Treasury Strategies

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March 13, 2012

The Honorable Luis A. Aguilar
Commissioner
U.S Securities & Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

MAR 19 2012

Re: Analysis of Capital Buffer for Money Market Mutual Funds
File No. 4-619: Money Market Fund Reform

Dear Commissioner Aguilar:

On behalf of Treasury Strategies, Inc., we write to call your attention to our recent analysis of the consequences of requiring money market mutual funds ("MMFs") to maintain a capital buffer. There are several troubling potential consequences of such a requirement. As we have noted in the enclosed copy of our report, a capital buffer may create incentives for investors and fund managers, as well as new compliance burdens, that would have the opposite result of the intended goals of financial reform.

In brief, the existence of a buffer may create an initial false sense of comfort among investors, thereby attracting investors who are not properly cognizant of risk. Yet, this false confidence could easily give way to a run if and when losses are charged against the capital buffer. Any such charge would be likely to act as an "early warning" signal to fund investors, encouraging them to exit the fund before the buffer was exhausted. Similarly, while financial reform is intended to result in decreased concentration and lower systemic risk, we conclude that a capital buffer may lead to greater risk-taking as asset managers seek to increase yield, or to greater concentration of capital in the largest banks, as money fund sponsors exit the business.

Perhaps most importantly, our analysis reviews the anatomy of financial runs, and summarizes how the Commission's 2010 amendments to Rule 2a-7 have addressed the circumstances that trigger runs. We urge the Commission to consider how those rule changes have benefited the markets, and to evaluate whether further changes are truly needed, or would only result in unintended consequences.

Sincerely,

Tony Carfang
Partner

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Partner

Enclosure

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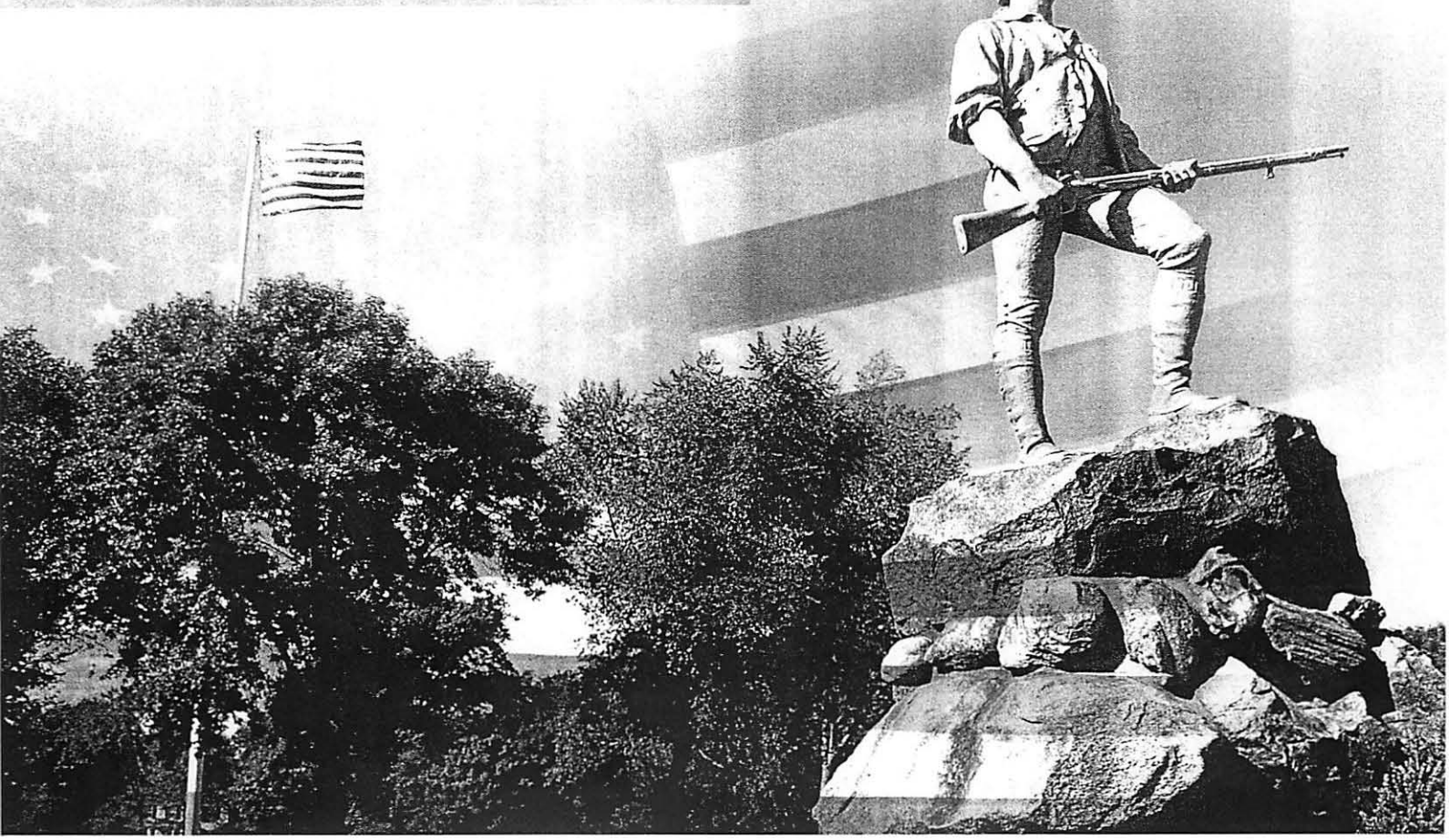
TREASURY STRATEGIES, INC.

