charles SCHWAB

May 31, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: File No. 4-619 – Release No. IC-29497 – President's Working Group Report on Money Market Fund Reform

Dear Ms. Murphy:

Attached is a copy of a comment letter recently filed by Charles Schwab Investment Management, Inc. ("CSIM")[1], to the International Organization of Securities Commissions ("IOSCO") in response to its Consultation Report of April 27, 2012, "Money Market Fund Systemic Risk Analysis and Reform Options."[2]

In our letter, we provide our perspective on the Consultation Report. We discuss several concerns with the Report, and in particular challenge three of its basic premises: 1) that money market funds are dangerously susceptible to runs; 2) that money market funds are somehow more systemically risky than the global banking system; and 3) that there is a presumption that more regulation is needed, despite the lack of empirical evidence. We point to the SEC's 2010 reforms to Rule 2a-7 as having strengthened considerably money market funds and urge that a comprehensive analysis of the effectiveness of those reforms be undertaken prior to consideration of any further regulation.

We ask the Commission to give full consideration to our comments on the IOSCO Consultation Report as it continues to consider whether additional reforms to the regulatory regime for money market funds are necessary. We also ask that these comments be added to the record of public comments on the President's Working Group Report on Money Market Fund Reform.

[1] Founded in 1989, Charles Schwab Investment Management, Inc., a subsidiary of The Charles Schwab Corporation, is one of the United States' largest asset management companies, with approximately $200 billion in assets under management as of April 30, 2012. It is among the United States' largest money market fund managers and is the third-largest provider of retail index funds. In addition to managing Schwab proprietary funds, CSIM provides oversight for the institutional-style, sub-advised Laudus Fund family. CSIM currently manages 72 mutual funds, 25 of which are actively-managed funds, in addition to four separate account model portfolios, and 15 exchange-traded fund offerings.

[2] Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf.

We appreciate the opportunity to share these comments with the Commission. We would be happy to answer any questions or provide additional information to the Commissioners or staff.

Sincerely,

Marie Chandoha

Marie Chandoha
President, Charles Schwab Investment Management

Attachment: IOSCO Comment Letter dated May 28, 2012 charles SCHWAB

May 28, 2012

Mr. Mohamed Ben Salem
International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid, Spain

RE: Public Comment on Money Market Fund Systemic Risk Analysis and Reform Options

Dear Mr. Ben Salem:

Charles Schwab Investment Management, Inc. ("Schwab")[3] appreciates the opportunity to offer comments for the consideration of the International Organization of Securities Commissions ("IOSCO") on its Consultation Report of April 27, 2012, "Money Market Fund Systemic Risk Analysis and Reform Options."

Schwab is one of the largest managers of money market fund assets in the United States, with 3.2 million money market fund accounts and approximately $150 billion in assets under management as of April 30, 2012. About 85% of those assets are in sweep funds, with the remainder in purchased funds. Sweep accounts automatically invest idle cash balances while providing investors with convenience, liquidity and yield. Schwab's expertise and experience are in retail money market funds, helping individual investors manage their cash. It is from that perspective that we offer these comments.

Overview

Schwab appreciates the work that went into the preparation of the Consultation Report, particularly in the discussion of the different regulatory schemes governing money market funds (and their equivalents) in different jurisdictions across the globe and in its Appendix B, which analyzes what happened during the 2008 financial crisis and the steps various jurisdictions have taken in response. The Report is also comprehensive in its exploration of more than 20 possible reforms, and is, for the most part, balanced in its assessment of the pros and cons of those options.

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Nevertheless, Schwab finds numerous aspects of the Report troubling. Perhaps most troubling are three of its basic premises: 1) that money market funds are dangerously susceptible to runs; 2) that they are somehow more systemically risky than the global banking system; and 3) that there is a presumption that more regulation is needed, despite the lack of empirical evidence. We believe strongly that money market funds are one of, if not the, safest investment options in the market today, with an incomparable track record of safety, security, convenience and investor satisfaction. As an investment product, they carry some risk, but the risks are clearly and simply disclosed, of short duration and managed through high-quality investments. If the regulatory goal is to eliminate all risk from the product, then the bar is set impossibly high. Rather, the focus should be on ensuring that money market funds retain sufficient liquidity to handle surges in redemption requests and maintain rigorous scrutiny over the quality of their investment portfolio. As we discuss, we believe that reforms put in place by US regulators in 2010 have accomplished that – and the volatile markets of the summer of 2011 served as a test for those new requirements, a test that US money market funds passed with flying colors.

Finally, we discuss in this comment letter our concerns that there are limited alternatives to money market funds, particularly for individual investors, and that the result of many of the reform ideas posed in the Consultation Report will be a rapid flight from money market funds either to banks or to unregulated or less regulated alternative products. Either way, the potential systemic risks of those outcomes are several orders of magnitude greater than any minimal risk currently posed to the global financial system by money market funds.

