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Via SEC Internet Comment Form

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

Re: File No. S7-11-09
Release No. IC-28807
Money Market Reform

To the Commission:

This letter offers a specific proposal for the regulation of Money Market Funds (MMFs). The proposal responds to comments made at the Commission's Roundtable Discussion on May 10, 2011 and the public comments on the President's Working Group report on Money Market Fund Reform, per Investment Company Act Release No. IC-29497. I respectfully request that this correspondence be included in the record of the Commission's rule-making in this area.

I will assume without further argument a general consensus that the Commission's prior Money Market Fund reforms ("the Reforms") – which require more liquidity and portfolios of shorter maturity and higher quality – are insufficient to address the systemic risks of this particular financial intermediary. These Reforms do not address a central weakness: the inability of MMFs to bear the default of *any* portfolio security. Presumably a MMF is not entitled to use amortized cost accounting for a security that has defaulted and penny-rounding is also unlikely to be available. [1] Unless the Fund's sponsor steps in to buy the defaulted security at par, the Fund will "break the buck." The Reforms at best partially address the limited capacity of MMFs to bear market risk associated with increased default risk of assets on MMF balance sheets, which can reduce

[1] See Investment Company Act Rule 2a-7(c) (2010) (use of either amortized cost or penny rounding requires directors' good faith belief that such valuation "fairly reflects the market-based net asset value per share").

the market value of a Fund's portfolio below the permitted lower bound under penny-rounding. The Reforms have value because tightened credit quality should reduce value fluctuations, and greater liquidity and shorter maturities make it more likely that a Fund would be able to satisfy redemption requests without a "fire sale" disposition of Fund assets, thus reducing the risks of a negative valuation spiral.

In response to the proposals discussed in President's Working Group, three main reform proposals have emerged. The first is to permit net asset values (NAV) to float, in order to desensitize investors to relatively small valuation fluctuations in money market funds. The second is to create a liquidity back-up facility that could lend against money market fund assets at par, to avoid asset fire sales that would depress values. The third is to provide a capital cushion that could absorb losses in respect of a default on a portfolio security or upon the below-par sale of a portfolio asset. In my view the third general proposal, for a capital cushion, is the best approach for addressing the systemic risks of money market funds, given existing practical constraints, including the desirability of a proposal that can be effectuated under existing statutory authority. This letter offers a specific proposal designed to achieve goals of systemic stability and simplicity in implementation.

The proposal in rough form is this: All money market funds will issue two classes of equity, Class A, designed to retain a fixed NAV, and Class B, whose value will float to cover outright defaults or depreciation in market value of portfolio securities. Class B issuances must equal (or exceed) the largest single portfolio position permitted by regulation or by the fund's fundamental policy (a self-imposed limitation) plus an additional amount to reflect the risk of a general decline in money market asset values outside of such a default. Because Class B is loss bearing, Class A will be able to retain a fixed NAV in virtually all circumstances.[2] The proposal treats institutional funds and retail funds differently as to the source of the Class B capital. For institutional funds, the investors in the fund must buy the class B shares; for retail funds, the sponsor must buy the Class B shares. The following discussion therefore treats these two types of funds separately. The discussion also separately treats government funds.

Institutional Funds. Others such as the Squam Lake group have proposed a two class structure to provide an equity cushion.[3] The novel element of my proposal is the source of the equity: investors in institutional funds will provide the additional equity, as follows. An investor will initially be required to buy a "unit" that consists of Class A and Class B shares. However, the investor's subsequent purchases and redemptions of Class

[2] In the event that the combination of default losses and market value losses exceed the Class B buffer, then the fund should suspend redemptions and liquidate. See below.
[3] See Squam Lake Group, Reforming Money Market Funds (Jan. 14, 2011).

A shares need not be accompanied by the purchase of additional Class B shares so long as the investor's Class B ownership is at least as large as the required initial ratio.

An example will illustrate: Assume the required capital cushion is 5 percent. Then a party putting $100 in an institutional fund would buy a "unit" $95 of Class A shares and $5 of Class B. Each day the net asset value of the unit would be measured at fair market value. Any variation from par would be allocated to the Class B shares, which floats; the Class A shares would retain a fixed NAV. Thus although the value of the unit may fluctuate, the Class A NAV remains fixed.

Assume further that the party redeems $10 of Class A shares. It can choose to retain its corresponding investment in Class B shares ($.50 in this example), meaning that when it subsequently buys (up to) $10 in Class A, no further Class B purchases are required. Should it want to redeem the Class B shares, it can, but only a week later, at the then-NAV of those shares.