PROPOSED CAPITAL REQUIREMENT FOR MONEY MARKET MUTUAL FUNDS: A DISASTER ON ALL FRONTS

TAKE A STAND NOW AGAINST
ILL-CONCEIVED REFORM PROPOSALS
THAT THREATEN THE MMF INDUSTRY!



PROPOSED CAPITAL REQUIREMENTS FOR MONEY MARKET MUTUAL FUNDS:

A DISASTER ON ALL FRONTS

In response to recent calls by regulators to impose a capital requirement on money market mutual funds, Treasury Strategies, Inc. has prepared the following analysis and critique. Treasury Strategies (TSI) is the world's leading Treasury consulting firm working with corporations and financial institutions in the areas of treasury, liquidity, and payments.

Regulators have periodically called for money market mutual fund (MMF) reforms, despite the industry's nearly flawless track record. During its 40-year history there have only been two instances of any MMF investor incurring even a small loss. Although it has demonstrated remarkable reliability, the $2.6 trillion MMF industry is in danger of being dismantled, and its utility destroyed, by the current ill-considered reform proposals.

Regulators cite two primary objectives:

- Preventing a systemic breakdown stemming from a run on a MMF that spills over into the larger financial sector.
- Preventing a MMF investment from ever "breaking the buck," which is thought to be a proximate cause of a systemic breakdown.

The proposal to require funds to accumulate a capital base inside the funds will not only ***fail*** to achieve regulators' objectives of preventing a financial run or loss, but may in fact ***stimulate*** these undesirable events. Key dangers of the proposal include:

- Reduced transparency for investors
- Confusion leading to more risk averse/panic-prone investors
- Increased moral hazard for fund companies and investors
- Asset management firms and bank advisors exiting the business
- Increased volatility
- Increased costs and decreased yields, especially for retail investors and smaller fund companies
- Increased concentration of assets into the largest banks
- Creation of new (AIG-like) systemic risks

Treasury Strategies believes the capital requirement proposal will result in severe negative consequences for investors, fund advisors, businesses of all sizes, and the broader overall economy. We advocate that regulators abandon this proposal.

