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January 25, 2013

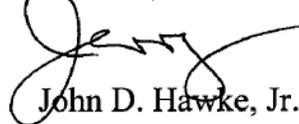
Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: President's Working Group Report on Money Market Fund Reform;
Rel. No. IC-29497; File No. 4-619;
Comment submitted on the Proposed Recommendations Regarding
Money Market Mutual Fund Reform (Docket No. FSOC-2012-0003);
Alternative Three: NAV Buffer with Other Measures**

Dear Ms. Murphy:

Enclosed is a copy of comments we submitted today on behalf of our client, Federated Investors, Inc., to the Financial Stability Oversight Council (the "Council") on the Council's recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform*; specifically, "*Alternative Three: NAV Buffer with Other Measures.*" We ask that our comments be made a part of the Commission's record.

Sincerely,



John D. Hawke, Jr.

January 25, 2013

The Honorable Timothy Geithner
Chairman, Financial Stability Oversight Council
c/o Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Recommendations Regarding Money Market Mutual Fund
Reform (Docket Number FSOC-2012-0003);
Alternative Three: NAV Buffer with Other Measures

Dear Secretary Geithner:

We are writing on behalf of our client, Federated Investors, Inc., and its subsidiaries (“Federated”), to provide comments in response to the Financial Stability Oversight Council’s (the “Council’s”) recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform* (“Release”); specifically, “*Alternative Three: NAV Buffer with Other Measures.*”¹ The proposal in Alternative Three would require money market mutual funds (“MMFs”) to have a risk-based NAV “buffer” of 3 percent, which, according to the Council, would provide explicit loss-absorption capacity and could be combined with other measures. A separate alternative proposed by the Council, Alternative Two, also contains a 1 percent capital element as an adjunct to a minimum balance at risk (“MBR”) requirement for shareholder redemptions.

As discussed in greater detail in our letter of December 17, 2012, we believe the Council has arbitrarily and improperly invoked its Dodd-Frank Section 120 authority, in an attempt to pressure the SEC to move forward on proposals that a majority of its commissioners found unsupported by data or economic analysis and potentially risky to the financial system. The Council ignored the overwhelming public comments in the SEC docket raising substantial concerns about the very proposals the Council put forward

¹ Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) (“Release”). This comment addresses Alternative Three of the Council’s proposals. Separate letters filed this same date comment on Alternatives One and Two.

in its Release. We do not believe Congress intended the Section 120 process to be used arbitrarily and in disregard of agency processes, in circumstances where an agency is continuing to grapple with a regulatory issue under its direct jurisdiction, simply because, in this case, the agency's former chair could not muster the votes for proposals that clearly would be ineffective in achieving their primary purpose, would introduce more risk to the system, and would impose significant costs to issuers and investors.

We, nonetheless, appreciate the opportunity to provide comments and, again, call to the Council's attention the significant flaws in the proposed reforms, which should have been abundantly clear from the comment letters, reports and surveys compiled in the SEC's docket and available to the Council before it issued its Release.

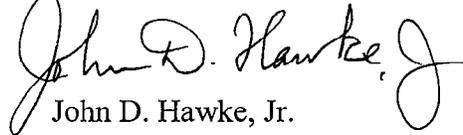
As discussed in the enclosed paper, the Council should not recommend that the SEC adopt the proposal described in Alternative Three, for the following reasons:

- (1) A capital buffer would not achieve the intended purpose of preventing large sustained redemptions from MMFs, but would instead make large sustained redemptions more likely.
- (2) A capital buffer would be prohibitively expensive to both investors and MMF sponsors, if it could be implemented at all.
- (3) A capital buffer would create moral hazard and would be confusing to investors, suggesting that what investors now understand to be an investment product carrying a risk of loss would, instead, have the guarantee features of a bank deposit.
- (4) The requirement for a capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.
- (5) A capital buffer would change the fundamental nature of MMFs, making them less attractive to investors, which would result in a substantial shrinkage or elimination of MMFs.
- (6) Shrinkage or elimination of MMFs would harm the economy, investors, municipal governments and businesses and cost jobs by increasing the cost and decreasing the availability of credit, and increasing systemic risk.
- (7) The current capital structure of MMFs – 100% equity capital and no debt – together with very high portfolio liquidity, transparency, credit quality and maturity requirements put in place by SEC in 2010, address redemptions concerns.

ARNOLD & PORTER LLP

We urge all members of the Council to review the comments submitted in response to its Release and to give careful thought to the issues discussed in the attached paper as well as those raised by other commenters. We further urge the Council to withdraw its Release.

Sincerely,

Handwritten signature of John D. Hawke, Jr. in cursive script.

John D. Hawke, Jr.

Enclosure

ARNOLD & PORTER LLP

cc: Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
Elisse B. Walter, Chairman of the U.S. Securities and Exchange Commission
Thomas J. Curry, Comptroller of the Currency
S. Roy Woodall, Jr., Independent Member with Insurance Expertise
John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions
John Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Michael McRaith, Director of the Federal Insurance Office
Eric Froman, Office of the General Counsel, Department of the Treasury
Amias Gerety, Deputy Assistant Secretary for the Financial Stability Oversight Council
Sharon Haeger, Office of the General Counsel, Department of the Treasury
Mary Miller, Under Secretary of the Treasury for Domestic Finance
Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission
Troy A. Paredes, Commissioner, U.S. Securities and Exchange Commission
Daniel M. Gallagher, Commissioner, U.S. Securities and Exchange Commission
Diane Blizzard, Deputy Director, Division of Investment Management, U.S. Securities and Exchange Commission
Norman B. Champ, Director, Division of Investment Management, U.S. Securities and Exchange Commission
David W. Grim, Deputy Director, Division of Investment Management, U.S. Securities and Exchange Commission
Craig Lewis, Director and Chief Economist, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission
Penelope Saltzman, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission

**Proposal for a Capital Requirement for Money Market Mutual
Funds:
Ineffective in Protecting Against Runs in Periods of Stress;
Harmful to Investors and the Economy**

Comment Submitted for Docket No. FSOC-2012-0003

January 25, 2013

**Proposal for a Capital Requirement for Money Market Mutual Funds:
Ineffective in Protecting Against Runs in a Crisis;
Harmful to Investors and the Economy**

We are submitting this paper on behalf of our client, Federated Investors, Inc., and its subsidiaries (“Federated”). Federated has served since 1974 as an investment adviser to money market mutual funds (“MMFs”).¹

This paper responds to the release issued by the Financial Stability Oversight Council (“Council”) requesting comments on *Proposed Recommendations Regarding Money Market Mutual Fund Reform* (“Release”).² Specifically, this paper responds to “*Alternative Three: NAV Buffer with Other Measures*.”³ Alternative Three would require MMFs to have a risk-based net asset value (“NAV”) “buffer” of 3 percent “to provide explicit loss-absorption capacity,” which the Release says could be combined with other measures to enhance the effectiveness of the buffer and potentially increase the resiliency of MMFs.⁴ The Release lists other potential measures, such as more stringent diversification requirements, increased liquidity levels, and more robust disclosure.⁵ The Release also states that these other measures could reduce the size of the required buffer.⁶ Note that a separate alternative proposed in the Release, Alternative Two, also contains a 1 percent capital element as an adjunct to a minimum balance at risk (“MBR”) requirement for shareholder redemptions.⁷ Alternative Two is discussed in a separate paper filed with the Council on this date entitled, “Proposal for a Minimum Balance at Risk and NAV Buffer for Money Market Mutual Funds.” However, comments in this paper relating to the costs and other adverse consequences of a capital requirement also apply to the capital element of Alternative Two.

The Release states that the buffer could be funded by any funding method or combination of methods found optimal, such as: (1) an MMF sponsor could establish an escrow account and

¹ Federated has thirty-nine years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated’s Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

² Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) (“Release”).

³ Release at 69474.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 69469-74.

contribute assets pledged to support the fund's NAV; (2) an MMF could issue a class of subordinated non-redeemable equity securities that would absorb first losses in the funds' portfolios and that could be sold to third parties or purchased by a fund's sponsor or affiliates; or (3) an MMF could retain some earnings it would otherwise distribute to shareholders.⁸ No capital would be held against cash, Treasury securities, and Treasury repos; 2.25 percent capital would be held against other daily liquid assets (or weekly liquid assets in the case of tax-exempt funds); and 3.00 percent capital would be held against all other assets.⁹ The Release suggests transition times of up to six years to establish the full buffer.¹⁰ Treasury funds would not be subject to the capital requirement.¹¹

The Release states that, while the 3 percent risk-based capital requirement "may reduce the probability that an MMF investor suffers losses, it is unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer."¹²

Currently, MMFs are financed entirely by a single class of equity capital of investing shareholders. There are no junior or senior classes of equity, no priority or subordination of rights of one shareholder over another – indeed, these structures are prohibited by Sections 1(b) and 18 of the Investment Company Act. MMFs do not use debt, borrowing or other forms of leverage. If the portfolio of an MMF increases or decreases in value, the shareholders own those gains and losses equally as a percentage of the amount each has invested in the MMF. The purpose of this structure – which is a fundamental purpose in the recitals to the Investment Company Act – is to assure fairness among the investors, prevent conflicts of interest between share classes, and discourage inappropriate incentives and risk-taking.

The Release assumes that there is a "first-mover advantage" for shareholders to redeem shares before a portfolio loss is recognized, and posits that a small capital buffer will eliminate this supposed "first-mover advantage" and the incentive to "run" that it creates. The creation of a class of subordinated capital under the Council's capital proposals is intended to reduce the risk of senior share class investor redemption "runs" and reduce the risk that investors in the senior share class would suffer a loss of principal. But the Release acknowledges that the capital requirement could not eliminate either risk.¹³ The innuendo of the Council's Release is that, due

⁸ *Id.* at 69474.