Notice what this proposal accomplishes: it requires the users of institutional money market funds to supply the capital necessary for their stability and it creates disincentives for such investors to "run." These are advantages over proposals that contemplate sale of Class B shares to a separate group of capital suppliers. In particular, the "unit" concept means that an investor who "ran" by redeeming Class A shares at par at a time of falling asset values could not thereby impose losses on non-redeeming investors. The losses would be borne by the matched Class B shares, including shares held by the "running" investor, which cannot be disposed of except after a week's lag.

The unit concept therefore provides an additional element of systemic stability beyond proposals that just call for a capital cushion. A capital cushion cannot, by itself, fully protect against runs. Even if the capital could absorb the loss of the largest portfolio position, another default could break through the Class B. Thus in periods of financial instability, runs remain a threat despite first loss protection, because the run strategy presents no downside for the individual running investor. A Class A/Class B unit changes the dynamic. Default risk, especially risk of multiple defaults that break through the Class B, is fact low. By contrast, given a run, the chance of fire sale losses is much higher. A holder of matching Class B shares now sees downside in the decision to run, with a much greater probability of loss because of the run itself. The combination of the capital layer and the unit approach should significantly increase money market fund stability.

What share of the fund's capital should be represented by the Class B shares; meaning, how large an equity cushion? One straightforward approach is this: the Class

B percentage should at least equal the largest permitted portfolio position plus an additional amount to reflect the volatility of asset values apart from a default on that position. In the unlikely event of a default, the potential loss of an unsecured debt position is total (as with Lehman Brothers commercial paper). An additional cushion should be available to cover market value losses of securities that have not defaulted. So, if the fund was permitted by the SEC regulation and the fund's fundamental policy to invest up to 5 percent of the securities of any given issuer, the relevant history suggests that the right amount of capital should be 5.5 percent.[4] But this 5.5 percent in Class B shares is not particularly costly for the investor, because the full unit will be invested in portfolio securities. Default, after all, will be a very low probability risk. In normal times, the only cost is the diminished liquidity of a week's delay for complete close-out of a position at the fund. This is a small cost.

In the debate around the President's Working Group report, institutional users of money market funds have strenuously argued on behalf of fixed NAV as an essential feature. Fixed NAV makes money market fund transactions as smooth as cash transactions at a bank, avoiding the accounting and tax issues that would burden MMF transactions with costs and inconvenience. Such a non-bank transaction account comes at a cost, however, in terms of systemic stability. It seems entirely right that the beneficiaries of such accounts should internalize those costs, which this proposal for a Class A/Class B unit does.

Think of it this way: Money market funds permit institutional users to outsource the cash management function while obtaining money market rates that have been higher on average than bank rates. MMFs provide efficient diversification and credit investigation in money market instruments. If MMFs did not exist, large institutions would have to assemble their own staffs to perform such functions. Purchase of the Class B shares is an efficient alternative to such on-going costs; it can be seen as a relatively small one-time commitment that provides indefinite benefits, not unlike being required to maintain a minimum balance in a bank account to obtain its benefits.

[4] This figure reflects a .5% volatility bound drawn from prior MMF experience that funds rarely "broke the buck" (i.e., exceeded that bound) even without sponsor support. The volatility percentage could be set on the basis of historical data, for example, by looking at the lowest bound of average MMF "shadow" NAVs during fall 2008, without giving effect to sponsor support. Conceivably funds could lower the required volatility cushion by a fundamental policy that limited assets to particular classes of low volatility assets. This would be relevant in setting the capital policy for government funds or funds that promised a specific mix of prime and government assets.

As noted above, a fund could reduce required capital by limiting portfolio positions through its fundamental policy, but there should be a minimum level of capital for all funds, because of the correlation risk, meaning the risk of default contagion among issuers with counterparty relationships or similar business models.

Moreover, in forcing investors to internalize some of the costs of a run, the unit approach reduces the risk of a run in the first place. There are two reasons investors might run. If investors lose confidence in a broad asset class, they will want to quickly disinvest, even if their position suffers a loss, before further defaults materialize. But in the case of money market instruments, default risk is quite low, as demonstrated by the 2008-09 financial crisis. A more common source of run risk arises from the collective action problem: if there is slightest risk of loss, an investor wants to be at the head of the disinvesting line to maximize the chance for a full payout. If all costs are borne by others, why not run? By contrast, internalization of this risk among the Class A holders (through their matching Class B positions) is likely to produce a cooperative outcome of "don't run."