Background on US Money Market Funds

In the United States, money market funds are extremely transparent investments that have been regulated by the Securities and Exchange Commission (SEC) since the 1970s. There are about 650 money market funds in operation today, holding almost $2.6 trillion in assets. About 33 million American households are invested in a money market fund.[4] The hallmark of a money market fund is its stable $1 per share price. Individual investors rely on these funds as a critically important cash management tool that provides convenience, stability and a solid return. Investors have a dependable place to put their cash, but have the convenience of having access to those assets intra-day to use for purchasing securities, paying bills, or any other purpose. While the return in today's historically low interest rate environment is minimal, money market funds have traditionally paid a substantially higher return than bank products. In fact, the Investment Company Institute has estimated that, since 1990, money market funds have paid in dividends $242 billion more than investors would have received if that money was kept in a bank deposit account[5]. The fact that individual investors continue to invest in a product despite the unusually low returns is clear evidence that they have confidence in the product and value its many convenient features.

Money market funds also play a critically important role, as the Consultation Report points out, in meeting the short-term capital needs of American banks, businesses, non-profits, municipalities and states. Money market funds purchase more than one-third of all short-term

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[4] Source: Investment Company Institute
[5] "Money Market Funds: Valued By Investors, Play a Critical Role in the US Economy." Investment Company Institute, available at http://www.ici.org/pdf/12_mmf_inv_econ.pdf.

commercial paper issued by banks and businesses, and hold about 60 percent of the short-term debt issued by municipalities. This short-term, low-cost financing allows banks and businesses to operate more efficiently and allows states and municipalities to manage their cash and pay for important investments to strengthen their communities. Organizations of all types rely on the money market fund as the lifeblood of their operations.

Overall, money market funds play a critical role in the US financial system, providing important liquidity, stability and convenience to tens of millions of investors and institutions. The goal of any regulator should be to first "do no harm" and ensure the preservation of this trusted product in the financial marketplace.

Money Markets Are Not Banks

The Consultation Report spends just two paragraphs comparing and contrasting money market funds and banks, but Schwab believes that this distinction merits amplification. Put quite simply, money market funds are <u>not</u> banks. Rather, they offer an alternative to bank products. One of the main reasons that individual investors continue to strongly support money market funds, even in this near-zero interest rate environment, is because they provide a number of advantages to banks. The Charles Schwab Corporation also has a bank, and offers a variety of bank products. Individual investors like having a variety of options for how to manage their cash. Many of our clients utilize both bank products and money market funds – they prefer having that choice.

While both money market funds and banks offer some similar features – including principal preservation, immediate liquidity, and transaction services – it is the differences between the two that are important to emphasize. Money market funds are an investment product and as such offer a number of important contrasts to bank products:

- **Capital Ratio:** Banks in most jurisdictions are required to have a capital ratio of less than 10%. Regulators around the world have been negotiating for years to increase the requirements, under the basic notion that strong capital requirements are a good thing. Most money market funds, on the other hand, have capital ratios of 100%.
- **Leverage:** Money market funds, as noted in the Consultation Report, are not in the business of leveraging their holdings. They have no liabilities, only assets. Banks, on the other hand, leverage the vast majority of their deposits, lending money out to people and businesses.
- **Liquidity Requirements:** Money market funds have strict liquidity requirements, which were established by the US Securities and Exchange Commission in 2010. Under the new rules, 10% of a prime fund's assets must be liquid within one day, and 30% of all funds' assets must be liquid within one week. At Schwab, as at other major money market fund firms, the real-life liquidity of our funds significantly exceeds those requirements. Indeed, an estimated $800 billion of all US money market fund assets held today are liquid within a week. To date, banks have no such requirements.
- **Weighted Average Maturity:** The weighted average maturity (WAM) of assets held in a money market fund must be 60 days or less, and most money market funds have WAMs of significantly less than that. Not only are banks under no such requirements,

but banks are in the business of lending money in situations, such as the 30-year mortgage, where the asset will not mature for many years.

- **Weighted Average Life:** In addition, the introduction of Weighted Average Life (WAL) calculations, also a result of the 2010 SEC reform initiatives, restrict the maximum weighted average life maturity of a fund's portfolio to 120 days. Previously there was no such limit. The effect of this restriction limits the ability of a fund to invest in long-term floating rate securities
- **Transparency:** We believe that one of the most important differences is the transparency of money market funds as compared with banks. Money market funds are required to report their holdings, their net asset value and other information on a monthly basis to the SEC, which makes that information publicly available on a 60-day lag. In addition, funds are now required to share their holdings with the public by posting that information on the fund's website within 5 business days of the end of each month. Banks are not required to tell clients anything about their holdings. In fact, those holdings tend to be so opaque that, as we saw in the financial crisis in 2008 and continue to see today, bank executives have difficulty sorting it out themselves.
- **Money Market Funds put the client first:** In the United States, all mutual funds covered by the Investment Company Act of 1940 must segregate client assets and invest those assets for the sole benefit of the client. This is not true of banks.