⁹ Under Alternative Two, 0.75 percent capital would be held against other daily liquid assets (or weekly liquid assets in the case of tax-exempt funds); and 1.00 percent capital would be held against all other assets. *Id.* at 69469.

¹⁰ *Id.* at 69475. For Alternative Two, the transition time suggested is two years. *Id.* at 69470.

¹¹ Treasury MMFs invest at least 80% of their assets in cash, Treasury securities and Treasury repos. Release at 69469.

¹² Release at 69475.

¹³ *Id.*

to imperfections in their capital structure – the absence of any “loss absorption capacity” – MMFs caused the 2007-2009 financial crisis.¹⁴ This is simply a canard, easily disproved by a glance at a timeline of the financial crisis and the order in which markets and financial institutions came unglued.

As discussed in more detail below, a capital requirement should not be imposed on MMFs for the following reasons:

- (1) A capital buffer would not achieve the intended purpose of preventing large sustained redemptions from MMFs, but would instead make large sustained redemptions more likely.
- (2) A capital buffer would be prohibitively expensive to both investors and MMF sponsors, if it could be implemented at all.
- (3) A capital buffer would create moral hazard and would be confusing to investors, suggesting that what investors now understand to be an investment product carrying a risk of loss would, instead, have the guarantee features of a bank deposit.
- (4) The requirement for a capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.
- (5) A capital buffer would change the fundamental nature of MMFs, making them less attractive to investors, which would result in a substantial shrinkage or elimination of MMFs.
- (6) Shrinkage or elimination of MMFs would harm the economy, investors, municipal governments and businesses and cost jobs by increasing the cost and decreasing the availability of credit, and increasing systemic risk.
- (7) The current capital structure of MMFs – 100% equity capital and no debt – together with very high portfolio liquidity, transparency, credit quality and maturity requirements put in place by SEC in 2010, address redemptions concerns.

¹⁴ Release at 69455-56, 69460.

(1) A capital buffer would not achieve the intended purpose of preventing large sustained redemptions from MMFs, but would instead make large sustained redemptions more likely.

What prevents runs? After much study, the FDIC staff concluded in 2006 that what stops a run on a bank is liquidity, rather than capital.¹⁵ That FDIC staff conclusion is consistent with studies concluding that what prevents runs or mass shareholder redemptions from MMFs is a high level of liquidity and stringent portfolio credit quality standards.¹⁶ Holding liquid assets in portfolio (altering the left hand side of the balance sheet where reside the cash and other assets that can be used to redeem investors) increases liquidity. Creating a subordinated class of capital (altering the right hand side of the balance sheet which reflects no assets that can be used to redeem investors), particularly of a few percent or less, does not increase liquidity. If anything, creating a junior class of equity puts earnings pressure on an MMF to alter its balance sheet to decrease near-term liquid assets to generate investment returns available from longer-term, higher risk investments in order to either build capital through retained earnings or to compensate investors who have invested in the new class of subordinated equity capital of the MMF.

The Council's capital proposals would introduce, for the first time, a form of leverage into the capital structure of MMFs. The proposal would transform MMF shareholders into creditors protected against loss by a small, more junior class of shareholder.¹⁷ Under the Council's capital proposals, a small sliver of subordinated junior capital would be required to absorb portfolio losses in order to protect the much larger class of senior shareholders of MMFs. This would transform the senior shareholders from owners of all gains and losses on the portfolio into more passive investors who do not suffer the first losses, but are subject to losses if the small sliver of capital is exhausted. Under the proposed structure, when there is a portfolio loss,

¹⁵ Kathleen McDill and Kevin Sheehan, Sources of Historical Banking Panics: A Markov Switching Approach, FDIC Working Paper 2006-01 (Nov. 2006), http://www.fdic.gov/bank/analytical/working/wp2006_01/wp2006_01.pdf.

¹⁶ Hal Scott, *Interconnectedness and Contagion*, Committee on Capital Markets Regulation at 222-24 (Nov. 20, 2012), http://www.capmktreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Letter from Treasury Strategies to SEC (Mar. 19, 2010); Stephan Jank & Michael Weddow, *Sturm und Drang in Money Market Funds: When Money Market Funds Cease to be Narrow*, Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No. 20/2008 (2008); Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), <http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp>.

¹⁷ See Letter from John D. Hawke, Jr. to SEC (Feb. 24, 2011); Letter from Federated Investors to SEC (May 6, 2011). Unless otherwise stated, all letters cited in this paper were filed in response to the SEC's Request for Comment on the President's Working Group Report on Money Market Fund Reform, File No. 4-619, <http://www.sec.gov/comments/4-619/4-619.shtml> (letters dated 2010 or later) or the SEC's Request for Comment on a Proposed Rule: Money Market Fund Reform, File No. S7-11-09, <http://www.sec.gov/comments/s7-11-09/s71109.shtml> (letters dated 2009).

because the junior shares absorb all of that loss until the junior capital is exhausted before any portion of the loss is allocated to senior shareholders, a senior shareholder under this structure has an incentive to redeem its shares in order to exit the fund at full value ahead of other senior shareholders in the event that the MMF portfolio incurs further losses. The small sliver of capital provides the senior shareholders a few days of extra time to redeem shares before the sliver is exhausted. In contrast, with a single class of common shareholders, if portfolio assets lose value such that the fund is in danger of breaking the buck and the fund board responds appropriately, the board will cause the fund to price and redeem shares at a fluctuating NAV before any shareholder has an opportunity to gain an advantage through redemption.

The two-tier capital structure gives holders of the senior class less of an incentive to consider portfolio risks in an MMF before investing, and a greater opportunity to redeem shares when those risks manifest themselves in portfolio losses. In addition, the introduction of the new form of leverage creates an incentive for the manager of the MMF to increase portfolio risk in order to generate higher portfolio returns to reward holders of the junior class of shares or to raise capital by generating retained earnings. As with any form of leverage, the Council's capital proposals would create a classic "moral hazard" within MMFs.

With respect to similar proposals floated earlier for MMFs to create a new class of subordinated capital, a July 2012 report from the Staff of the Federal Reserve Bank of New York ("FRBNY Staff Report") acknowledged that a small buffer will not prevent investors from fleeing in a crisis but could nonetheless create moral hazard by "blunt[ing] portfolio managers' incentives for prudent risk management and investors' incentives to monitor risks in their funds."¹⁸

Treasury Strategies, in a report filed with the Securities and Exchange Commission ("SEC") last year, stated that a capital requirement could change both the expectations and nature of investors in MMFs: "If a capital buffer existed, investors would be more likely to view an MMF as a deposit rather than an investment. This would attract an investor class that is *more* likely to flee at the first sign of distress or rumor, thus *increasing* the likelihood of a run."¹⁹

Once a capital buffer is instituted, speculative runs by investors will begin when the buffer is first drawn upon, rather than when a fund breaks the buck.²⁰ A comment letter filed by Professors Jill Fisch, of the University of Pennsylvania Law School, and Eric Roiter, of the

¹⁸ McCabe, Ciprini, Holscher & Martin, *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 6 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> ("FRBNY Staff Report").

¹⁹ Letter from Treasury Strategies to SEC (Mar. 19, 2012) (emphasis original).

²⁰ Letter from Treasury Strategies to SEC (Mar. 19, 2012); Letter from Fidelity Investments to SEC (May 5, 2011); Letter from Jill Fisch and Eric Roiter to SEC (Dec. 2, 2011).

Boston University School of Law, explained, the likely outcome this way: once an MMF taps the capital buffer in an effort to avoid breaking the buck, “investors are put on notice that the fund might not be able to sustain its \$1 NAV. Knowing that the capital buffer is limited (somewhere between, perhaps, 0.5% to 3% of NAV), investors might have an *extra* incentive to redeem before the cushion is exhausted, thereby aggravating rather than reducing problems of collective action.”²¹

Much of the Council’s efforts to date have been to attempt to conform the structure of various types of intermediaries to that of a bank.²² Thus, rather than accepting that MMFs are financed 100% by a single class of shareholder equity and not by debt or other forms of leverage, the Council re-imagines the existing shareholders of MMFs as creditors, and thus sees a need for a new form of junior capital, in order to conform MMFs to a bank model where the bank balance sheet is financed by depositors and other creditors, who are “protected” against portfolio losses by a small layer of capital.

One might ask whether this capital structure has worked at banks (or the similar structure at structured investment vehicles (“SIVs”) used by banks to securitize assets) to prevent runs. The answer clearly is “no.” A highly leveraged capital structure creates a moral hazard that amplifies both risk-taking in portfolio investments and the risk of runs by providers of senior funding. During the 2007-2009 financial crisis, many banks, including Wachovia, Washington Mutual and IndyMac Bank, suffered from devastating runs by creditors, which brought them to and beyond the brink of insolvency. All told during the financial crisis, one MMF broke a buck, but over 300 federally-insured U.S. banks became insolvent and were closed.²³ Similarly, the small sliver of equity capital in SIVs, broker-dealers, mortgage finance companies, and government-sponsored enterprises did nothing to prevent credit from drying up for those entities during the crisis. Each suffered from runs during the financial crisis.

Is the capital model employed by banks superior in promoting stability to that currently used by MMFs? Over the past 40 years, two MMFs have broken the buck, one costing investors roughly 4 cents on the dollar, and the other less than one cent, and neither costing taxpayers a nickel. In contrast, over the same period, more than 2900 banks have failed, costing the federal government over \$164 billion.²⁴ The capital structure used by banks has not been very

²¹ Letter from Fisch & Roiter to SEC (Dec. 2, 2011).

