market Events Leading Up to September 2008

June 2007

- Two Bear Stearns hedge funds suspended redemptions in the face of deteriorating investments in securities backed by subprime mortgages.

Summer and Fall of 2007

- A number of additional short-term investment pools (*e.g.*, unregistered "enhanced cash" funds, liquidity pools run by municipalities, and offshore funds) began to fail after investing in securities backed by subprime mortgages.
    - BNP Paribas, France's largest bank, froze three investment funds that operated in a manner similar to European variable NAV money funds but were unable to sell mortgage-related assets to meet redemptions.
    - An unregistered commodity cash pool managed by Sentinel Management Group, Inc., erroneously described by CNBC as a money market fund, halted redemptions and failed within a week.
    - Local government investment pools run by King County, Washington and the State of Florida experienced difficulties due to structured investment vehicle ("SIV") and asset-backed commercial paper ("ABCP") investments. King County intervened to buy the troubled securities, and the Florida pool experienced a cascade of redemptions, until it froze withdrawals in November.

August 2007 to March 2008

- A number of major financial institutions in the U.S. and Europe, including American Home Mortgage Corp., HomeBanc Corp,, Sachsen Landesbank, Northern Rock, plc, Financial Guaranty Insurance Company, and Countrywide failed. Others, such as Citigroup, Inc. and the monoline insurers Ambac Financial Group, Inc. and MBIA, Inc. needed significant help (both government and private) to survive.
- The auction rate securities market froze as securities for sale exceeded demand, auction agents refused to take the excess supply on their balance sheets, and the auctions failed en masse.

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[1] Much of the information in this appendix was drawn from the Investment Company Institute, *Report of the Money Market Working Group* (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf, and the U.S. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (January 2011), available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

- During this time, the money market[2] continued to exhibit considerable stress. For example, spreads between yields on one-month asset-backed paper and Treasury bills widened dramatically, reaching nearly 400 basis points at one time.

Weekend of March 15-16, 2008

- The federal government orchestrated a rescue of Bear Stearns, allowing JPMorgan Chase & Co. to purchase Bear Stearns, with the federal government guaranteeing up to $30 billion in potential losses. Under this transaction, Bear Stearns's shareholders suffered very significant losses but its debt holders were unharmed. As of May 31, 2007, Bear Stearns's assets were 31 times its shareholder equity.

April 2008

- Wachovia amassed a first quarter loss of $350 million.

July 14, 2008

- Office of Thrift Supervision closed IndyMac Bank, making it the largest-ever thrift to fail.

July 22, 2008

- Washington Mutual reported a $3.3 billion loss. Depositors withdrew $10 billion during the next two weeks.

- Wachovia amassed an $8.9 billion second-quarter loss.

VIII. Key Market Events—September 2008

Weekend of September 6 and 7

- The government placed the nation's two largest mortgage finance companies, Fannie Mae and Freddie Mac, in conservatorship and made a plan to provide financial support to the agencies through the purchase of senior preferred stock and the extension of short-term secured loans.

Week of September 8

- Long-circulated rumors about the financial stability of Merrill Lynch & Co., Inc., AIG, and Lehman gained traction.

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[2] In the United States, the market for debt securities with a maturity of one year or less is generally referred to as "the money market." For an overview of the money market, including its structure and participants and the key characteristics of money market funds, see Appendix B.

Weekend of September 13 and 14

- Bank of America Corporation agreed to buy Merrill Lynch for $50 billion.

- The future of AIG, one of the largest underwriters of credit default swaps, remained highly uncertain, as credit rating agencies threatened to downgrade the company's debt, a move that would have prompted counterparties to make margin calls on their contracts which would be in excess of AIG's available liquidity.

- The Treasury Department and the Federal Reserve tasked CEOs of major Wall Street firms to come up with a private sector solution to prevent a Lehman bankruptcy.

Monday, September 15

- Lehman, lacking a buyer and failing to obtain government assistance, declared bankruptcy.

  - As with Bear Stearns, the viability of Lehman had been questioned for several months. Nevertheless, Lehman's failure was an especially difficult shock for the market because it represented an abrupt reverse in direction by the U.S. government from its previous decisions to intervene and rescue Bear Stearns (an investment bank smaller than Lehman), Fannie Mae, and Freddie Mac.

- The collapse of Lehman on September 15 triggered a severe credit freeze in the short-term markets, as investors pulled back from lending to financial institutions and rushed to buy short-dated Treasury securities.

- Yields at the short-end of the Treasury market traded down sharply, with 4-week bills trading at 0.28 percent, down from 1.35 percent on Sept. 12 and 1.51 percent on Sept. 11.

- At the same time, investors retrenched from the commercial paper market. Issuance at the longer end of the market fell sharply. Issuers had difficulty attracting investors to paper with maturities beyond the end of the week. Issuance volume on commercial paper with maturities beyond 4 days dropped to $23 billion on Sept. 15 from $51 billion on Sept. 12.

- In the afternoon, AIG was downgraded by S&P, Moody's, and Fitch, triggering billions of dollars in additional cash collateral calls on AIG's credit default swaps.

- On September 15, 2008, prime money market funds had outflows of $50 billion, of which presumably a large fraction simply represented normal outflows associated with tax payments. In the previous four years, outflows from prime money market funds averaged $20 billion on September tax payment days. After accounting for estimated outflows related to tax payments and outflows from the Reserve Primary Fund, outflows for all prime

money market funds totaled approximately $18 billion or 0.9 percent of total net assets.[3] Government money market funds had inflows of $2 billion on September 15.

Tuesday, September 16

- The Treasury bill market continued to be swamped by heavy demand as investors sought the safety of short-term U.S. Government securities. The 4-week bill traded at 0.23 percent and the 3-month bill traded at 0.84 percent. Stresses in the commercial paper market increased as issuers continued to have difficulty attracting investors beyond the very short end of the market. Issuance beyond 4 days dropped to $20 billion.

- Outflows from prime money market funds began to pick up as some investors in these funds, like other investors, began to seek the safety of U.S. Government securities. Outflows from prime funds totaled $32 billion, while inflows to government money market funds were $33 billion.

- After the markets closed, Reserve Primary Fund announced that it would no longer redeem shares at $1.00. The fund held about 1.2 percent of its assets in Lehman debt.

- Late in the evening after the markets were closed, the Federal Reserve announced that it had agreed to lend AIG up to $85 billion. The U.S. government took nearly an 80 percent stake in the company.

Wednesday, September 17

- Other money market funds with exposure to Lehman also experienced difficulties. Nevertheless, all money market funds, with the exception of the Reserve Primary Fund, maintained their $1.00 NAV.

- Investors continued to flee to the Treasury bill market for safety. Four-week bills traded at 0.07 percent and 3-month bills were at 0.03 percent. Meanwhile, the credit squeeze in the commercial paper market continued: issuance beyond 4 days fell to $18 billion, with 40 percent of that issuance between 5 and 9 days. Outstanding commercial paper was down $51 billion from a week earlier, or about 3 percent.

- Colorado Diversified Trust, a local government investment pool (not a money market fund) transferred its assets to another LGIP to maintain its rating (the pool held 1.8

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[3] Data for September 15 includes estimated redemptions of $11.6 billion processed by the Reserve Primary Fund on September 15. As of September 12, the Reserve Primary Fund had $62.6 billion in total net assets. As of the close of business on September 15, the Reserve Primary Fund had approximately $51 billion in total net assets. The fund was effectively frozen at this level until it starting making distributions to shareholders beginning October 30. *See* https://www.primary-yieldplus-inliquidation.com/pdf/PressReleasePrimDist2008_1030.pdf. Daily data for all other money market funds are from iMoneyNet.

percent of its portfolio in Lehman paper). The trust served as a cash pool for more than 60 local government entities in Colorado.

- Inflows to government money market funds rose to $49 billion and prime money market fund investors redeemed, on net, $106 billion.

Thursday, September 18

- Short-term markets continued to trade under pressure of investors' flight to quality. Demand for Treasury bills kept yields well below their prior week levels, with the 4-week bill yield at 0.25 percent and 3-month bills traded at 0.23 percent.

- Commercial paper issuance beyond 4 days remained depressed at $24 billion. Investors' deep concerns about the viability of banks and other financial institutions around the world, and about the willingness and wherewithal of their governments to support them, constricted the access of these firms to funding in the short-term markets. For example, financial firms were only able to place 11 issues of commercial paper with maturities beyond 40 days, compared with 149 issues on September 12.

- For a third day, money market fund investors mirrored behavior in the broader markets, as investors sought the security of government securities. Inflows to government money market funds totaled $58 billion, and outflows from prime funds were $94 billion.

- Putnam Investments announced in the morning that it was closing the Putnam Prime Money Market Fund. The fund had no exposure to Lehman or other troubled issuers, but had experienced significant redemption pressures from its concentrated institutional investor base. The fund determined to close rather than sell portfolio securities into a liquidity constrained market; this action allowed the fund to treat all shareholders fairly. On September 24, the fund merged with Federated Prime Obligations Fund at $1.00 per shares and shareholders did not lose any principal.

Friday, September 19

The Federal Reserve and the Treasury Department announced a series of broad initiatives designed to stabilize the market, which had ceased to function even for very short-term, high-credit securities.

- The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance purchases of high-quality ABCP from money market funds.

- The Commercial Paper Funding Facility (CPFF) provided a backstop to U.S. issuers of commercial paper through a special purpose vehicle that would purchase three-month unsecured commercial paper and ABCP directly from eligible issuers.

- The Treasury Department announced its Temporary Guarantee Program for Money Market Funds, which temporarily guaranteed certain account balances in money market funds that qualified for and elected to participate in the program. ICI worked with Treasury and other regulators to limit the reach of the Treasury Guarantee Program, urging that the guarantee be limited and temporary. The program expired on September 18, 2009. No claims were made on the Guarantee program, and no amounts were paid out. Instead, Treasury and, as a result, taxpayers, received an estimated $1.2 billion in premiums paid by participating money market funds.

- Pressures in the Treasury market eased somewhat after the announcement of these programs. The yield on the 4-week bill rose to 0.75 percent, and 3-month bills yields were at 0.99 percent. Commercial paper markets remained under pressure, however, with only $25 billion in new issuance beyond 4 days.

- Money market fund flows returned to the level and pattern seen on September 16. Outflows from prime funds totaled $36 billion, and inflows to government money market funds were $47 billion.

IX. Key Events of Late September 2008 to October 2008

Although the steps taken by the Federal Reserve and the Treasury Department helped to stabilize the commercial paper market and thereby moderate outflows from money market funds, further developments added to investor concerns about overall stability of the global financial markets. These events unfolded through September and into October.

September 21

- The Federal Reserve Board approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

September 25

- After nearly two weeks of speculation about the future of Washington Mutual, Inc., the FDIC officially placed it in receivership. A credit downgrade on September 15 had sparked a run and caused investors to pull $16.7 billion in assets, or 9 percent of its June 2008 deposits, from the bank.[4] The FDIC subsequently sold the savings bank to JPMorgan.

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[4] http://files.ots.treas.gov/730021.pdf

September 28

- The governments of the Netherlands, Belgium, and Luxembourg rescued Fortis Bank.

September 29

- The British government rescued Bradford & Bingley plc, a mortgage lender. Iceland nationalized Glitnir Bank.

September 30

- The governments of Belgium, France, and Luxembourg rescued Dexia SA, a major European banking group.

September 22 through September 30

- Money market fund investors continued to shift their holdings from prime funds to government money market funds. Outflows from prime funds during the week totaled $103 billion and inflows to government funds were $146 billion.

October 2

- The Irish president signed legislation guaranteeing Irish banks.

October 3

- Congress passed and President George W. Bush signed the Emergency Economic Stabilization Act of 2008, which included the Troubled Asset Relief Program ("TARP") that allowed Treasury to purchase assets and equity from banks. The FDIC approved Wells Fargo's offer to buy Wachovia, reversing an earlier offer by Citigroup to purchase the banking firm.

October 7

- Icelandic bank Landsbanki was placed into receivership.

October 8

- Icelandic bank Kaupthing was nationalized

October 13

- Treasury invested $125 billion from TARP in preferred shares of nine large commercial banks.

- The Federal Reserve, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank announced a coordinated program "to provide broad access to liquidity and funding to financial institutions."

Appendix B

The U.S. Money Market

The U.S. money market is a huge, complex, and significant part of the financial system in which many different participants interact each business day. This appendix provides essential context about the U.S. money market by describing: the structure of the market; the vehicles through which investors can access money market instruments (many of which compete directly with money market funds); the unique characteristics of money market funds; and the role and growth of money market funds as financial intermediaries in the money market.

Structure of the U.S. Money Market

In the United States, the market for debt securities with a maturity of one year or less is generally referred to as "the money market."[1] The money market is an effective and low cost mechanism for helping borrowers finance short-term mismatches between payments and receipts. For example, a corporation might borrow in the money market if it needs to make its payroll in 10 days, but will not have sufficient cash on hand from its accounts receivable for 45 days.

The main borrowers in the U.S. money market are the U.S. Treasury, U.S. government agencies, state and local governments, financial institutions (primarily banks, finance companies, and broker-dealers), and nonfinancial corporations. Borrowers in the money market are known as "issuers" because they issue short-term debt securities. U.S. money market funds also lend to large foreign-domiciled corporations that may need dollars, often because they have U.S.-based operations.

Reasons for borrowing vary across the types of issuers. Governments may issue securities to temporarily finance expenditures in anticipation of tax receipts. Mortgage-related U.S. government agencies borrow in the money market to help manage interest-rate risk and rebalance their portfolios. Banks and finance companies often use the money market to finance their holdings of assets that are relatively short-term in nature, such as business loans, credit card receivables, auto loans, or other consumer loans.

Corporations typically access the money market to meet short-term operating needs, such as accounts payable and payroll. At times, corporations may use the money market as a source of bridge financing for mergers or acquisitions until they can arrange or complete longer-term funding. In addition, all types of borrowers may seek to reduce interest costs by borrowing in the money market when short-term interest rates are below long-term interest rates.

Borrowers use a range of money market securities to help meet their funding needs. The U.S. Treasury issues short-term debt known as Treasury bills. U.S. Government sponsored agencies such as Fannie Mae and Freddie Mac issue Benchmark and Reference bills, discount notes,

[1] Securities that have final maturities of more than one year but whose yields are reset weekly, monthly, or quarterly also are generally considered part of the money market.

and floating rate notes (collectively, "agency securities"). State and local municipalities issue cash-flow notes to provide short-term funding for operations, and bond anticipation notes and commercial paper to fund the initial stages of infrastructure projects prior to issuing long-term debt. They also issue variable rate demand notes to gain access to the short end of the yield curve. Banks and other depositories issue large CDs[2] and Eurodollar deposits.[3] Furthermore, banks and broker-dealers use repurchase agreements, a form of collateralized lending, as a source of short-term funding.

Corporations, banks, finance companies, and broker-dealers also can meet their funding needs by issuing commercial paper, which is usually sold at a discount from face value, and carries repayment dates that typically range from overnight to up to 270 days. Commercial paper is sold as unsecured or asset-backed. Unsecured commercial paper is a promissory note backed only by a borrower's promise to pay the face amount on the maturity date specified on the note. Firms with high quality credit ratings are often able to issue unsecured commercial paper at interest rates below bank loan rates. Asset-backed commercial paper ("ABCP") is secured by a pool of underlying eligible assets. Examples of eligible assets include trade receivables, residential and commercial mortgage loans, mortgage-backed securities, auto loans, credit card receivables, and similar financial assets. Commercial paper has been referred to as "the grease that keeps the engine going . . . . the bloodline of corporations."[4] One alternative to issuing commercial paper is to obtain a bank line of credit, but that option is generally more expensive.[5]

Although the size of the U.S. money market is difficult to gauge precisely (because it depends on how "money market" instruments are defined and how they are measured), it is clear that a well-functioning money market is important to the well-being of the macro-economy. We estimate that the outstanding values of the types of short-term instruments typically held by taxable money market funds and other pooled investment vehicles (as discussed below)—such as

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[2] CDs are generally classified as large (or jumbo) or small. Large or jumbo CDs are issued in amounts greater than $100,000. Small CDs are issued in amounts of $100,000 or less.

[3] In addition, U.S. banks (including branches of foreign banks in the United States) can lend to each other in the U.S. federal funds market. Banks keep reserves at Federal Reserve Banks to meet their reserve requirements and to clear financial transactions. Transactions in the federal funds market enable depository institutions with reserve balances in excess of reserve requirements to lend reserves to institutions with reserve deficiencies. These loans are usually made overnight at the prevailing federal funds rate. Also, banks worldwide can provide funding to each other via the interbank lending market for maturities ranging from overnight to one year at the prevailing London Interbank Offered Rate.

[4] Boyd Erman, "The Grease That Keeps the Engine Going," *The Globe and Mail (Canada)* (October 8, 2008), available at http://www.theglobeandmail.com/servlet/story/RTGAM.20081008.wrbanksep08/BNStory/Business (quoting Steve Foerster, a professor at the Richard Ivey School of Business at University of Western Ontario).

[5] *Id.* The expense of these credit lines is expected to increase, and their availability may decrease, as the Basel Committee on Banking Supervision's endorsement of capital and liquidity reforms for banks (known as "Basel III") are implemented and banks are required to include credit commitments in their liquidity, net stable funding, and other calculations. *See* Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 4 (Basel Committee on Banking Supervision, December 2010), rev. June 2012.

commercial paper, large CDs, Treasury and agency securities, repurchase agreements, and Eurodollar deposits—total roughly $10.5 trillion.[6]

While these money market instruments fulfill a critical need of the issuers, they also are vitally important for investors seeking both liquidity and preservation of capital. Major investors in money market securities include money market funds, banks, businesses, public and private pension funds, insurance companies, state and local governments, broker-dealers, individual households, and nonprofit organizations.

Financial Intermediaries for Money Market Instruments

Investors can purchase money market instruments either directly or indirectly through a variety of intermediaries. In addition to money market funds, these include bank sweep accounts, investment portals, and short-term investment pools, such as offshore money funds, enhanced cash funds, and ultra-short bond funds, as described below.

- ***Money market funds.*** Money market funds offer investors a variety of features, including liquidity, a market-based rate of return, and the goal of returning principal, all at a reasonable cost.[7] These funds are registered investment companies that are regulated by the SEC under the U.S. federal securities laws, including Rule 2a-7 under the Investment Company Act of 1940. That rule, which was substantially enhanced in 2010, contains numerous risk-limiting conditions intended to help a fund achieve the objective of maintaining a stable NAV using amortized cost accounting.[8] Money market fund shares typically are publicly offered to all types of investors.

- ***Bank or broker sweep accounts.*** These sweep accounts are passive investment vehicles that require no further action on the part of the customer once the account has been established. Sweeps usually occur at the end of the day, and typically affect the total remaining collected balances (or all available cash) in customer accounts, after all other transactions have been posted. Sweep accounts are invested in a variety of money market instruments, including Eurodollar deposits, money market funds, repurchase agreements, and commercial paper.

- ***Investment portals.*** Portals are online interfaces that provide clients the ability to invest easily and quickly in short-term securities or short-term investment pools. Although portals generally focus on a single investment option, such as time deposits or money market funds, many are multi-provider and offer clients an array of choices within the investment option. Corporate treasurers and other institutional investors

[6] For complete data sources, *see* Figure 2.

[7] These and other characteristics of money market funds are described more fully below.

[8] The regulation of money market funds, including Rule 2a-7's risk-limiting conditions and the amortized cost method of valuation, is discussed in greater detail in Section IV of this letter.

find portals to be a convenient way to compare money market funds in terms of their assets under management, ratings, yields, and average maturities.

- ***Short-term investment pools.*** In addition to money market funds, several types of financial intermediaries purchase large pools of short-term securities and sell shares in these pools to investors. Such pools include offshore money funds, enhanced cash funds, ultra-short bond funds, short-term investment funds, and local government investment pools. Each of these pools is described below. Although the basic structure is similar across these products, there are key differences among them and among the types of investors to whom they are offered.

  - ***Offshore money funds*** are investment pools domiciled and authorized outside the United States. There is no global definition of a "money fund," and many non-U.S. money funds do not maintain a stable NAV.[9] These funds are typically denominated in the currency of their domicile. In Europe, money funds are available in U.S. dollars, Euros, Swiss Francs, or sterling and many accrue dividends, causing their NAVs to steadily increase.[10] European money funds historically were not bound by Rule 2a-7-like restrictions; however, CESR issued guidelines in May 2010 with criteria for European money funds to operate as either "short-term money market funds" or "money market funds."[11] Europe has an established and strong market of stable NAV money funds, including a large number of dollar-denominated money funds that are triple-A rated by credit rating agencies. The dollar-denominated stable NAV money funds are used by multinational institutions and others seeking dollar-denominated money funds. The market for the European triple-A rated stable NAV money funds has grown from less than $1 billion in 1995 to

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[9] *See generally* Committee of European Securities Regulators ("CESR"), Guidelines on a Common Definition of European Money Market Funds (CESR/10-049), May 19, 2010, paragraph 21(valuation), available at http://www.cesr.eu/popup2.php?id=6638; CESR, A Consultation Paper: A Common Definition of European Money Market Funds (CESR/09-850), Oct. 20, 2009, paragraph 8 (valuation), available at http://www.cesr-eu.org/data/document/09_850.pdf. *See also* CESR, Guidelines Concerning Eligible Assets for Investment by UCITS, CESR/07-044, March 2007, at 8 (article reference 4(2), amortization and valuation of money market instrument), available at http://www.cesr-eu.org/popup2.php?id=4421. On January 1, 2011, CESR became the European Securities and Markets Authority.