These examples of the ways banks and money market funds differ are important because they underscore a fundamental distinction between the two: banks are in the business of using deposits to make loans – an important function in our financial system. Money market funds are designed exclusively for cash management. Individuals and institutions invest in money market funds to keep their cash safe and accessible. As demonstrated within Schwab, there is undoubtedly a place for both money market funds and bank products in today's cash management system.

There is one more important distinction between money market funds and banks: money market funds are not guaranteed, while bank deposits are federally insured up to $250,000. Money market funds are not guaranteed because the risks are clearly disclosed to investors and because of the regulatory structure in which they operate, which limits risk and ensures that funds are highly resistant to market volatility.

Money Market Funds and Systemic Risk

The Consultation Report is focused on analyzing the risk that money market funds pose to the global financial system. In our view, that risk is drastically overstated. The evidence for that risk is based entirely on the 2008 financial crisis, during which a single US money market fund "broke the buck," or failed to maintain its $1 per share price. This marked only the <u>second time since the advent of the US money market fund industry in 1971 that a fund had failed to maintain its $1 per share price</u>. Indeed, the two funds that did break the buck paid their shareholders between 96 and 99 cents on the dollar. By contrast, just since 2008, more than 500 US banks and credit unions have failed. Those events have cost investors and taxpayers more than $80 billion in deposit insurance funds.

Much of the Consultation Report focuses on the susceptibility of money market funds to runs, and the Report asserts that a key reason for runs is that the funds' constant net asset value (CNAV) creates a "false belief that MMF shares a risk-free cash equivalent."[6] The Report, however, contains no evidence, empirical or anecdotal, that individual investors have this expectation. Indeed, as the Report notes on multiple occasions, money market funds are investment products that are not guaranteed. In the United States, money market funds must clearly and directly disclose that they are investment products, that they are not guaranteed and that there is a risk of losing money. Money market fund investors are made aware of this fact again and again. Indeed, a recent study by Fidelity found that 75% of their retail clients understand MMFs are not guaranteed by the government.[7]

Finally, the Report also expresses concern that there is unreasonable risk of money market funds sparking broader macroeconomic impact in volatile markets by suddenly pulling their money from the short-term funding market. We believe this to be a misplaced concern. The Federal Reserve Board, as prudential regulator of bank holding companies, has almost complete authority to regulate bank borrowing activities and could use that power to constrain short term bank borrowings if it wished to do so.

Impact of the 2010 SEC Reforms Has Not Been Analyzed

In the wake of the 2008 financial crisis and the breaking of the buck by a single money market fund, the SEC moved quickly, with broad industry support, to propose reforms in the form of amendments to Rule 2a-7. The amendments were approved by the SEC in January 2010 and went into effect in May of that year. The 2010 reforms addressed numerous issues by enhancing the quality, maturity and liquidity of US money market funds, as well as improving transparency and oversight. They were the most sweeping reforms to the product since the 1980s. An explanation of the reforms is contained in Appendix B of the Consultation Report, but there is no analysis or discussion of whether those amendments have been effective at mitigating the risks outlined in such detail earlier in the Report. Nor is there any discussion of whether the 2010 SEC reforms should be mirrored in other jurisdictions, and then studied to determine their impact in those markets. We believe this is a significant flaw in the Report because the document operates from a presumption that additional reforms are necessary, without any empirical evidence that justifies such a position.

Schwab believes it is critically important that a careful analysis of the effectiveness of the 2010 amendments to Rule 2a-7 be undertaken before further reforms are considered. In our letter to the SEC dated April 6, 2012[8], we make this point and provide specific data from Schwab's proprietary money market funds to support our contention that the reforms have made money market funds substantially more transparent, secure, stable and liquid. In particular, we believe the bolstering of liquidity requirements made significant strides to limit the risks of "runs" on

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[6] IOSCO Consultation Report, p. 14

[7] *See* comment letter to SEC from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., April 26, 2012. Available at http://www.sec.gov/comments/4-619/4619-170.pdf.