²² Jonathan R. Macey, *Money Market Funds: A Vital Source of Systemic Stability* (Fall 2012) at 31-35, 35-37 (“Macey 2012”).

²³ FDIC Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html> (listing bank closures from 2007-2010).

²⁴ *Id.*; FDIC, *Failures and Assistance Transactions*, <http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30> (listing bank failures from 1973 to 2013).

successful in preserving bank solvency or preventing runs on banks. There is no reason to believe that it will be successful at MMFs.

(2) A capital buffer would be prohibitively expensive to both investors and MMF sponsors, if it could be implemented at all.

In discussing earlier proposals for MMFs to create a new class of subordinated capital, the FRBNY Staff Report warned that raising sufficient capital for a large enough buffer to effectively absorb losses would be “challenging,” and present “complications” regardless of its source (according to the report, capital derived from fund income would take years to build; capital from third parties would require creation of a new, untested security; capital provided by the fund industry would potentially lead to further consolidation of the industry among affiliates of large, systemically important financial institutions, shifting risk from MMFs to those institutions).²⁵

The scalability problem. One of the problems created by the introduction of a two-tier capital structure to MMFs is in how the capital buffer will interact with the typical growth and shrinkage of MMFs arising from normal investor demands. Under the current capital structure – 100% equity capital financing of a single class of common equity – there is no need to synch up the size of the capital base with the size of the fund. They are one and the same. As investors choose to invest additional assets in the MMF, they provide all of its capitalization. When investors redeem assets, they simultaneously redeem an equal amount of capital. The MMF’s capital base expands and contracts as needed to fund dollar-for-dollar the asset base. In this way, MMFs operate very much like separately-managed accounts of institutional investors that invest their liquidity balances directly into money market instruments. They can expand or shrink the balances invested in money market assets, or particular categories of money market assets, as needed to address their investment needs.

If, however, a second class of subordinated capital is introduced, the size of that new additional capital layer must be coordinated with the size of the senior capital that it is designed to “protect” against first loss. If investors purchase senior shares of an MMF, its assets under management (“AUM”) increases. If capital ratios are to be met, the size of the subordinated equity must also expand by an equal percentage in order for the MMF to continue to meet its capital coverage ratios. The subordinated capital does not automatically appear from the sky to meet this need.

If the source of junior capital is retained earnings, there is no natural connection between the timing or amount of retained earnings to build the junior capital buffer and the investor demand for senior shares that expands the MMF size and creates the need for the additional

²⁵ FRBNY Staff Report at 6-7.

junior shares. The upper bound for MMF growth becomes retained earnings. Moreover, the means of enforcing the proposed capital requirement – restricting new investments to cash, Treasury securities and Treasury repurchase agreements – will reduce the MMF’s earnings, making it more difficult to rebuild the capital buffer with retained earnings. Given the short-term nature of an MMF’s portfolio, a prime MMF that falls below the capital requirement could easily find itself forced to convert to a Treasury MMF.

If the source of the junior capital is the fund manager or third-party investors, there remains no automatic connection between the availability, amount and timing of new investment in the MMF to support demand among investors for senior shares of the MMF. If markets experience turbulence, investors willing to buy the riskier subordinated shares may dry up. MMFs may be required to turn away investors in the senior common shares due to problems in obtaining investors for the junior subordinated shares.

Similarly, if investors redeem senior shares and the MMF’s AUM shrinks, there will be more junior subordinated equity than needed, which will be a drag on net returns to the senior class, depressing its returns, which may lead to further redemptions, further contractions, etc.

The result of introduction of a two-tier equity capital structure with tranches of capital that do not automatically match up with one another is to make MMFs unable to respond by growing and shrinking to meet the demands of investors for MMFs (or for particular types of MMFs).

The capital availability problem. A second problem with the Council’s capital proposals is that the amount of capital required to fund it may not be available when needed. If up to 3% of capital is required for all prime MMFs as well as all tax-exempt MMFs, at their current AUMs – which currently aggregate to approximately \$1.7 trillion – between \$45 and \$50 billion in subordinated equity would be required to be raised.²⁶ This would be a completely new form of highly-leverage capital instrument whose closest market analogy would be the equity tranches of SIVs. Even for SIVs, the equity tranche consisted of capital notes that had a stated term or allowed the equity holders to vote to wind-up the SIV, rather than being subject to the perpetual subordination envisioned in Alternative Three, which truly would be unprecedented.

²⁶ Broadly speaking, prime MMFs would need to raise approximately 2.25% capital on 10% Daily Liquid Assets and 3.00% capital on the remaining 90% of assets, although prime MMFs would exclude cash, Treasuries, and Treasury repurchase agreements from the capital calculation. According to the ICI Fact Book, as of December 31, 2011, industry-wide about 7% of prime MMF assets were Treasuries and about 13.1% were repurchase agreements (although it is not clear what amount of prime MMF repurchase agreement assets were Treasury repurchase agreements, nor is the value of other cash assets clear). Investment Company Institute, *2012 Investment Company Fact Book* (2012), http://www.icifactbook.org/2012_factbook.pdf. Thus, the capital requirement would vary based on the future asset composition of prime MMFs, but with today’s asset composition could total \$45 to \$50 billion.

Approximately \$5.1 billion was raised in initial public equity offerings in the United States during 2012.²⁷ Total U.S. public equity offerings during 2012 raised approximately \$253 billion across all industry sectors.²⁸ It is not realistic to assume that an entirely new category of highly leveraged junior equity issued by one industry segment could garner between \$45 and \$50 billion of this total from the U.S. public equity markets. Alternative Three would require MMFs to raise during a transition period of maybe six years the same amount of a capital that SIVs were estimated to have accumulated over a period of over 20 years.²⁹

MMFs would have to offer an exceptional rate of return to attract investment in non-redeemable shares, the sole purpose of which is to absorb portfolio losses. Without any other potential for profit, junior shareholders would have to earn all of their return through dividends. Without a fixed term for the investment, these dividends would have to compensate junior shareholders for the indefinite use of their capital, as well as for the portfolio risks they would bear.

Subordinated equity also would create a different form of maturity mismatch between the extremely short term of the fund's portfolio and the indefinite term of the junior capital. When short-term interest rates fall, or if the junior capital earns interest at a floating rate and spreads tighten, the fund will have less income from its portfolio from which to pay interest on the junior capital. Both of these effects (higher rates and mismatched maturities) would increase the cost of junior capital and decrease the returns to the common shareholders, deterring investment in the fund. This could spiral out of control if the fund suffers substantial redemptions but cannot retire the excess junior capital, insofar as the redemptions will reduce the fund's income with no corresponding reduction in the expense of the junior capital, further reducing returns to the common shareholders. A fund would have to pay a substantial premium for the right to redeem the junior capital in this circumstance, which would also increase the cost of the junior capital. If the goal is to maintain MMFs as a stable funding source to borrowers in the money markets during a future financial crisis, issuing non-redeemable subordinated shares that drive ordinary shareholders from MMFs by depressing their yields would not be a successful approach.

The Release asks if other types of subordinated capital might be appropriate. Issuing junior capital that has a fixed term like preferred stock or bonds would introduce equally hazardous risks. In order to reduce the cost and maturity mismatch created by the junior capital, the fixed term would need to be relatively short, so MMFs would face rollover risk as the

²⁷ Committee on Capital Markets Regulation: Global IPOs by Foreign Countries (Broadly Defined) (2013), <http://capmktreg.org/education-research/competitiveness-measures/equity-raised-in-public-markets/>.

²⁸ Committee on Capital Markets Regulation: U.S. Share of Equity Raised in Public Markets (2013), <http://capmktreg.org/education-research/competitiveness-measures/equity-raised-in-public-markets/>.

²⁹ J.P. Morgan, U.S. Fixed Income Markets Weekly at Table 2 (showing an estimated \$50 million in equity funding for SIVs) (Aug. 24, 2007).

maturity dates for junior securities approach. If there were not sufficient investor interest at an affordable price to replace the junior securities, the MMFs would need to shrink or wind down their operations. In times of financial uncertainty, investor demand for a highly leveraged, deeply subordinated interest in a pool of money market assets would likely be far less than in more stable financial times. This would mean far less of this capital would be available when needed, and would cost significantly more than in more stable economic times. At best, this junior capital cushion would provide a period of wind-down for MMFs as it matured and is redeemed. Therefore, this type of capital would also fail to serve the goal of reducing rollover risk to borrowers, because MMFs issuing subordinated instruments with near term maturities would experience their own rollover risk.

Regardless of its term, reliance on junior capital would impair a prime MMF's ability to attract new assets. Under the proposal, if an MMF grew faster than its ability to maintain the required capital cushion, it would have to invest exclusively in cash, Treasury securities and Treasury repo. This would lower the yield from the MMF's portfolio and, consequently, make its yield less competitive with other MMFs. Issuing additional junior capital will increase the MMF's expense (both the issuance cost and the interest paid on the junior capital), which make the MMF's yield even less competitive. The MMF may have to wait for any Treasury securities and Treasury repo it purchased to mature before investing in higher yielding prime securities and restore its yield to a competitive level. In the interim, the reduction in yield will have made the MMF less attractive to new investors and may even prompt current shareholders to redeem.