THE ANATOMY OF A FINANCIAL RUN

Before evaluating a proposal's effectiveness in preventing a run, it is important to understand the anatomy of a financial run. Financial institutions are susceptible to runs because they support highly liquid short-term liabilities with less liquid and longer-term assets. This maturity transformation is crucial to a well-functioning economy, as it facilitates the flow of funds from those with surplus to those with a shortage, in the form of deposits/investments and loans.

However, a maturity mismatch can be problematic when many depositors want to withdraw funds over a short period of time. The financial institution is forced to sell assets prior to maturity and perhaps at a loss to meet depositor demands. At some point, the financial institution will run out of assets that can be readily liquidated without a loss. This is far more problematic with a bank than with a money fund. In a money fund, the difference between the average maturity of the assets and the liabilities can be measured in days or weeks. In a typical commercial bank portfolio, the difference is measured in months, if not years.

A run is caused by investors who believe if they wait too long to withdraw their money, they may lose some or all of it. It is this psychological aspect combined with people's natural aversion to loss that make runs so dangerous.

Three types of financial runs are relevant to financial institutions:

- Credit-driven runs occur as a result of a confirmed negative credit event in a security in which the institution invested; this leads investors to liquidate shares to limit possible losses.
- Liquidity-driven runs are precipitated by investors redeeming shares out of fear that, if they fail to do so immediately, they will be unable to later.
- Speculative runs occur as a result of rumors or speculation about what may or may not occur within a fund.

Type of Financial Run	Proximate Cause	2010 MMF Regulations
Credit Driven Run	Credit Loss	Tightened Credit Standards
Liquidity Driven Run	Market Seizing	Instituted Liquidity Requirement of 10% Next Day, 30% Weekly Shortened Maturity Structure
Speculative Run	Uncertainty/ Misinformation	Reporting of Holdings Reporting Shadow NAV

Source: Treasury Strategies, Inc.

Although interrelated in terms of outcome, the proximate causes are quite different. Quite simply, the proximate cause of a credit-driven run is poor credit quality of the underlying assets. The proximate cause of a liquidity-driven run is a seizing up of the markets. The proximate cause of a speculative run is rumor based on a lack of transparency into the financial institution's assets and liabilities.

The reforms instituted in early 2010 by the SEC and the MMF industry have already adequately dealt with ***each*** of these three situations.

THE TIMING OF A FINANCIAL RUN

It is also important to understand that there are two ways in which a financial run plays out:

- Firestorm runs occur in a panic environment in which investors rush to cash out at any price, notwithstanding any barrier. In today's electronic world, these are likely to play out within hours or a day or two at most.
- Prolonged runs occur when investors fail to roll over maturing investments or reinvest in instruments upon which the institution had come to rely.

Given its nature and speed, it is unlikely that any intervention or barriers to exit will succeed in preventing the firestorm run. It is best to have in place the safeguards that prevent the proximate causes of the run. These are precisely the safeguards that went into effect for the money market fund industry with the Securities and Exchange Commission's Rule 2a-7 amendments in early 2010.

A prolonged run, on the other hand, occurs over an extended period of time. It is usually quite visible well ahead of time. For example, investors refuse to roll over their maturing commercial paper or holders of auction rate securities fail to bid at future auctions. Because of the slow nature of these runs, regulators have a number of tools at their disposal. Additional efforts to "bar the door" have no effect whatsoever, since these runs are caused, not by investor withdrawals, but rather by investors refusing to reinvest.

SUFFICIENCY OF CURRENT MMF REGULATIONS

During the financial crisis of 2007-09, investors staged runs on entire asset classes, not just specific institutions.

The first asset classes to "freeze" in mid-2007 were non-2a-7 enhanced cash funds and asset-backed commercial paper. These were followed by the collapse of the auction rate securities market and mortgage derivative markets.

Individual institutions also experienced runs. These included some local government investment pools and a college liquidity fund. An investment bank failed when its short-term funding dried up, essentially a run by sophisticated investors. Several well-capitalized corporations experienced difficulty in placing their highly rated commercial paper. Several large commercial banks like IndyMac, Washington Mutual, and Countrywide experienced runs as their short-term funding failed and depositors fled. Government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac were unable to fund themselves in the securities markets, investors refusing to reinvest.