[10] While U.S. mutual funds must annually distribute their income and capital gains, many offshore funds tend to roll-up their income and capital gains. Offshore funds with this "roll-up" treatment therefore provide two advantages over investments in comparable U.S. funds: (1) tax deferral, and (2) conversion of ordinary income into capital gains, which are taxed at a lower rate.

[11] CESR's two-tier categorization is intended to recognize a distinction in Europe between: (1) a "short-term money market fund," which may have a stable or floating NAV and, among other conditions, must operate with a shorter weighted average maturity (no more than 60 days) and weighted average life (no more than 120 days); and (2) a longer-term "money market fund," which only may have a floating NAV and, among other conditions, operate with a longer weighted average maturity (no more than 6 months) and weighted average life (no more than 12 months).

approximately $516 billion as of May 4, 2012, with $206 billion of those assets in dollar-denominated money funds.[12]

- ***Enhanced cash funds*** are investment pools that typically are not registered with the SEC. These funds seek to provide a slightly higher yield than money market funds by investing in a wider array of securities that tend to have longer maturities and lower credit quality. In seeking those yields, however, enhanced cash funds are not subject to and therefore need not abide by the SEC rule restrictions imposed on money market funds governing the liquidity, credit quality, diversification, and maturity of investments. Enhanced cash funds target a $1.00 NAV, but have much greater potential exposure to fluctuations in their portfolio valuations. Enhanced cash funds are privately offered to institutions, wealthy clients, and certain types of trusts. They also may be referred to as "money market plus funds," "money market-like funds," "enhanced yield funds," or "3(c)(7) funds" (after the legal exception from regulation under the Investment Company Act upon which they typically rely).

- ***Ultra-short bond funds*** are comparable to enhanced cash funds in their portfolio holdings, but most of these funds are not operated to maintain a stable NAV. These funds generally are SEC-registered investment companies and are offered for sale to the public.

- ***Short-term investment funds ("STIFs")*** are collective investment funds operated by bank trust departments in which the assets of different accounts in the trust department are pooled together to purchase short-term securities. STIFs are offered to accounts for personal trusts, estates, and employee benefit plans that are exempt from taxation under the U.S. Internal Revenue Code. STIFs sponsored by U.S. banks are regulated by the U.S. Office of the Comptroller of the Currency ("OCC"). Under OCC regulations, STIFs, like money market funds, use amortized cost accounting to value their assets.[13]

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[12] Institutional Money Market Fund Association, statistical data available at http://www.immfa.org/stats/default.asp. These figures include assets of funds denominated in Euros or sterling, converted to dollars at spot exchange rates as of May, 4, 2012.

[13] The OCC has issued a notice of proposed rulemaking that would tighten restrictions for STIFs. Short-Term Investment Funds, Department of the Treasury, Office of the Comptroller of the Currency, 77 FR 21057 (April 9, 2012) ("Release"), available at http://www.gpo.gov/fdsys/pkg/FR-2012-04-09/pdf/2012-8467.pdf. According to the release, the OCC's proposed changes to the rules governing STIFs were "informed by" the SEC's 2010 amendments. ICI filed a comment letter supporting the efforts of the OCC to improve investor protection by strengthening the resilience of STIFs and increasing the transparency of these products. Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Office of the Comptroller of the Currency, dated June 8, 2011, available at http://www.regulations.gov/#!documentDetail;D=OCC-2011-0023-0006.

- ***Local government investment pools ("LGIPs")*** typically refer to U.S. state- or county-operated funds offered to cities, counties, school districts, and other local and state agencies so they can invest money on a short-term basis. The agencies expect this money to be available for withdrawal when they need it to make payrolls or pay other operating costs. Most LGIPs currently available are not registered with the SEC, as states and local state agencies are excluded from regulation under the U.S. federal securities laws. Investment guidelines and oversight for LGIPs may vary from state to state.

Characteristics of Money Market Funds

Investors expect to purchase and redeem shares of money market funds at a stable NAV, typically $1.00 per share. Investors view a stable $1.00 NAV as a crucial feature of money market funds, because it provides great convenience and simplicity in terms of its tax, accounting, and recordkeeping treatment. Investment returns are paid out entirely as dividends, with no capital gains or losses to track. This simplicity and convenience are crucial to the viability of money market funds because, in contrast with other mutual funds, they are used primarily as a cash management tool. In money market funds that allow check-writing, the $1.00 NAV gives investors assurance that they know their balance before they draw funds. Without a stable $1.00 NAV, many, if not most, investors would likely migrate to other available cash management products that offer a stable $1.00 NAV as they seek to minimize tax, accounting, and recordkeeping burdens.

In addition to a stable $1.00 NAV, money market funds seek to offer investors three primary features: liquidity, a market-based rate of return, and return of principal.

- ***Liquidity***. Money market funds provide "same-day" liquidity, allowing investors to redeem their shares at a price per share of $1.00 and generally to receive the proceeds that day. Retail investors value this feature because it allows them to manage cash both for daily needs and to buy or sell securities through brokers. Corporate cash managers must have daily liquidity in order to manage accounts payable and payrolls.

- ***Market-based rates of return***. Unlike competing bank deposit accounts such as money market deposit accounts, money market funds offer investors market-based yields.

- ***Return of principal***. Money market funds seek to offer investors return of principal. Although there is no guarantee of this (and investors are explicitly warned that this may not always be possible), money market funds manage their portfolios very conservatively.

Other important characteristics of money market funds include:

- ***High-quality assets***. Money market funds may invest only in liquid, investment-grade securities. Money market funds are not permitted to rely on credit rating agencies; instead,

they maintain their own credit departments to manage their credit risk exposures. Institutional investors value this independent credit analysis, either because they may not have sufficient expertise in credit analysis or because money market funds can provide it more cost effectively. Money market funds generally do not have leverage or off-balance sheet exposure.

- ***Investment in a mutual fund.*** Money market funds are mutual funds. Their investors receive all of the same regulatory protections that other U.S. mutual fund investors have under the Investment Company Act. Most money market funds also are publicly offered and therefore registered under the U.S. Securities Act of 1933.

- ***Diversification.*** Money market funds often invest in hundreds of different underlying securities, providing investors diversification that would otherwise be difficult, if not impossible, to replicate and manage through an individual portfolio or through a single bank.

- ***Professional asset management.*** Like other mutual funds, the assets of money market funds are professionally managed so as to achieve the fund's objectives, which are disclosed in its prospectus.

- ***Economies of scale.*** Money market funds provide a low-cost cash management vehicle for investors. In part, money market funds achieve low cost through economies of scale—pooling the investments of hundreds to thousands of individual retail investors, sometimes with the large balances of institutional investors.

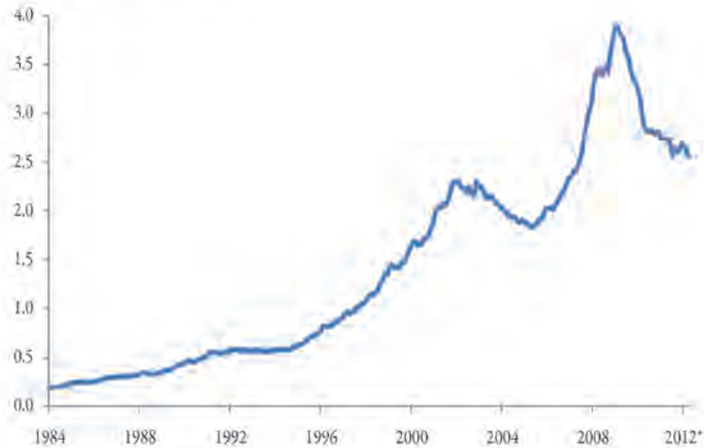
Money Market Funds as Financial Intermediaries

Money market funds efficiently channel dollars from all types of investors to a wide variety of borrowers, and have become an important part of the U.S. money market. As of April 2012, , 609 money market funds had a combined $2.6 trillion in total net assets under management, up from $180 billion as of year-end 1983, the year the SEC adopted Rule 2a-7 (Figure 1).

Figure 1

Total Net Assets of Money Market Funds

*Trillions of dollars, monthly**



** Data through April 30, 2012*

Source: Investment Company Institute

By investing across a spectrum of money market instruments, money market funds provide a vast pool of liquidity to the U.S. money market. As of March 2012, taxable money market funds held $2.2 trillion of repurchase agreements, CDs, U.S. Treasury and agency securities, commercial paper, and Eurodollar deposits. Taxable money market funds' investments in these short-term instruments represent 20 percent of the total outstanding amount of such money market instruments, underscoring the current importance of money market funds as an intermediary of short-term credit (Figure 2). In comparison, we estimate that money market funds held less than 10 percent of these same instruments in 1983.

Money market funds also are major participants within individual categories of taxable money market instruments. As of March 2012 , these funds held 38 percent of outstanding short-term agency securities, 37 percent of commercial paper, 17 percent of short-term Treasury securities, 19 percent of repurchase agreements, 21 percent of large CDs, and 4 percent of Eurodollar deposits.

Money market funds are a significant source of funding to U.S. state and local governments for public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. As of March 2012, money market funds had $337 billion under

management and accounted for an estimated 74 percent of outstanding short-term municipal debt (Figure 2).

Figure 2

Selected Money Market Instruments

March 2012

	Total	Money market fund holdings	
	Billions of dollars	*Billions of dollars*	*Percentage of total*
Total taxable instruments	$10,390	$2,086	20
Agency securities[1]	889	334	38
Commercial paper	994	363	37
Treasury securities[2]	2,917	484	17
Repurchase agreements[3]	2,697	501	19
Certificates of deposit[4]	1,712	354	21
Eurodollar deposits[5]	1,181	50	4
Tax-exempt instruments[6]	454	337	74

[1] Debt issued by Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency due to mature by the end of March 2012; category excludes agency-backed mortgage pools.

[2] Marketable Treasury securities held by the public due to mature by the end of March 2012.

[3] Repurchase agreements with primary dealers; category includes gross overnight, continuing, and term agreements on Treasury, agency, mortgage-backed, and corporate securities.

[4] Certificates of deposit are large or jumbo CDs, which are issued in amounts greater than $100,000.

[5] Category includes claims on foreigners for negotiable CDs and non-negotiable deposits payable in U.S. dollars, as reported by banks in the U.S. for those banks or those banks' customers' accounts.

[6] Estimated as of March 2012. Category includes variable rate demand notes, auction rate securities, tender option bonds, and other short-term debt. Category does not include long-term fixed-rate debt due to mature by the end of March 2012.

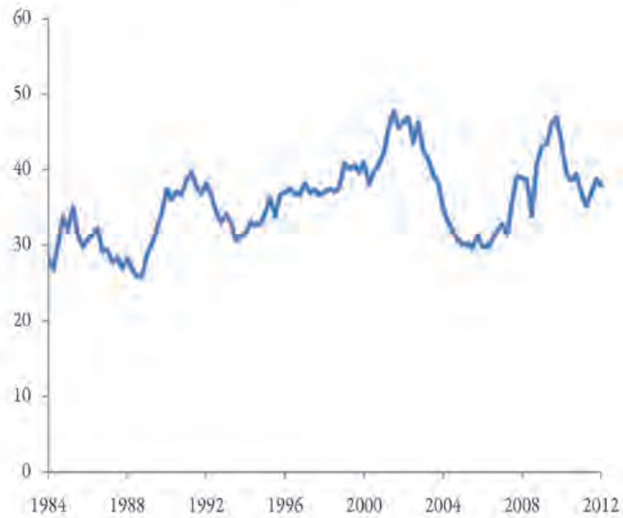
Sources: Investment Company Institute, Federal Reserve Board, U.S. Treasury Department, Fannie Mae, Freddie Mac, Federal Housing Finance Agency, Federal Reserve Bank of New York

Since the early 1970s, money market funds have benefited the economy by providing households and businesses more access to financing at a lower cost. Growth in money market fund assets has helped to deepen the commercial paper market for financial and nonfinancial issuers. Many major nonfinancial corporations have come to rely heavily on the commercial paper market for short-term funding of their day-to-day operations at interest rates that are typically less than rates on bank loans. As of March 2012, money market funds held $363 billion (37 percent of the market) in outstanding commercial paper (Figure 3).

Figure 3

Money Market Funds' Holdings of Commercial Paper

*Percentage of total commercial paper outstanding, quarterly**



**Data through March 2012*

Sources: Investment Company Institute and the Federal Reserve Board.

PREPARED STATEMENT OF J. CHRISTOPHER DONAHUE

PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERATED INVESTORS, INC.

JUNE 21, 2012

Opening Statement

I would like to briefly respond to the major points made in Chairman Schapiro's testimony.

First, the Chairman is primarily concerned that a credit event will cause a money market fund to break a dollar. Rule 2a-7 already makes sure these are rare events with minimal impact, but it cannot prevent them altogether. We are investment professionals at managing risks, not magicians who make risks disappear. The President's Working Group acknowledged this when it observed that: "Attempting to prevent any fund from ever breaking the buck would be an impractical goal that might lead . . . to draconian and—from a broad economic perspective—counterproductive measures."

Yet this is precisely what a capital requirement attempts to do—prevent a fund from ever breaking a dollar. The Chairman knows that raising capital directly from third parties is impractical, that sponsors cannot afford capital and that, at current market rates, funds do not have the income to build their own capital cushion. Even at normal interest rates, it would take over a decade for funds to build even a 1 percent capital cushion on their own. A 1 percent capital cushion would not have prevented the Reserve Primary Fund from breaking a dollar, so clearly capital will not prevent funds from ever breaking a dollar. It may lull shareholders into a false sense of security, however, and increase their expectations of a bailout. In short, requiring capital would be counterproductive.

Second, the Chairman asserts that small investors will bear the loss from a credit event, because large institutional shareholders will redeem before the fund breaks a dollar. This ignores the responsibility of the fund's directors in protecting the interest of all shareholders. In fact, if you listened only to the Chairman's speeches and testimony on money market funds, you would never know that funds have directors, a majority of whom are independent of the fund's manager, or that Rule 2a-7 has always required them to prevent material dilution or other unfair results to shareholders.

The contrast between the actions of the directors of the Reserve Primary Fund and the directors of the Putnam Prime Money Market Fund during the financial crisis is instructive. The Reserve Fund directors allowed shareholders to continue redeeming for a dollar for more than a day after the Lehman bankruptcy, even though Reserve did not provide any concrete support to the fund. They may have done this because, at the time, directors could not suspend redemptions without first obtaining an order from the Commission. Notwithstanding this, when faced with redemption requests in excess of their fund's liquidity, the Putnam Fund directors suspended redemptions until they could arrange a merger with a Federated advised money market fund which had access to the Federal Reserve's liquidity program for asset-backed securities. By making their shareholders' interest paramount to all other considerations, the Putnam Fund directors protected their shareholders, large and small.

Despite her professed concern for small investors, the Chairman has never mentioned any reforms that would make it easier for directors to protect them or that would help directors prepare for an event that might threaten their fund's $1 NAV.

Third, the Chairman persists in assuming that a money market fund breaking a dollar will cause a run by its shareholders, which will lead to a fire sale of the portfolio, which will result in a downward spiral of asset prices and a credit crunch. Her assumptions are based on the behavior of prime fund shareholders during the greatest financial crisis since the Great Depression; a crisis that was fully underway before the Reserve Fund broke a dollar. She ignores the fact that none of these things occurred when the Community Bankers fund broke a dollar in 1994, when the market was not undergoing a liquidity crisis.

The Chairman did announce yesterday, with much fanfare, that sponsors have had to step in 300 times to prevent their funds from breaking a dollar. While I share Senator Toomey's skepticism as to how her staff arrived at this figure, I also wonder what we are supposed to conclude from this number. She admits that sponsor support is not necessarily a bad thing. She cannot be suggesting that funds are regularly on the verge of breaking a dollar—her written statement says that these 300 "occasions" relate to about a dozen credit events over a span of three decades. I think that the ability of sponsors to handle nearly all of these events without Government intervention demonstrates the inherent strength and resilience of money market funds. I bet the FDIC would be envious of this record.

Tellingly, the Chairman ignores how the reforms adopted in 2010 addressed all of her assumed problems.

- Funds that break a dollar can now suspend redemptions and liquidate without a Commission order, so funds can stop a run by their shareholders.
- Investors can see all of their fund's holdings, so they would know that other funds are not at risk of breaking a dollar.
- Funds currently have three times the liquidity needed to handle the level of redemptions experienced during the financial crisis, so funds would not need to conduct fire sales and would not cause asset prices to spiral downward.

After the 2010 reforms, there is no reason to suppose that a fund breaking a dollar will snowball into some sort of credit crunch.

Fourth, the Chairman's dogmatic belief in the systemic risks of money market funds will necessarily taint any cost/benefit analysis of her proposed reforms. If she begins by assuming that a fund breaking a dollar will cascade into a full scale financial crisis of the magnitude experienced in 2008, then the case for reform is a foregone conclusion. In other words, she would make perfection the enemy of the good. If it adopts reforms on this basis, the Commission will sacrifice real, quantifiable benefits to millions of shareholders and borrowers for speculative and unsubstantiated reductions in supposed systemic risks. This approach to risk/reward analysis would be like requiring passengers on a cruise ship to spend the trip in the life boats: you'd be safer in theory, but it would defeat the purpose. Ironically, if (as every survey indicates) her proposed reforms will drive shareholders out of money market funds and into the largest banks, then they will increase systemic risk and make credit markets more fragile.

Finally, the Chairman calls for an honest, public debate of her proposed reforms. Federated already tried the case for a stable NAV in an evidentiary heading before an administrative judge in the 1970s, which the Commission settled by issuing the original exemptive orders permitting use of amortized cost valuation. More recently, the Commission requested comment on a floating NAV in both the reforms proposed in 2009 and in connection with the President's Working Group report. No one, apart from members of the Federal Reserve and academics, supported this proposal. Essentially, the Chairman is insisting that the debate on floating the NAV continue until she gets the answer she wants.

Regarding her alternative reforms, I have explained why it is not feasible to impose a meaningful capital requirement. Although the Chairman did not say much about redemption restrictions, she knows that there are insurmountable legal and operational obstacles to such restrictions. She has no reason to believe that investors will continue to use funds subject to these restrictions. Therefore, all of the Chairman's proposals would have the same result—the effective destruction of money market funds.

I look forward to answering your questions.

Prepared Statement

Chairman Johnson, Ranking Member Shelby, Members of the Committee, I want to thank you for providing me the opportunity to appear at today's hearing. I am the President and CEO of Federated Investors, Inc. (Federated), the third largest manager of money market funds (MMFs) in the United States. Our MMFs currently have assets of approximately $240 billion, with millions of individual and thousands of institution shareholders for whom we provide investment management, including corporations, Government entities, insurance companies, foundations and endowments, banks, and broker-dealers. Federated has 1,450 employees.

Federated has provided extensive data and commentary to the Securities and Exchange Commission (SEC), in response to its request for comments on the Report of the President's Working Group on Financial Markets regarding possible changes to MMFs (the "PWG Report")[1] and to the Financial Stability Oversight Council (FSOC) and banking regulators in connection with rule making proposals to implement Titles I and II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). A list of links to Federated's comment letters is included at the end of my statement.

We are concerned that, based upon recent speeches by the SEC Chairman and a number of members of the Federal Reserve Board, key regulators have largely disregarded the comments received in response to the PWG Report—not only

[1] The PWG Report was published for comment in Release No. IC-29497, "President's Working Group Report on Money Market Funds" (Nov. 3, 2010), available at *http://www.sec.gov/rules/other/2010/ic-29497.pdf.*

Federated's comments, but also others who pointed out errors underlying, obstacles to and unintended consequences of possible reforms. More disturbingly, although as of this date neither the SEC nor FSOC have proposed rules or other action specifically targeting MMFs, key members of both agencies have continued to pursue reform proposals heedless of the PWG Report's important warning that "[a]ttempting to prevent any fund from ever breaking the buck would be an impractical goal that might lead . . . to draconian and—from a broad economic perspective—counterproductive measures . . . "[2] Their attempt to eliminate risk from MMFs has resulted in draconian proposals that would eliminate MMFs, if not altogether, then as a meaningful component of the U.S. cash markets.

Let us remember that money market funds did not cause the recent financial crisis.[3] They were simply not immune to the largest financial crisis since the Great Depression. Yet instead of targeting the causes of the crisis, the SEC Chairman and certain members of the FSOC have threatened ill-conceived reforms whose demonstrable costs far outweigh any plausible benefits. Indeed, even the existence of a benefit from the proposals being discussed is debatable when a full accounting of the impact on the banking system and the expansion of the Federal safety net are taken into account. The flawed process leading to this outcome—where bank regulators now dictate the content of securities law without meaningful dialog with those affected or serious study of unintended consequences—does not embody the best traditions of Government. It is therefore incumbent upon all of us, regulators, industry and Congress, to bring perspective and rationality to the debate. It is our obligation to weigh the enormous benefits of MMFs against a realistic assessment of the speculative benefits, and evidence of significant adverse economic consequences, that the various "reform" proposals would bring. We strongly endorse Congressional efforts to clarify the SEC's statutory obligation to perform cost/benefit analysis and to commission a thorough evaluation of the need for additional reform to money market funds. Such a study should not only include an evaluation of the impact of the 2010 reforms to MMF regulations, but also should factor in the reforms adopted in the Dodd-Frank Act. Americans deserve a regulatory process that can hear their voice: they would prefer to keep the massive efficiency gains with the current system and accept the risk of a very high quality, tightly regulated investment product, rather than turn back the clock and return to a world even more dominated by the largest banks.