In short the proposal promotes systemic stability for two reasons: Knowing that there is a mechanism for loss-bearing that protects the liquid Class A shares reduces the incentive to run. Knowing that all Class A shareholders will internalize some of the run costs also will reduce the propensity to run.

Moreover, the proposal will have an additional pro-stability effect in the money market fund world by reducing the "hot money" character of institutional behavior. Currently corporate treasurers monitor money market fund rates via portals that let them quickly switch to pursue higher yield, or perhaps in troubled times, to pursue greater safety. The small liquidity costs of the Class A/Class B unit structure would add a friction to rapid switching. For example, assume an investor had placed $100,000 with Fund One but saw that Fund Two paid 10 basis points more. The investor's initial purchase of Fund One shares would have been split between Class A shares, $94,500, and Class B, $5500. The one week delay in Class B redemption means that the investor could immediately move no more than $99,450, which itself would be allocated between the Class A and Class B. Rapid switching among several different money market funds would entail accumulating liquidity costs, frictions that would reduce the underlying activity.

The remaining questions relate to addressing circumstances of defaults and value changes to the Class B shares. *Case 1.* In the case where losses and market value declines exceed the fund's capital cushion, redemptions should be suspended and the fund should engage in orderly liquidation. This refers to cases in which the market value of the Class B stock is zero or in deficit (including "retained" Class B stock attributable to investors who have sold their matching Class A positions in whole or in part). This is likely to be a very rare circumstance.

Case 2. Rules for the case in which losses and market value declines are less than the fund's capital cushion should be fashioned to avoid "zombie" funds and to enhance MMF stability. The key is to assure that new purchases do not bear losses associated with prior purchases, that is, to avoid discouraging new investment because of the "buoying up" problem. Over time the fund will rebuild its capital cushion, through new transactions with existing and new investors. *Case 2A.* For example, assume Fund Three has experienced a portfolio loss of two percent. Investors will able to redeem Class A shares at par, but loss-bearing Class B shares will be worth approximately 45 percent of their value[5], meaning they will be valued at approximately $.55, not $1.00 a share. Assume that all Class B shares would be valued identically regardless of vintage. The key to Fund Three's viability, and its capacity to rebuild its capital cushion over time, is to price the newly purchased Class B shares at the market price, not a par, at the time of purchase. This means that in respect of its 5.5 percent Class B investment, New Investor will receive approximately 1.8 times the number of Class B shares as would have been received in the non-defaulted state. In other words, as part of the loss bearing associated with the Class B shares, the existing Class B holders will be diluted by the entry of new investors into the Fund. But they are no worse off than otherwise had Fund Three been forced to wind down because of the dearth of new investment and are better off because of the option value in preserving a transactional relationship.[6]

Case 2B. By contrast, assume Fund Four suffers no realized losses but portfolio values move negatively so that Class B shares are valued below par. As noted above, market fluctuations have historically been tightly bound. Nevertheless the pricing formula of Case 2A best protects against the risk that existing funds might become "zombie" funds.[7] This pricing method has pro-stability features, since the high probability of gain on the Class B shares as portfolio investments in fact pay without default will draw new investment into money market funds at times of market instability. In other words, the Class A/Class B unit structure can be an anti-run feature for money market funds.

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[5] The math is ($2/5.5%). The relatively sharp fall (in percentage terms) of the Class B shares is because they bear all of the loss.

[6] "New Investor" in this example includes existing investors who add to their fund balances. Their matching Class B share purchases will also be priced at the actual Class B price.

Note that the fund sponsor always has the option to replace the defaulted security at par (as has commonly occurred), to protect the sponsor's reputation. But to protect systemic stability, the Rule needs to address circumstances in which such voluntary actions may not occur.

[7] This can be illustrated by an example in which new Class B shares are sold at par in such circumstances. Assume Fund Five has $1000 in assets, which now have a market value of $995, meaning a decline of .5%. New Investor buys a $100 unit, $94.50 in Class A, $5.50 in Class B. New Investor's Class B shares will be worth only $.82 a share, meaning an immediate loss from $5.50 in Class B to $4.50. Once again this is because all the losses are concentrated on the Class B shares.

Retail Funds. Retail funds present a distinct situation from institutional funds because of the different nature and goals of the investors. Retail investors generally regard money market funds as a higher-yielding substitute for a bank account.[8] They depend on the check-writing feature and the fixed redemption amount. For a retail investor, the MMF alternative is not assembling and managing a diversified portfolio of money market instruments.

