ARNOLD & PORTER LLP

Thought this might be of interest to you.

Jerry Hawke

555 Twelfth Street, NW ▪ Washington, DC 20004-1206
202.942.5908 ▪ Fax 202.942.5999 ▪ John.Hawke@aporter.com

ES141353

ARNOLD & PORTER LLP

John D. Hawke, Jr.
John.Hawke@aporter.com

+1 202.942.5908
+1 202.942.5999 Fax

555 Twelfth Street, NW
Washington, DC 20004-1206

March 26, 2012

VIA FEDERAL EXPRESS

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System
20th and C Streets, NW
Washington, DC 20551

Dear Mr. Chairman:

During the course of a hearing before the Senate Banking Housing and Urban Affairs Committee on March 1, 2012, you made several statements about money market mutual funds (MMFs) that warrant comment, both for what was said and for what was omitted. Of course, that lengthy hearing was focused principally on other matters, and I appreciate that your comments about MMFs were made in response to the question of a single Senator.

While we have previously offered a number of comments on MMFs on behalf of our client, Federated Investors, Inc., I believe it is important to offer these additional comments in light of the extremely disruptive and potentially devastating consequences of the adoption of any of the changes to MMF regulation currently being discussed.

- **On the Subject of SEC Regulation and Oversight:**

While you acknowledged that the SEC "has already done some constructive things in terms of . . . improved liquidity requirements" for MMFs, it is important to recognize both the scope and effectiveness of those SEC enhancements, the significantly enhanced disclosure and reporting requirements put into place by the SEC for MMFs, and the much more robust surveillance and oversight regime for MMFs now existing at the SEC. Specifically:

-- MMFs now have far more liquidity (10% overnight; 30% weekly liquidity under SEC rules, with most funds maintaining even higher levels), higher quality and shorter maturity assets than they did in September 2008.

-- MMFs currently hold 7-day cash liquidity of approximately $1.1 trillion, an amount seven times the largest outstanding borrowing by banks from the Federal Reserve under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) in 2008, and multiples of the amounts needed to meet redemptions in September 2008.

-- The Greek debt crisis and U.S. budget impasse in the Summer of 2011 resulted in large movements of cash out of many MMFs in percentages similar to those seen in September 2008. But the funds were able to handle these redemption requests with no problems. Under the amended SEC rules, MMFs had all the cash they needed to meet redemptions without creating the kind of apprehensions that could lead to runs.

-- MMFs must now file electronic reports with the SEC each month with detailed information about each of their portfolio securities, including the name of the issuer, credit quality and ratings, maturity dates, principal amount, market-based value and amortized cost value. MMFs must also publicly disclose on their own websites, details about each of their portfolio securities, such as the name of the issuer, principal amount, maturity dates, yields, and amortized cost value. This allows investors to make informed choices and to better communicate with fund managers regarding a fund's portfolio.

-- The SEC now closely reviews and sorts reports filed by MMFs. One SEC official explained that it uses the new data "to monitor characteristics and trends of holdings, and to identify areas that raise questions" and that the data can help the SEC "assist other regulators with systemic risk monitoring responsibilities, such as Treasury and the Federal Reserve." The SEC frequently queries MMF managers about reported trends in yields and portfolios, fund growth, repo counterparties, and general market conditions.

- **On the Subject of Runs:**

While you commented that MMFs "still could be subject to runs," it is important to recognize that:

-- MMFs have had but one "run" in their entire 40-year history, and that, as you are keenly aware, occurred 18-months into a widespread and virtually unprecedented global financial crisis. To say that MMFs "still could be subject to runs" is to suggest that a threat of runs hangs over MMFs as an everyday possibility, and the comment does not take account of the fact that on the one occasion when there was an exceptionally high volume of redemptions it was in the midst of a systemic meltdown of gigantic proportions.

-- Today MMFs hold 30% or more of their assets in 7-day available cash and 10% in overnight available cash -- a far greater level of liquidity than they had in September of 2008, when the level of redemptions requested by fund investors was about 15% of fund assets. MMFs are now required to have more than double the amount of cash on hand than was needed in September 2008 to pay redeeming shareholders.

-- Rather than inhibiting runs, each of the proposals now being considered -- a variable NAV, a subordinated capital buffer, or a mandatory holdback or nonrefundable redemption fee -- would be likely to have the perverse and unintended effect of accelerating, rather than detrring, runs, as perceived deteriorations in markets caused MMF investors to seek redemptions. In a variable NAV environment investors anticipating a downward move in the NAV would be likely to exit before such a move occurred. Similarly, were a capital buffer to be required, any charge of losses against the buffer would be likely to serve as an early warning signal of potentially imminent trouble, encouraging investors to exit before the buffer was exhausted. And a nonrefundable redemption fee that was triggered by some market event would also be likely to encourage earlier redemptions before the trigger point was reached.

- **On the Tools Available To Provide Emergency Liquidity:**

While you observed that "some of the tools we used in 2008 to arrest . . . the run on the funds are no longer available, the Dodd-Frank Act would not, as I understand it, prohibit the Federal Reserve from implementing a program similar to the AMLF program put into place in 2008. The DFA prohibits government lending to bail out failing institutions. Under the AMLF, however, the Fed made loans to healthy member banks to enable them to purchase at par from MMFs -- none of which were "failing" -- what it insisted could only be high quality assets, which then collateralized the Fed's advances. This was a liquidity program not unlike the lending the Fed provided to banks in 1970 to maintain liquidity in the commercial paper market after Penn Central failed. No losses were experienced in the program, as might have been expected given the high quality and short maturities of the assets that were being liquified.