Setting the Record Straight on Money Market Funds

Before addressing these threatened reforms, I would like to dispel some myths regarding MMFs that purport to justify the need for further reforms.

Myth: The $1 share price of MMFs is a "fiction" or "gimmick."

Fact: The stable $1 price is real—MMFs have redeemed their shares for at a stable $1 price for over 40 years, with only two exceptions.

Every day, for over 38 years, Federated's MMFs have redeemed shares at a stable $1 value. This is true of every other MMF currently in existence. During the past 40-plus years, only two MMFs have redeemed shares for less than a $1, known as "breaking a dollar."

This record of stability is the result of the high quality and short-duration of MMF portfolios, not accounting wizardry. Regulations require MMF portfolios to consist of a diversified cross-section of the highest quality debt instruments available in the market. The market values of these instruments rarely deviate significantly from their amortized cost. Federated regularly monitors the estimated market value of its MMFs (known as their "shadow prices"), which typically do not deviate by even a tenth of a cent from $1 (i.e., 10 basis points). An Investment Company Institute (ICI) sampling of the shadow prices of other MMFs shows that this is common throughout the industry.[4]

Such small shadow price deviations do not affect a MMF's ability to operate at a stable value because portfolio instruments quickly return to their amortized cost. MMFs typically maintain an average maturity of between 30 and 50 days. This makes it easy for MMFs to wait for investments to mature, rather than selling them at a gain or loss.

MMFs also avoid gains and losses by maintaining more than enough liquidity to meet anticipated shareholder redemptions. This "best practice" was codified in the

[2] PWG Report at 13.

[3] "Dissecting the Financial Collapse of 2007–2008: A Two-Year Flight to Quality", May 2012, available at *http://www.sec.gov/comments/4-619/4619-188.pdf.*

[4] "Pricing of U.S. Money Market Funds at 4", ICI Research Report (Jan. 2011), available at *http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf.*

regulatory reforms adopted in 2010. The MMFs' record for managing liquidity is exemplary—no fund has ever broken a dollar because a fund failed to maintain sufficient liquidity to meet redemptions. The capacity of some MMFs to maintain daily liquidity was tested again in the summer of 2011, and every fund answered the challenge without any disruption to the market.

On a related point, critics sometimes assert that the $1 share price misleads investors into believing that MMFs are like banks. These critics overlook the fact that most of the money held in MMFs comes from sophisticated institutional investors, who surely appreciate the differences between MMFs and banks. Recent surveys show that most retail investors also appreciate that their MMF can break a dollar and that no one has promised to protect them from any losses.[5] These critics further ignore the bold face disclaimer on the front of every Federated MMF prospectus and advertisement: "Not FDIC Insured—May Lose Value—No Bank Guarantee." Thus, MMFs fully disclose the risk that they may break a dollar and the overwhelming majority of MMF shareholders understand and accept this risk.

Myth: MMFs have only been able to maintain a $1 share price due to the support provided by their managers.

Fact: Over 90 percent of MMFs have maintained a $1 share price without any support from their managers.

At the beginning of 2007, there were 728 MMFs. The Federal Reserve has recently asserted that, from 2007 to 2010, approximately 50 MMFs received support from their manager.[6] This means that over 90 percent of MMFs maintained a $1 share price throughout the recent financial crisis without any support from their managers. All of Federated's MMFs maintained a $1 share price without any support from Federated during the period. Historically, managers have provided support to their funds in part because they typically do not incur any losses as a result of the support. This explains why managers commonly find it in their interest to protect their MMFs' shareholders at no material cost to themselves. Although no manager promises to provide support for its funds, mutually beneficial support arrangements should be appreciated as an indication of the resilience of MMFs rather than as a weakness.

Myth: MMFs are susceptible to runs.

Fact: In over 40 years, there has been only one run on prime MMFs and it was a consequence of a general flight to safety at the height of the financial crisis.

As I noted, there have been two instances of a MMF breaking a dollar. The first, in 1994, did not produce a run on MMFs. In fact, it went largely unnoticed. The second, the Reserve Fund, coincided with the redemption of approximately 15 percent of the assets held by prime MMFs during the week of September 15, 2008.

So far as I know, the SEC has not attempted to study why breaking a dollar in 1994 had no impact on other funds, while prime MMFs experienced substantial redemptions at the time the Reserve Fund broke a dollar. The SEC appears to assume that, because the run on MMFs coincided with the Reserve Fund breaking a dollar, the Reserve Fund caused the run. A comparison of the market conditions in 1994 and 2008 refutes this assumption.

In 1994, the Community Bankers MMF broke a dollar because it held derivative securities that the SEC found "were too risky and volatile for a money market fund."[7] The credit market was operating normally, so there were no concerns about the availability of liquidity. The market therefore viewed Community Bankers as an isolated incident, with no implications for other MMFs or for the market in general. Shareholders did not run from other MMFs because they had no reason to suspect that another MMF would break a dollar.

In contrast, 2008 was marked by a complete loss of confidence in the financial system. The run on MMFs coincided with the rescue of AIG, the arranged merger of Merrill Lynch with Bank of America and many other financial shocks. Many investors were uncertain as to whether other financial institutions would fail and whether they would receive Government support. Rather than risk a default, these investors sought to shift their cash to Government securities, draining liquidity from the

[5] "The Investor's Perspective: What Individual Investors Know About the Risks of Money Market Mutual Funds", FMR LLC (Apr. 2012), available at *http://www.sec.gov/comments/4-619/4619-170.pdf.*

[6] Presentation by Federal Reserve Bank of Boston President Rosengren (Apr. 11, 2012), available at *http://www.frbatlanta.org/documents/news/conferences/12fmc/12fmc_rosengren_pres.pdf.*

[7] In the Matter of Craig S. Vanucci and Brian K. Andrew, Investment Company Act Release No. 23638 (Jan. 11, 1999), available at *http://www.sec.gov/litigation/admin/33-7625.txt.*

credit market. The credit market was completely frozen before the Reserve Fund tried to liquidate its portfolio.

Other MMFs were not immune to this market turmoil. Their shareholders also fled to Government securities, as evidenced by the fact that nearly two-thirds of the assets redeemed from prime MMFs were added to Government MMFs. This also shows that redemptions were motivated by concerns regarding the credit market generally and not MMFs themselves. This suggests that the shareholders would have redeemed regardless of whether the Reserve Fund broke a dollar, in order to eliminate credit risk by shifting their cash to Government securities.

Thus, the record over the past 40 years includes one fund that broke a dollar without causing a run, and one run that coincided with a MMF fund breaking a dollar but was largely caused by a flight to safety in response to an unprecedented financial crisis. That certainly does not qualify MMFs as "susceptible" to runs. There is no reason to project that an event in the future that causes one or more MMFs to break a dollar would prompt shareholders to redeem from other MMFs not affected or threatened by the event. Indeed, in light of the significant enhancements in transparency and liquidity of MMFs following the 2010 reforms, MMF investors should be even less likely to run.

Myth: Taxpayers rescued MMFs in 2008.

Fact: We did not ask for or need the Treasury's Temporary Guarantee Program (the "Treasury Program") and no claims were made under the program.

MMFs required liquid markets, not tax dollars, to weather the financial crisis in 2008. Their portfolios were sound, but the global liquidity crisis impacted MMFs just as it did virtually all other asset classes.

Due the lack of market liquidity, we requested liquidity, rather than Federal insurance, for our MMFs in response to the financial crisis. During our discussions, the Treasury told us that the Treasury Program was going to be announced; we never asked for it. We did not think that the Treasury Program addressed the real problem—the need to reassure shareholders that MMFs had enough liquidity to continue to redeem their shares for $1.

In my view, the Federal Reserve's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF),[8] rather than the Treasury Program, restored confidence in MMFs. AMLF provided funding to banks and other institutions to buy asset-backed commercial paper from MMFs. AMLF ultimately funded sales of approximately $220 billion, a small fraction of the massive liquidity the Federal Reserve pumped into virtually every corner of the financial markets during the crisis.

AMLF was announced on the same day as the Treasury Program—September 19, 2008. By the second week of October, prime MMF assets had stabilized. Although some would attribute this to the combination of AMLF and the Treasury Program, it is noteworthy that prime fund assets grew continuously throughout the rest of 2008, even though the Treasury Program only covered balances held on September 19th, so these additional assets were not guaranteed. Moreover, the Treasury Program was limited to $50 billion, which was just over 1 percent of the September 19th MMF assets. Thus, within four weeks of the onset of the financial crisis, investors were confident enough to invest in prime MMFs without reliance on a Federal guarantee.

Regardless of the reasons, it cannot be disputed that confidence in prime MMFs was fully restored without any Federal expenditures. In fact, the Treasury kept all $1.2 billion of premiums paid under the Treasury Program without paying any claims. All of the paper sold under AMLF was repaid in full, with interest, when due.

The recovery of prime MMFs with a relatively minor liquidity program is a testament to the inherent resiliency of MMFs. If banks and other financial institutions had responded as well to their support measures, which included trillions in additional Federal deposit insurance, multiple liquidity programs and the investment of hundreds of billions under TARP, the financial crisis would have been resolved before the end of 2008. MMFs were the last institutions to require a liquidity program and the first to recover—a mark of resiliency and not of "fragility."

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[8] Information on AMLF can be found at *http://www.federalreserve.gov/newsevents/reform_amlf.htm.* Another liquidity facility, the Money Market Investor Funding Facility was established but never utilized.

The 2010 Reforms Addressed the Need for Liquidity During a Financial Crisis

MMFs were not only the first to recover from the financial crisis; they also were the first to adopt reforms to prevent a recurrence of problems encountered during the crisis. In March 2009, the ICI provided the SEC with proposed regulatory reforms. Using the ICI's report as a starting point, the SEC proposed reforms in June of 2009 and adopted final rules in February 2010. Most of the reforms were implemented by May 2010 and the balance by the end of that year. No other industry responded as promptly or adopted such far-reaching reforms as MMFs.

Four of the reforms targeted liquidity. First, the SEC adopted a new rule, 22e-3, permitting a MMF's board of directors to suspend redemptions while liquidating a fund. This gives directors two options if a MMF breaks a dollar. If there is adequate market liquidity, the fund can operate with a fluctuating NAV and sell its portfolio to pay for redemptions. If markets are frozen or it would otherwise serve the shareholders' interest, the directors can suspend redemptions and distribute payments from the portfolio as it matures. As I mentioned, MMFs historically maintain average maturities of 30 to 50 days, so shareholders would receive most of their money back within this period. The maximum permitted maturity is 397 days, so the liquidation would not take much longer than a year to complete.

Rule 22e-3 gives directors the power to prevent a run from a MMF that has broken or threatens to break a dollar. It also prevents a fire sale of the portfolio into an illiquid market. The result is that every MMF, not just the largest, already has the type of orderly resolution plan contemplated by Title II of the Dodd-Frank Act, except that the plan does not require a Federal receiver or Federal insurance.

The second reform was to increase transparency. Every MMF must post its entire portfolio on its Web site as of the end of each month. This allows the public and regulators to identify which MMFs are affected by a credit or other adverse event Although affected MMFs may need to address the event, shareholders in unaffected funds will not face the same uncertainty as investors in banks and other less transparent institutions. They should not have any reason to redeem from MMFs that they know to be sound and unimpaired by the event.

The third reform codified an industry practice of knowing your customers and monitoring their share activity. This requires that a MMF manager monitor and prepare for the risk of large shareholder redemptions, taking into account current market conditions. This is designed to assure that MMFs remain prepared to meet their shareholders' liquidity needs.

The final reform deals with the possibility that some shareholders may nevertheless redeem from MMFs on the occurrence of certain market events, regardless of their actual risks. The reform established liquidity floors: minimum amounts of liquidity that each MMF must be able to generate on a daily and weekly basis without selling anything other than Treasury and other Government securities. The floors are 10 percent for daily liquidity and 30 percent for weekly liquidity. Remember that 15 percent of prime fund assets were redeemed during the week of September 15, 2008, so the weekly liquidity floor is twice the level of redemptions experienced during that period. In these still uncertain times, prime MMFs are maintaining an average weekly liquidity of 43 percent, nearly three times the level of the 2008 redemptions. [9]

These reforms were tested during the summer of 2011. In response to concerns about European banks and whether Congress would raise the U.S. debt ceiling, shareholders redeemed over 10 percent of prime MMF assets during the period from June 8 through August 3, 2011. [10] As you would expect, redemptions were higher in some prime MMFs than in others. None of the MMFs had trouble meeting these redemption requests and there was no impact on the overall market. Throughout the period, average weekly liquidity in prime MMFs remained at 40 percent or more, so the funds covered these redemptions without tapping into their liquidity cushion. The new reforms clearly passed this real-life stress test.

Certain members of FSOC and the Chairman of the SEC contend that more must be done to prevent a recurrence of the redemptions experienced in September 2008. Apart from ignoring the fact that prime MMFs are already prepared to handle significantly larger redemptions, their contention also ignores how the redemptions resulted from a general financial panic. No reform of MMFs can prevent shareholders from seeking a safe haven during such a complete loss of investor confidence. Efforts to eliminate all risks from MMFs will not prevent a future crisis; they will only eliminate MMFs.

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[9] ICI summary of data from Form N–MFPs as of April 30, 2012.

[10] "ICI Summary: Money Market Funds Asset Data", available at *http://www.ici.org/info/mm__summary__data__2012.xls.*

Reforms Currently Under Consideration Are Fundamentally at Odds With the Nature of Money Market Funds and the Needs of Their Shareholders

Investors use MMFs to obtain stability and daily liquidity with a market rate of return. Each of the reforms that the SEC Chairman has recommended: a floating NAV, redemption restrictions and capital, would eliminate one of these essential elements. The consequences of these reforms would therefore be, from an investor's perspective, the elimination of MMFs as a viable alternative for cash investment. This is confirmed by surveys and other data, which suggest that the threatened reforms would drive upwards of three-quarters of their assets from MMFs.

(a) MMF NAVs Should Only Float When Necessary To Protect Shareholders

MMFs already have floating NAVs, as demonstrated by the fact that funds have broken a dollar. The question is how often the NAV should float. Under current regulations, directors must float the NAV when necessary to protect shareholders from excessive dilution or other unfair results. Dilution is presumed to be excessive when the shadow price deviates from $1 by more than half a cent, although directors retain some latitude for judgment even in this circumstance.

The threatened reform would require the NAV to float regardless of the shareholders' interest. Studies of historical shadow prices show that share prices would fluctuate infrequently, with periods of several years between price fluctuations. Moreover, the price changes would typically not amount to more than one or occasionally two-tenths of a percent and would not last for longer than several weeks. The potential fluctuations would require shareholders to monitor, calculate and record infinitesimal and ephemeral gains and losses on cash investments for accounting and tax purposes. From a shareholder's perspective, dealing with these potential price fluctuations would result in enormous costs.

Surveys show that investors would rather move their money elsewhere rather than deal with such pointless fluctuations.[11] Many fiduciaries will not have a choice, as statutes or trust instruments may require investment of cash in stable value investments. Therefore, eliminating the stable value that, under normal circumstances, shareholders want and MMFs deliver will eliminate MMFs as a viable alternative for most cash investors.

(b) Redemption Restrictions Could Be Worse Than Floating NAVs

Shareholders object to redemption restrictions even more strongly than they do to a floating NAV. This is understandable: although a floating NAV would cause share prices to fluctuate needlessly, the fluctuations would be infrequent and temporary. Redemption restrictions, on the other hand, would continually disrupt a shareholder's access to his or her cash in order to address an event (the fund breaking a dollar) that might occur once in 20 years, if it ever occurs at all. Their reaction is similar to passengers on a cruise who have been asked to confine their activities to the lifeboats just in case the ship hits an iceberg.

In addition to shareholders' rejection of redemption restrictions, there are no practical means of implementing them. Although the SEC has not provided any details of the redemption restrictions under consideration, as a general matter they must involve: (1) setting aside a certain percentage of shares or proceeds from the redemption of shares for a period of time and (2) charging any losses incurred by the fund during the period against the shares or proceeds set aside. Fund organizational documents and share trading systems were not designed to do these things. Therefore, implementing redemption restrictions would entail completely rewriting every fund's organization documents and getting shareholders to approve the changes, and reprogramming every trading system for fund shares. The transition costs would be staggering, as would the ongoing operational cost of tracking and restricting shares or proceeds. Many intermediaries would probably stop offering MMFs rather than bear these costs.

(c) Reguiring Excess Capital Would Prevent Money Market Funds From Offering a Market Rate of Return and Introduce Moral Hazards

Even the SEC Chairman and members of the FSOC seem to have realized that forcing MMFs to raise subordinated capital from third parties or their managers would make the fund unduly complicated and impractical. I will therefore assume that the only capital proposal still under consideration would be for MMFs to build up capital over time through retaining a portion of their earnings. From a share-

[11] "The Investor's Perspective: What Individual Investors Know About the Risks of Money Market Mutual Funds", supra note 5, and "Money Market Fund Regulations: The Voice of the Treasurer", Apr. 2012, available at *http://www.ici.org/pdf/rpt__12__tsi__voice__treasurer.pdf.*

holder's perspective, this form of capital requirement would impose a certain loss—in the form of reduced returns—in order to reduce the risk of a speculative loss—the possibility that the fund might break a dollar.

It also would take an exceedingly long time to build up a significant capital buffer. With interest rates currently near zero, MMFs do not have any income to retain for a capital buffer. Even in normal market conditions, the yield on a prime MMF averages only 18 basis points more than the yield on a Government agency MMF. Assuming for purposes of analysis that the difference is constant, which it is not, and that shareholders would continue to use prime MMFs if this spread was cut in half, which they may not, it would take over 11 years for a prime fund to build a 1 percent capital buffer through retained earnings.

This analysis does not include the taxes imposed on the fund's retained income. After factoring in State taxes, close to half of any earnings reduction will go to the Government rather than building a capital buffer for the shareholders. Federal corporate income taxes alone, at current rates, would increase the time required to build a 1 percent capital buffer to more than 17 years.

Capital buffers also could create a moral hazard by leading MMF shareholders to believe that they will not bear the risk of portfolio losses. This can only increase expectations that a MMF should be bailed out if its losses exceed the capital buffer, as Federal regulators would have represented to the public that their capital requirements were sufficient to make MMFs safe. The financial system will be better off if the hint of protection from a capital buffer does not dilute current warnings that MMFs are not guaranteed and may lose money.

Once we understand that MMFs are investments, we should realize that MMFs are already funded entirely by shareholder capital. Shareholders receive higher yields to compensate them for the risk of their MMF breaking a dollar, which has proven to be a highly profitable arrangement for MMF shareholders.

Destruction of Money Market Funds Will Injure the Economy and Increase Systemic Risks

As I noted, the best available estimates suggest that requiring a floating NAV or redemption restrictions will drive upwards of three-quarters of the assets out of MMFs. At current asset levels, this would comprise more than $2 trillion. It is harder to estimate the impact of capital requirements, insofar as we do not know the elasticity of demand for prime MMFs relative to their spread over Government MMFs. Reduced returns will surely translate into reduced assets, however.

Where would all this money go? Very large institutional investors, those with over $100 million in investments who could qualify for the Rule 144A safe harbor, might invest directly in the same instruments as MMFs. They would have to hire managers for these investments, who would be unlikely to have as many resources or as much experience as those who currently manage MMFs. The portfolios would not be as well diversified as MMFs. A better alternative for these institutions might be to invest in a private MMF, completely unregulated by the SEC. Thus, one consequence of the threatened reforms would be to reduce the SEC's oversight and regulation of participants in the money markets.

Other institutional investors, and nearly all retail investors, would have to move their cash to banks. This would increase systemic risks in several respects. First, bank holding companies already designated as systemic risks under the Dodd-Frank Act control over half of MMF assets.[12] This suggests that most of the money driven out of MMFs will end up in banks that are already too big from a systemic risk perspective.

Second, much of the retail and some of the institutional money will end up in insured accounts, increasing the size of the Federal safety net. Banks will also need to raise additional capital for these deposits, at a time when they are already straining to comply with the new Basil III requirements.

Third, to limit the need for additional capital, banks are unlikely to use the new funds to make commercial loans. Unlike prime MMFs, which have to put every dollar to work, banks have the option of leaving funds in their Federal Reserve accounts. Banks may also find it easier to invest in Treasury and Government agency securities. To the extent that banks choose to make commercial loans, the absence of competition from MMFs will allow them to charge higher interest rates. Hence, the reduction in prime MMF assets will produce a corresponding reduction in credit to the private sector and an increase in the cost of such credit. If we consider that prime MMFs hold over 40 percent of the outstanding commercial paper, we can appreciate the potential impact of this on the economy.

[12] Crane Data.

The credit impact on municipalities will be even worse. Most municipalities rely on loans from tax-exempt MMFs to bridge the period between expenditures and periodic tax collections. Before MMFs, banks provided this financing, charging municipalities the prime rate for their working capital. Assuming banks will return to this role, the additional interest charges will place a considerable drag on already over-burdened municipal budgets.