In a detailed report analyzing the feasibility of a capital requirement for MMFs, the Investment Company Institute ("ICI") concluded that "small funds and small fund complexes would likely find it difficult and costly to issue and roll over subordinated securities, resulting in industry consolidation and raising a barrier to entrants."³⁰

Several fund managers also have expressed doubts about the feasibility of the capital proposal. Charles Schwab stated, "We do not believe there is a viable market for a subordinated share class that would take first loss position in exchange for a higher return."³¹ The ICI provided a detailed review and data analysis of two possible sources of funding for a capital buffer – requiring fund sponsors to commit capital or having funds build a capital buffer from fund income³² – and found that a buffer coming from either adviser's profits or investor yield

³⁰ Letter from ICI to SEC (May 16, 2012).

³¹ Letter from Charles Schwab to IOSCO, filed with SEC (May 31, 2012). *See also* Letter from Fidelity Investments to IOSCO (May 30, 2012) ("It is highly speculative that any market will develop for such subordinated shares.").

³² Letter from ICI to SEC (May 16, 2012). ICI considered funding the capital buffer from the market as a third possibility, and noted "significant legal, business, accounting, and economic hurdles to raising capital in the market."

would take many years to build up.³³ The third alternative, raising subordinated/third party capital, was thoroughly analyzed and discussed with SEC and Federal Reserve staff in Fall 2011 and determined to be unmarketable and not viable.

A capital requirement borne by MMF managers or MMF common shareholders would drive many sponsors of MMFs out of the business.³⁴ According to an analysis prepared by Treasury Strategies, “A capital requirement of 50 basis points (0.50%), if applied against all MMFs, would total \$12.5 billion. Given today’s ultra-low interest environment, it would not be feasible to build the buffer by retaining a portion of the customer yield. As a result, the requirement would fall to the fund sponsors. They would also be responsible for replenishing the capital, should any losses be incurred within the portfolio. From the sponsors’ perspective, that is tantamount to providing a blanket guarantee on the entire fund. Their only logical alternative is to exit the business.”³⁵

The Securities Industry and Financial Markets Association (“SIFMA”) further explained, “If the level of required capital cannot be sustained by the marketplace, the result of a capital requirement would be to severely curtail the availability of money market funds, eliminating an attractive cash management option for investors, likely prompting a shift to less heavily regulated investment vehicles which pose more systemic risk, and eliminating a source of financing for issuers.”³⁶

³³ *Id.*

³⁴ Letter from Invesco to IOSCO, filed with SEC (May 25, 2012); Letter from Treasury Strategies to SEC (Mar. 19, 2012); Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117.

³⁵ Letter from Treasury Strategies to SEC (Mar. 19, 2012). BlackRock commented, “[A]bove approximately 70 basis points of capital, the money market industry will no longer return the industry cost of capital to fund sponsors [This] will cause the industry to contract . . . unless fees rise” Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117.

³⁶ Letter from SIFMA to SEC (Jan. 10, 2011). *See also* Letter from ICI to SEC (May 16, 2012); Letter from SunGard Global Network to SEC (Mar. 16, 2012); Letter from Federated Investors to SEC (May 6, 2011); Letter from Senator Patrick J. Toomey (R-PA), Michael F. Bennet (D-CO), Mike Crapo (R-ID), Jon Tester (D-MT), Mark Kirk (R-IL), and Robert Menendez (D-NJ) to SEC (Nov. 4, 2011), <http://www.preservemoneymarketfunds.org/senate-letter-to-sec-chairperson-mary-schapiro/>.

The economic cost of capital problem.³⁷ The Release posits that the economic cost of the new class of junior subordinated capital will be *de minimis* at 0.0075%.³⁸ This assumption is plainly wrong, unsupported by data or meaningful Council analysis in the Release, and flatly at odds with information that has been submitted in response to the President's Working Group on Financial Markets report on Money Market Mutual Fund Reform Options. MMFs have pushed down short-term borrowing costs for prime corporate and municipal borrowers well below the rates charged by banks. If MMFs shrink or disappear those rates will go back up.

The Release estimates a cost of capital of 5% above the returns on common shares of MMFs, based on returns on BBB-rated corporate bonds. If the junior subordinated capital had no fixed maturity or a very long-dated maturity, it would need to bear equity-like returns and would face a limited market. A better estimate of equity returns would imply a significantly higher cost of capital, nearly double that rate.³⁹

The Release then assumes the 5% cost of capital is spread out over the portfolio of the MMF at a leverage ratio of 100-1 and passed through entirely to issuers whose instruments are held in the MMF's portfolio. Dividing 5% by 100 and then dividing that further by the percentage of financing provided by MMFs, the Release reaches its 0.0075% estimate of the economic cost of the Council's equity capital proposal.

The Release notes that the economic cost of its proposal would be lower still if issuers into the money markets shifted to obtaining funding from other sources.⁴⁰ That assumption ignores the fact that the cost of obtaining financing from a bank is approximately 200 to 300 basis points higher than the cost of obtaining financing from an MMF.⁴¹ Accordingly, if money

³⁷ While the economic costs of the Council's capital proposals are briefly discussed herein, a more detailed analysis of these issues may be found in a forthcoming letter by Stephen A. Keen, to be filed on behalf of Federated Investors.

³⁸ Release at 69480-81.

³⁹ See NYU Stern Business School, Cost of Capital by Sector (Jan. 2012), http://w4.stern.nyu.edu/~adamodar/New_Home_Page/datafile/wacc.htm (estimate of 7.6% (Midwestern banks) 9.76% (diversified financial services) 11.43% (life insurance); Roger J. Grabowski, Duff & Phelps, VALCON 2012 Developing the Cost of Equity Capital: Risk-free rate and ERP during periods of "Flight to Quality" (Feb. 24, 2012), avail. online at <http://materials.abi.org/sites/default/files/2012/Feb/DevelopingCostEquityCapital.pdf> (concluding a 2012 equity risk premium of 5.5% above a long-term risk free rate of 4.0% for a total cost of capital of 9.5% during normal economic times, but significantly higher costs of capital during periods involving "flights to capital").

⁴⁰ Release at 69480-81.

⁴¹ See Board of Governors of the Federal Reserve System, *Selected Interest Rates (Weekly) – H.15* (updated Jan. 14, 2013), <http://www.federalreserve.gov/releases/h15/current/> (showing the weekly average prime rate charged by banks on short-term loans to business); Board of Governors of the Federal Reserve System, *Commercial Paper Rates and Outstanding Summary* (updated Jan. 16, 2013), <http://www.federalreserve.gov/releases/cp/> (showing daily interest rates for 90-Day AA Nonfinancial Commercial Paper).

market issuers are forced to obtain their financing from banks, their costs will increase dramatically. Conversely, if MMFs are disintermediated by a shift by money market issuers to obtaining their financing directly from separately managed accounts or from less regulated bank short-term investment funds (“STIFs”), hedge funds and offshore funds, a primary goal of the Council proposal – stabilizing the funding sources for money market issuers and limiting their rollover risks in a future financial crisis – is gutted, as those alternate funding sources will pull funding from money markets when their principals flee to quality in the face of market uncertainty.

Analyzing the costs of two possible sources of funding for a capital buffer, the ICI found the following in a report filed with the SEC last year:

- Assuming the buffer would come from fund sponsors, “all advisers would expect to earn the market rate of return on such capital. If they cannot earn that rate of return, they would seek better business alternatives, such as moving investors to less-regulated cash management products where investors still must bear the risks of investing.”⁴² The ICI further observed that the rate of return on capital contributed would have to be quite large, because although the likelihood of potential losses in a money market fund is very low, the *percentage* losses on its small capital investment could be large in the event the buffer must be tapped. Assuming a 1.5 to 3 percent buffer, the funds’ current fee structure and current market conditions, ICI calculated that recouping the buffer would take every dollar of at least 8 to 20 years of advisers’ profits from the fund. In the alternative, advisers would be forced to raise fund fees between 16 and 40 basis points to achieve a market rate of return on pledged capital.
- If a buffer were to come from withheld shareholder yield, ICI calculated it would take a prime MMF 10 to 15 years to raise a 0.5 percent buffer given plausible assumptions about future interest rates, the reaction of investors to the buildup of the buffer, and the willingness of fund advisers to continue to absorb fee waivers. Under the “best of circumstances,” ICI calculated the 0.5 percent buffer would take at least 5 years to buildup.⁴³

A capital buffer funded by withholding a portion of income and gains from MMF shareholders would reduce yields and would motivate investors to abandon MMFs in search of higher yields elsewhere, including in unregulated and less transparent vehicles.⁴⁴ A joint letter

⁴² Letter from ICI to SEC (May 16, 2012). ICI considered funding the capital buffer from the market as a third possibility, and noted “significant legal, business, accounting, and economic hurdles to raising capital in the market.”

⁴³ *Id.*

⁴⁴ Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies); Letter from State Street to SEC (Feb. 24, 2012); Letter from Northern Kentucky Chamber to

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from the Independent Directors Council and the Mutual Fund Directors Forum stated that reduced yields will make MMFs “substantially less attractive to investors” and result in a shift to alternative products.⁴⁵

In a survey of institutional MMF users commissioned by the ICI, Treasury Strategies found that the institution of a capital buffer will drive a large portion of current users out of the MMF market.⁴⁶ Of the more than 200 institutional users of MMFs surveyed, 36% said they would decrease or stop using MMFs if the fund contained a capital buffer. Of those, 35% said they would stop using MMFs entirely. Even the survey respondents who said they would continue using MMFs upon the institution of a capital buffer showed little tolerance for loss of yield. More than half of those users would divest given a 2 basis point loss, and 92% would divest at 5 basis points.