- **On Investors' Assumptions About the Safety of MMFs:**

While you commented that "part of the reason that investors invest in money market mutual funds is because they "think they're absolutely 100 percent safe and there's no way to lose money," I know of no empirical basis for such a statement. To be sure, MMFs <u>are</u> exceptionally safe, and even in the most notable case of an MMF faced with unusual credit losses, the Reserve Primary Fund experience in 2008, investors lost less than a penny on the dollar when that fund was liquidated. The following points are worthy of note:

> -- MMF prospectuses clearly and prominently disclose that fund shares can lose value, that a fund can break a buck, and that shares are not insured.
>
> -- Two-thirds of the investments in MMFs come from institutional investors, who certainly have understood the possibility that a MMF could break a buck. Indeed, it was principally institutional investors -- managers of other peoples' money who use MMFs as a cash management tool for their clients -- that lined up for redemptions after Reserve Primary broke the buck in 2008.
>
> -- A recent survey by Fidelity Investments demonstrated that three out of four Fidelity retail MMF customers understand that there is no government guarantee standing behind MMFs.

-- When MMFs are compared with uninsured bank deposits, MMF investors are justified in feeling very comfortable about the soundness of their investment -- because of regulatory requirements that fund portfolios be made up of high quality, short maturity and highly liquid assets, and because of the transparency to which fund holdings are subjected -- protections that holders of uninsured bank deposits do not enjoy.

- **On the Implications of Proposed Transformational Changes to the Continued Viability of MMFs:**

While you stated that you "envision that money market mutual funds will be part of the future of the U.S. financial system," there are many in the MMF industry and many users of MMFs who believe that the kinds of transformational changes to MMFs being discussed today would effectively drive MMFs out of existence -- in particular, a proposal to require a variable net asset value, which you recognized the industry will reject "pretty categorically," or a proposed requirement for some sort of mandatory "holdback" when redemptions are sought. Each of these proposals would fundamentally alter the suitability of MMFs for liquidity management.

MMFs have come to play a critical role in the management of liquidity by individuals and institutions and in the provision of short term credit to American business and governmental entities. A myriad of institutional money managers, responsible for managing liquidity in millions of customer accounts, as well as untold numbers of corporate and state and local treasurers, depend on the efficiency, predictability and stability of MMFs, and the "dollar-in-dollar out" feature of MMFs is of critical importance to their use of MMFs. Indeed, many current users of MMFs could be prohibited from continuing to use them by laws or fiduciary requirements that would eliminate this feature.

It is not clear that those proposing these changes have fully investigated the real-world ramifications and costs that would result. For example, a move to a variable NAV would in all likelihood prevent same-day settlement of trades. Moreover, every purchase or sale would be likely to have tax ramifications, since they would inevitably result in gains or losses, however miniscule. In addition, any "holdback" of redemptions would cause nightmarish problems for money managers using omnibus accounts, who would face enormous complexities in managing their day-to-day use of a combined account in which hundreds or thousands of customers or beneficiaries might have interests.

- **On the Impact on the Banking System:**

While there are some who believe that MMFs should be migrated into the commercial banking system, little thought seems to have been given to the ramifications of a wholesale movement of MMF balances into banks -- ramifications that the Federal Reserve would undoubtedly be concerned about. This is another area where serious investigation and analysis should be pursued before changes are proposed that would accelerate such migration.

At present MMFs hold about $2.6 trillion in balances. Taking the worst case, if all of those balances were to migrate to the banking system, over $100 billion in new leverage-ratio capital alone would be required to support such an enormous volume of new deposits -- a practical impossibility at a time when banks are facing diminished loan demand and significant capital needs -- not to mention the vast additional costs of paying a return on such funds, of risk-based capital requirements, and of deposit insurance premiums and reserve requirements. Of course, not all balances would transfer, but if even half the funds now in MMFs moved to banks the costs would still be staggering.

The impact on the FDIC would also be staggering. Based on the current ratio of insured deposits to total domestic deposits (approximately 64%, excluding non-interest bearing deposits temporarily insured under DFA until the end of this year), an inflow of $2.6 trillion to the banking system would add about $1.7 trillion in new "permanently" insured deposits, against which the FDIC would be required to hold additional reserves (at the statutory designated reserve ratio of 1.35%) of about $23 billion (or $34 billion to meet the FDIC's internally targeted reserve ratio of 2%). As of December 31, 2011, the deposit insurance fund, only recently having emerged from seven successive quarters of deficit, stood at $9.2 billion. Simply to meet the DFA 1.35% minimum reserve target for the <u>current</u> amount of permanently insured deposits by the statutory deadline of September 30, 2020, the fund would need an additional $66 billion. It is not realistic to think that the fund could readily or feasibly add still another $23 billion to this shortfall to accommodate an inflow of MMF balances.

Finally, the impact on concentration in the banking system -- with an increased aggravation of the systemic sensitivity of our largest banks -- would be daunting. If as little as two-thirds of MMF balances moved into the banking system and 75% of that went to the ten largest bank, the concentration in those banks would increase by $1.3 trillion, causing the concentration ratio to increase from the present 65% of total deposits to 74%.

Mr. Chairman, money market funds are of enormous importance to millions of investors, and before policy makers propose far-reaching changes to the regulation and operation of funds that would be likely to impair, if not destroy, their utility, the most searching sort of investigation into the potential consequences of any such changes, and a carefully calibrated cost-benefit analysis -- not to mention an objective analysis of the efficacy of the SEC's new regulatory regime for MMFs --should be made. It is not clear that such inquiries have yet been conducted.

Respectfully,

John D. Hawke, Jr.

John D. Hawke , Jr.