



Henry M. Paulson, Jr.
Chairman

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Chairman Mary Schapiro
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Mail Stop 1070
Washington, D.C. 20549

Dear Chairman Schapiro,

As promised, this letter excerpts parts of my book, *On the Brink*, published in February of 2010 which I thought would be helpful to the consideration of your proposed rules to reform money market funds. In the Afterword, I make the following recommendation for an SEC rule which I continue to strongly advocate:

Afterword

There are more than 1,100 money market mutual funds in the U.S., with \$3.8 trillion in assets and an estimated 30 million-plus individual customers. This is a concentrated yet fragmented industry with the top 40 funds managing about 30 percent of the assets. These funds invest for the most part in commercial paper instruments with a top credit rating or in government or quasigovernment securities. Before the crisis, investors had come to believe that they would always have liquidity and would be able to get 100 percent of their principal back, because funds would always maintain a net asset value (NAV) of at least \$1.00.

In the immediate aftermath of the Lehman failure, money market mutual funds came under intense pressure. A number were on the verge of "breaking the buck." This dramatically eroded investor confidence, causing redemption requests to soar. In turn, the money funds pulled back on their funding of the many large financial institutions that depended on them for a big portion of their liquidity needs. It was a development that we were not well equipped to address.

We stepped in to guarantee the money market funds to prevent the crisis from getting worse, but the fundamental problems in the industry's business model remain. Many of these funds charge investors very low fees, often as little as 5 basis points—or 0.05 percent— while offering interest rates that are higher than those available on insured bank deposits or on Treasury bills. If something looks too good to be true, it almost always is. In this case, it was the money fund industry's soft or implicit guarantee of immediate liquidity and full return of principal with a premium yield and a low fee. Many, if not most, of these funds simply did not have the financial capacity to maintain their liquidity or a 100 percent preservation of capital for their investors in the midst of the credit crisis.





This expectation of complete liquidity with no fear of loss is a problem that should be addressed. Money funds are investment products, not guaranteed accounts. For years, the SEC has tried, unsuccessfully, to address this misperception. The SEC should explore whether fund managers should move from a fixed NAV, which makes money market funds resemble insured bank accounts, to a floating NAV. The funds would still be great products and could offer attractive returns, liquidity, and very low volatility and principal risk. But, as clients saw slight variations in principal, they would have a tangible indication that they were not investing in a bank account.

Source: On the Brink (pages 449-450)

I have also taken the liberty of excerpting passages from my first person narrative which underscore the very significant risk our nation faced emanating from money market funds and our decision to use the Exchange Stabilization Fund to guarantee them.

September 16, 2008

By noon, European stocks had tumbled, the U.S. markets were starting to dip, and the news was about to get worse. Lehman's failure and AIG's escalating difficulties had begun to roil money market funds. Typically, these funds invested in government or quasi-government securities, but to produce higher yields for investors they had also become big buyers of commercial paper. All morning we heard reports that nervous investors were pulling their money out and accelerating the stampede into the Treasury market. The Reserve Primary Fund, the nation's first money market fund, had been particularly hard-hit because of substantial holdings of now-worthless Lehman paper.

Many Americans had grown accustomed to thinking that money market funds were as safe as their bank accounts. Money funds lacked deposit insurance but investors believed that they would always be able to withdraw their money on demand and get 100 percent of their principal back. The funds would maintain a net asset value (NAV) of at least 1.00, or \$1 a share. No fund had dipped below that level—or, in industry parlance, "broken the buck"—since the bond market rout of 1994. Funds that broke the buck were as good as dead: investors would all withdraw their money.

In retrospect, I see that the industry's setup was too good to be true. The idea that you could earn more than what the federal government paid for overnight liquidity and still have overnight liquidity made absolutely no sense. It had worked for so long only because people didn't ask for their money. But when Lehman failed, people started to ask.