Commenters also provided analyses of the costs of a capital requirement borne by fund sponsors, which would cause fund sponsors to exit the business.⁴⁷

The junior subordinated class is designed to take the first loss on portfolio assets. As proposed, the new structure is highly leveraged – somewhere between 99-1 and 97-3 depending on the asset mix and which proposal is involved. This greatly magnifies the portfolio risk to investors in the junior class for which they will require some form of compensation. Assuming a separate class of junior shareholders is created, because the junior subordinated shares would bear much greater risk than the senior common shares of the MMF, the MMF would need to pay junior shareholders a higher return. To pay the cost of capital of the junior subordinated shares, a portion of portfolio asset returns would need to be shifted from senior common shareholders to junior subordinated shareholders of the MMF.

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SEC (Jan. 20, 2012). *See also* PWG Report at 34 (stating that “a substantial mandatory capital buffer for MMFs would reduce their net yields and possibly motivate institutional investors to move assets from MMFs to unregulated alternatives (particularly if regulatory reform does not include new constraints on such vehicles).”).

⁴⁵ Letter from Independent Directors Council and Mutual Fund Directors Forum to SEC (May 2, 2012).

⁴⁶ Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies).

⁴⁷ Letter from Treasury Strategies to SEC (Mar. 19, 2012). BlackRock commented, “[A]bove approximately 70 basis points of capital, the money market industry will no longer return the industry cost of capital to fund sponsors [This] will cause the industry to contract . . . unless fees rise” Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117. *See also* Letter from SIFMA to SEC (Jan. 10, 2011) (“If the level of required capital cannot be sustained by the marketplace, the result of a capital requirement would be to severely curtail the availability of money market funds, eliminating an attractive cash management option for investors, likely prompting a shift to less heavily regulated investment vehicles which pose more systemic risk, and eliminating a source of financing for issuers.”).

If instead, the junior class is an accumulated stash of retained earnings built up over time and held in a suspense account rather than a separate shareholder class, the retention could only be built up by withholding earnings from shareholders, and thereby reducing their returns. Either way, the already low returns to prime MMF shareholders would be further reduced.

Because the Council is proposing that no capital requirements be imposed on Treasury MMFs, the return on Treasury MMFs sets a lower bound on a minimum return that would need to be paid to shareholders. According to BlackRock, “assuming a 6-basis point charge to the fund, prime funds’ yields would have been lower than government funds’ more than 1/3 of the time. Looking forward, this relationship is sensitive and could result in substantial flows of capital among funds, thereby destabilizing the industry.”⁴⁸ MMF investors would have no reason to accept lower returns on prime MMF common shares than they could earn on Treasury MMF shares. There simply is not enough yield in prime MMF portfolios under current market conditions to pay for any of the new forms of capital suggested in the Release.

Other Technical Problems with Capital Proposals. In a paper on the feasibility of various types of capital requirements, ICI noted that there are “significant legal, business, accounting, and economic hurdles to raising capital in the market.”⁴⁹ Among these technical issues are the tax treatment of MMFs. MMFs, like all U.S. mutual funds, are permitted to deduct dividends paid to shareholders during each tax year. Any earnings a fund retains, however, are taxed at corporate tax rates. Retained earnings are subject to an additional excise tax if the MMF fails to distributed at least 98% of its taxable income and net gains each calendar year. If the MMF fails to distributed at least 90% of its income and net gains each taxable year, it also loses the right to deduct its dividends, so that all of its income becomes subject to double taxation, first to corporate taxes and then as taxable dividends to its shareholders. These tax requirements would make it extremely difficult and inefficient to build a capital buffer by retaining earnings, and could cut an MMF’s yield to such an extent as to drive away shareholders. Depending upon how these tax provisions are amended to permit the retention of earnings, shareholders may be taxed on “phantom” earnings that are withheld as part of the buffer and not available to them. Assuming *that* tax issue is resolved through further amendments to the tax code, the process for accounting for and recapturing the deferred taxes on the withheld earnings that form the buffer would be a very complicated process.

In addition, a capital buffer would present fairness issues if it is built up through retained income and gains, as current shareholders would be forced to pay to protect future

⁴⁸ Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117.

⁴⁹ Letter from ICI to SEC (May 16, 2012).

shareholders.⁵⁰ Such a program would shift wealth from current investors to future investors in MMFs.

The deferral of income and gains to set aside a hidden capital buffer to calm investors by offsetting future portfolio losses also has the awkward attribute of being a form of income “smoothing” that long has been a target of SEC enforcement actions as a specie of securities fraud.⁵¹ It is not too surprising that the banking regulators developed this capital proposal to calm MMF shareholders and reduce their propensity to “run” in a crisis, as the bank regulators (until the SEC put a stop to the practice at banks in 1998) had long encouraged or permitted banks to engage in similar practices to reserve income in good years as a buffer to offset loan losses in bad years and create an appearance of stability; they continue to voice support for a return to the practice.⁵²

In addition, creating a two-class structure for an MMF (or any registered investment company) is prohibited by Sections 1(b) and 18 of the Investment Company Act, and is contrary to the legislative findings and legislative purposes behind that Act to prevent the conflicts of interest among different stakeholders that necessarily follow from leveraged or multi-class capital structures. The SEC would need to waive this fundamental prohibition in order to permit the two-class capital structure. To the extent that retained earnings are used to create the capital buffer, this method conflicts with several valuation and accounting requirements codified in the Investment Company Act, which also would need to be waived by the SEC.⁵³

Moreover, existing MMFs would have to amend their charters and other organizational documents in order to issue a subordinated class of equity. To accomplish this, it would be necessary to obtain MMF board approval, provide notice and disclosure to existing investors and obtain approval of the changes by shareholder vote, and amend the prospectuses and registration statements of the MMFs. There is a significant economic cost involved in this process, including

⁵⁰ Letter from Federated Investors to SEC (May 6, 2011).

⁵¹ See, e.g., Complaint, *SEC v. Federal Home Loan Mortgage Corporation et al.*, Case No. 07-CV-1728 (D.D.C. filed Sept. 27, 2007); Complaint, *SEC v. James N. Standard et al.*, No. 06-CV-7736 (S.D.N.Y. filed Sept. 27, 2006); *In the Matter of American International Group, Inc.*, SEC Rel. No. 34-48477 (Sept. 11, 2003).

⁵² Bernanke, *Financial Reforms to Address Systemic Risk*, Remarks at Council on Foreign Relations, (Mar. 10, 2009), <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>; Balla & Rose, *Loan Loss Reserves, Accounting Constraints, and Bank Ownership Structure*, Federal Reserve Bank of Richmond Working Paper No. WP-09 (Nov. 17, 2011), http://www.richmondfed.org/publications/research/working_papers/2011/pdf/wp11-09.pdf; Balla, Rose & Romero, *Loan Loss Reserve Accounting and Bank Behavior*, Federal Reserve Bank of Richmond Economic Brief EB12-03 (Mar. 2012), http://www.richmondfed.org/publications/research/economic_brief/2012/pdf/eb_12-03.pdf; Rivard, Bland & Hatfield Morris, *Income Smoothing Behavior of U.S. Banks Under Revised International Capital Standards*, 9 IAER 288 (Nov. 2003).

⁵³ Investment Company Act § 22. 17 CFR §§ 270.2a-4, 270.22c-1.

legal and accounting fees, documentation costs, printing, mailing, use of proxy solicitors and other steps needed to bring the matter to a vote and obtain the required approvals.

(3) A capital buffer would create moral hazard and would be confusing to investors, suggesting that what investors now understand to be an investment product carrying a risk of loss would, instead, have the guarantee features of a bank deposit.

The three alternative Council proposals are internally inconsistent in their aims. On the one hand, the Council proposes a movement to a continually floating NAV so that investors will better understand that their investments may lose value, which the Council believes will desensitize investors to future events that cause an MMF to break the buck and thus investors will be less likely to redeem their shares to avoid a loss in a future financial crisis.⁵⁴ On the other hand, with its capital proposal, the Council proposes to create a capital buffer to insulate MMF common shareholders from portfolio losses, so that they will not redeem their shares in a financial crisis.⁵⁵ The two approaches cannot be reconciled.

The capital buffer also creates concerns about transparency and investor confusion.⁵⁶ The Treasury Strategies report stated that the “guaranteed” return of principal implied by a capital requirement promotes the false notion that MMFs are deposits, increasing moral hazard from the investor’s perspective.⁵⁷ MMF disclosures currently advise shareholders that their investments are not guaranteed, which creates an incentive for investors not to chase yield, but instead to consider the quality of the manager and of the investment portfolio of the MMF.⁵⁸ With a capital buffer in place, investors lose that incentive and instead benefit most from investing in the riskiest fund with the greatest yield.⁵⁹ This feedback loop of risky incentives will significantly undercut the gains made through the 2010 amendments by increasing systemic risk.⁶⁰ Treasury Strategies has noted that “adding a capital requirement to funds places increased

⁵⁴ Release at 69466.

⁵⁵ *Id.* at 69469, 69475.

⁵⁶ Letter from Keystone ELF to SEC (Nov. 18, 2011) (“How does [the floating NAV] address the transparency issues addressed by the required ‘shadow NAV?’ Will there now be three NAV’s to track? By artificially skewing the NAV in a more positive light, are we giving more comfort for investors?”).

⁵⁷ Letter from Treasury Strategies to SEC (Mar. 19, 2012).

⁵⁸ Letter from John D. Hawke, Jr. to SEC (Feb. 24, 2011). *See also* Macey 2012 at 25-27.