In the case of these commercial banks, GSEs, and investment bank failures, government rescues protected investors and increased moral hazard in the marketplace.

By August of 2008, ***only two major liquidity-related asset classes had not experienced a failure:*** U.S. government securities and money market mutual funds.

Then Lehman Brothers failed and the government did not come to the rescue. That directly led to two other "failures" that same week. AIG failed to the tune of $185 billion and was rescued by the federal government. The Reserve Fund sustained a credit loss of $785 million and was not rescued, resulting in investors ultimately receiving $0.99 for each MMF share that originally cost $1.00.

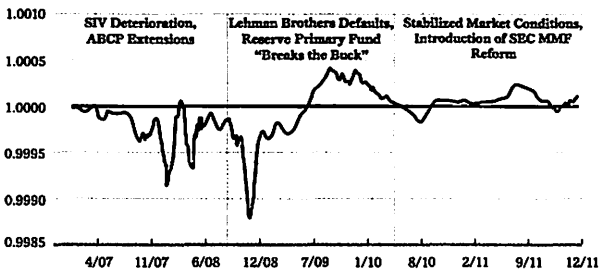
Curiously, in the aftermath of these developments, regulators have targeted money market funds as needing draconian regulatory change. This is in spite of the fact the MMFs were the ***last*** asset class to encounter difficulty and suffered the smallest losses in both real and proportional terms. The SEC has already enacted tightened MMF rules in 2010. However, it continues to debate additional changes to address run prevention.

The Rule 2a-7 changes in 2010 addressed all three types of runs: credit-driven, liquidity-driven and speculative runs. The changes reduced the likelihood of a fund "breaking the buck" due to a run and were executed in a way that did not destroy the money fund business. They did so by mandating:

- More robust fund liquidity measures
- Stronger portfolio quality standards
- Shorter maturity limits
- Increased transparency of portfolio holdings and valuations
- Independent ratings and reporting requirements

Since these changes were enacted, MMFs have become even more predictable with less underlying portfolio volatility, as demonstrated by a FitchRatings January 18, 2012 Special Report.[1]

MEDIAN NAV VOLATILITY OF FITCH-RATED U.S. PRIME MMFS – 30-DAY MOVING AVERAGE
(1/1/07 – 12/31/11) — Median NAV (Moving Average) — $1.00 Share Price



This chart shows that prior to the 2010 changes (a period during which only one MMF "broke the buck"), MMFs were capable of sustaining massive volatility during very turbulent market conditions. Since the changes, MMFs have become even more stable, and have endured both firestorm and prolonged credit-driven and liquidity runs with ease.

Additional measures, such as capital requirements, will distort the market equilibrium and dilute the positive effects of the successful 2010 2a-7 reforms.

[1] FitchRatings Special Report: "U.S. MMF Shadow NAV Volatility Declines Post-Crisis," January 18, 2012.

REDUCED TRANSPARENCY FOR INVESTORS

Increased transparency is an important weapon in the fight against speculative runs because it counteracts the rumors and fear that fuel them. In addition to increasing credit standards and shortening the weighted average maturity, Rule 2a-7 changes improved MMF transparency. These include mandated monthly disclosure of all portfolio holdings on the fund's website and monthly filings of portfolio holdings with the SEC.

If a capital requirement is implemented, new transparency issues arise, as described below. The capital requirement adds complexity, uncertainty, and lack of transparency to an instrument whose hallmarks are simplicity, stability, and transparency. This would be an issue for a wide variety of investor groups from sophisticated corporate institutional investors to less sophisticated individual/retail consumers.

Were the capital requirement to be drawn upon by a fund manager, the fund advisor would face one of two disclosure options, either of which has problematic consequences:

- Risk creating a run on the fund by disclosing the fact that the buffer has been breached
- Reduce transparency due to the lack of full disclosure

The capital requirement run-reduction notion rests on the assumption that investors will not be alarmed when the buffer is breached. Yet, alerting the public that the buffer has been deployed could precipitate a run.

