

January 5, 2011

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

Re: File Number 4-619
Comment Letter on President's Working Group Report on Money Market Fund Reform

Dear Ms. Murphy:

The **Report on Money Market Fund Reform** by the PWG is well-written and there seems to be a clear understanding by its authors of what is at stake. "Without additional reforms to more fully mitigate the risk of a run spreading among MMFs, the actions to support the MMF industry that the U.S. government took beginning in 2008 may create an expectation for similar government support during future financial crises, and the resulting moral hazard may make crises in the MMF industry more frequent than the historical record would suggest." (PWG Report - p. 18)

The PWG Report discusses a number of policy options and describes possible reactions to each. But it fails to make recommendations and does not assess the probability of the market reactions nor estimate the dollar magnitude associated with each. Without such critical analysis, the Report will serve only as "background information" for the real analysis that now must be undertaken by the FSOC.

As a person with extensive money fund industry experience (30+ years) and no vested self interest, I can offer some objective observations and recommendations to the FSOC.

Money Fund Product Flaws

I am a huge fan of MMFs and spent most of my career working in the industry in one way or another. Since the MMF's inception in the early 1970's, it has become clear to me that the original product structure has been overwhelmed by risks that have grown faster than industry assets. Consider the fact that it holds the promise of a stable transaction price of \$1.00 per share while it has \$2.8 trillion of one-day liabilities mismatched against portfolio securities with maturities out as far as 397 days. The maturity, liquidity, credit risk associated with that mismatch is enormous and there is no official emergency liquidity facility, no reserves, no capital, and no access to committed capital. There are no other stable value products that do not have collateral, capital, or a contractual guarantee to support fulfillment of the \$1.00 per share expectation. The original premise under which the SEC agreed to allow amortized cost valuation (stable NAV) was then based upon the belief that money market securities rarely fluctuated in value and that there was a relatively fluid secondary market to accommodate the few sales that might be needed to meet redemption requests. We now know that valuations of money market securities do fluctuate, that market makers are disappearing, and the ones that remain are unreliable when needed in a crisis. In addition, the institutional segment of the market barely existed in the late 1970's. But now, institutions account for about 70% of assets and are generally quite volatile due to hyper-yield sensitivity. The mounting liquidity risks which

were highlighted by the meltdown and emergency bailout require product reforms that go beyond those adopted by the SEC.

Although MMF sponsors and institutional investors continue to oppose product reforms, it must be remembered that good public policy is often unpopular. If MMF sponsors act responsibly now with regard to accepting the need for product reforms, then the industry might be able to restore investor confidence on a stand-alone basis. Investor confidence now only exists due to the palpable perception that federal government support continues to be available (and at no cost to sponsors).

Liquidity Risk

Let us agree that liquidity risk is still the major threat to MMFs (and, by extension, the whole U.S. financial system). More specifically, the bulk of the threat derives from the institutional investor market sector where MMFs are subject to billion dollar same-day redemption requests from individual corporate or institutional investors. The recent SEC reforms did not reduce the probability of future panicky redemption runs. They only codified certain fund liquid asset requirements in the hope of meeting redemptions. But most MMFs already met those liquid asset requirements before the run on The Reserve Fund. In fact, that incident most likely increased the probability of another redemption run because opportunistic institutional investors saw how important it was to get out at \$1.00 per share before the situation got worse. The “solution” must reduce that probability.

Who absorbs the overnight liquidity risk? Presently, each fund is mandated to hold 10% of assets to meet daily redemptions portfolio securities. If more than 10% of a MMF is called for redemption in a single day, there is serious volatility among its shareholders and in the marketplace. So the ability to sell additional securities at amortized cost is in question. At that point, is the sponsor ready, willing, and able to help out with a liquidity infusion or security lift-out? Why are institutional investors so carefully protected from risk? Ever since the introduction of Rule 2a-7, investors have been getting a really good deal. Essentially, their principal was protected either by the amortized cost accounting method or by the sponsors’ willingness to cover losses for them. At the same time, they have been receiving yields that exceed levels they would have received by investing in overnight commercial paper on their own. It was one thing when a sponsor was willing to protect its shareholders with its own resources, but the equation changed when the federal government was forced to bail out the industry, and could be called upon to do so again.