The reforms will destroy MMFs in a more fundamental sense as well. As I observed, investors look to MMFs for stability and daily liquidity with a market rate of return. A floating NAV would prevent MMFs from offering stability, redemption restrictions would prevent them from offering daily liquidity, and capital requirements would prevent them from offering a market rate of return. Therefore, all of the reforms are designed to eradicate MMFs as we now know them, rather than to "shore up" the funds as asserted by the SEC's Chairman.

The SEC Should Conduct a Thorough Study of Money Market Funds, Their Shareholders and the Effects of the 2010 Reforms and the Dodd-Frank Act Before Proposing Any Further Reforms

Previous reforms to MMF regulations involved careful examinations by the SEC staff of the performance and operations of MMFs, including on-site visits and face-to-face discussions with fund managers. In the case of the 2010 reforms, the SEC staff had the benefit of a report and recommendations from the ICI's Money Market Fund Working Group. The Working Group was composed primarily of portfolio managers who had hands-on experience in guiding their MMFs through the 2008 financial crisis. This put them in the best position to know what tools and changes might serve to avoid or manage another crisis. The SEC gave serious consideration to the reforms proposed by the ICI Working Group. Although the reforms adopted by the SEC in 2010 went further than Federated thought was warranted, the reforms were largely consistent with the information provided in the Working Group's report.

Such due diligence and interaction has been lacking in this "second phase" of the reform process. So far the process has consisted of a series of trial balloons floated by the regulators and shot down by the industry, representatives of MMF shareholders and organizations concerned with the efficiency of short-term credit markets. The SEC staff has not made any efforts to look beyond industry-level data and examine what happened to individual funds and shareholders during September 2008, or to establish what changes might be realistic from a performance or operational perspective.

The 2010 reforms require MMFs to file a monthly report with the SEC containing volumes of information regarding their portfolios. The SEC staff has yet to use this information to provide any public assessment of the impact of the 2010 reforms on the risks and character of MMFs. In addition, the SEC staff has not attempted to analyze whether the "know your customer" requirements of the 2010 reforms have affected fund cash flows.

As a first critical step in their cost/benefit analysis of possible reforms, the SEC staff must identify the benefits of MMFs to investors, capital formation and market efficiency, and quantify these benefits to the fullest possible extent. They must quantify how the proposed reforms would jeopardize these benefits. As numerous commenters have documented significant adverse consequences, the SEC must thoroughly evaluate the associated cost and risk to the capital markets and economy, including the substantial risk of the loss or increased cost of credit to the many borrowers who rely on MMFs for short term funding.

The SEC staff also must demonstrate and measure any purported reduction in systemic risk of a proposed reform. The SEC may not, as Commissioner Gallagher aptly put it, "simply hand-wave and speak vaguely of addressing 'systemic risk' or some other kind of protean problem." [13] I hope that the Committee agrees that any further reforms of MMF regulations should comply with the same rigorous standards for cost/benefit analysis that the SEC has represented it will apply to regulations mandated by the Dodd-Frank Act.

The ICI, Federated, and other MMF managers, and other organizations have attempted to fill this information gap by sponsoring surveys and preparing studies of the financial and operational impact of various proposals. With the advent of FSOC, the SEC staff no longer appears to give this information the same consideration that they gave to the ICI Working Group report. Certainly the SEC Chairman continues to make public statements that either are contradicted by these studies or fail to acknowledge important issues raised by them.

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[13] "SEC Reform After Dodd-Frank and the Financial Crisis", speech by Commissioner Daniel M. Gallagher before the U.S. Chamber of Commerce (Dec. 14, 2011), available at *http://www.sec.gov/news/speech/2011/spch121411dmg.htm.*

Although I confess to being skeptical of the need for further reforms, Federated is willing to consider and assist the SEC, the ICI and the industry in assessing reform proposals that would enhance the resilience of MMFs. I am asking this Committee to encourage the SEC to do the research necessary to determine what changes, if any, are truly needed, and to express its commitment to the continued vitality and growth of this important investment product.

I look forward to answering your questions.

ATTACHMENTS AND REFERENCES

Attachments

1. Money Market Funds and Folklore: A Response to Chairman Volcker
2. The FSOC: Band of Equals or New Bully on the Block
3. Leave Money Market Funds Alone!
4. Busting through the Folklore About Money Market Funds: The Fact Is they Cost Taxpayers Nothing
5. A Regulatory Success Story: How the SEC's 2010 Rule Changes Have Increased Liquidity and Transparency at Money Market Funds
6. Excerpt from Letter from John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the FSOC, Dec. 15, 2011
7. Letter from John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, Feb. 24, 2012
8. Excerpt from Letter from John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the FSOC, Nov. 5, 2010
9. Statement of Federated Investors, Inc. Submitted to the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services United States House of Representative, June 24, 2010

Federated Comment Letters on Money Market Fund Proposals

John W. McGonigle, Vice Chairman, Federated Investors, Inc., Jan. 7, 2011, available at http://www.sec.gov/comments/4-619/4619-15.pdf. [Comments on the PWG Report.]

John D. Hawke, Jr., on behalf of Federated Investors, Feb. 24, 2011, available at http://www.sec.gov/comments/4-619/4619-82.pdf. [Response to the Squam Lake Group comments on the PWG Report.]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., Mar. 15, 2011, available at http://www.sec.gov/comments/4-619/4619-89.pdf. [Response to Mr. Paul Volcker comments on the PWG Report.]

John W. McGonigle, Vice Chairman, Federated Investors, Inc., Mar. 25, 2011, available at http://www.sec.gov/comments/4-619/4619-83.pdf. [Response to comments of Mr. Paul Volker and the Squam Lake Group on the PWG Report.]

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John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to Federal Reserve Board and FDIC, June 10, 2011, available at http://www.federalreserve.gov/SECRS/2011/June/20110621/R-1414/R-1414_061011_81322_587072501071_1.pdf. [Comments on the Federal Reserve and FDIC's Notice of Proposed Rulemaking regarding resolution plans and credit exposure reports.]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, Dec. 15, 2011, available at http://www.sec.gov/comments/4-619/4619-111.pdf. [Comment on CFTC amendments to Regulation 1.25 continuing to authorize investment of customer funds in MMFs.]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, Dec. 15, 2011, available at http://www.sec.gov/comments/4-619/4619-112.pdf. [Comments on FSOC's Advanced Notice of Proposed Rule Making regarding authority to require supervision and regulation of certain non-bank financial companies.]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, Feb. 24, 2012, available at http://www.sec.gov/comments/4-619/4619-122.pdf. [Comments on redemption restrictions.]

John W. McGonigle, Vice Chairman, Federated Investors, Inc., Mar. 16, 2012, available at http://www.sec.gov/comments/4-619/4619-140.pdf. [Comments on operational and legal impediments to redemption restrictions.]

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[Comments on Federal Reserve's Proposed Rule for enhanced prudential standards and early remediation requirements for covered companies.]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, June 1, 2012, available at http://www.sec.gov/comments/4-619/4619-189.pdf. [Comments on Federal Reserve's Proposed Rule defining ""Predominantly Engaged in Financial Activities."]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, June 1, 2012, available at http://www.sec.gov/comments/4-619/4619-190.pdf. [Comments on International Organization of Securities Commissions ("IOSCO") consultation report on Money Market Fund Systemic Risk Analysis and Reform Options.]

PREPARED STATEMENT OF BRADLEY S. FOX

VICE PRESIDENT AND TREASURER, SAFEWAY, INC.

JUNE 21, 2012

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as State and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the Nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—is represented. Also, the Chamber has substantial membership in all 50 States.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to discuss the potential impact that additional changes to money market mutual fund regulation contemplated by the Securities and Exchange Commission (SEC) would have on the business community.

My name is Brad Fox, and I am the Vice President and Treasurer of Safeway Inc. Safeway Inc. is one of the largest food and drug retailers in North America with 1,678 stores and $44 Billion in annual revenue at year end 2011. We employ approximately 178,000 people in a geographic footprint that includes the western and southwestern regions of the U.S., the Chicago area and the mid-Atlantic region, with stores locally here in the District of Columbia, Baltimore, and Northern Virginia areas. I am also a Chairman Emeritus of the National Association of Corporate Treasurers (NACT). I am here testifying on behalf of the U.S. Chamber of Commerce and the hundreds of corporate treasurers who are tasked with managing their companies' cash flows and ensuring that they have the working capital necessary to efficiently support their operations. I have been active in an advocacy role on money market fund regulatory change since the fall of 2009, representing the interests of Safeway and the membership of the NACT.

Key Points

There are several important points that I wish to stress to the Committee:

- Money market mutual funds play a critical role in meeting the short-term investment needs of companies across the country. According to May 2012 data from Investment Company Institute, corporate treasurers with cash balances and other institutional investors continue to have confidence in these funds, investing up to $900 billion or approximately 65 percent of the assets in prime money market funds because they provide liquidity, flexibility, transparency, investment diversity, and built-in credit analysis. There are no comparable investment alternatives available in the marketplace today.
- Money market funds also represent a significant source of affordable, short-term financing for many Main Street companies. Approximately 40 percent of all corporate commercial paper in the market place is purchased by these funds.
- Treasurers are extremely concerned that the changes to money market mutual fund regulation would fundamentally alter the product so that it no longer remains a viable investment option. The significance of such a change cannot be overstated. Should it happen, money market mutual funds would no longer remain a viable buyer of corporate commercial paper, which would drive up borrowing costs significantly and force companies to fund their day to day operations in a less efficient manner.

- Some corporate treasures are already making plans to withdraw funds from money market accounts to ensure full access to their funds and avoid the proposed redemption holdback. Also, floating net asset values for money market funds would result in a significant accounting burden for companies across America investing in this product. Most treasury workstations built for managing corporate cash do not have accounting systems to track net asset values (NAVs) on each transfer into and out of money market funds. Putting the systems issue aside, many treasurers would refrain from returning to money market funds to avoid the significant time and effort required to record the gains and losses on each investment and the potential impact on quarterly earnings results. The NACT believes that the SEC must carefully consider whether any additional regulations are required, as the 2010 reforms seem to be working even under the stress of the European sovereign debt crisis. Additional regulations can make the capital markets inefficient and drive up costs harming corporate growth and job creation.

Why Money Market Mutual Funds Are Important

Money market mutual funds play a critical role in the U.S. economy because they work well to serve the investment and short-term funding needs of businesses across America. Corporate treasurers rely on money market mutual funds to efficiently and affordably manage cash. Cash balances for companies fluctuate on a daily, weekly, monthly, or other periodic basis, and depending on the nature of the business, some companies' cash levels can swing widely—from hundreds of dollars to hundreds of millions of dollars. A corporate treasurer's job is to ensure that there is sufficient liquidity to meet working capital needs, and money market mutual funds are the most liquid, flexible and efficient way to do that on the investment side. They are also an important source of short term funding.

Money Market Mutual Funds as an Investment

There are many reasons why money market funds are an attractive investment choice in the business community. For companies with cash surpluses, money market mutual funds offer a stable $1.00 price per share that allows for ease of accounting for frequent investments and redemptions. They also offer market rates of return for cash that typically get no interest earnings sitting in a commercial bank account. Moreover, investments in money market mutual funds can be made and redeemed on a daily basis without fees or penalty, providing the liquidity needed to manage working capital needs.

These funds also offer a diversified and expertly managed short-term investment vehicle. This allows companies to invest in one fund while diversifying exposure to a number of underlying investments. Additionally, investment advisors to money market mutual funds perform the credit analysis of the underlying assets so that treasurers and their staffs don't have to spend time and resources analyzing the credit worthiness of multiple individual investments, but rather the mutual fund itself.

It is important to note that corporate treasurers understand the risk of investing in money market mutual funds. We are professional stewards of our companies' cash and we take our responsibility seriously. As a large food retailer, we have significant cash inflows and outflows on a daily basis that need to be managed efficiently and effectively. In the few instances when we have cash to invest, money market mutual funds are attractive to us since they are subject to a high degree of transparency, which means that we can easily ascertain what investments are in each money market mutual fund and the degree of risk associated with each fund.

Money Market Mutual Funds as a Financing Source

Money market mutual funds also represent a major source of funding to the corporate commercial paper market in the U.S., purchasing approximately 40 percent of all outstanding commercial paper. In April 2012, U.S. money market mutual funds held $380 billion in commercial paper, according to iMoneyNet. This source of financing is vital to companies across America as commercial paper is an easy, affordable way to quickly obtain short-term financing. Without money market mutual funds, the commercial paper market would be substantially less liquid, forcing companies to turn to more expensive means of financing. Higher financing costs will create a drag on business expansion and job creation.

For example, Safeway is a business with significant swings in weekly cash flows, so we have found it most efficient to manage our net borrowing position in the commercial paper market. As our working capital needs can change over the course of a week by as much as $200 million, the ability to borrow overnight in the commercial paper market allows us to manage our position very efficiently. On a daily

basis, we collect all of our cash, checks, and payment card receipts from our stores. We then review and pay all vendor and other operating and capital expenses. The commercial paper position is then adjusted accordingly through incremental borrowing or repayment to balance our daily books and avoid holding excess cash.

If instead, we had to use our revolving credit facility with our banks for overnight borrowings, those borrowings would be priced at the Prime Rate, approximately 2.5 percent higher than where we can place overnight commercial paper. To request a more comparable, LIBOR-based funding from our bank group would require 3 days advance notice, be for a minimum term of 14 days and still be at a rate about 0.25 percent higher than our commercial paper for the same term. These borrowing restrictions would inevitably lead to over or under-borrowed positions because they will rely on longer term forecasts, further driving up costs when compared to balancing at the margin using overnight commercial paper. Our banks provide these credit facilities to serve as backup lines for commercial paper issuance. Their preference is to not fund these low-priced credit facilities to investment grade companies, and to save their capital for loans to lower rated companies which do not have the same access to public markets where they can earn higher returns.

2010 Changes to Rule 2a-7

Before discussing possible further changes in the regulation of money market mutual funds, it is important to emphasize that such changes will not occur in a vacuum. Just 2 years ago, the U.S. Securities and Exchange Commission made enhancements to money market mutual fund regulation through Rule 2a-7. These changes greatly strengthened these funds, but most importantly, increased their liquidity requirements. Funds are now required to meet a daily liquidity requirement such that 10 percent of the assets turn into cash in one day and 30 percent within one week. This large liquidity buffer makes it unlikely that large redemption requests—even at the rate seen in the 2008 financial crisis—would force a fund to sell assets at a loss prior to their maturity.

Despite the fact that the 2010 reforms have just been implemented, advocates of further regulation have focused much attention on three significant structural changes to money market funds—redemption restrictions, a floating NAV and a mandatory capital buffer. As discussed below, we believe each of these would have a significant negative impact on the ongoing viability of these funds, and thereby inflict collateral damage on the corporate commercial paper market.

Redemption Restrictions

There are serious concerns about the SEC's potential implementation of redemption holdbacks or other restrictions on the ability to access funds invested in money market mutual funds. Some corporate treasures are already making plans to withdraw funds from money market accounts to have full access to their funds and avoid the complexities of monitoring simultaneous holdback positions on multiple transfers into and out of money market funds.

The reasons for this should be obvious. If corporate treasurers can't get access to cash investments, they would be forced to seek alternative resources to meet working capital needs. This includes issuing debt or drawing on our credit facilities, incurring additional costs that may be deployed more efficiently elsewhere. Such actions are imprudent and illogical. Let me be clear: a corporate treasurer's number one priority is liquidity, so any kind of redemption holdback or restriction will not work. We would take our money elsewhere.

Floating Net Asset Value

There are similar concerns among the treasurer community with regard to the proposal to establish floating NAVs for money market mutual funds. Most treasury workstations built for managing corporate cash do not have accounting systems in place to track NAVs on each transfer into and out of money market funds. Treasury workstations would need to be upgraded to accommodate these changes, and that investment would significantly lag behind the timing of implementing floating NAVs. As a result, corporate treasurers would likely withdraw money market fund investments until the systems issue is solved. On a related note, the systems upgrade costs would force a reallocation of capital expenditure away from more economically productive uses like business expansion and job growth.

Even putting the systems issue aside, many treasurers would refrain from returning to money market funds to avoid having to record the gains and losses on each investment that would flow through quarterly earnings results. Corporate treasurers diversify fund investments, and as such, are typically in multiple money market mutual funds at any given time. Tracking the capital gains and losses on each fund where investments and redemptions occur frequently is very complex. Treasurers currently don't have the manpower (or resources) to track this, nor do we have

the desire to expend limited resources doing so. We would simply find other places for our cash.

In addition, many treasurers are precluded from investing in variable rate instruments. Taken as a whole, the challenges associated with investment in floating NAV funds would outweigh the potential return for many treasurers.

Capital Buffer

One other proposal that the Securities and Exchange Commission has publicly discussed is the implementation of some type of capital buffer in an attempt to protect against losses. While this should sound appealing to investors, the reality is it doesn't. If the capital buffer is funded by the parent company, due to already thin profit margins, it would drive some fund companies out of business, leaving fewer choices for investors. Additionally, some costs may be passed on to investors. If the capital buffer is built up over time by allocating some of the fund's yield to the buffer, it would take too long to build the necessary buffer to protect against losses. Similarly, the creation of a subordinated class of shares to provide the buffer would require additional returns to be paid to those shareholders, and given the near zero interest rate environment, this could eliminate any remaining returns for investors. Thus, increasing fees or reducing yields is likely to deter many investors, including corporate treasurers, from investing in money market mutual funds.

Summary/Conclusion

In summary, Corporate Treasurers are very concerned about a sizable contraction of the 2a-7 money market mutual fund industry that is likely to result from the changes currently contemplated by the SEC. On the investing side, corporations would be forced to withdraw from prime money market funds to ensure full access to their money and avoid the accounting burden imposed by floating NAVs, and instead invest in less flexible bank investment products, other unregulated funds, or individual securities. In so doing, they would lose the liquidity and risk diversification benefit of the 2a-7 structure and increase individual counterparty risk. On the funding side, a decrease in 2a-7 capacity would lead to higher costs and less liquidity for commercial paper issuers, and place greater stress on banks to make up the difference with additional lending. There would be greater uncertainty in the daily activities of treasury departments, and that uncertainty would likely lead to more caution in planning capital investments to grow businesses and create jobs.

Rule 2a-7 money market mutual funds have been the gold standard structure around the world for many years. The question must be asked, why make additional changes now? With the reforms implemented in 2010 to provide greater liquidity, safety and transparency, these funds have proven to be very stable and attractive investments during a time of great upheaval in global markets related to the European sovereign debt crisis. Given this stress test and resulting strong performance by money market mutual funds, we renew our advocacy position questioning whether any further regulation of the money market mutual fund industry by the SEC is needed. Altering the structure and nature of money market mutual funds would take away a vital short-term cash management tool for companies throughout the country.

Thank you.

PREPARED STATEMENT OF DAVID S. SCHARFSTEIN

EDMUND COGSWELL CONVERSE PROFESSOR OF FINANCE AND BANKING, HARVARD BUSINESS SCHOOL

JUNE 21, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to appear here today to offer my perspectives on money market mutual fund reform. My name is David Scharfstein, and I am the Edmund Cogswell Converse Professor of Finance and Banking at Harvard Business School. I am also a member of the Squam Lake Group, which is comprised of 13 financial economists who offer guidance on the reform of financial regulation. Our group has issued a policy brief that advocates the introduction of capital buffers for money market funds. I would like to provide a rationale for our recommendations, but my statement, though aided by feedback from members of the Squam Lake Group, is not being made on its behalf or any other organizations with which I am affiliated.

Introduction

Observers of the first 35 years of money market fund (MMF) history might have concluded that MMFs are a relatively safe investment and cash management tool with no significant implications for financial system stability. But the events surrounding the financial crisis of 2007–2009 suggest otherwise. When the Primary Reserve Fund "broke the buck" after the failure of Lehman Brothers, it precipitated large redemptions from prime MMFs, mainly by institutional investors who were concerned that large MMF exposures to stressed financial firms would lead to losses. This "run" on prime MMFs added to stresses on the financial system at the peak of the financial crisis because large banks depend on MMFs for short-term funding. Faced with large withdrawals, MMFs were unable to invest in the commercial paper (CP), repurchase agreements (repo) and certificates of deposit (CDs) issued by large banks, broker-dealers, and finance companies. To stop the run, stabilize the money markets, and ease the funding difficulties of large financial institutions, the U.S. Treasury had little choice but to temporarily guarantee MMF balances.

While extreme, the events of 2008 point to fundamental risks that prime money market funds pose for the financial system. The main points that I want to make are as follows:

1. Prime MMFs have evolved into a critical source of short-term, wholesale funding for large, global banks. They are now a much less important funding source for nonfinancial firms.
2. Prime MMF portfolios embed financial system risk because they are short-term claims on large, global banks. Moreover, during periods of stress to the financial system, some MMFs have actively taken on systemic risk by investing in higher-yielding, risky securities in an effort to grow their assets under management.
3. The structure of MMF funding embeds financial system risk because MMF shareholders can pull their funds on demand, and have done so en masse when risk is amplified. This in turn creates systemic funding difficulties for large banks that rely on MMFs for their funding.
4. The SEC's 2010 reforms are a potentially useful first step in enhancing money market fund stability, but more reforms are needed to reduce risk in the financial system. Requiring capital buffers large enough to meaningfully reduce portfolio and run risk is a desirable next step in MMF reform.