⁵⁹ *Id.*

⁶⁰ Letter from Treasury Strategies to SEC (Mar. 19, 2012); Letter from John D. Hawke, Jr. to SEC (Feb. 24, 2011).

pressure on fund managers to drive yield. In order to meet this pressure, managers will have to either extend maturities or add credit risk.”⁶¹

In its report, Treasury Strategies cited two empirical studies demonstrating moral hazard in the deposit insurance context: a 2000 study that found “explicit deposit insurance tends to be detrimental to bank stability;”⁶² and a more recent study finding that “banks take on higher risk in the presence of explicit insurance and hence that explicit deposit insurance has generated moral hazard incentive for banks.”⁶³ Treasury Strategies stated that there is an “obvious parallel” between an MMF capital requirement and FDIC deposit insurance: “Just as insurance can change the behavior of the insured, a capital requirement will encourage fund advisers to buy riskier investments, as they seek higher yields to increase assets under management.”⁶⁴

Professor Macey of Yale Law School has noted this issue as well:

The government intervention may be having the opposite effect by providing artificial support and perhaps an unrealistic sense of security. Imposing a like regime upon MMFs would squash alternatives and bring more assets under this problematic umbrella.

...

If regulators’ goal is to end the need for government bailouts for financial institutions that are “too big to fail,” cash investors must bear some risk and responsibility. Making the government’s role in regulating MMFs substantially more oppressive, or killing them off entirely and re-routing the money to FDIC-insured banks (most likely Systemically Important Financial Institution (SIFI) banks) will not help to achieve this objective. Regulation that nudges investors towards banks will only compound these many destabilizing forces inherent within banks. Instead of attempting to treat MMFs more like banks, regulators should instead seek to keep assets in the more-stable MMFs.⁶⁵

⁶¹ Letter from Treasury Strategies to SEC (Mar. 19, 2012). *See also* Letter from Federated Investors to SEC (May 6, 2011).

⁶² Letter from Treasury Strategies to SEC (Mar. 19, 2012) (citing Asli Demirgüç-Kunt and Enrica Detragiache, *Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation*, April 2000).

⁶³ Letter from Treasury Strategies to SEC (Mar. 19, 2012) (citing Isabelle Distigui, Tchudjane Kouassi, Amine Tarazi, *Bank Deposit Insurance, Moral Hazard and Market Discipline: Evidence from Central and Eastern Europe*, June 2011).

⁶⁴ Letter from Treasury Strategies to SEC (Mar. 19, 2012).

⁶⁵ Macey 2012 at 17-19.

(4) The requirement for a capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.

The Council’s proposal for a capital buffer, discussed in this paper, and its MBR/NAV buffer proposal, discussed in a separate paper submitted by Arnold & Porter this same date titled “Proposal for a Minimum Balance at Risk and NAV Buffer for Money Market Mutual Funds,” would each have significant implications for market discipline – for MMF managers and MMF investors.

MMFs currently operate under the discipline of (1) managing to a stable NAV and publishing the market NAV and every portfolio holding periodically; (2) operating without the “net” of any capital buffer and therefore managing the portfolio to avoid undue credit or interest rate risk; and (3) managing to regulatory liquidity requirements and even higher in order to meet customer demands under a scenario where large customers may redeem 100% of their holdings on demand. In addition, MMF sponsors must continuously know and anticipate the cash needs of their investors – not simply because SEC regulations require it, but because it is critical to maintaining an MMF’s liquidity and maintaining a stable NAV. MMF sponsors are further disciplined by the knowledge that a misjudgment regarding an asset purchased for the MMF could result in a cost to the sponsor (who may determine to purchase or provide other support for the asset), reputational damage (and the consequent loss of assets as a result of shareholder redemptions), or closure of the fund if its valuation drops only ½ of one cent per share. MMF shareholders are further disciplined by the knowledge that MMFs operate without any safety net of capital and, therefore, investors cannot passively sit on their hands and abandon their monitoring responsibilities.

The Release states that the availability of the NAV buffer “would give the fund an explicit form of support” that, “[u]nlike . . . discretionary sponsor support . . . during times of stress would not be in question.”⁶⁶ But, by replacing the uncertainty of sponsor support with the assurance of capital, the NAV buffer would diminish investors’ incentives to closely monitor the fund.

The Release goes on to say this capital buffer “could impose additional discipline on fund managers by ensuring that small losses which today are not reflected in funds’ share prices, force changes in portfolio management,” because if a buffer fell below the required amount the fund would be required to limit its new investments to cash, Treasury securities, and Treasury repos.⁶⁷ Here, the proposal removes the purest form of discipline for managers – the potential cost to the sponsor or prospect of fund closures as a result of a blown credit – and replaces it with the uncertain disciplining effect of an asset limitation.

⁶⁶ Release at 69472.

⁶⁷ *Id.*

The Release states that the 30-day redemption delay in the MBR proposal is “designed to provide protection against preemptive runs while not unnecessarily inconveniencing redeeming shareholders or blunting the role of redemptions in imposing market discipline.”⁶⁸ It then says, “The MBR may also enhance market discipline by causing MMF investors to monitor more carefully MMF operations and risk-taking and redeem shares from a poorly run MMF well in advance of any specific problems developing in the fund’s portfolio because investors would be unable to redeem quickly during a crisis to avoid losses.”⁶⁹ But, MMF investors already closely monitor MMFs because MMFs have no capital – and no buffer for error. It makes no sense to require a capital buffer, state that the purpose of the buffer is to assure investors and deter them from running, and then rationalize that investors will be incentivized to monitor an MMF with an MBR because they will be unable to quickly redeem shares withheld.

(5) A capital buffer would change the fundamental nature of MMFs, making them less attractive to investors, which would result in a substantial shrinkage or elimination of MMFs.

The ICI has stated that “[a]dding subordinated debt or equity would turn a rather simple product—the money market fund—into a considerably more complex offering. . . . [T]he approach potentially would create competing interests between the subordinated and senior investors, such as the subordinated investors’ desire to avoid losses and senior investors’ desire for the fund to take greater risks to boost fund yields. A market-raised capital buffer would reduce the yield available to senior shareholders, and subordinated investors would have a highly levered investment.”⁷⁰

By statute, and by their very nature, all mutual funds, including MMFs, have a single class of equity and do not use leverage. All investors share equally in incomes, gains and losses according to their percentage ownerships. This is why they are called *mutual* funds. This structure was put in place by Congress to do away with the conflicts of interest and skewed incentives that will always exist with multiple classes of shares with different priorities and economic rights.⁷¹ For many investors, this equal treatment of all shareholders is the most attractive aspect of mutual funds, including MMFs. By creating a multi-class equity structure and introducing financial leverage in the form of a subordinated class, the product is fundamentally changed into something like a bank or an SIV of the sort used in the toxic asset securitizations that were the actual proximate cause of the 2007-2009 financial crisis.

⁶⁸ *Id.* at 69471.

⁶⁹ *Id.*

⁷⁰ Letter from ICI to SEC (May 16, 2012).

⁷¹ Investment Company Act 1(b). Macey 2012 at 25-29.

A group of 33 Members of Congress who are all former state and local government officials expressed concern that the imposition of additional changes to MMF regulation that have been discussed by policymakers, including the capital requirement, “would alter the fundamental structure of MMFs and would, in turn, lead investors to other less-regulated products.”⁷²

The Council’s capital proposals, if implemented, would harm MMF investors and the money markets by creating conflicts of interests with the new subordinated shareholders and/or with managers, create moral hazards, reduce returns to investors and increase short-term borrowing costs. The proposed capital standards would not meet the requirement under Section 2(c) of the Investment Company Act that rulemakings must further the protection of investors, and promote efficiency, competition, and capital formation.

(6) Shrinkage or elimination of MMFs would harm the economy, investors, municipal governments and businesses and cost jobs by increasing the cost and decreasing the availability of credit, and increasing systemic risk.

The Release acknowledges the importance of MMFs to the economy.⁷³ A capital requirement that results in a shrinkage of MMF assets would contract the market for and raise the costs of, short-term public and private debt financing.⁷⁴ MMFs provide critical financing to every sector of the short-term credit market. If MMFs were taken out of the financial system, and the role currently performed by MMFs in providing short-term financing was performed solely by commercial banks, the economy would be harmed through increased financing costs to business and governments.

Banks are far less efficient than are MMFs in providing funding to corporate and government borrowers in the money markets. Banks have overhead costs that are far higher per dollar of assets than the operations costs of MMFs. A comparison of expense data shows that cost differential is between 200 and 300 basis points per year per dollar of assets. This large cost differential between the expense ratios of MMFs as compared to banks means there are lower returns to savers and higher costs to borrowers when balances are intermediated through the banking system. If MMFs disappeared and were replaced by banks, the higher cost of borrowing

⁷² Letter from 33 Members of Congress to SEC (May 1, 2012), http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658551.pdf.

⁷³ Release at 69455.

⁷⁴ Letter from 33 Members of Congress to SEC (May 1, 2012); Letter Greater Raleigh Chamber of Commerce to SEC (Feb. 28, 2012); Letter from the Northern Kentucky Chamber of Commerce to SEC (Jan. 20, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with SEC (Dec. 15, 2011). *See also* Letter from Melanie Fein to SEC (May 11, 2012).

would translate directly into less economic growth, fewer jobs, and even further cuts to government programs, payrolls, pensions and benefits.