Critical questions are:

1. Are MMF sponsors able to absorb all of the liquidity risks for a \$2.8 trillion industry whose product promises same-day availability at a constant \$1.00 per share? Apparently not.
2. Should the federal government be obligated to provide another bailout at no cost to the industry? Of course not.
3. Why has the investor been able to avoid all risks? Shouldn’t the liquidity solution involve transferring some of the liquidity risk back to investors?

Recommendations to FSOC on Systemic Liquidity Risk –

As mentioned above, the bulk of the liquidity problem resides with institutional prime and institutional tax free MMFs, so my recommendations (in order of preference) are specific to them. All retail MMFs and institutional government MMFs do not have a liquidity problem due to the nature of the investor type or portfolio securities and should continue to use amortized cost accounting with no restrictions on redemptions.

A. Preferred Option #1 – Shift some of the liquidity risk back to investors.

Retain the stable NAV but the SEC would mandate each of the following measures for institutional prime MMFs and institutional tax free MMFs:

- a. Place definitive asset restrictions on “hot money”, i.e. from securities lenders, asset-liability managers, or any client who appears willing to redeem suddenly to pursue a slightly higher yield (1-5 basis points). For example: hot money asset limits, maximum dollar redemptions for the fund per day or per client per day, etc.
- b. Place restrictions on total assets received from independent electronic trading portals which use omnibus trading accounts where the fund is not able to establish a direct client relationship. These trading portals are capable of blindsiding a fund with massive redemptions for same-day settlement. In fact, portals facilitate MMF volatility by comparing daily yields and encouraging clients to move to the highest yielding funds. There should be limits on the percentage of a fund’s assets that may be derived from independent portals (where there is no client-fund relationship) and limits on the amount taken per individual portal.
- c. Have the ability to place redemption restrictions on any client account at any time, e.g. dollar limits per day. (This may already appear in some prospectuses.)
- d. Allow the temporary suspension of cash redemption orders without requiring liquidation of the fund. At the same time, as an alternative, allow redemption in kind at amortized cost using the least liquid and lowest quality securities in the portfolio. I envision a process of approval whereby any institutional prime or tax free MMF can request approval from the FSOC (or SEC) to suspend cash redemptions (and allow RIK). After a swift review of the request, the FSCO/SEC could issue an order for a suspension of cash redemptions/RIK that would apply to all institutional prime and tax free MMFs in order to avoid stigmatizing any particular MMF. That would stop the redemption run in its tracks and would allow investors to assess the situation with less emotion and more facts. At the same time, it would protect passive investors. If a few MMFs are really having a problem, it would be due to credit, not liquidity and the sponsor can then deal with that situation (i.e. recapitalize or liquidate). The FSOC/SEC can lift the order when the storm has passed and normal redemptions can resume. There should be new language inserted in prospectuses to disclose this new procedure and make it clear that the FSOC/SEC will be inclined to use it often, if necessary.

B. Preferred Option #2 – The next option to consider is to use a two-tiered system of MMFs in which retail MMFs and institutional government MMFs continue to use a stable NAV while institutional prime MMFs and tax free MMFs would convert to a floating NAV. The floating NAV creates the potential for shareholders to realize a loss or exacerbate losses amidst a

panic redemption. It should cause them to be less emotional and more analytical before they redeem, thereby reducing, but not eliminating, systemic liquidity risk.