Another important difference is the relationship between the MMF sponsor and the MMF investor. In the case of the retail investor, the MMF is generally packaged with other mutual funds and other financial services offered by the sponsor. In most cases, the sponsor's core business is not providing transactional services to retail investors. Rather, the retail MMF account represents one aspect of a multi-faceted relationship the goal of which is to serve all of the investor's wealth management and other financial services needs (e.g., credit cards). Institutional MMF sponsorship is simply a different business. Some institutional fund sponsors, banks, for example, provide other corporate finance services, but others, such mutual fund complexes, generally do not.

Perhaps the overarching difference is the comparative sophistication of retail vs. institutional customers. This was demonstrated in the financial crisis, in which institutional MMF participants were much more prone to run than retail investors. Retail MMF positions are much "stickier" than institutional positions and present much less run risk. Moreover, although both classes of MMF investors want a simple product, institutional investors have greater capacity to see through and manage complexity.

These differences argue for a somewhat different structure for retail MMFS. The main difference is that the sponsors themselves should be responsible for assuring the supply of matching Class B capital. Sponsors should have the choice of (i) purchasing and holding Class B shares to match retail customer Class A purchases or (ii) underwriting the sale of matching Class B shares to third party capital suppliers, or (iii) combining both.[9] In other respects the Class A and Class B shares would pay out and be valued as in the institutional fund case. This means that in ordinary times, Class B holders would receive the same return as Class A holders but would also provide first loss-protection against portfolio defaults.

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[8] MMFs are really a partial substitute, since most funds have a minimum withdrawal amount, often $250 or $500, that means that the investor also needs a bank account for daily transactional purposes. Perhaps for this reason the Federal Reserve counts money market fund deposits in M2, which includes savings accounts, rather than M1, which includes checking accounts.

[9] I would not favor substituting a third party guarantee for actual capital, because of the correlation risks. Defaults that require guarantor performance are likely to be (i) correlated across MMFs, so the guarantor may have to perform on multiple guarantees, and (ii) correlated with stresses in the guarantor's other financial businesses, which will undermine the guarantor's performance capabilities.

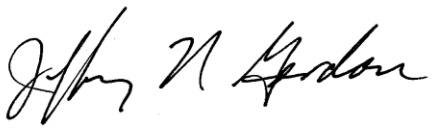
This arrangement will impose costs on sponsors in this arrangement, but those costs could be mitigated by portfolio diversification decisions that would reduce the required level of matching Class B and by fees charged to MMF investors. These costs will also be covered by cross-subsidy from other elements of the sponsor's relationship with the retail investor. To be clear, sponsors should have the option of offering only "institutional funds" to all of its customers, meaning requiring retail investors to buy matching Class B shares. This may not find acceptance in the marketplace. Thus the proposal also offers a "retail" MMF alternative that the sponsor can choose to offer. Because of the greater cost imposition, the sponsor should be free to limit access to the retail MMF as it chooses.[10] For example, the sponsor could limit the availability of its retail MMF to investors who do other financial business with the sponsor.

Government Funds. Government money market funds present a special case because of the negligible default risk and the pattern demonstrated in fall 2008 that in a financial crisis investors run *toward* government funds. Thus government funds do not present the same systemic risk concerns as other MMFs. One possible concern is that investors who urgently need cash to cover losses in other positions would demand immediate liquidity, at a level that might exceed the "cash in the market" and thus lead sales below par even in government funds. In the case of government funds, this issue should be addressed by the current liquidity standards, including the recent Reforms. Assuming that the definition of a security eligible for a government fund remains stringent, I think that no further rule change would be necessary. In other words, for government funds only, shares could be sold without the Class A/Class B unit structure, and the current amortized cost/penny rounding accounting could be retained. Alternatively, if the goal is to provide a uniform product, government funds could be sold in institutional or retail variants, with a small Class B capitalization amount, perhaps 0.50% or 0.25%.

[10] For example, the sponsor is unlikely to offer a retail MMF to an institutional investor because the absence of the institutional purchase of matching Class B shares exposes the sponsor to greater run risk. As observed previously, the financial crisis showed that the run risk associated with a retail investor is smaller.

The guiding principle of this proposal is straightforward: Money market mutual funds impose systemic risk costs on the entire financial system. The costs should be internalized. These proposals for institutional MMFs and retail MMFs should achieve that goal while preserving the key attributes of fixed NAV, relative simplicity, and access to money market rates that make the MMF attractive in the marketplace.

Very truly yours,



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