Shrinking MMFs will directly reduce the amount of credit financing they are able to provide through the short-term money markets. MMFs are significant purchasers of commercial paper, short-term state and local government debt, and short-term Treasury and federal agency securities.⁷⁵ MMFs will purchase significantly less public and private debt once the funds' holdings are reduced. A letter from 33 Members of Congress who are all former state and local officials warned that “[a]ny reduction in demand for money market funds would reduce demand for the securities issued by state and local governments and purchased by MMFs. As a result, states and municipalities would be deprived of a critical funding source and would be faced with increasing debt issuance costs.”⁷⁶

Shrinking MMFs would increase systemic risk by causing further growth of the largest SIFI banks. Over 75% of recent deposit growth that was caused by unlimited deposit insurance of demand deposit accounts flowed into the ten largest banks. The ten largest U.S. banks represent 65% of banking assets and 75% of U.S. GDP. Institutional investors hold approximately two-thirds of MMF shares. If two-thirds of MMF balances move into the banking system and 75% of that flows into the ten largest banks, that would increase the size of the ten largest SIFI banks by \$1.3 trillion to 74% of U.S. banking assets and 84% of U.S. GDP. Increasing the concentration of the banking industry and the size and systemic importance of the largest banks is directly contrary to the purposes stated in the preamble to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 “to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts.”⁷⁷

This movement of balances from MMFs to bank deposits would also result in a much larger federal safety net with fewer assets to backstop FDIC insurance. Each trillion dollars of balances shifted from MMFs to bank deposits results in the FDIC’s Bank Insurance Fund falling an additional \$20 billion below its 2% target ratio of BIF assets to covered deposits. Even without this increase, the FDIC projects that it will not reach its target ratio until at least 2020.

The existence of MMFs to hold these large, short-term corporate balances reduces the risk to the U.S. banking system by keeping them from moving across the balance sheets of U.S. banks, reducing the size of the federal safety net, and reducing the interest rate risk and funding

⁷⁵ PWG Report at 7.

⁷⁶ Letter from 33 Members of Congress to SEC (May 1, 2012). *See also* Letter from ICI to SEC (May 25, 2012); PWG Report at 34 (“If asset managers or other firms were unwilling or unable to raise the capital needed to operate the new SPBs, a sharp reduction in assets in stable NAV MMFs might diminish their capacity to supply short-term credit....”).

⁷⁷ Preamble to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

risk that these balances would otherwise present to banks. MMFs benefit the financial system by providing a relatively safe means for commercial users to store short-term liquidity away from the banking system and its explicit federal guarantee.⁷⁸

Nor do banks want a large new inflow of short-term deposits. Because of their cost structures, including the cost of capital, FDIC insurance premiums, and personnel and occupancy expense, banks cannot profitably invest deposit inflows into short-term money market assets. In order to avoid losing money on every new dollar, banks must invest the deposit inflows into loans and other long term, higher risk assets, which creates interest rate risk, funding risk and credit risk for the bank on these balances. These balances, coming in from corporate treasurers or through omnibus accounts, are often in very large dollar amounts and placed for short periods of time. The balances often exceed the FDIC deposit insurance limit of \$250,000 many times over. Relying upon this type of balance to finance a part of a bank's balance sheet creates funding risk. In a crunch, the bank may need suddenly to replace this funding source just as cash availability is becoming much more expensive and much less available. This is why some banks at times have turned away new large deposit balances or charged depositors a fee to hold the balance.

If investor balances are instead shifted to separately managed institutional investor accounts that invest directly in commercial paper, bank deposits and other money market instruments, or to STIFs, hedge funds or offshore funds, the financing remains subject to roll-over risk. Investors will choose not to renew this financing in a crisis as they shift liquidity balances to lower risk assets such as government securities and government securities MMFs. In times of uncertainty, an investor "flight to quality" will occur regardless of the structure imposed on MMFs.⁷⁹ As the European Commission recently concluded, "withdrawal [by MMFs] of deposits from banks perceived as weak only mirrors what [MMFs'] underlying shareholders would do anyway at times of stress. So [MMFs] should be seen more as a messenger of stress in the system rather than the underlying cause."⁸⁰

⁷⁸ Macey 2012 at 17-19, 29-30.

⁷⁹ See Letter from Federal Reserve Bank of Dallas to Financial Stability Oversight Council (Jan. 7, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0030> (observing that an even sharper contraction of the commercial paper market occurred during the Great Depression than during the recent financial crisis). Notably, there were no MMFs in existence during the Depression (nor had the Investment Company Act of 1940 been enacted). A similar observation could be made regarding the Panics of 1857 and 1873, the Hard Times of 1893, the Panic of 1907, and the Penn Central commercial paper panic of 1970.

⁸⁰ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 72 (Nov. 2012), http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp472_en.pdf.

(7) The current capital structure of MMFs – 100% equity capital and no debt – together with very high portfolio liquidity, credit quality and maturity requirements put in place by SEC in 2010, address redemptions concerns.

MMFs are financed exclusively by common equity capital provided by MMF shareholders. MMFs do not use leverage or other forms of debt or borrowing. The Release suggests a requirement that MMFs issue a new category of subordinated equity capital to absorb the “first loss” on defaulted portfolio securities.

With the exception of the Reserve Primary Fund itself, the main problem faced by MMFs during the financial crisis was not capital. It was liquidity. A few percentage points of junior capital does little or nothing to address liquidity problems. Instead, maintaining a short-term fixed income portfolio, which holds a large amount of ready cash and near-cash assets and essentially self-liquidates in its entirety in a relatively short period of time, provides a much better protection against a “run.”⁸¹ This is the approach taken by the SEC in Rule 2a-7, and these liquidity requirements have been made even more stringent through the 2010 amendments to that rule.

According to an analysis provided by Fidelity Investments in March of last year, MMFs held more than \$1 trillion in 7-day liquidity, many times the amount required to satisfy shareholder redemptions during the September 2008 crisis (\$310 billion) and the June through August 2011 period of the European debt crisis and U.S. debt ceiling debate (\$172 billion).⁸² Fidelity stated, “[t]he large liquidity cushions now required by Rule 2a-7 have mitigated risk without imposing exceedingly costly unintended consequences.”⁸³ Because the 2010 reforms are working to lessen the incentive to run and now require funds to have sufficient levels of liquidity to meet shareholder redemptions during periods of market stress, Fidelity said additional reforms, including a capital requirement, are unnecessary. The recent SEC staff study also reported high levels of MMF liquidity, stating, “Today, the typical prime money fund holds over one quarter of its portfolio in DLA [daily liquid assets] and nearly one half of its portfolio in

⁸¹ Hal Scott, *Interconnectedness and Contagion*, Committee on Capital Markets Regulation at 222-24 (Nov. 20, 2012), http://www.capmksreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Stephan Jank & Michael Weddow, *Sturm und Drang in Money Market Funds: When Money Market Funds Cease to be Narrow*, Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No. 20/2008 (2008); Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), <http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp>.

⁸² Letter from Fidelity Investments to SEC (Mar. 1, 2012).

⁸³ *Id.*

WLA [weekly liquid assets]. Some prime money market funds choose to hold considerably more DLA and WLA than required.”⁸⁴

The capital structure in the Proposed Recommendations would transform shareholders of MMFs essentially into depositors or creditors, who are protected against loss by a small, more junior class of shareholder, and who would not share in any upside yield. This would introduce a form of leverage to MMFs for the first time. Currently, MMFs have 100% equity capitalization. Shareholders are not guaranteed against losses. Instead, they are very clearly told that, although the fund will attempt to maintain a stable net asset value per share (generally \$1 per share) there is no guarantee that it will be able to do so, and are told very clearly that there is no federal guarantee of the value of their shares. This creates an incentive for investors not to chase yield, but instead to consider the quality of the investment portfolio of the MMF. The absence of a junior class of securities also reduces the incentive for the sponsor as the likely holder of that junior class to pursue a higher risk portfolio investment strategy in order to increase the residual return to the junior class of equity after paying the senior investor class its yield, the way, for example, that bankers and hedge fund sponsors do.

A capital buffer would be inappropriate in the MMF context.⁸⁵ As SIFMA has pointed out previously in a comment filed with the SEC, “[u]nlike banks, money market funds do not use leverage or hold non-transparent assets, and they do not have operating assets, use off-balance sheet financing or have deposit insurance. It is for these reasons that banks have capital buffers that are structured to shield the Federal Deposit Insurance Corporation, depositors and other creditors. Investors in money market funds are shareholders, not creditors. They are subject to potential loss, in return for a market return on their short-term investments.”⁸⁶ A former Federal Reserve lawyer further noted that “[c]apital may be appropriate as a loss-absorbing mechanism for banks, which are in the business of assuming credit risk on long-term loans and other assets. Unlike banks, MMFs operate subject to the strict limitations of Rule 2a-7 and are permitted to incur only minimal credit risk.”⁸⁷ Other comment letters filed with the SEC emphasized the differences between MMFs, which do not use leverage or hold non-transparent assets, have operating assets, use off-balance sheet financing or have deposit insurance, and banks, which do have these attributes and are in the business of assuming credit risk on long-term loans and other

⁸⁴ SEC Division of Risk, Strategy, and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, at 20-22 (Nov. 30, 2012), <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>.

⁸⁵ Letter from SIFMA to SEC (Jan. 10, 2011); Letter from ICI to SEC (Jan. 10, 2011).

⁸⁶ Letter from SIFMA to SEC (Jan. 10, 2011).

⁸⁷ Letter from Melanie Fein to SEC (Apr. 18, 2012).

assets.⁸⁸ Investors in MMFs are shareholders, not creditors, and subject to potential loss, in return for a market return on their short-term investments.