Money Market Funds and Systemic Risk

A. MMFs as an Important Funding Source for Large, Global Banks

Total MMF assets are almost $2.6 trillion. Of this amount, $1.4 trillion are in prime funds, down from a peak of over $2 trillion in August 2008. Approximately $900 billion of prime MMF assets are in institutional funds, and the remainder are in retail funds. Importantly, prime MMF portfolios are mainly invested in money-market instruments issued by large, global banks—for the most part in CP, repo, and CDs. Exhibit 1 lists the largest nongovernment issuers of money market instruments held by prime MMFs.[1] These top 50 issuers account for 93 percent of prime MMF assets that are not backed by the Government. And 93 percent of these are claims on large global banks, most of which (78 percent) are foreign banks. The rest are mostly claims on financial firms, including the finance arms of large corporations. There are only 2 nonfinancial firms in the top 50 issuers. Altogether, only about 3 percent of prime MMF assets are invested in paper issued by nonfinancial firms. A combination of dramatic growth of financial CP, and declining nonfinancial CP issuance since its peak in 2000, has meant that MMFs have small exposures to nonfinancial issuers.[2]

Given that prime MMFs mostly invest in money market instruments issued by financial firms, it is not surprising that they provide a sizable share of the short-term, wholesale funding of large financial institutions. A rough estimate is that prime MMFs provide about 25 percent of this funding.[3]

[1] I am grateful to Peter Crane of Crane Data for providing these data.

[2] As of the first quarter 2012, there was only $127 billion of domestic nonfinancial CP outstanding, down from its peak of over $300 billion in 2000. Commercial paper is also a much smaller share of the liabilities of nonfinancial firms—now just 1.6 percent as compared to its peak of 6.5 percent in 2000.

[3] Here I am defining short-term wholesale funding as uninsured domestic deposits + primary dealer repo + financial CP.

Thus, prime MMFs essentially collect funds from individuals and firms to provide financing to large banks, which in turn use the proceeds to buy securities and make loans. This process essentially adds a step in the chain of credit intermediation. The benefit of adding this step is that it provides MMF investors with a diversified pool of deposit-like instruments with the convenience of a single deposit-like account. But the cost is that it adds risk to the financial system. Risk is increased because MMFs allow investors to redeem their shares on demand, thereby increasing the likelihood of a run on MMFs and the banks they fund during periods of stress to the financial system. Risk may also be increased because MMFs have incentives to chase yield (and risk) in an effort to attract more assets. And investors may be willing move assets to a riskier fund because they can exit the fund on demand. MMFs and their investors do not take into account the full societal costs of the risks they take because they do not bear all the costs and because the Government has proven willing to support money markets and MMFs during times of financial system stress. Indeed, most of the Government interventions during the financial crisis were directed at supporting the money markets and money market funds. (See Exhibit 2 for a list of these interventions.) Regulation of MMFs is needed to reduce excessive run risk and portfolio risk.

B. Systemic Portfolio Risk

In a recent speech, Eric Rosengren, President and CEO of the Federal Reserve Bank of Boston, noted that there is considerable credit risk in the portfolios of prime MMFs as measured by credit default swap (CDS) spreads.[4] He reported that as of September 30, 2011, 23 percent of holdings were backed by a firm with a CDS spread between 200 and 300 basis points, about 10 percent by a firm with a CDS spread between 300 and 400 basis points, and almost 5 percent were backed by a firm with a CDS spread in excess of 400 basis points. For reference, as of September 30, 2011, the average investment grade corporate bond had a CDS spread of roughly 145 basis points.[5] Thus, as of September 2011, a meaningful fraction of the securities in prime MMFs were issued by firms with CDS spreads well in excess those of the safest investment grade companies.

Importantly, because MMFs own a pool of claims on large financial institutions, this credit risk also includes considerable financial system risk. If the financial system is under stress, as it was in the 2 years surrounding the failure of Lehman Brothers in September 2008, it manifests itself in short-term funding difficulties, and an increase in the risk of money market instruments.

Moreover, during the financial crisis of 2007–2009, and the more recent eurozone sovereign debt crisis, some MMFs actually sought to increase risk and yield in an attempt to attract investors and grow assets under management in a low interest-rate environment. In particular, during the summer of 2007, interest rates on asset-backed commercial paper (ABCP) rose dramatically in response to concerns about the quality of subprime loans that served as collateral for these conduits. Some MMFs responded to this spike in market risk by actually increasing portfolio risk, taking on higher-yielding instruments like ABCP in an effort to boost returns and attract new investors. Indeed, institutional investors proved to be very responsive to higher yields, moving assets to MMFs that had increased yields and risk. Exhibit 3, based on data used in a 2012 study by Marcin Kacperczyk and Philipp Schnabl, shows that MMFs offering the highest yields were able to grow their assets by close to 60 percent from August 2007–August 2008, while those that did not increase yields by very much saw little or no asset growth.[6]

Prime institutional funds responded in similar fashion to the eurozone sovereign debt crisis. As concerns rose about the exposure of eurozone banks to struggling eurozone countries (such as Greece, Portugal, Spain, and Italy), yields on instruments issued by these banks increased. This created an opportunity for MMFs to increase yields and attract assets, albeit with an increase in risk. Indeed, a recent study by Sergey Chernenko and Adi Sunderam finds that some funds loaded up on

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[4] *See,* “Money Market Mutual Funds and Financial Stability”, speech by Eric Rosengren at Federal Reserve Bank of Atlanta 2012 Financial Markets Conference, Stone Mountain, Georgia, April 11, 2012. *http://www.bos.frb.org/news/speeches/rosengren/2012/041112/041112.pdf*

[5] In particular, the CDX.IG CDS index, which includes 125 investment grade corporate bonds, had a 5-year CDS spread of 144 basis points on September 30, 2011. By contrast, the CDX.HY CDS index, which includes 100 high yield bonds, had a 5-year CDS spread of 829 bps. Note that these CDS spreads are for bonds with a longer maturity and, in some cases, lower seniority than the money market instruments held in MMF portfolios, and thus will tend to be riskier. Nevertheless, the point is that MMFs can have significant exposures to risky banks.

[6] *See,* Marcin Kacperczyk and Philipp Schnabl, “How Safe Are Money Market Funds?” Working Paper, Stern School of Business, New York University, April 2012. I am grateful to Philipp Schnabl for preparing Exhibit 3.

the riskier, higher-yielding securities of eurozone banks and in the process were able to grow assets.[7]

Two important points emerge from these studies. First, some MMFs view it as in their interest to chase risk in an attempt to increase yields and grow assets even though such risk-taking could threaten the viability of the fund, trigger runs at the fund and other ones (as later happened with the Reserve Primary Fund), and ultimately threaten the stability of the broader financial system. Second, institutional investors can be extremely yield sensitive and risk tolerant; they appear willing to move large sums to increase returns by 10 or 20 basis points. In part, this may be because they get some measure of protection from the option to redeem their shares on demand. But when they protect themselves in this way, they exacerbate the stress on MMFs and they threaten the ability of MMFs to fund the activities of the banking sector.

C. Systemic Funding Risk

As just noted, the funding structure of MMFs creates risks for the broader financial system. Because MMF shares are demandable claims—they allow investors to redeem their shares on a daily basis—investors can pull their funds from MMFs at the slightest hint of trouble. Funding risks are also amplified by the fact that MMFs are allowed to maintain a stable $1 NAV per share using amortized cost accounting and rounding. This enables investors to redeem their shares at a $1 share price even if the marked-to-market value is less than $1 per share. The stable NAV feature creates incentives for investors to beat other investors out the door before the fund breaks the buck and is no longer allowed to redeem shares at the $1 share price.

A run is not just damaging to the MMF, but it could be damaging to the broader financial system. A run at one MMF could precipitate runs on other MMFs if, as one might expect, investors are concerned that the factors that led to losses in one fund could affect other funds. In this case, multiple funds will have difficulty rolling over the securities in their portfolio, amplifying the funding stresses on financial institutions, which can spill over into the real economy. It is altogether possible that an otherwise healthy bank will face funding difficulties because the failure of another bank leads to a run on the MMF sector.

A systemic MMF run has occurred twice in the last 4 years. As shown in Exhibit 4, the failure of Lehman Brothers in September 2008 precipitated a run on prime institutional MMFs, with assets falling by 29 percent within 2 weeks. There was no run on prime funds by retail investors. The run would likely have been much more severe had Treasury not stepped in and temporarily guaranteed MMF balances.

A similar, but slower-moving version of this story played out in the second half of 2011, as prime institutional MMF investors became concerned about the exposure of European banks to the sovereign debt of struggling eurozone countries. Given the large presence of money market instruments issued by eurozone banks in the portfolios of U.S. MMFs, this led to significant redemptions from prime institutional MMFs from June–December 2011, as shown in Exhibit 4. Again, the redemptions were more pronounced among institutional investors than retail investors. This is consistent with research showing that it is institutional investors that are more prone to chase yield and risk, and then pull their funds when their perspectives on risk change.[8] MMF outflows have added to the stresses on eurozone banks, particularly on their ability to fund their dollar loans both here and abroad.

Regulatory Reform Alternatives and the Need for Capital Buffers

The broad goal of money market fund regulation should be to ensure that portfolio risk and funding risk are within acceptable limits. Regulation can take a variety of forms to achieve this objective. Portfolio risk can be limited by placing restrictions on what MMFs can hold in their portfolios, or by reducing the incentives of MMFs to take excessive risk. Funding risk can be limited by reducing the ability of shareholders to redeem their shares on demand, or by reducing their incentives to do so.

A number of reform proposals are being considered, including elimination of stable NAVs and capital buffers (possibly combined with redemption restrictions). These reforms would be in addition to new regulations adopted by the SEC in early 2010, which require MMFs to hold more liquid, higher quality and shorter maturity assets, allow MMFs to suspend redemptions under certain conditions, and require more disclosure of MMF portfolio holdings and their value.

[7] Sergey Chernenko and Adi Sunderam, "The Quiet Run of 2011: Money Market Funds and the European Debt Crisis", Working Paper, Harvard Business School, March 2012.

[8] Kacperczyk and Schnabl, op. cit.

The MMF industry has argued that these reforms are sufficient to ensure MMF safety.[9] While these reforms may, in fact, be helpful in reducing portfolio and funding risk, SEC Chairman Mary Shapiro is right to point out that more needs to be done.[10] While it is desirable to have MMFs hold more liquid securities to buffer against large redemptions, it is often difficult for regulators to identify assets that will continue to be liquid during a liquidity crisis. Indeed, even securities backed by high quality collateral became illiquid during the financial crisis in 2008.[11] Moreover, the requirement that MMFs hold shorter maturity securities, while potentially enhancing the safety of MMFs, may actually come in conflict with the objectives of other regulatory initiatives to get banks to be less reliant on short-term, wholesale funding.[12]

Additional reforms are also needed because a number of the tools that the Government used to support money markets and stabilize MMFs are now more restricted or unavailable. In particular, the Emergency Economic Stabilization Act of 2008, the legislation that created the Troubled Asset Relief Program, outlaws the use of Treasury's Exchange Stabilization Fund to guarantee MMF shares as it did in September 2008. And programs that the Federal Reserve and FDIC introduced to stabilize money markets during the crisis would now require either executive branch or Congressional approval.[13] Some might argue that without these emergency supports, moral hazard will be reduced and, as a result, MMFs and their shareholders will take less risk. But the response of MMFs and their shareholders to the eurozone sovereign debt crisis suggests otherwise.

The two main types of reform proposals are (i) replacement of the stable NAV structure with a floating NAV structure; (ii) various forms of capital buffers. The capital buffer proposals include: requirements that sponsors put their own capital at risk; creation of two shareholder classes, one subordinate to the other; and redemption holdbacks that are put at risk when shareholders redeem their shares.

Floating NAV Proposal

As noted, above stable NAVs exacerbate run incentives when MMFs get in trouble because early redemptions are made at the $1 share price even if the market-value NAV is less than $1. There are a number of ways in which a floating NAV structure would help promote MMF stability. First, it would reduce the benefits of early redemptions from a stressed fund since redemptions would occur at market values rather than an inflated $1 NAV. Second, it would likely make clear to investors that MMFs are risky investment vehicles and it would provide a more transparent view of the risk. This could help to dampen the sort of yield-chasing behavior we have recently observed, followed by the runs that occur during a crisis. Thus, the floating NAV proposal, while mainly acting to reduce funding risk, could also help to reduce portfolio risk.

The MMF industry has strongly opposed floating NAVs, arguing that investors derive significant operating, accounting, and tax management benefits from the ability to transact at a fixed price.[14] While there may be benefits of such a pricing structure, it is unclear how much of the institutional demand for MMFs derives from such a structure. After all, many large institutional investors manage their own pool of money market instruments, which of course fluctuate in value. It is possible that a good deal of MMF demand comes from the higher yields they have historically been able to offer, combined with the potential benefits of being able to diversify across money market instruments. These benefits would continue to exist in a floating NAV structure.

Another concern is that floating NAVs might not be sufficient to stop runs in times of stress. Advocates of floating NAVs believe that the fixed NAV structure is

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[9] *See,* for example, "Response to Reported SEC Money Market Funds Proposals", Investment Company Institute, February 17, 2012.

[10] SEC Chairman Schapiro is quoted as saying, "While many say our 2010 reforms did the trick—and no more reform is needed—I disagree. The fact is that those reforms have not addressed the structural flaws in the product. Investors still have incentives to run from money market funds at the first sign of a problem." *See,* Sarah N. Lynch, "SEC Schapiro Renews Call for Money Fund Reforms", Reuters, March 15, 2012.

[11] *See,* Morgan Ricks, "Reforming the Short-Term Funding Markets", The Harvard John M. Olin Discussion Paper Series, No. 713, May 2012.

[12] In particular, the Tri-Party Repo Task Force established by Federal Reserve Bank of New York has recommended that dealers should shift to longer-term repo funding. See also "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring," Bank for International Settlements, December 2010, for a description of international regulatory initiatives to reduce bank dependence on short-term funding.

[13] Ricks, op. cit.

[14] *See,* "Report of the Money Market Working Group", Investment Company Institute, March 17, 2009.

the attribute of MMFs that significantly exacerbates run incentives. An alternative view is that runs derive from a change in investor perception of risk combined with their ability to redeem shares on demand regardless of whether the redemption occurs at $1 or slightly less. Indeed, given the illiquidity of securities in MMF portfolios, mass selling of those securities could drive down their price. The prospect of fire sales also gives MMF shareholders incentives to exit early and could precipitate a run. One MMF industry study has pointed out that floating-NAV instruments, such as "ultra-short" bond funds and certain French floating-NAV money market funds were not immune from substantial sudden redemptions during the financial crisis.[15] If so, then some form of a capital buffer could be a more effective run-prevention mechanism.

Capital Buffers

The Squam Lake Group, of which I am a member, has proposed capital buffers as a mechanism for promoting more stable MMFs.[16] The policy brief outlines a number of possible ways that capital buffers could be structured and suggests that individual MMFs be given some flexibility in choosing the precise form of the buffer. For example, some sponsors may prefer to set aside their own capital, while others may prefer to issue a subordinated, loss-absorbing share class. While some choice may be desirable, it will be necessary to restrict the menu of options so that investors can readily assess the degree of capital support.

With a capital buffer, first losses are incurred by capital providers, either fund sponsors or subordinated share classes. This reduces the incentive of MMF investors to run because they can be more confident that their investment is protected. A capital buffer could also act to reduce portfolio risk. If the sponsor provides the capital, the sponsor would presumably have greater incentives than it does now to avoid losses. Even if capital is provided by a subordinated share class, sponsors would have incentives to reduce portfolio risk to limit the cost of this capital and increase yields on the senior share classes.

Although capital buffers may seem like a significant departure from the current regime, MMF sponsors have often provided capital support when necessary. As documented recently by Eric Rosengren, fund sponsors provided capital support in 56 instances from 2007–2010. In nine cases, support exceeded 1 percent of net asset value.[17] However, capital requirements are preferable to ad hoc capital support because with capital requirements investors will know that there is layer of capital support to protect them; if capital support is ad hoc, investors will run in the face of uncertainty about whether support will be forthcoming.

There is also active debate about what the right level of capital should be. Industry advocates suggest relatively low levels of capital given historical loss rates. However, it is important to set capital levels comfortably above historical loss rates and prior levels of ad hoc capital support so that investors are confident that their funds are safe and have no incentive to run. In addition, historical loss during the crisis of 2007–2009 occurred against the backdrop of extraordinary Government support of the money markets and money market funds. Without such support, which may not be forthcoming to the same degree in the next crisis, loss rates could well be higher than the historical crisis average. For these reasons, capital buffers would need to be set meaningfully in excess of historical loss rates and ad hoc capital support levels.

Finally, the MMF industry has generally opposed capital buffers, arguing that they are costly and would make MMF sponsorship unprofitable. While there are costs of a capital buffer, the costs should not be particularly high if, as industry opponents argue, MMFs are relatively safe.[18] Moreover, as discussed above Moreover, capital is also costly to banks, and yet there is widespread agreement that they should hold capital. Like banks, MMFs are systemically significant financial inter-

[15] Ibid.

[16] "Reforming Money Market Funds: A Proposal by the Squam Lake Group", January 14, 2011.

[17] Rosengren, op. cit.

[18] For example, suppose there was a capital buffer that required sponsors to set aside 2 percent of NAV in Treasuries. Sponsors would have to pay a liquidity premium for holding Treasuries. This liquidity premium is on the order of 1 percent. With a 2 percent buffer, this cost amounts to just 2 basis points. The potentially greater cost comes from the possibility that the sponsor loses the capital as compared to a situation where the sponsor just walks away from the fund. If the risk is low, this cost should be minimal. Note also that many sponsors choose to support their funds when they risk breaking the buck, so relative to such noncontractual support the cost of the buffer is even lower.

mediaries and as such should have capital buffers to promote a more stable financial system.

Thank you for the opportunity to present my views on money market fund reform. I look forward to answering any questions you may have.

Exhibit 1: List of Top-50 Non-Government Issuers in Prime MMF Portfolios, May 2012
Total prime money market fund (MMF) assets were $1,423 billion. Approximately $308 billion of prime MMF assets were invested in Treasuries, Agency securities or municipal securities. Based on data from Crane Data.

Rank	Issuer	May 2012 (USD billions)	Percent of Prime MMF Assets	Rank	Issuer	May 2012 (USD billions)	Percent of Prime MMF Assets
1	Barclays Bank	56.8	3.99%	26	HSBC	17.4	1.22%
2	Deutsche Bank AG	52.1	3.66%	27	DnB NOR Bank ASA	15.8	1.11%
3	Bank of Tokyo-Mitsubishi UFJ Ltd	45.4	3.19%	28	BNP Paribas	15.2	1.07%
4	Bank of Nova Scotia	42.9	3.01%	29	Skandinaviska Enskilda Banken AB	14.5	1.02%
5	Sumitomo Mitsui Banking Co	42.6	2.99%	30	Canadian Imperial Bank of Commerce	14.1	0.99%
6	National Australia Bank Ltd	41.4	2.91%	31	Australia & New Zealand Banking Group Ltd	13.7	0.96%
7	JP Morgan	40.4	2.84%	32	Credit Agricole	13.4	0.94%
8	Credit Suisse	40.2	2.82%	33	Straight-A Funding LLC	11.6	0.81%
9	RBC	37.8	2.66%	34	FMS Wertmanagement	11.4	0.80%
10	Rabobank	37.6	2.65%	35	ABN Amro Bank	10.4	0.73%
11	Bank of America	37.1	2.60%	36	Norinchukin Bank	10.3	0.72%
12	Westpac Banking Co	28.9	2.03%	37	Lloyds TSB Bank PLC	9.6	0.68%
13	Citi	28.5	2.00%	38	Toyota	9.2	0.64%
14	ING Bank	25.8	1.81%	39	State Street	9.1	0.64%
15	Mizuho Corporate Bank Ltd	25.7	1.81%	40	Wells Fargo	8.9	0.62%
16	RBS	23.5	1.65%	41	Natixis	7.7	0.54%
17	General Electric	22.9	1.61%	42	NRW Bank	6.6	0.46%
18	Bank of Montreal	22.6	1.59%	43	Morgan Stanley	6.3	0.44%
19	Svenska Handelsbanken	22.4	1.57%	44	Nestle	6.2	0.43%
20	Commonwealth Bank of Australia	21.6	1.52%	45	MetLife Insurance Company	5.5	0.39%
21	Toronto-Dominion Bank	20.9	1.47%	46	US Bank	5.2	0.36%
22	UBS AG	20.1	1.41%	47	Swedbank AB	4.9	0.34%
23	Societe Generale	19.6	1.38%	48	Coca-Cola Co	4.5	0.31%
24	Nordea Bank	19.4	1.36%	49	Branch Banking & Trust Co	4.3	0.30%
25	Goldman Sachs	17.5	1.23%	50	Oversea-Chinese Banking Co	4.1	0.29%

Exhibit 2: Select Interventions in Money Markets During the Financial Crisis
Source: Morgan Ricks, "Reforming the Short-Term Funding Markets," The Harvard John M. Olin Discussion Paper Series, No. 713, May 2012.