When contemplating a two-tiered system with a stable NAV for retail funds and a floating NAV for institutional MMFs, industry sponsors have previously complained that they are unable to determine the difference between “retail investors” and “institutional investors”. It seems that this argument is somewhat of a smoke screen. For liquidity risk purposes, it is relatively easy to distinguish one from the other by identifying the decision-maker who initially selects the MMF and transmits the redemption orders. For example, a trust bank cash sweep program may contain 30,000 individuals each with an average balance of \$5,000. While some may say that these are retail investors, for liquidity risk purposes, this client is clearly institutional because the selection of a specific fund was made by the manager of the bank’s cash operations unit and that person’s operatives decide when to redeem whether it is due to a credit concern or a need to receive a higher yield or higher 12b-1 fees. The bottom line is that, if sponsors are unable or unwilling to isolate the more volatile money from the stable money, then the FSOC should institute a Floating Rate NAV for both types of MMFs.

- C. **Preferred Option #3** (the last resort) - If the money fund industry resists the reasonable options listed above, then FSOC should mandate that institutional prime and tax free MMFs be converted into special purpose deposit-taking banks with appropriate regulation, capital, and reserves. As long as the federal government continues to be the only viable source of large scale back-up liquidity for MMFs, it is intellectually dishonest to pretend that MMFs are not the functional equivalent of deposit-taking banks. Thus, inclusion in the federal banking system is warranted.

Recommendations to FSOC on Credit Risk and Credit Ratings

Although the SEC has recently “tightened” certain aspects of credit risk in MMFs, they will not be very effective because the new rules are still based on NRSRO credit ratings. There is still a glaring conflict of interest in the business model of rating agencies in that issuers pay to be rated. How can an investor rely on ratings that are created for the benefit of the issuer? The second weakness in the credit review process is that there are still too many MMF sponsors that are understaffed relative to the number of “approved issuers” that are supposedly being monitored. What is a prudent ratio of analysts-to-approved credit issuers? Can three fully dedicated analysts safely monitor 500 approved issuers? And when a credit research department is understaffed, analysts become more reliant upon a credit rating which, as we have seen countless times, is a lagging indicator of credit deterioration, especially under the business model where the issuer is the revenue-paying client. Therefore, if the SEC (and many corporate investors) still want to continue to use credit ratings as the basis for portfolio safety, it should: 1) require rating agencies to change their business model to one where investors pay for objective ratings and, 2) establish guidelines for a “fully staffed” credit research operation to ensure that there will not be undue reliance on credit ratings.

Specific Comments on Policy Options

1. Floating Net Asset Value

- a. If the FSOC goal is to reduce systemic liquidity risk associated with MMFs and sharply reduce the need for future government bailouts, I firmly believe that conversion to a floating NAV is a viable option. But it would not be my first choice.

(See “Recommendations” above.) The PWG Report was very clear in explaining how a mark-to-market valuation would spread any losses equitably and thereby remove some of the incentive to race to the exit in times of market disruption. The floating NAV is clearly not a favorite of investors who have come to view the MMF as a riskless investment and do not want to give up the free lunch. That is human nature. But is it good public policy for the federal government to be the industry’s liquidity backstop at no cost to sponsors or investors?

- b. Opponents of this option mention that some investors might shift assets to other unregulated vehicles. First, the departure of the most abusive, opportunistic institutional investors would actually reduce the risk for remaining investors and result in a safer product. Second, the feared migration to unregulated funds has not been quantified and is probably overstated. In addition, the capacity for existing unregulated funds is relatively small and the operators of such funds may not welcome a flood of hot money with riskless expectations. Third, bear in mind that institutional investors regularly invest directly in the money markets either using an in-house staff or by using external separately managed accounts. However, in both cases, they must provide for their own liquidity.
- c. Opponents have been particularly shrill with their concern that the floating NAV would result in lower MMF assets leading to a reduced supply of credit and, ultimately, higher financing costs. This is a rather lame rationale. First, there is no way of quantifying this prediction. Second, the SEC approved the creation of MMFs solely as an investment vehicle for retail investors and not as a means of providing low-cost financing to businesses, institutions, or state and local governments. None of the SEC, the U.S. Treasury, or the Fed believes that MMFs are an entitlement for borrowers in the market for short term financing. Third, any cash that moves out of MMFs due to a conversion to a floating NAV would not “disappear” as a source of financing. The same amount of debt instruments would instead be absorbed through purchases directly by institutional investors and non-MMF asset managers.
- d. Opponents cite concerns about a sudden withdrawal of assets from stable NAV MMFs. The conversion would be managed in a number of steps and the Fed would be able to provide liquidity during the transition period, much like it did during the MMF bailout.
- e. Opponents cite concerns that a floating NAV would produce significant price variation and create nuisance gains and losses. First, any competent portfolio manager should be able to manage the fund such that there is very little variation in daily mark-to-market valuation. Second, in order to ease the transition to a floating NAV, the U.S. Treasury and the IRS should be able to construct new rules that simplify accounting for MMFs. This is not an insurmountable challenge especially if it accomplishes the goal of shifting liquidity risk from sponsors and the federal government to opportunistic institutional investors.
- f. The PWG Report suggests that one risk to a conversion to floating NAV would be a deterioration of discipline (p. 22) in the management of MMFs. On the contrary, institutional investors will become even more diligent in their scrutiny of MMFs and,