Not only will the presence of the capital requirement fail to reduce the likelihood of a speculative run, it may actually incite a run earlier. Instead of beginning when the fund "breaks the buck," the run will now start when the buffer is accessed. Instead of being a safety net for investors and preventing a run, the buffer's deployment will exacerbate the public's tendency to adopt a fear reaction.

The second option, not disclosing a capital buffer drawdown, contradicts the transparency Rule 2a-7 has sought to increase. Omitting the capital buffer from required monthly reporting will expose the investor base to undesirable uncertainty and complexity. This is contrary to MMF investor goals – they choose to place money in MMFs because of the simplicity, stability, and certainty of the investment.

The proposed capital requirement raises disclosure issues that will increase complexity, reduce transparency, and precipitate a run.

CONFUSION LEADING TO MORE RISK AVERSE/ PANIC-PRONE INVESTORS

A capital requirement for MMFs encourages the false notion in investors' minds that MMFs are more like bank deposits than investments. 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.

Investors have alternatives if they want a place to put their cash that is insured and therefore not, by definition, an investment. Several types of bank deposits are available to individuals and corporations.

In contrast, investors opt for investments, such as MMFs, knowing there is principal risk.

MMFs inform investors of relevant risks through disclosures, which state that an investment is not guaranteed and may fluctuate in value. The existence of a capital buffer assumes investors are unable to understand this disclosure and need to be protected from the risk inherent in all investments.

INCREASED MORAL HAZARD FOR FUND COMPANIES AND INVESTORS

Another consequence of requiring MMFs to maintain a capital buffer is increased moral hazard, for both fund advisors ***and*** investors. Adding a capital requirement to funds places increased pressure on fund managers to drive yield. In order to meet this pressure, managers will have to either extend maturities or add credit risk. These outcomes are contrary to regulators' stated objectives.

Just as insurance can change the behavior of the insured, a capital requirement will encourage fund advisors to buy riskier investments, as they seek higher yields to increase assets under management. There is an obvious parallel between a MMF capital requirement and FDIC deposit insurance, which exhibits this moral hazard consequence.

Empirical studies support the idea that moral hazard associated with deposit insurance leads to increased systemic risk. A 2000 study based on data from 61 countries found "explicit deposit insurance tends to be detrimental to bank stability,"[2] an effect that increased as coverage became more extensive.

A more recent study examined data from 203 banks across ten central and eastern European countries. It found that "banks take on higher risk in the presence of explicit insurance and hence that explicit deposit insurance has generated moral hazard incentives for banks."[3] Neither data set included the financial crisis of 2007-2008, which would certainly have strengthened these findings.

The "guaranteed" return of principal implied by a capital requirement reinforces the false notion that MMFs are deposits, increasing moral hazard from the investors' perspective as well. If they view invested principal as either insured or protected, investors will increasingly seek funds with the highest yields, regardless of the funds' risk profile.

[2] Asli Demirgüç-Kunt and Enrica Detragiache, "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation," April 2000.

[3] Isabelle Distinguin, Tchudjane Kouassi, Amine Tarazi, "Bank Deposit Insurance, Moral Hazard and Market Discipline: Evidence from Central and Eastern Europe," June 2011.

ASSET MANAGERS AND BANKS WOULD BE FORCED TO EXIT THE BUSINESS

The mechanics of the capital requirement proposal are unclear and have not yet been defined by regulators. However, its implementation will certainly create asymmetrical costs across various parties.

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.

For example, in the event the buffer is ever utilized, the duty to replenish the funds could potentially fall on the sponsor. In essence, this amounts to MMF sponsors providing a level of insurance to their own funds. Requiring fund sponsors to replenish their own capital buffers will only create more complexity and interconnectedness within the financial system.