As Professor Macey has observed, banks are inherently unstable because “(1) their assets and liabilities are mismatched with respect to maturity and (2) their assets and liabilities are mismatched with respect to liquidity; (3) their assets are opaque and thus hard to monitor; and (4) banks are very thinly capitalized.”⁸⁹ In contrast, Professor Macey concluded that “the assets held by MMFs are more liquid, more transparent, easier to value, and better match the liabilities in terms of maturity and liquidity than assets held by banks and other financial institutions.”⁹⁰

To put it another way, it is very hard to know what a bank's assets (the left-hand side of its balance sheet) are worth or how much money a bank would get if it had to sell them. Banks finance their portfolios primarily with deposits and other promises to repay creditors a fixed principal amount plus interest (together with equity capital, the right-hand side of the balance sheet). Most of these bank debt obligations are medium and near term deposits and borrowings. Bank assets are medium and long-term, most not publicly offered or traded, with most loans originated by the bank in privately negotiated loan transactions. These assets are carried at historical cost on the bank's balance sheet which may or may not reflect their current value. The Federal Reserve and other banking agencies have fought a long public relations and legislative battle to prevent the SEC and the accounting profession from requiring banks to calculate and publicly disclose the current value of their assets.⁹¹ Capital provides a cushion or fudge factor between the unknown current value of a bank's assets and the fixed and certain amount the bank must repay its creditors.

⁸⁸ Letter from SIFMA to SEC (Jan. 10, 2011). *See also* Letter from Melanie Fein to SEC (Apr. 18, 2012).

⁸⁹ Macey 2012 at 17-18.

⁹⁰ *Id.* at 28.

⁹¹ *See* SEC Office of the Chief Accountant, Division of Corporation Finance, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* (2009), <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>; Elizabeth Blankespoor, Thomas J. Linsmeier, & Catherine Shakespeare, *Fair value accounting for financial instruments: Does it improve the association between bank leverage and credit risk?* (Stanford Graduate Business School Research Paper No. 2107 (June 2012), <https://gsbapps.stanford.edu/researchpapers/library/RP2107.pdf>); Christian Laux and Christian Leuz, *Did Fair-Value Accounting Contribute to the Financial Crisis?* 24 *Journal of Economic Perspectives* 93 (Winter 2010), <http://nd.edu/~carecob/April2011Conference/LeuzPaper.pdf>; William R. Emmons, *Fair Value Accounting: Don't Shoot The Messenger*, Federal Reserve Bank of St. Louis, Central Banker (Summer 2009), <http://www.stlouisfed.org/publications/cb/articles/?id=1332>; Joyce Joseph-Bell, Ron Joas, and Neri Bukspan, *Banks: The Fight over Fair Value*, Bloomberg/Businessweek, Markets & Finance (Oct. 15, 2008), <http://www.businessweek.com/stories/2008-10-15/banks-the-fight-over-fair-value-businessweek-business-news-stock-market-and-financial-advice>; Sanders Shaffer, *Evaluating the Impact of Fair Value Accounting on Financial Institutions: Implications for Accounting Standards Setting and Bank Supervision*, Federal Reserve Bank of Boston, Working Paper No. QAU 12-01 (Dec. 31, 2011), <http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1201.pdf>.

In contrast, the assets of an MMF have a known current value and it is easy to determine what the MMF will get for them if sold. MMF assets are purchased in transactions from public reporting issuers and have very short maturities. On average, MMF portfolio assets have been purchased within the past thirty days and will be repaid within the next sixty days. The portfolio of an MMF is almost entirely replaced every few months. Although they are carried at historical/amortized cost, MMFs also calculate and disclose the current value of their portfolio assets, and MMF boards under SEC rules are permitted to use amortized cost only so long as the board believes it fairly reflects the market-based net asset value per share. In contrast to bank assets, because of the very short maturity and high credit quality of MMF assets, the difference between the amortized cost and current value of MMF assets is negligible.⁹² MMF assets are financed entirely by equity, not debt, and there is no obligation to pay equity holders a set amount on redemption. MMF shareholders have a right only to a pro rata piece of the current value of the MMF's portfolio as of the end of the day on which the redemption request is processed. Unlike at banks, there is no need at an MMF for a separate subordinated capital layer to serve as a buffer or fudge factor between the value of the portfolio assets shown on the left-hand side of the balance sheet and the amount due to stakeholders on the right hand side of the balance sheet.

The Council's capital proposal in Alternative Three would also impose on MMFs, in addition to a new form of subordinated capital, other heightened standards such as additional liquidity requirements, additional diversification/counterparty credit limit standards, additional disclosure requirements, or other as-yet unspecified requirements. MMFs have long been subject to requirements of these sorts, and the SEC's 2010 Amendments to Rule 2a-7 provided enhancements to these requirements. We believe it is appropriate for the SEC to periodically consider changes to these requirements as they have from time to time in the past. There may be incremental changes to Rule 2a-7 that could further enhance the stability of MMFs and investor understanding of MMFs.

Without a specific proposal on these additional standards, however, it is difficult in the abstract to provide specific comments. Care should be taken not to make MMFs less stable and more subject to risk by imposing tighter standards without consideration of all of the potential consequences and costs. For example, by setting lower limits on the exposure of an MMF to a particular issuer, the MMF would be required to move the overage currently invested in those issuers into other issuers in which it otherwise would not have invested (or invest a larger

⁹² SEC Division of Risk, Strategy, and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* at pp 26-30 (Nov. 30, 2012), <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>; Robert Comment, *Do Money Market Funds Require Further Reform?* (Nov. 23, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2174125; Blackwell, Troske & Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk*, U.S. Chamber of Commerce Center for Capital Markets Competitiveness (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf.

amount than it otherwise might have invested). This could result in a systematic shift of a portion of portfolio assets from the soundest credits (as viewed by the MMF's investment adviser) to weaker credits. While this may reduce the exposure of the MMF to any one issuer as a percentage basis, it would increase the overall exposure of the portfolio to weaker credits or to credits about which the investment adviser has less information. Diversification is good, but at some point becomes counterproductive. Similarly, a shift towards greater liquidity would further reduce portfolio returns, which would have the triple effect of making MMFs less attractive to investors, further reduce the ability of the MMF to generate or pay for a new layer of junior capital, and further push the financing available to issuers in the money markets towards shorter maturities, something that the Council understands is not optimal. Given the extraordinary liquidity currently required under Rule 2a-7 and the even larger amounts of liquidity actually held by MMFs (well over 40% of AUM, totaling over \$1 trillion, in seven-day liquid assets) of roughly triple the amount redeemed from MMFs during the week of September 15, 2008, adding further to liquidity requirements may be counterproductive.

As noted at the beginning of this paper, the innuendo of the Council's Release is that, due to imperfections in their capital structure, MMFs caused the 2007-2009 financial crisis.⁹³ This is easily disproved by a glance at a timeline of the financial crisis and the order in which markets and financial institutions came unglued. MMFs did not cause the 2007-2009 financial crisis. Even the European Commission has concluded,

[I]n the context of the financial crisis, it must be noted that the underlying cause of risks to financial stability operating through money market funds did not originate in money markets. In particular, risks arose within the banking sector (due to securitised loan assets) that fed through to prime MMFs and due to the behaviour of investors in response to falling NAVs. Moreover, the impact on MMF investors in terms of realised losses were either zero or very small (Macey, 2011).⁹⁴

In other words, banks and the banking system are the primary risk to financial stability. MMFs are not the problem. The capital structure of MMFs is not the problem. Turning MMFs into banks or bank-like entities with bank-like capital structures, or eliminating or shrinking MMFs, will not reduce systemic risks, it will increase systemic risks by concentrating an even larger percentage of financial intermediation into the banking system and a handful of the largest banks.

⁹³ Release at 69455-56, 69460.

⁹⁴ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 66 (Nov. 2012).

Conclusion. MMFs are financed 100% by common equity. MMFs do not use debt or other forms of leverage. The Council’s capital proposals would, for the first time, introduce financial leverage to MMFs. The change in capital structure proposed by the Council are not needed and would make MMFs less stable rather than more stable in the event of a financial crisis.

The stated purpose of the change is to reduce the risk of “runs” on MMFs (sustained investor redemptions) created by a hypothetical “first-mover advantage” that the Council believes incents investors to redeem at the first sign of trouble in MMFs. What prevents and stops runs is not capital, however, but large amounts of available liquidity and high credit quality. The SEC has already acted to bolster MMF liquidity and credit quality through the 2010 amendments to Rule 2a-7. Capital does not prevent runs at banks, and there is no reason to believe it will prevent investor redemptions at MMFs.

As for the “first-mover advantage”, in the current structure it can occur only if the MMF’s board fails in its duty to immediately recognize a decrease in value of shares when there is a portfolio event that would cause the MMF to break the buck, as happened at the Reserve Primary Fund in September 2008. The introduction of a subordinated capital tranche as proposed by the Council would provide a lag time between the first sign of trouble in an MMF’s portfolio and a hit to the value of the senior shares that would *create* an incentive and an opportunity for an MMF’s senior shareholders to redeem early in hopes of getting paid in full before the capital buffer is exhausted.

To the extent that the Council capital proposals could be implemented at all, they would be sufficiently expensive to investors, issuers that obtain financing from MMFs, and MMF sponsors, to result in a dramatic shrinkage in MMFs. This would cause investors to move liquidity balances elsewhere: to “Too Big to Fail” SIFI banks that are more risky and less efficient *and* require massive federal government support to stay afloat; to individually-managed investment accounts for the largest investor entities to invest directly in commercial paper, bank notes and other money market instruments; or to STIFs, hedge funds and offshore investment vehicles that are less transparent, less regulated, less efficient and result in the same “roll-over risk” for issuers in the money markets that the Council apparently wants to ameliorate through its plan to change the structure of MMFs.⁹⁵

The Council’s suggested changes to the capital structure of MMFs should not be proposed or adopted. If implemented, they will shrink MMFs, raise the cost and limit the availability of short-term credit, and harm borrowers, investors and the economy.

⁹⁵ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 72 (Nov. 2012); Macey 2012 at 28, 35-41.