instead of relying on SEC guidelines (amortized cost) for principal protection; the market will provide the discipline to toe the line. The weak players who have hidden behind the cushion of amortized cost valuation and sloppy pricing practices will be quickly identified and weeded out while the stronger ones who are able to manage with low NAV volatility would be rewarded with more assets.

- g. The fifth concern (p.22) is almost incomprehensible and certainly far-fetched. It suggests that, on one hand, a floating NAV may be difficult to implement and, on the other, that it might result in such rare or miniscule NAV changes that investors would not notice the difference until there was a minor price change. At that point, they might react to a change by suddenly redeeming. Let me remind readers that the proposed change should only apply to institutional MMFs. (Retail investors are very stable.) Institutional investors are keenly aware of these proceedings. If there is a conversion, they will be very familiar with the possibility of a NAV change and will have established their own level of tolerance to price change. There will be no surprises on the rare occasion when there is a change in the NAV unless it is due to a sudden deterioration in credit. These institutional investors will also know that if they overreact by bolting from the fund, that they could create more losses and might then hesitate to redeem. From a regulatory point of view, at least the losses will be shared equitably unlike the current situation under a stable NAV where the first to redeem are taken out at \$1.00 per share while passive investors absorb all the losses.

2. Private Emergency Liquidity Facilities for MMFs

The idea of an industry-sponsored private liquidity facility has a great deal of conceptual appeal, especially to the FSOC for obvious reasons. Indeed, the tenor of its arguments in the section beginning on p.23 suggests that this is the FSOC's "preferred option".

Nevertheless, this "solution" is short on specifics. Presumably it involves the creation of a MMF industry operated bank. If so, in an emergency, this bank would use its privileged access to the Fed to gain liquidity for all its owner/sponsor MMFs.

- Would such bank be sufficiently capitalized to support numerous trips to the Fed's discount window with requests for as much as \$1 trillion in collateralized loans over the course of 3-5 days?
- If not fully capitalized to support \$1 trillion from the onset of a run, how would it give investors the confidence that their liquidity needs would be met? Without that confidence, institutional investors will bolt just as fast as if there were no private facility in the first place.
- In a panic-stricken market, how do you value such collateral? Reminder: in 2008 there NO bids on AAA-rated commercial paper during the run on MMFs during the week that Lehman Brothers failed. (It is curious how pricing services managed to value securities in MMFs for which there were no bids.)
- Would this MMF industry bank have enough capital to absorb collateral valuation losses? For example, if collateral losses were only 0.5%, the capital loss on \$1 trillion would be \$5 billion. What de novo bank would have that much capital as it opens its doors? If the initial capital is substantially smaller, collateral valuation losses would be shared by the shareholders in the MMFs. Under that scenario, investors would still bolt in order to avoid the being in a

position in which their MMF broke the buck in absorbing its share of losses from the bank's collateral as well as any possible remaining bad credits in the MMF. Or is the Fed supposed to accept any and all collateral at amortized cost?