Money Market Instrument	Emergency Policy Measure
Money market mutual fund shares	MMF Guarantee (Treasury)
	Money Market Investor Funding Facility (Fed)
Uninsured Deposits	Transaction Account Guarantee (FDIC)
	Term Auction Facility (Fed)
	Deposition Insurance Limit Increase (EESA)
Eurodollars	Central Bank Liquidity Swaps (Fed)
Financial Commercial Paper	Temporary Liquidity Guarantee Program (FDIC)
Nonfinancial Commercial Paper	Commercial Paper Funding Facility (Fed)
Asset-Backed Commercial Paper	ABCP MMF Liquidity Facility (Fed)
Primary Dealer Repo	Primary Dealer Credit Facility (Fed)
	Term Securities Lending Facility (Fed)

Exhibit 3: Average Asset Growth for High- and Low-Yield Funds

This figure plots asset growth for high and low-yield funds from August 2007 to August 2008. High (low) yield funds are defined as funds in the top (bottom) quartile of average gross yields during the period from August 2007 to August 2008. The average yield differential between top and bottom quartile funds was 42 basis points. Asset growth is computed as assets of the average fund per quartile. Assets are normalized to zero as of the first week of August 2007. Based on data used in Marcin Kacperczyk and Schnabl, "How Safe are Money Market Funds?" Working Paper, Stern School of Business, New York University, April 2012. Figure prepared by Philipp Schnabl.

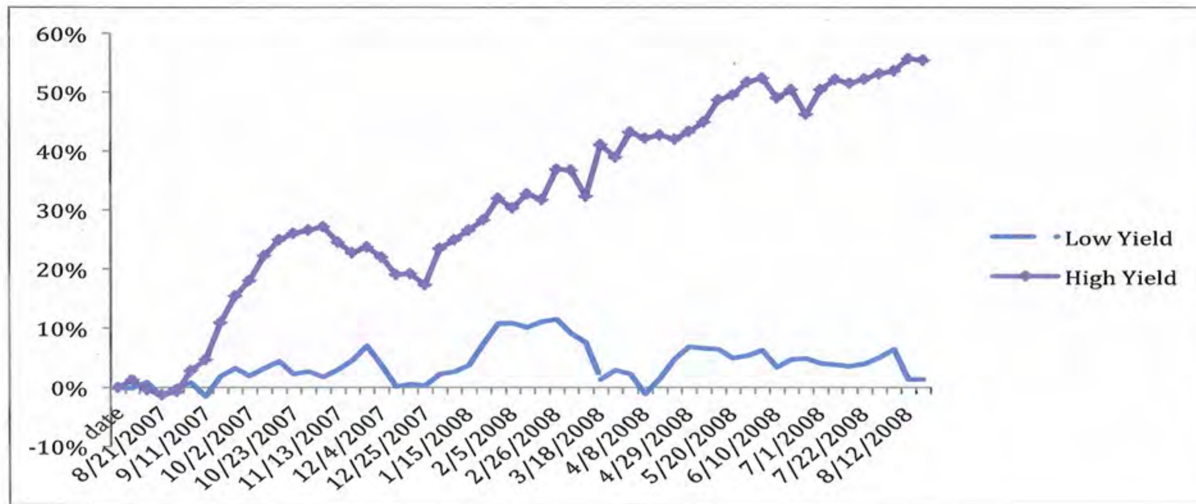
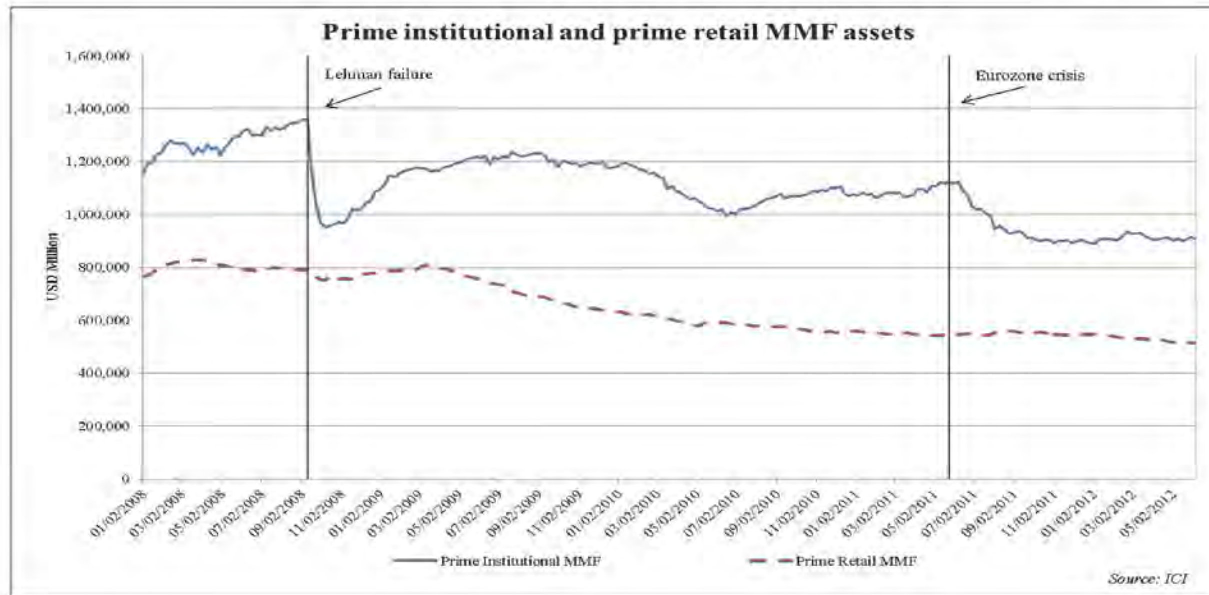


Exhibit 4: Assets of Prime Institutional and Retail Money Market Funds

This graph shows significant outflows from prime institutional MMFs following the failure of Lehman Brothers September 2008 and the escalation of the Eurozone crisis in the summer of 2011. No significant outflows occurred from prime retail funds after these events. Data from Investment Company Institute.



ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT SUBMITTED BY THE FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT BROKER-DEALERS
AND INDEPENDENT FINANCIAL ADVISORS

The Financial Services Institute (FSI) represents independent broker-dealers (IBD) and the independent financial advisors affiliated with them. We are pleased that the Committee is holding this hearing to explore the issues facing money market mutual funds and their investors. We wish to register our concerns regarding proposed changes to the structure of money market funds, particularly our strong opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

The Importance of Money Market Mutual Funds to Main Street Investors

We are deeply aware of the value money market funds provide to investors—middle-class Americans, businesses, non-profit institutions, and state and local governments—because these are the clients our members serve. Since the financial crisis of 2007–2009, policymakers have made great progress in making money market funds even stronger. A few regulators and commentators, however, continue to advocate changes that would undermine the economic and investor benefits of money market funds by eliminating the stable $1.00 per-share price. In our view, forcing money market funds to float their NAVs would harm investors and the broader U.S. economy. Therefore, we strongly support maintaining the ability of money market funds to offer a stable $1.00 per-share value.

For the independent broker-dealers and financial advisors we represent and the investors whom they serve, money market funds provide a high degree of liquidity, diversification, and convenience, along with a market-based yield. The stable NAV is central to these benefits. Investors purchase and redeem millions of dollars in money market fund shares every day. With a stable NAV, typically set at $1.00 per share, those investors are relieved of the burden of tracking gains or losses for tax or financial accounting purposes.

To force floating NAVs would take away these benefits while risking the following negative effects:

- **Hobbling cash management**. Many governmental bodies, businesses, and institutions operate under legal constraints or investment policies that prevent them from investing cash balances in instruments that fluctuate in value. If money market funds were required to float their NAVs, many clients of independent broker-dealers and financial advisors would be forced to use alternative funds that are less regulated, less secure, and less liquid.
- **Driving up the cost of investing and doing business**. Individuals, businesses, and institutions use money market funds to hold excess cash for short periods of time and maximize liquidity. Floating the NAV would undermine the convenience and simplicity of using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. With a floating NAV, every money market sale would be a tax-reportable event, substantially increasing tax and

recordkeeping burdens and significantly reducing the benefits of money market funds to Main Street investors.

- **Increasing the cost of financing.** Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligations, such as funding payrolls, replenishing inventories and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to businesses will be significantly disrupted.

- **Depriving investors of tax-exempt income and state and local governments of needed financing.** Mutual funds, including money market funds, can pass the benefits of tax-exempt income to investors—a feature that banks and other packaged investment products cannot provide. This has helped create a robust market in municipal securities to meet the capital and operating needs of America's communities. As the short end of that market, tax-exempt money market funds hold more than $300 billion in assets, accounting for more than half the short-term securities issued by state and local governments. Driving investors away from money market funds will hurt both investors and state and local governments.

- **Creating a financing gap**. Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure and less liquid.

To avoid these negative consequences, we believe that any further reforms for money market funds must preserve their fundamental features. As Treasury Secretary Timothy Geithner said recently, any further changes to money market funds must be made "without depriving the economy of the broader benefits that those funds provide."

Forcing the adoption of floating NAVs for money market funds would not make these funds more resilient under adverse market conditions, and it would destroy many economic benefits. Therefore, we oppose any proposals that would change the stable $1.00 value of money market funds.

We are not alone in expressing our concerns with the proposed changes. Recently, thirty three members of the House of Representatives and six U.S. Senators have written to the SEC to express concern about changes to the regulation of money market funds. Also, more than two dozen local government groups have expressed similar concern. Finally, three of the five SEC Commissioners expressed their objections to further money market reforms by publishing a statement pointing out that the International Organization of Securities Commissions ("IOSCO") recently published Consultation Report analyzing systemic risks and reform options for money market mutual funds does not reflect their views.

We thank the Committee for holding this hearing and for the work it is doing to address these issues. Please contact David T. Bellaire, Esq., FSI's General Counsel & Director of Government Affairs at 202 803-6061 or david.bellaire@financialservices.org if you would like more information on the Financial Services Institute and our position on this important issue.

Background on FSI and the Independent Broker-Dealer Community
The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive

financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees of their affiliated broker-dealer firm.[1] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market for advisors affiliated with IBDs is clients who have tens and hundreds of thousands, as opposed to millions, of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[2] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. Our mission is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. We also provide our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

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[1] Cerulli Associates at http://www.cerulli.com/

[2] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

LETTER SUBMITTED BY MICHELE M. JALBERT, EXECUTIVE DIRECTOR—POLICY AND STRATEGY, THE NEW ENGLAND COUNCIL

The New England Council

June 28, 2012

The Honorable Tim Johnson
Chairman
Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Richard C. Shelby
Ranking Member
Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Johnson and Ranking Member Shelby:

For nearly three decades, money market funds have served as a cost-effective means for a wide array of investors to achieve market rates of return, while promoting stability of principal and liquidity of their investment. Money market funds are highly regulated by the Securities and Exchange Commission (SEC) and according to the Investment Company Institute, $2.7 trillion of all investments in mutual funds – approximately 22 percent – are in money market funds. These funds also serve as a crucial source of short-term financing, especially in the recovering U.S. economy, where cash flow for the government, employers and others may be uneven.

Because of their design, money market funds allow corporations to meet short-term operating needs, such as payroll and accounts payable. Financial institutions use them to finance holdings of short-term assets such as consumer loans and credit card receivables. State and local governments may use money market funds to fund expenditures in advance of tax receipts or for a variety of other short-term borrowing needs. In sum, the current money market fund system provides borrowers with enormous flexibility in financing during a period of uncertain economic recovery, while offering investors stability of principal and great liquidity – which benefit individuals and families facing their own difficult financial straits.

In October 2010, the President's Working Group on Financial Markets proposed that money market funds shift from the standard $1 per share valuation, to a floating Net Asset Value (NAV). This proposal was designed to reduce large shareholder redemptions when financial markets experience heightened volatility and sharp declines. While well-intentioned, the floating NAV proposal would have serious consequences for an important mechanism that is helping facilitate our nation's economic recovery. In particular, states and municipalities around

the New England region could face a contraction of available financing, just at a time when they are struggling with some of the tightest budget restrictions in memory.

The intent of the original President's Working Group proposal for a floating NAV was to help investors understand, and reduce, the risk associated with investment. It was thought that if the NAV fluctuated in a money market fund, investors would have a clearer sense that there was some risk involved. The New England Council believes most investors understand the modest risk associated with money market funds. Further, such a shift could well force investors to seek other less-regulated products that seek to maintain a stable unit price. There are a number of other products, such as offshore money fund or enhanced cash pools, which are not regulated under the Investment Company Act.

Money market funds are highly regulated under Rule 2a-7 of the 1940 Act. In response to the credit crisis and liquidity concerns arising in late 2008 -2009, the SEC reviewed the investment guidelines, credit quality, and financial reporting. This review led to the 2010 rule amendments that changed the investment requirements by raising the credit quality, reducing the maturity of money market funds' portfolio and increasing the reporting requirements. Money market funds are required to perform stress test scenarios reflecting the impact certain market conditions and investor redemption activity would have on the money market fund's net asset value. The SEC amendments also required monthly financial reporting to the SEC including holdings information and shadow pricing results. This added disclosure helps to better inform and protect investors and these amendments have had a significant impact on increasing the amount of liquid assets held by money market funds.

At this point, the consequences of a move to a floating NAV are multifold. A shift to a floating NAV would add significantly to the administrative costs for a money market fund, thereby decreasing net yield. It would also add to the administrative burden for the shareholder in terms of tax, accounting, and record-keeping. One of the major benefits of money market funds with a stable NAV is the convenience and easy liquidity of the holdings, so individuals and families can quickly access their cash when needed, with a minimum of record-keeping requirements.

From the borrowers' standpoint, a move to a floating NAV would reduce the funds available for expenses, such as corporate operating needs, infrastructure projects and other municipal cash requirements. It is likely that a substantial number of investors would not continue to use money market funds; many institutional investors are precluded from investing cash balances in pools which do not maintain a stable NAV. Similar legal restrictions may apply to corporations, municipalities and various state-regulated entities around the country. This constriction in ready capital would hamper the efforts of states, cities and towns trying to manage difficult financial circumstances.

THE NEW ENGLAND COUNCIL

The New England Council

According to the National Association of State Treasurers, a shift to a floating NAV "would not be in the interests of either investors or debt issuers and could potentially destabilize the market." Within the New England region, these concerns are echoed. The Rhode Island Economic Development Corporation wrote in comments submitted to the Securities and Exchange Commission, "American business would lose one of its most important sources of capital raising and instruments to meet investment needs if money market funds are, directly or indirectly, forced to abandon their stable net asset value (NAV) under proposals discussed in the President's Working Group on Financial Markets Report." According to comments submitted to the Securities and Exchange Commission last year, "The New Hampshire Treasury believes that such a change would not be in the interests of either public-sector investors or debt issuers and could potentially destabilize the market. Furthermore, the New Hampshire Treasury believes that a floating NAV could decrease investor demand and transform the current money market funds into short-term bond funds with its inherent risk, volatility and liquidity problems." Bruce Poliquin, Maine State Treasurer, notes "It would be unlikely for Maine State Treasury to use floating NAV money market funds. Such vehicles would increase investment risk for the State's short term liquidity and capital preservation needs, especially during volatile market conditions. Also, fund administrative costs would likely rise, thereby decreasing net yield – another negative." Steve Grossman, Massachusetts State Treasurer notes, "A change to a floating NAV would severely hamper government entities in their ability to have a secure, liquid and convenient instrument for investing. This proposal could unintentionally subject an investor to losses when withdrawing cash, a prospect that would undermine Massachusetts' financial position.

Given the unintended, but very negative, consequences of a shift to a floating NAV for money market funds, particularly for city, state and local governments around the New England region, we respectfully ask that such a proposal be rejected. If there is any additional material or information that you need, please do not hesitate to contact me.

Sincerely,

Michele M. Jalbert
Executive Director – Policy & Strategy

PREPARED STATEMENT SUBMITTED BY JEFFREY N. GORDON, RICHARD PAUL RICHMAN PROFESSOR OF LAW AND CO-DIRECTOR, CENTER FOR LAW AND ECONOMIC STUDIES, COLUMBIA LAW SCHOOL

Submission by Jeffrey N. Gordon

Richard Paul Richman Professor of Law and Co-Director, Center for Law and Economic Studies, Columbia Law School

Prespectives on Money Market Mutual Fund Reform

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

June 21, 2012

Chairman Johnson, Ranking Member Shelby, and other members of the Committee, thank you for the opportunity to address the topic of money market fund reform through this written submission. I have studied the money market fund problem since the fall of 2008. This has resulted in two detailed comment letters to the SEC, one in September 2009 and the other in August 2011, both of which are attached to this submission. A co-author and I have also conducted empirical analysis of the relative run risks of floating vs. fixed net asset value ("NAV") funds, based on a "natural experiment" involving off-shore dollar-denominated money market funds during "Lehman week" in September 2008. These self-regulated funds generally follow the SEC rules on portfolio composition but are available in both fixed and floating NAV. We find that the fixed/floating distinction does not explain the variation in the run rate across funds; rather, the relative risk of the fund, proxied by yield prior to Lehman week, is the crucial fund-level explanatory variable. (We are in the process of finishing a draft of this research which should be public shortly.)

For record, none of my research in this area has been supported by any party other than Columbia Law School as part of the customary research funding it provides to faculty members.

Based on this cumulative work, my views are the following:

- Money Market Mutual Funds ("MMFs") are like banks except they have no provision for bearing loss and internalize none of the systemic risk costs of their activities.
- MMFs present a unique "two-sided" run problem that makes them an unstable source of credit. Since most MMF credit it now extended to banks, this makes MMFs a significant vector for financial crisis.
- These problems can be addressed through requiring MMF investors to acquire bundles of Class A/Class B shares, in which fixed NAV is preserved for the Class A shares.

To elaborate on these views:

First, a money market mutual fund is like a bank in that it holds a portfolio of risky assets (non-U.S. Treasury) yet, unlike a bank, holds no capital nor any other first-loss protection. Its NAV will fall below $1 upon the default of virtually any appreciable portfolio holding, unless the sponsor decides to step in to cover the loss. The fact that sponsors frequently have provided such suppport provides no assurance that a particular sponsor(s) will have sufficient resources or willingness to provide support in the midst of a financial crisis.

The Reserve Primary Fund illustrates the problem of sponsor incapacity for a large fund, and at only $60 billion, this fund was hardly the largest. Moreover, it is simply false that sponsors provided sufficient support to protect their MMFs during September 2008. The entire industry received massive federal support that consisted not only of the well-known Treasury guarantee (for which a fee was paid) but also a Federal Reserve guarantee of the most problematic MMF assets, for which no fee was paid. This guarantee took place through the terms on which the Fed offered to extend credit through its "Asset-Backed Commercial Paper MMF Liquidity Facility": lend to MMFs (though back-to-back bank loans) at par on a non-recourse basis to finance the weakest assets in the MMF portfolio. Approximately $150 billion was drawn down on this facility in the first 10 days following the Reserve Primary Fund default. Nine of the ten largest MMFs, representing two-thirds of all MMF assets, used the AMLF. Only Vanguard did not use the emergency credit facility. [1]

Second, the lack of capital or any other first-loss protection means that MMFs are exposed to a "two-sided run problem." One side of the run problem is well understood: MMF fund investors who perceive a risk of default will want to be first in line at the withdrawal window. If other investors perceive a similar risk, the best strategy is to withdraw first and ask questions later, producing a run. The second side of the run problem is less well-understood but equally important. MMFs provide short term finance to financial institutions (especially banks) as well as to non-financial commerical paper users. Precisely because they have no first loss protection against default of portfolio securities, MMFs will be extremely sensitive to the risk of default by the parties they finance. This means, for example, if a bank runs into financial distress, MMFs will either shorten the maturity of the obligations from this counterparty or refuse to rollover the obligations altogether. In other words, because of the first run problem, the MMF depositor run risk, MMFs in turn creates a run problem for parties that depend on MMF financing. Because of the threat that depositors will run on the MMFS, the MMFs may run on their counterparties.

Third, the two-sided run problem has very important (negative) macro implications. A little background is necessary. The main function of MMFs currently is to provide diversified portfolios of credit-screened short-term claims on financial firms to

[1] *See* Ben Levisohn **&** Daisy Maxey, *Absent Help, More Funds Might Have Broken Buck,* Wall St. J Online, Dec. 1, 2010.

cash-holding institutions seeking safety and liquidity. For example, an operating company with large cash reserves could deposit the funds in a bank or itself assemble a portfolio of money market instruments. An MMF is better than these two alternatives, because a diversified portfolio of financial firm claims is safer than a deposit in a single bank (given the cap on deposit insurance) and the MMF can achieve scale economies in producing divesified, screened portfolios of such claims. In the evolution of MMFs from the 1980s until the present, the largest users have become institutional, and the mix of MMF assets has moved overwhelmingly to claims on financial firms (and related financing entities). Such financial sector claims constitute an estimated 80 percent of all non-US government assets held by prime MMFs. Although it is true that MMFs are the dominant source of commercial paper issued by non-financial firms, such CP issuances have become an increasingly unimportant part of the MMF balance sheet.