The issue is further complicated for bank sponsors. The bank is essentially providing an unlimited guarantee to the fund shareholder. Other banking regulations, such as Basel III, might require any bank sponsor making such an implicit guarantee to consolidate the fund portfolios on to the bank's balance sheet. That would certainly be the death knell of bank-sponsored funds.

MMF advisors are already under sharp profit pressure from prolonged low rates and regulatory changes. Unable to bear new capital requirement costs and still maintain profitability, advisors will look to pass at least some costs on to investors. When this occurs, sophisticated institutional investors will redeploy assets elsewhere for better yield, putting the entire capital burden on less sophisticated, individual investors.

A capital requirement will also disproportionately harm asset management fund providers, which are solely mutual fund companies. Asset management fund companies would be at a serious disadvantage relative to more diversified firms since they do not have revenues from ancillary business lines to support the accumulation of a buffer. Many of these funds would simply be forced to exit the business.

Much like an exodus of investors, the exit of numerous asset management advisors and bank fund advisors could destroy a $2.6 trillion industry and create the type of run regulators seek to prevent with a buffer.

INCREASED VOLATILITY

The need to first build the buffer and ultimately recoup capital costs will create competitive pressure to increase yields. The only two ways to do this while maintaining a competitive yield are by taking on credit risk or by moving further out on the risk curve, increasing fund risk and volatility. Funds that choose not to compete in this way will see assets decline, and will eventually exit the market. This will increase concentration risk, which will be compounded by the fact that assets in remaining funds are in risker investments.

Furthermore, a capital requirement introduces additional volatility by undermining the concept of a constant Net Asset Value (NAV). A mandated capital requirement of 50 basis points (bps) would essentially widen the acceptable NAV fluctuation range from $0.995-$1.005 to $0.990-$1.005 cents. This incentivizes fund advisors to take on additional risk, increasing volatility and the probability of a fund "breaking the buck" and experiencing a run.

The imposition of a capital requirement will not achieve regulators' stated goal of reducing the likelihood of a fund "breaking the buck" and precipitating a run. In fact, it would have the opposite effect. It would increase industry volatility by creating new moral hazard for fund advisors and investors, incenting them to take additional risks in search of higher yield, and transferring that risk to whoever funded the buffer.

A Federal Reserve Report found that "sponsor support has likely increased investor risk for money market funds." Moreover, the report found that "sponsor-supported funds exhibited greater investor risk than the rest of the prime fund industry by several measures: they had lower expense ratios, more rapid growth in the previous year, and greater flow volatility and sensitivity to yield."[4] This furthers the notion that a sponsor-funded buffer would increase systemic risk through greater volatility and moral hazard.

DECREASED YIELDS AND INCREASED COSTS FOR RETAIL INVESTORS

Imposing a capital requirement on MMFs will decrease yields to investors and increase costs for advisors, destroying the economic value of MMFs for both investors and advisors, especially in the current rate environment. Additional negative consequences include:

- Increased risk of MMF runs due to a mass exodus by investors
- Increased systemic risk due to greater concentration of assets at large, complex financial institutions
- Asset management and boutique fund providers and retail MMF investors taking on a disproportionate part of the additional capital burden

Large investors have the ability to move funds among various asset classes and geographies with

[4] Federal Reserve Board, Finance and Economics Discussion Series – The Cross Section of Money Market Fund Risks and Financial Crises. Patrick E McCabe, 2010-51 (the "Report"), p. 35.

ease. It is highly likely that they will exit MMFs in search of higher market yields during the buffer accumulation phase. This will result in the cost of the capital requirement being borne almost entirely by retail investors.

In the current rate environment, having the fund accumulate capital is infeasible. MMF rates are already at an all-time low and teeter on the edge of being completely uneconomic. A buffer charge of even 1 basis point would cut the average investor's yield in half. Not only would this leave investors with a paltry yield, it would also require years to build a modest buffer.