Bottom Line: This is an attractive concept because it attempts to shift the cost and responsibility for liquidity risk to fund sponsors. But there is a drawback in that it still does not require investors to absorb much of the risk. Nevertheless, this is academic because the facility is extremely unlikely to reach a useful critical mass for many, many years. In the meantime, the federal government would remain the de facto liquidity backstop for the MMF industry.

3. Mandatory Redemptions in Kind

For future redemption runs on institutional MMFs, as mentioned in my recommendations above, I favor redemption in kind as one of the available tools for fund managers. It could be used in combination with a suspension of cash redemptions. As emotions rise, it would be useful in forcing shareholders to evaluate the situation more carefully before redeeming because it could result in a loss for them that may not be necessary.

4. Insurance for MMFs

Credit insurance on MMFs, in theory, might offer some comfort to shareholders by absorbing a portion of realized credit losses. However, previous efforts to insure MMFs have not been successful because of relatively low coverage amounts, high deductibles, high premiums, and a paucity of insurance providers. The same barriers remain today. The more pertinent point is that credit insurance has not and most likely will not stave off a redemption run in a panic. This is a liquidity issue, not a credit issue.

If the FSOC vision is a form of "deposit insurance" in which a highly capitalized and extremely liquid private entity were to "guarantee" full and timely payment on a same-day basis, then this option is too hopeful. There is no such private entity. As with the Private Liquidity Facility, a newly dedicated entity would take decades to accumulate a sizeable insurance pool of deposit insurance fees that are necessary to make it effective. For example, if institutional MMFs held \$1 trillion in assets and were charged 2 basis points each year as insurance premiums to absorb losses and provide liquidity during a redemption run, that would only raise \$200 million in pool assets per year. After 20 years, assuming no losses, capital assets would reach only \$4 billion, and that would not halt a liquidity panic.

5. Two-Tier Systems of MMFs

I have described above in Preferred Option #2 that I support a variation of a two-tiered system. I believe that retail MMFs do not represent a liquidity risk and, therefore, do not need to be changed. (In fact, some of the SEC recent reforms that applied to retail MMFs were unnecessary in light of their historical stability.) I believe also that institutional government MMFs do not need additional reforms because, in a panic, their securities usually gain in value and additional money usually flows into the funds. The systemic risk problem stems from institutional prime MMFs and, to some degree, institutional tax free MMFs both of which attract highly volatile, opportunistic, and well informed professional investors. That is where the focus of any solution should be.

If my Preferred Option #1 is rejected, then I favor conversion of institutional prime and institutional tax free MMFs into floating NAV funds.

6. Regulating Stable NAV MMFs as Special Purpose Banks

The PWG Report did a great job of outlining the considerations for Special Purpose Banks (p.32). This option would obviously be the last resort in seeking a solution to systemic liquidity risk. Although the SPB would not need as much capital as a traditional commercial bank, it would still require a huge amount that would be uneconomical. While conceptually a valid approach, it would be a drastic change with many complex issues requiring a great deal of study. In the meantime, the focus should be on policy options that are achievable in the near future before there is another redemption run.

7. Enhanced Constraints on Unregulated MMF Substitutes

I believe it is premature to assume that changes to the current MMF product structure will lead to massive flows into unregulated funds such as private placement cash vehicles managed by securities lender cash reinvestment units, cash plus, enhanced cash, or stable value.

Regardless of the ultimate solution adopted by the FSOC relative to domestic MMFs, I do support some additional oversight for unregulated funds such as requiring them to use mark-to-market valuation (floating NAV) if they do not adhere to all money fund rules. Such funds typically achieve higher returns by investing in longer maturities (out to 5 years) and lower credit quality. But they still offer daily liquidity and very often use amortized cost valuation which stabilizes the NAV but masks the portfolio risks which are substantially greater than traditional MMFs.

Thank you for the opportunity to share my comments on this important matter.

Sincerely,



John M. Winters, CFA