Around 1:00 p.m., Bill Osborn, the chairman of Northern Trust and a good friend from Chicago, called with a firsthand report. "I hate to bother you, Hank," he said. "But there is no liquidity in the markets. The commercial paper market is frozen."



Bill proceeded to tell me about problems he was having with his money market funds. Because the market for commercial paper had seized up, the funds were under real pressure from withdrawals, and he was looking for ways to avoid breaking the buck. He was working on a way the parent company could support the funds financially without taking the obligation on its balance sheet.

But this solution required accounting relief. He'd already called the SEC but wanted to let me know of the looming problem.

I told Bill that I was focused on AIG, but that the Fed was working on a number of liquidity programs to get people to start buying paper again.

"They can't come soon enough," he said. "I've never seen anything like this."

Nor had I. Begun as an alternative to banks for U.S. consumers, money funds had more than 30 million retail customers. In recent years, the business had become increasingly corporate—and global. Companies used the funds for their cash management needs, and money poured in from overseas investors—Singaporeans, British, and Chinese—eager to get a little more yield than on straight Treasuries.

This kind of money was "hot," likely to flee at the first sign of trouble, and I feared the start of a run on the \$3.5 trillion industry, which provided so much critical short-term funding to U.S. companies. I immediately thought of my meeting with Jeff Immelt the day before, and his trouble selling commercial paper. I called Chris Cox, who told me that he was aware of the accounting issue; his accounting policy people were already working on it, but there was no obvious solution.

Source: On the Brink (pages 233-235)

September 17, 2008

Between 7:00 a.m. and 7:40 a.m., Ken Wilson called me three times to brief me on the alarming calls he was getting: Bank of New York Mellon CEO Bob Kelly, BlackRock chief Larry Fink, and Northern Trust CEO Rick Waddell had all reported requests for billions in redemptions from their money market funds. The Reserve Primary Fund was bad enough, but if these institutions' funds broke the buck, we would have a full-scale panic as corporations, insurance companies, pension funds, and mom-and-pop customers all tried to withdraw their money at the same time.

Source: On the Brink (pages 242-243)



September 18, 2008

President Bush was very concerned about the money market funds and commercial paper markets because of how deeply they affected the average American's daily life. As he said, "You've got to protect the guy in Midland, Texas, who wants to take \$10,000 out of his money market fund to buy something."

*Leaving the meeting, I was more convinced than ever that we had to move fast on the money market guarantee. It was a step that we could take unilaterally. As soon as I returned to Treasury, I stopped by David Nason's office and told him I wanted the guarantee announced in the morning, even if it couldn't be finalized for weeks: we had to make clear right away what we were doing. I instructed David to work closely with Steve Shafran and make this his top priority.
Source: *On the Brink* (pages 256-257)*

September 19, 2008

The money market guarantee was an extraordinary improvisation on the part of Nason and Shafran. They had raced through the night to sketch its outlines and make the plan work. In time, funds participating in the guarantee would pay fees into a reserve that supplemented the ESF, which would not expend a single dollar on the program.

Treasury was operating so much on the fly that Nason drafted staff from the Terrorism Risk Insurance Program, which he oversaw, to help formulate the agreements and pricing schemes of the guarantee. It was announced on September 19, opened ten days later, and was, I believe, the single most powerful and important action taken to hold the system together before Congress acted. (The guarantee was intended to be a temporary program, and Congress has since ended it.)

*Initially we worried about industry acceptance of the plan. Nason and Shafran had canvassed everyone from executives at Charles Schwab and Vanguard Group to the Investment Company Institute, the industry's trade association, and found that many were concerned about having to pay to insure what was already a lowmargin product. But in the end we had virtually 100 percent market participation and collected over \$1 billion in premiums.
Source: *On the Brink* (pages 263)*

You should feel free to use this any way which helps you secure this important reform, including quoting from it, or sharing all or part of it with the press or members of Congress.

Sincerely,

Henry M. Paulson, Jr.