Two implication follow. First, MMFs have become a major vector for financial sector distress. Because the credit-worthiness of financial firms is highly correlated, if a single financial firm defaults on its money market issuances, MMFs will take this as a signal of the likelihood of other defaults in the financial sector and will thus run on many other financial firms by refusing to roll over credit. This will provoke an immediate funding crisis throughout the financial sector. Second, even without an outright default, as the threat of financial distress looms, MMFs will restrict the terms on which they extend credit, for example, shortening maturities and refusing to rollover credit for certain financial firms. The knock-on effects are significant: responding to their MMF funders, banks will behave accordingly in their own credit extensions, to avoid a liquidity shortfall. Loans will not be made; maturities will shorten. Recent press accounts, which describe the shortening of MMF credit extensions to banks and the MMFs' withdrawal from lending to European banks alongside the corresponding contraction in bank assets, show that this effect is not hypothetical. A constriction of credit is obviously a negative for economic growth.

Here is the policy-relevant structural point: A significant fraction of this particular vicious circle is the direct result of the fragility of the MMFs themselves as presently designed. To repeat: the MMFs have no capacity to bear default on any portfolio security. Thus much of the wholesale short term funding mechanism dances to the MMFs' short-rigged tune.

Fourth, it is possible to design an MMF that will preserve the benefits currently associated with MMFs but reduces some of the systemic risk and other negative effects. My August 2011 comment letter extensively presents such a proposal. The main feature is this: institutions that invest in MMFs buy two classes of MMF stock, Class A and Class B, as a Class A/Class B bundle, in a ratio of roughly 95% to 5%.[2, 3] Class A shares carry fixed NAV and thus can be used transactionally without tax or accounting consequences; Class B may float in value and may bear loss. An investor can withdraw Class A shares at will. Class B shares can be withdrawn only upon a 7 day (or 30 day) lag, a holdback.

[2] I treat retail funds differently but they could be handled the same way.
[3] I pick 5% because that is the largest allowable portfolio position for a single issuer under Rule 2a-7.

The proceeds of Class A and Class B shares will be invested identically by the MMF. In ordinary times, the investors face no costs, except some loss of liquidity on the 5%. But the Class B shares do bear the risk of loss in a default of a portfolio security that is not covered by a sponsor or losses occurring in a fire sale of assets to raise cash for redemptions. Other details are spelled out in the comment letter.

There are three advantages. First, this arrangment significantly enhances MMF stability, which will reduce not only their systemic risk potential but will also change MMF behavior in periods of financial stress, like right now. Because MMFs will have first loss protection, their own funding decisions need not be on hair trigger, with positive effects throughout the short term funding process. This may encourage bank extensions of credit to non-financial borrowers.

Second, the structure of the Class A/Class B bundle protects not only against portfolio defaults but also against run risk. That is because a Class A holder also owns Class B. Class A holders will therefore be far less likely to run, because a run that leads the MMF to sell assets at firesale values and thus to break the buck will be costly for the holder's Class B shares. Before a run was "free" to the holder; now there will be potential costs.

Third, the cost of this arrangement is borne by the MMF users, not the sponsors or the taxpayers. This proposal will not drive the MMF industry out of business. Fact is, institutional MMF investors have no better alternative. Short term bond funds of course have floating NAV. Bank deposits carry risk if uninsured This proposal merely requires institutional MMF investors to internalize the cost of systemic stability for MMFs rather than relying on implicit guarantees from the rest of the financial sector and the US Government (and the taxpayers).

Thank you very much for your attention.

# # #

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August 12, 2011

Via SEC Internet Comment Form

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-11-09
Release No. IC-28807
Money Market Reform

To the Commission:

This letter offers a specific proposal for the regulation of Money Market Funds (MMFs). The proposal responds to comments made at the Commission's Roundtable Discussion on May 10, 2011 and the public comments on the President's Working Group report on Money Market Fund Reform, per Investment Company Act Release No. IC-29497. I respectfully request that this correspondence be included in the record of the Commission's rule-making in this area.

I will assume without further argument a general consensus that the Commission's prior Money Market Fund reforms ("the Reforms") – which require more liquidity and portfolios of shorter maturity and higher quality – are insufficient to address the systemic risks of this particular financial intermediary. These Reforms do not address a central weakness: the inability of MMFs to bear the default of *any* portfolio security. Presumably a MMF is not entitled to use amortized cost accounting for a security that has defaulted and penny-rounding is also unlikely to be available.[1] Unless the Fund's sponsor steps in to buy the defaulted security at par, the Fund will "break the buck." The Reforms at best partially address the limited capacity of MMFs to bear market risk associated with increased default risk of assets on MMF balance sheets, which can reduce

[1] See Investment Company Act Rule 2a-7(c) (2010) (use of either amortized cost or penny rounding requires directors' good faith belief that such valuation "fairly reflects the market-based net asset value per share").

the market value of a Fund's portfolio below the permitted lower bound under penny-rounding. The Reforms have value because tightened credit quality should reduce value fluctuations, and greater liquidity and shorter maturities make it more likely that a Fund would be able to satisfy redemption requests without a "fire sale" disposition of Fund assets, thus reducing the risks of a negative valuation spiral.

In response to the proposals discussed in President's Working Group, three main reform proposals have emerged. The first is to permit net asset values (NAV) to float, in order to desensitize investors to relatively small valuation fluctuations in money market funds. The second is to create a liquidity back-up facility that could lend against money market fund assets at par, to avoid asset fire sales that would depress values. The third is to provide a capital cushion that could absorb losses in respect of a default on a portfolio security or upon the below-par sale of a portfolio asset. In my view the third general proposal, for a capital cushion, is the best approach for addressing the systemic risks of money market funds, given existing practical constraints, including the desirability of a proposal that can be effectuated under existing statutory authority. This letter offers a specific proposal designed to achieve goals of systemic stability and simplicity in implementation.

The proposal in rough form is this: All money market funds will issue two classes of equity, Class A, designed to retain a fixed NAV, and Class B, whose value will float to cover outright defaults or depreciation in market value of portfolio securities. Class B issuances must equal (or exceed) the largest single portfolio position permitted by regulation or by the fund's fundamental policy (a self-imposed limitation) plus an additional amount to reflect the risk of a general decline in money market asset values outside of such a default. Because Class B is loss bearing, Class A will be able to retain a fixed NAV in virtually all circumstances.[2] The proposal treats institutional funds and retail funds differently as to the source of the Class B capital. For institutional funds, the investors in the fund must buy the class B shares; for retail funds, the sponsor must buy the Class B shares. The following discussion therefore treats these two types of funds separately. The discussion also separately treats government funds.

Institutional Funds. Others such as the Squam Lake group have proposed a two class structure to provide an equity cushion.[3] The novel element of my proposal is the source of the equity: investors in institutional funds will provide the additional equity, as follows. An investor will initially be required to buy a "unit" that consists of Class A and Class B shares. However, the investor's subsequent purchases and redemptions of Class

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[2] In the event that the combination of default losses and market value losses exceed the Class B buffer, then the fund should suspend redemptions and liquidate. See below.

[3] See Squam Lake Group, Reforming Money Market Funds (Jan. 14, 2011).

A shares need not be accompanied by the purchase of additional Class B shares so long as the investor's Class B ownership is at least as large as the required initial ratio.

An example will illustrate: Assume the required capital cushion is 5 percent. Then a party putting $100 in an institutional fund would buy a "unit" $95 of Class A shares and $5 of Class B. Each day the net asset value of the unit would be measured at fair market value. Any variation from par would be allocated to the Class B shares, which floats; the Class A shares would retain a fixed NAV. Thus although the value of the unit may fluctuate, the Class A NAV remains fixed.

Assume further that the party redeems $10 of Class A shares. It can choose to retain its corresponding investment in Class B shares ($.50 in this example), meaning that when it subsequently buys (up to) $10 in Class A, no further Class B purchases are required. Should it want to redeem the Class B shares, it can, but only a week later, at the then-NAV of those shares.

Notice what this proposal accomplishes: it requires the users of institutional money market funds to supply the capital necessary for their stability and it creates disincentives for such investors to "run." These are advantages over proposals that contemplate sale of Class B shares to a separate group of capital suppliers. In particular, the "unit" concept means that an investor who "ran" by redeeming Class A shares at par at a time of falling asset values could not thereby impose losses on non-redeeming investors. The losses would be borne by the matched Class B shares, including shares held by the "running" investor, which cannot be disposed of except after a week's lag.

The unit concept therefore provides an additional element of systemic stability beyond proposals that just call for a capital cushion. A capital cushion cannot, by itself, fully protect against runs. Even if the capital could absorb the loss of the largest portfolio position, another default could break through the Class B. Thus in periods of financial instability, runs remain a threat despite first loss protection, because the run strategy presents no downside for the individual running investor. A Class A/Class B unit changes the dynamic. Default risk, especially risk of multiple defaults that break through the Class B, is fact low. By contrast, given a run, the chance of fire sale losses is much higher. A holder of matching Class B shares now sees downside in the decision to run, with a much greater probability of loss because of the run itself. The combination of the capital layer and the unit approach should significantly increase money market fund stability.

What share of the fund's capital should be represented by the Class B shares; meaning, how large an equity cushion? One straightforward approach is this: the Class

B percentage should at least equal the largest permitted portfolio position plus an additional amount to reflect the volatility of asset values apart from a default on that position. In the unlikely event of a default, the potential loss of an unsecured debt position is total (as with Lehman Brothers commercial paper). An additional cushion should be available to cover market value losses of securities that have not defaulted. So, if the fund was permitted by the SEC regulation and the fund's fundamental policy to invest up to 5 percent of the securities of any given issuer, the relevant history suggests that the right amount of capital should be 5.5 percent.[4] But this 5.5 percent in Class B shares is not particularly costly for the investor, because the full unit will be invested in portfolio securities. Default, after all, will be a very low probability risk. In normal times, the only cost is the diminished liquidity of a week's delay for complete close-out of a position at the fund. This is a small cost.

In the debate around the President's Working Group report, institutional users of money market funds have strenuously argued on behalf of fixed NAV as an essential feature. Fixed NAV makes money market fund transactions as smooth as cash transactions at a bank, avoiding the accounting and tax issues that would burden MMF transactions with costs and inconvenience. Such a non-bank transaction account comes at a cost, however, in terms of systemic stability. It seems entirely right that the beneficiaries of such accounts should internalize those costs, which this proposal for a Class A/Class B unit does.

Think of it this way: Money market funds permit institutional users to outsource the cash management function while obtaining money market rates that have been higher on average than bank rates. MMFs provide efficient diversification and credit investigation in money market instruments. If MMFs did not exist, large institutions would have to assemble their own staffs to perform such functions. Purchase of the Class B shares is an efficient alternative to such on-going costs; it can be seen as a relatively small one-time commitment that provides indefinite benefits, not unlike being required to maintain a minimum balance in a bank account to obtain its benefits.

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[4] This figure reflects a .5% volatility bound drawn from prior MMF experience that funds rarely "broke the buck" (i.e., exceeded that bound) even without sponsor support. The volatility percentage could be set on the basis of historical data, for example, by looking at the lowest bound of average MMF "shadow" NAVs during fall 2008, without giving effect to sponsor support. Conceivably funds could lower the required volatility cushion by a fundamental policy that limited assets to particular classes of low volatility assets. This would be relevant in setting the capital policy for government funds or funds that promised a specific mix of prime and government assets.

As noted above, a fund could reduce required capital by limiting portfolio positions through its fundamental policy, but there should be a minimum level of capital for all funds, because of the correlation risk, meaning the risk of default contagion among issuers with counterparty relationships or similar business models.

Moreover, in forcing investors to internalize some of the costs of a run, the unit approach reduces the risk of a run in the first place. There are two reasons investors might run. If investors lose confidence in a broad asset class, they will want to quickly disinvest, even if their position suffers a loss, before further defaults materialize. But in the case of money market instruments, default risk is quite low, as demonstrated by the 2008-09 financial crisis. A more common source of run risk arises from the collective action problem: if there is slightest risk of loss, an investor wants to be at the head of the disinvesting line to maximize the chance for a full payout. If all costs are borne by others, why not run? By contrast, internalization of this risk among the Class A holders (through their matching Class B positions) is likely to produce a cooperative outcome of "don't run."

In short the proposal promotes systemic stability for two reasons: Knowing that there is a mechanism for loss-bearing that protects the liquid Class A shares reduces the incentive to run. Knowing that all Class A shareholders will internalize some of the run costs also will reduce the propensity to run.

Moreover, the proposal will have an additional pro-stability effect in the money market fund world by reducing the "hot money" character of institutional behavior. Currently corporate treasurers monitor money market fund rates via portals that let them quickly switch to pursue higher yield, or perhaps in troubled times, to pursue greater safety. The small liquidity costs of the Class A/Class B unit structure would add a friction to rapid switching. For example, assume an investor had placed $100,000 with Fund One but saw that Fund Two paid 10 basis points more. The investor's initial purchase of Fund One shares would have been split between Class A shares, $94,500, and Class B, $5500. The one week delay in Class B redemption means that the investor could immediately move no more than $99,450, which itself would be allocated between the Class A and Class B. Rapid switching among several different money market funds would entail accumulating liquidity costs, frictions that would reduce the underlying activity.

The remaining questions relate to addressing circumstances of defaults and value changes to the Class B shares. *Case 1*. In the case where losses and market value declines exceed the fund's capital cushion, redemptions should be suspended and the fund should engage in orderly liquidation. This refers to cases in which the market value of the Class B stock is zero or in deficit (including "retained" Class B stock attributable to investors who have sold their matching Class A positions in whole or in part). This is likely to be a very rare circumstance.

Case 2. Rules for the case in which losses and market value declines are less than the fund's capital cushion should be fashioned to avoid "zombie" funds and to enhance MMF stability. The key is to assure that new purchases do not bear losses associated with prior purchases, that is, to avoid discouraging new investment because of the "buoying up" problem. Over time the fund will rebuild its capital cushion, through new transactions with existing and new investors. *Case 2A.* For example, assume Fund Three has experienced a portfolio loss of two percent. Investors will able to redeem Class A shares at par, but loss-bearing Class B shares will be worth approximately 45 percent of their value[5], meaning they will be valued at approximately $.55, not $1.00 a share. Assume that all Class B shares would be valued identically regardless of vintage. The key to Fund Three's viability, and its capacity to rebuild its capital cushion over time, is to price the newly purchased Class B shares at the market price, not a par, at the time of purchase. This means that in respect of its 5.5 percent Class B investment, New Investor will receive approximately 1.8 times the number of Class B shares as would have been received in the non-defaulted state. In other words, as part of the loss bearing associated with the Class B shares, the existing Class B holders will be diluted by the entry of new investors into the Fund. But they are no worse off than otherwise had Fund Three been forced to wind down because of the dearth of new investment and are better off because of the option value in preserving a transactional relationship.[6]

Case 2B. By contrast, assume Fund Four suffers no realized losses but portfolio values move negatively so that Class B shares are valued below par. As noted above, market fluctuations have historically been tightly bound. Nevertheless the pricing formula of Case 2A best protects against the risk that existing funds might become "zombie" funds.[7] This pricing method has pro-stability features, since the high probability of gain on the Class B shares as portfolio investments in fact pay without default will draw new investment into money market funds at times of market instability. In other words, the Class A/Class B unit structure can be an anti-run feature for money market funds.

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[5] The math is ($2/5.5%). The relatively sharp fall (in percentage terms) of the Class B shares is because they bear all of the loss.

[6] "New Investor" in this example includes existing investors who add to their fund balances. Their matching Class B share purchases will also be priced at the actual Class B price.

Note that the fund sponsor always has the option to replace the defaulted security at par (as has commonly occurred), to protect the sponsor's reputation. But to protect systemic stability, the Rule needs to address circumstances in which such voluntary actions may not occur.

[7] This can be illustrated by an example in which new Class B shares are sold at par in such circumstances. Assume Fund Five has $1000 in assets, which now have a market value of $995, meaning a decline of .5%. New Investor buys a $100 unit, $94.50 in Class A, $5.50 in Class B. New Investor's Class B shares will be worth only $.82 a share, meaning an immediate loss from $5.50 in Class B to $4.50. Once again this is because all the losses are concentrated on the Class B shares.

Retail Funds. Retail funds present a distinct situation from institutional funds because of the different nature and goals of the investors. Retail investors generally regard money market funds as a higher-yielding substitute for a bank account.[8] They depend on the check-writing feature and the fixed redemption amount. For a retail investor, the MMF alternative is not assembling and managing a diversified portfolio of money market instruments.

Another important difference is the relationship between the MMF sponsor and the MMF investor. In the case of the retail investor, the MMF is generally packaged with other mutual funds and other financial services offered by the sponsor. In most cases, the sponsor's core business is not providing transactional services to retail investors. Rather, the retail MMF account represents one aspect of a multi-faceted relationship the goal of which is to serve all of the investor's wealth management and other financial services needs (e.g., credit cards). Institutional MMF sponsorship is simply a different business. Some institutional fund sponsors, banks, for example, provide other corporate finance services, but others, such mutual fund complexes, generally do not.

Perhaps the overarching difference is the comparative sophistication of retail vs. institutional customers. This was demonstrated in the financial crisis, in which institutional MMF participants were much more prone to run than retail investors. Retail MMF positions are much "stickier" than institutional positions and present much less run risk. Moreover, although both classes of MMF investors want a simple product, institutional investors have greater capacity to see through and manage complexity.

These differences argue for a somewhat different structure for retail MMFS. The main difference is that the sponsors themselves should be responsible for assuring the supply of matching Class B capital. Sponsors should have the choice of (i) purchasing and holding Class B shares to match retail customer Class A purchases or (ii) underwriting the sale of matching Class B shares to third party capital suppliers, or (iii) combining both.[9] In other respects the Class A and Class B shares would pay out and be valued as in the institutional fund case. This means that in ordinary times, Class B holders would receive the same return as Class A holders but would also provide first loss-protection against portfolio defaults.

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[8] MMFs are really a partial substitute, since most funds have a minimum withdrawal amount, often $250 or $500, that means that the investor also needs a bank account for daily transactional purposes. Perhaps for this reason the Federal Reserve counts money market fund deposits in M2, which includes savings accounts, rather than M1, which includes checking accounts.

[9] I would not favor substituting a third party guarantee for actual capital, because of the correlation risks. Defaults that require guarantor performance are likely to be (i) correlated across MMFs, so the guarantor may have to perform on multiple guarantees, and (ii) correlated with stresses in the guarantor's other financial businesses, which will undermine the guarantor's performance capabilities.

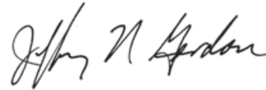
This arrangement will impose costs on sponsors in this arrangement, but those costs could be mitigated by portfolio diversification decisions that would reduce the required level of matching Class B and by fees charged to MMF investors. These costs will also be covered by cross-subsidy from other elements of the sponsor's relationship with the retail investor. To be clear, sponsors should have the option of offering only "institutional funds" to all of its customers, meaning requiring retail investors to buy matching Class B shares. This may not find acceptance in the marketplace. Thus the proposal also offers a "retail" MMF alternative that the sponsor can choose to offer. Because of the greater cost imposition, the sponsor should be free to limit access to the retail MMF as it chooses.[10] For example, the sponsor could limit the availability of its retail MMF to investors who do other financial business with the sponsor.

Government Funds. Government money market funds present a special case because of the negligible default risk and the pattern demonstrated in fall 2008 that in a financial crisis investors run *toward* government funds. Thus government funds do not present the same systemic risk concerns as other MMFs. One possible concern is that investors who urgently need cash to cover losses in other positions would demand immediate liquidity, at a level that might exceed the "cash in the market" and thus lead sales below par even in government funds. In the case of government funds, this issue should be addressed by the current liquidity standards, including the recent Reforms. Assuming that the definition of a security eligible for a government fund remains stringent, I think that no further rule change would be necessary. In other words, for government funds only, shares could be sold without the Class A/Class B unit structure, and the current amortized cost/penny rounding accounting could be retained. Alternatively, if the goal is to provide a uniform product, government funds could be sold in institutional or retail variants, with a small Class B capitalization amount, perhaps 0.50% or 0.25%.

[10] For example, the sponsor is unlikely to offer a retail MMF to an institutional investor because the absence of the institutional purchase of matching Class B shares exposes the sponsor to greater run risk. As observed previously, the financial crisis showed that the run risk associated with a retail investor is smaller.

The guiding principle of this proposal is straightforward: Money market mutual funds impose systemic risk costs on the entire financial system. The costs should be internalized. These proposals for institutional MMFs and retail MMFs should achieve that goal while preserving the key attributes of fixed NAV, relative simplicity, and access to money market rates that make the MMF attractive in the marketplace.

Very truly yours,



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Sept. 9, 2009

Via SEC Internet Comment Form

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-11-09
Release No. IC-28807
Money Market Reform

Dear Ms. Murphy:

This letter is submitted by me personally in response to the SEC's request for comments on its proposed Money Market Reform Rule announced in Release No. IC-28807. This letter proposes a different direction to reform, one that begins with the division between retail and institutional money market funds and that takes account of the different motives and needs of the investors in each.