No rational investor will accept a negative return when zero-yield federally insured deposit accounts are available at banks. Faced with this trade-off, investors will exit MMFs en masse for more attractive instruments. Institutional investors, who hold the bulk of MMF assets, are able to move hundreds of million dollars instantly – likely producing the type of firestorm run regulators seek to prevent.

INCREASED CONCENTRATION OF ASSETS INTO THE LARGEST BANKS

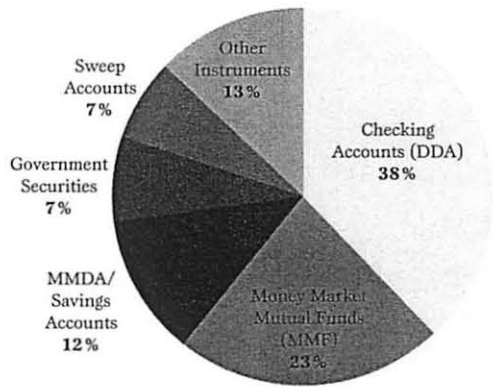
Even if a run were avoided, such a movement of funds would substantially increase systemic risk. Investors leaving MMFs will have three basic options:

- Riskier investments with higher yield
- Off-shore investments
- Bank deposits

The first two options increase systemic risk, as large amounts of assets move from relatively safe MMFs into riskier and less regulated investments. It is far more difficult for regulators to track these less transparent asset flows and to manage the resulting dislocations.

The third option also increases systemic risk. It drastically expands asset concentration in the banking sector, exacerbating the "too big to fail" phenomenon.

% OF U.S. CORPORATE LIQUIDITY BY INSTRUMENT



Source: Treasury Strategies Quarterly Corporate Cash Report, December 2011

Large corporations and institutional investors have funds to invest that dwarf the balance sheets of all but the largest U.S. banks. Corporations place 23% of their liquidity in money market mutual funds. Given current regulations, for a corporation to redeploy these assets into bank deposits, they must concentrate their funds with the largest banks. Even at the largest banks, these potentially huge flows will strain the already bloated balance sheets and lower the returns to bank investors.

CREATION OF NEW (AIG-LIKE) SYSTEMIC RISKS

There is an undeniable component of risk tied to the sponsor's obligation to replenish its own buffer. However, fund sponsors may choose not to hold additional risk for balance sheet purposes, shareholder perception, etc. Those opting not to hold additional risk will look for creative ways to shift or disperse the risk. These sponsors will find ways to package the risk, sell it elsewhere, and pass the fees along to shareholders if possible.

Packaging and selling of the MMF's credit risk creates an undesirable parallel to the credit default swap model for the financial system. Similar to AIG, buyers or insurers of this risk will reap financial benefits without actually having to invest in the fund – a dynamic that opens the door for speculation. Savvy investors will look for MMFs in danger of drawing on their buffers and place bets accordingly. This repackaging and selling of risk adds to the complexity and reduces the transparency of MMFs, and will also increase systemic risk as more financial institutions become stakeholders in funds.

CONCLUSION

The stated objective of regulators is to reduce the likelihood of a systemic financial run. This paper discussed the three types of financial runs: credit-driven, liquidity-driven and speculative. The modifications to SEC Rule 2a-7 instituted in early 2010 adequately deal with each of these three types. Furthermore, the negative effects of the current capital requirement proposal, as listed below, will roll back the solution already in place.

The capital requirement proposal will not only ***fail*** to achieve regulators' objectives of preventing a run or loss, but may in fact ***stimulate*** these undesirable events. Key dangers of the proposal include:

- Reduced transparency for investors
- Confusion leading to more risk averse/panic-prone investors
- Increased moral hazard for fund companies and investors
- Forced exits from the business for both asset management and bank advisors
- Increased volatility
- Increased costs and decreased yields, especially for retail investors and smaller fund companies
- Increased concentration of assets into the largest banks
- Creation of new (AIG-like) risks

Treasury Strategies believes the capital requirement proposal will result in severe negative consequences for investors, fund advisors, businesses of all sizes, and the broader overall economy. We advocate that regulators abandon this proposal.

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