"Reform" is of course timely in light of the fragility of Money Market Funds ("MMFs") revealed in the financial distress that followed the failure of Lehman Brothers. As the Commission describes quite well in the Release, Lehman's failure unexpectedly led to the "busting of the buck" by the Reserve Fund, which held a large amount of Lehman's commercial paper in its portfolio. The problems at the Reserve Fund in turn triggered a "run" especially by institutional investors on non-Treasury MMFs that was staunched only by an extraordinary MMF guarantee program provided by Treasury and by the creation of a special MMF liquidity facility by the Federal Reserve. It is also widely believed that FDIC decisions in addressing bank failures – whether or not to protect bank creditors – were influenced by concerns about the solvency of MMFs that held bank paper. Various MMFs undertook their own safeguards against the risk of runs, principally by selling off commercial paper (that is, making use of the Fed's facility) and by shifting their portfolio composition towards Treasury instruments (Federal agency debt for the adventurous) and by shortening maturities. These measures had their own consequence, namely a sharp contraction in the demand for commercial paper and other short term credit instruments that industrial and financial firms had come to rely upon in their corporate finance plans. The Federal Reserve responded with another special liquidity facility in which the Fed's became a buyer of last resort of commercial paper.

In response to this very unsettling episode, a near-calamitous run on a form of financial intermediary that accounts for nearly $4 trillion in assets, the SEC has come up with a quite modest set of

reform proposals: improve the quality of MMF portfolio securities, shorten maturities, enhance portfolio liquidity, and provide a smoother resolution process for occasions when an MMF has "busted the buck." With all respect, I think the SEC has failed to grapple with the fundamental problems with MMFs that last fall's financial crisis revealed and, in the main, its proposals will exacerbate systemic fragility, not reduce it.

Rather, the SEC should be preparing the way for serious consideration of proposals like those made by the Group of Thirty in February 2009, which call for a sharp division between funds that offer "withdrawals on demand at par, and assurances of maintaining a stable net asset value" and those that offer a "conservative investment option ... with no explicit or implicit assurances to investors than funds can be withdrawn on demand at stable NAV." The former accounts should be offered through special banks that include government deposit insurance. The latter accounts might be styled as "money market funds," subject to customary mutual fund valuation rules and no promise of a stable NAV.[1]

Barring such a wholesale rethinking, a minimum reform strategy should begin with a sharp division between MMFs sold to retail investors, "retail MMFs," and those that are sold to corporations, life insurers, pension funds and other large purchasers, "institutional MMFs." Retail MMFs should be covered by deposit insurance that is funded by risk-adjusted premiums. Institutional MMFs should give up the promise of a fixed NAV, and disclosure rules should replace mandatory portfolio composition rules. These changes will reduce the systemic risk created by the present MMF regulatory structure both by reducing the risk of "runs" and by reducing distortions in short term credit markets.

It is widely appreciated that MMF holders receive an unpaid-for benefit through an implicit, if imperfect, government guarantee of their accrued balances. The flaw with the SEC's approach is that the regulatory effort to substitute for the absence of explicit deposit insurance and to limit the implicit subsidy through restrictions on MMF portfolios adds systemic risk to financial intermediation by heightening the pressure on short-term money markets in the critical function of maturity transformation. This flaw turns out to be fundamental and requires a rethinking of the general MMF framework.

To understand this objection, it is necessary to appreciate the origin and consequences of MMF growth in the financial system. MMFs arose in the 1970s as an evasion of the regulatory ceiling on interest rates that depository institutions, banks and thrifts, could offer to depositors, so-called "Reg Q." At a time of high short interest rates, MMFs provided retail savers access to money market rates and became a substitute for both savings and checking accounts. The industry and the SEC understood this substitution. As a marketing tool, as consumer protection, and presumably as systemic risk mitigation, the industry and the SEC collaborated on a series of portfolio constraints, principally to limit maturities and to assure credit quality, in order to lower the risk that MMF shares would fall below a fixed net asset value, typically $1 a share. The SEC also provided a form of regulatory forbearance that permitted MMFs to use "hold to maturity" rather than "mark to market" valuations to smooth over small deviations from par. The SEC also from time to time has granted regulatory relief to permit MMF sponsors to support $1 net asset values through buying distressed securities in MMF portfolios. The limitations of

[1] Group of Thirty, Financial Reform: A Framework of Financial Stability 29 (Feb. 2009).

these SEC-crafted substitutes for deposit insurance became apparent in the financial market distress of fall 2008.

The deposit insurance gap for MMFs is relatively well-understood and appears to animate the SEC's reform proposal. Portfolios of shorter maturities and higher credit quality should be less exposed to default risk; this enhanced security partially substitutes for explicit deposit insurance in bolstering investor confidence. What is not appreciated is how MMFs have distorted financial intermediation by shifting the process of maturity transformation from banks to securities markets, which are prone to seize-up at times of financial distress. Indeed, by shortening maturities the SEC proposal will increase rather reduce the fragility of these markets because it makes it easier for MMFs to "run" at a time of financial distress.

What is "maturity transformation?" It is the conversion of the short term liquidity needs of depositors into long-term funding commitments for borrowers. Banks have traditionally performed this function. Depositors put funds into checking accounts and savings accounts and certificate of deposit, which can be withdrawn from the bank on demand, though perhaps with some notice in the case of savings accounts and the forfeiture of some interest in the case of CD's. In turn, the bank lends these deposited funds to borrowers on typically much longer-lived terms, whether to fund specific projects or asset purchases, or by way of a longterm lending commitment. This bank activity thus "transforms" short term liabilities into long-term assets, hence "maturity transformation." Under this arrangement, the bank will not necessarily have cash immediately available in the event of unexpected depositor withdrawals. But the bank can borrow money from other financial institutions on the security of its assets, and, in the case of systemic liquidity pressure, can borrow from a "lender of last resort," like the Federal Reserve. The process by which the different time horizons of depositors and borrowers are nevertheless matched up is at the core of a successful system of financial intermediation.

The entry of MMFs shifts the process of maturity transformation away from banks and into the short term securities markets, the money market. This is because the issuers of MMF-qualified debt under the SEC rules – commercial paper, for example – often use money market proceeds to fund long term projects or long term assets, counting on their ability to refinance, or "roll-over," their short term obligations as they come due. There are "demand" side reasons for the increasing use of money markets in this way. If the yield curve is "upward sloping," meaning that short run rates are less than long term rates, a borrower may be able to finance a longterm asset more cheaply through successive rollovers than through a bank loan. The borrower can deal with the possibility of interest changes through interest rate swaps and other hedging techniques. But there are also "supply side" reasons for the turn to money markets to finance longterm commitments, linked to the regulatory set up of MMFs. First, MMF investors do not pay for the implicit government guarantee, which means that MMFs have a pricing advantage over banks in competing for deposits. This increases the supply of short term finance. Second, the NAV stability requirements imposed by the SEC artificially limit MMF purchases to short term instruments, currently a weighted average portfolio maturity of 90 days but more broadly, instruments of approximately one year or less. This augments the supply of short term finance generally. Third, the "weighted average" rules permits funds to balance off longest maturity instruments that pay highest interest with shortest maturity instruments; this increases the supply of the instruments like overnight repurchase agreements. Fourth, the "quality" requirements for MMF-eligible instruments favor the highest rating securities; this gives issuers a reason to create credit vehicles that can receive high ratings from the credit rating agencies. MMFs thus provide a stimulus to the creation of short term instruments

through "structured finance." In sum, the regulatory set-up of MMFs increases the supply of short term credit and also distorts its particular forms.

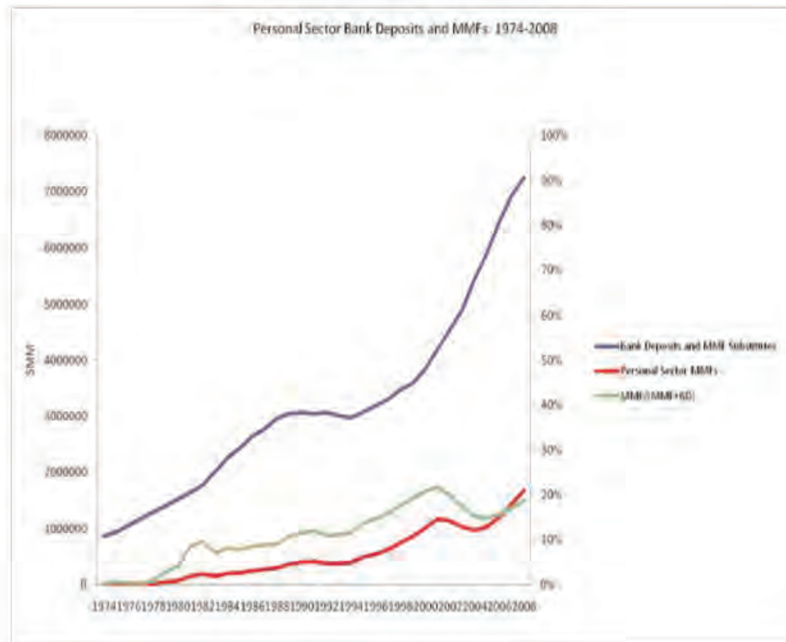
Last fall vividly illustrates the consequence of shifting maturity transformation towards the money markets. At a time of financial distress, commercial paper and other forms of short term debt did not "roll." Maturity transformation abruptly broke down as credit suppliers simply stopped lending. Money market funds were major participants in a "run" on the financial system. Not only did investors in money market funds, especially investors in so-called "institutional funds, cash out of their MMF positions, which required MMF liquidation of credit positions, but the MMFs independently withdrew from the commercial money market in favor of government money markets. This in turn contributed to the immediate crisis for investment banks, which were highly dependent on short term finance, resolved in the case of Goldman Sachs and Morgan Stanley only by their conversion to bank holding companies. It also contributed to the funding crisis faced by commercial issuers, resolved by the Federal Reserve's creation of the special credit facilities referred to previously.[2] It is worth repeating that the SEC's proposal to shorten average portfolio maturities will make it easier for MMFs to run in the future, simply by refusing roll over credits. Moreover, the pressure on MMFs to maintain a $1 NAV adds to the impetus to run both by converting current holdings to cash and by shifting purchases from commercial paper to government instruments.

These analytic points can be buttressed by looking at the data relating to patterns of MMF growth and practices over the past 35 years, drawn from data compiled by the Federal Reserve in its Flow of Funds reports.

[2] In some cases regular commercial paper issuers were able to turn to back-up lines of credit at banks but this in turn took funds that banks might have otherwise provided to other borrowers at a time of credit rationing.

Figure 1 shows the substitution of money market funds for retail bank deposits, now at the rate of approximately 20 percent. The top line reflects (on the left y-axis) the sum of "personal sector" bank deposits plus retail MMFs, what might be thought of as bank deposits plus MMFs that substitute for bank deposits. The second line shows (on the left y-axis) the dollar amount of retail MMFs, and the third line (which is in the middle line during most of the time period) shows (on the right y-axis) the percentage of bank deposits and substitutes represented by MMFs. Figure 1 shows that retail MMFs have steadily increased over the 1974-2008 period, now amounting to nearly $1.5 trillion. The figure also shows the substitution effect, which has also increased throughout most of the period, leveling off in the 20 percent range.

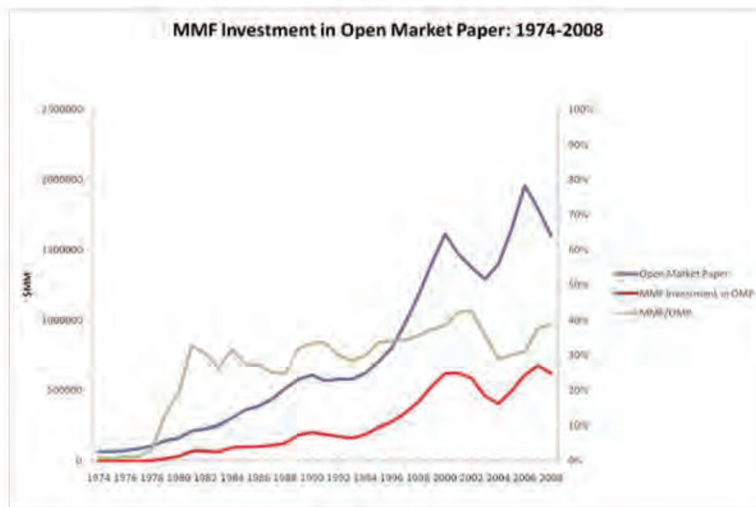
Figure 1



Source: Federal Reserve, Flow of Funds, Table L.5 (2009).

Figure 2 shows how the growth of MMFs has contributed to the expansion of money markets more generally, here categorized as "Open Market Paper" (principally commercial paper). The growth of the commercial paper market over the 1974-2008 period (top line, left y-axis) has been matched by the growth of MMF investment in commercial paper (bottom line, left y-axis). The fraction of MMF participation in the commercial paper market has remained at 30 percent or more from early in the period, peaking at 40 percent (middle line, right y-axis).

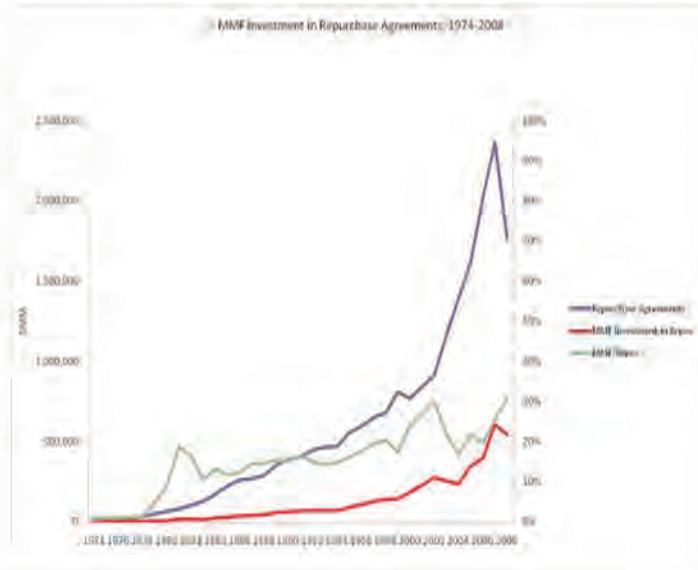
Figure 2



Source: Federal Reserve, Flow of Funds, Table L. 208 (2009)

The contribution of MMFs to the fragility of financial firms is reflected in Figure 3, which shows the MMF share of repurchase agreements, a form of very short term finance often rolled over nightly. Repurchase agreements are commonly used by investment banks and other financial institutions. As Figure 3 (top line, left y-axis) reflects, in the post-2000 period investment banks increasingly turned to overnight funding of their balance sheets, which increasingly came to include long-duration mortgage-backed securities. This is a classic case in which the money markets were employed for maturity transformation. Figure 3 (bottom line, left y-axis) shows the dollar increase in MMF participation in the repo market; the middle line, showing the ratio (right y-axis), has been 20 percent or more since early in the period, peaking at 30 percent. This regularity reflects the role of MMFs in a burgeoning financial practice that misfired in the face of financial distress. At the critical moment in fall 2008, the repo market simply froze; the buy-side participants "ran" by refusing to roll over their purchases. To be sure, many financial actors refused to roll over repo loans, but the pressure on MMFs to protect the $1 NAV gave MMFs special reason to act preemptively.

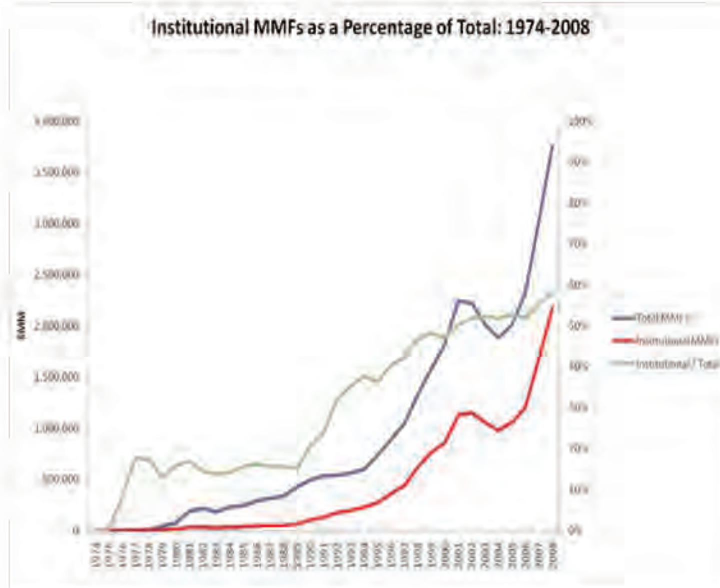
Figure 3



Source: Federal Reserve, Flow of Funds, Table L. 207 (2009)

Figure 4 shows another critical feature of MMF evolution that is not sufficiently reflected in the SEC's reform proposal: the increasing institutional use of MMFs to make money market investments. Figure 4 (top line, left y-axis) shows the growth of money market funds over the 1974-2008 period; the bottom line (left y-axis) shows the growth of institutional MMFs. Particularly important is the steadily increasing asset share of institutional MMFs, which reached nearly 60% of the total by 2008. This is a remarkable development. MMFs started as a vehicle for pooling small depositors' funds to provide access to money market instruments that otherwise would have been unavailable or uneconomic for them to acquire. But the most important purchasers of institutional funds, large business entities, can participate in money markets directly. Thus the MMF plays a different function for the two investor classes: For the retail investor, the MMF is a risk-free (but higher yielding) substitute for a bank account covered by deposit insurance; for the business investor, the MMF is a low-cost specialized provider of a corporate treasury function. In other words, the functional substitute for the business user of an MMFs is not a bank account covered by deposit insurance; rather, it's the entity's direct purchase of money market instruments. Yet institutional MMFs are covered by the same safety and soundness rules as retail MMFs: the portfolio maturity, credit quality, and NAV rules that exacerbate fragility in financial distress and that distort maturity transformation. Whatever the consumer protection arguments for such protections in the case of retail MMFs (despite the distortions), no such arguments pertain for institutional MMFs. There the distortions present only costs, no benefits.

Figure 4



Source: Federal Reserve, Flow of Funds, Table L.206 (2009).

Where does this lead in terms of MMF reform? A minimum reform strategy should create a sharp divide between retail MMFs ("RMMFs") and institutional MMFs ("IMMFs"). For IMMFs, the SEC should fundamentally change the rules. IMMFs should not be pemitted to vary standard valuation methodology to protect a fixed NAV. IMMFs should be freed of mandatory portfolio composition rules, including maturity and credit quality rules. Instead, IMMFs should be required to make detailed disclosure of their internally generated investment rules and make weekly web-site disclosure of their portfolio composition. At most the SEC should facilitate the creation of a number of "standard form" IMMFs that vary in particular portfolio features to economize on disclosure and search costs. Opting into one of these forms upon establishing an IMMF should be voluntary. The expectation is that NAV may fluctuate, but not very much, and probably much less than the package of money market instruments that IMMF purchasers would have assembled if acting independently. This avoids the need to provide a resolution process for IMMFs that "bust the buck," which is likely to be cumbersome, costly, and slow, if only because of the presumed infrequency of its use.

The result of these IMMF reforms should be to reduce systemic risk. IMMFs will not face special pressure to retain a fixed NAV. The end of mandatory portfolio restrictions should reduce supply side distortions in short term credit markets.

A minimum reform strategy for retail MMFs would impose deposit insurance on RMMFs as a condition for maintaining a fixed NAV. This would both reduce systemic risk (by reducing the likelihood than individual RMMF investors will "run") and eliminate supply side distortions in money markets by making RMMF purchasers internalize the cost of systemic risk reduction. Banks and RMMFs will compete for deposits on more level ground. Deposit insurance necessarily entails some regulation of portfolio composition to avoid moral hazard. One approach might be a risk-adjusted insurance fee rather than direct regulation of portfolio composition. Unlike in the case of banks, the short-term, market-traded nature of many RMMF-held instruments should make the assessment of a risk-adjusted fee relatively easy. Setting the fee, which should be assessed ex ante so as to avoid a search for a funding source at a time of systemic stress, will be a challenge in light of the infrequency with which MMFs have "busted the buck." One could imagine setting a cap on a fund that would accrue over time, scaled to the size of the industry, with a risk-adjusted "recycling" procedure that would rebate excess funding to lower risk funds while still collecting fees from higher risk funds. As with any guaranteed deposit system, the SEC would need to establish a resolution procedure that presumably it would administer.

This reforms should be adopted in lieu of the SEC proposals, which do not address the implicit deposit guarantee subsidy nor the supply-side distortions in money markets of the present regulatory structure.

The broader question is whether RMMFs should continue to receive regulatory sanction, or whether, following the proposal of the Group of 30, RMMFs should become limited purpose banks. Assuming that RMMFs paid appropriate risk-adjusted levels of deposit insurance, the remaining advantage of such a far-reaching proposal is to eliminate a regulatory structure that artificially shifts maturity transformation towards short term securities markets, principally with the objective of reducing systemic risk. (Presumably the convenience of RMMFs as part of a package of services offered by a mutual funds provider could be preserved by permitting establishment of a limited purpose bank within the fund family structure.) In this regard the history of the RMMF is important: It was invented as a work-around of interest-rate ceilings imposed by regulation and it has flourished under a regulatory

umbrella that has provided implicit, subsidized deposit insurance. The money market distortions created by its portfolio structure contributed to the sytemic break of fall 2008, a very serious cost.

What is the continuing value of the RMMF, a peculiar form of non-bank bank? In the spirit of the Treasury's white paper on financial regulatory reform, it seems to me that's inquiry that the SEC's MMF reform proposal should now undertake.

Sincerely,

s/Jeffrey N. Gordon

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