[8] *See* Letter from Marie A. Chandoha, President, Charles Schwab Investment Management, Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, April 6, 2012, available at http://www.sec.gov/comments/4-619/4619-161.pdf.

money funds. For example, we showed that in one of our prime money market funds, the average weekly liquidity had risen from 18.65% in January of 2008 to over 41% in February 2012. These liquidity requirements would allow Schwab to handle redemption requests nearly twice as large as the largest single day of redemptions following the 2008 financial crisis and more than twice as large as the largest single week of redemptions post-2008 crisis.

Similarly, the weighted average maturity decreased from 53 days in January 2008 to 34 days in February 2012. Both this figure and our liquidity ratios are well above what is required by the SEC. As we state in our letter to the SEC, "we believe this combination of strong regulatory oversight and prudent portfolio management enhances investor confidence and ensures that the fund could weather even the most extreme market circumstances – including circumstances that go well beyond the crisis of September 2008."

Moreover, our analysis examines the effect of these reforms in the unusually volatile markets of 2011 – a kind of "stress test" of the reforms. Several market events last summer caused concern among investors, including the escalating crisis in the EuroZone, the uncertainty of the US debt-ceiling debate, and the first-ever downgrade of US debt by a major credit rating agency, Standard & Poor's, on August 5, 2011. These and other events resulted in several periods during which redemption requests from money market funds were higher than normal. Our analysis showed that Schwab money market funds experienced remarkable price stability, and that investors in Schwab's funds demonstrated confidence in our products by having relatively modest redemption requests and by adding more than $6 billion in assets to our money market funds over the course of the year.

We believe strongly that this evidence, which represents the experience of just one money market fund firm among hundreds, merits further examination on a wider scale before additional reforms are considered at either the national or international level.

Interestingly, the Consultation Report acknowledges in a footnote the possibility that the 2010 SEC reforms "have played a significant role to help US MMFs weather the volatility of summer 2011 and the surge in redemption requests observed in June 2011 and again in late July/early August 2011."[9] We believe this possibility needs to be explored empirically prior to any further regulatory action.

The Consultation Report's Proposed Reforms

The Consultation Report includes more than 20 possible reforms. As has been indicated, Schwab does not believe that further reforms are needed at this time, at least not in the United States, where the 2010 SEC amendments to Rule 2a-7 have proven themselves to be very effective. But we would like to offer a few comments on some of the specific reform ideas suggested in the Report.

- *Move to a Variable NAV* – For a variety of reasons, we strongly oppose a requirement that money market funds report a variable net asset value. This would be nothing short of a fundamental change to a product that American investors have come to rely upon over

[9] IOSCO Consultation Report, Footnote 36, p. 26

the past four decades. Moreover, we are not aware of any evidence that variable NAV pricing would add to the safety and stability of money market funds, or reduce the likelihood of a run during a particularly volatile market. We do not believe there is a viable market for variable NAV money market funds in the United States, and that the result of such a move would be a flight to less regulated products or to banks. Either outcome would potentially be devastating to the financial system; increase, rather than decrease, systemic risk by concentrating assets in a small number of very large, very complex institutions; severely compromise the workings of the short-term credit markets on which businesses, states, municipalities and non-profit organizations depend for financing; and leave the individual investor with severely diminished options when it comes to cash management.

- *Subordinated share class* – We do not believe there is a viable market for a subordinated share class that would take first loss position in exchange for a higher return.
- *Convert MMFs to Special Purpose Banks* – One of our key points in this comment letter is that money market funds are not banks. We see no logical reason why an investment product that is clearly marketed as such should be converted to a bank product with a completely different set of regulations governing it.
- *Require retail investors to be restricted to either a constant net asset value fund or a variable net asset value fund* – We agree with the observation in the Report that in the United States "retail and institutional funds are indistinguishable due to widespread use of omnibus accounts to invest in MMFs."[10] Perhaps more simply, we do not know how any regulator could create a definition of what constitutes a retail MMF investor and an institutional MMF investor.
- *Redemption Restrictions* – Redemption restrictions, like a variable NAV, would fundamentally change the nature of a money market fund by prohibiting one of the key features that defines the product: the ability of investors to redeem his or her shares at any time. Redemption restrictions also pose enormous operational challenges, particularly in sweep accounts and retirement plan accounts.

Reforms Could Create Systemic Risk

Finally, we note that the Consultation Report makes two important points about the potential ramifications of significant reforms to the money market fund industry. First, the Report notes that "a sizeable shrinking of the MMF industry would therefore leave many investors with fewer investment alternatives for their cash management and could direct a greater concentration of assets toward the banking sector or unregulated or less regulated substitute products."[11] We believe this is a critically important point. As we have noted, it is our observation that individual investors prefer to have multiple options for managing their cash. A significant contraction in the availability of money market funds to retail investors would severely limit choices.

Perhaps more importantly, however, is the impact such an outcome would have on systemic risk. We agree that a drastic change to money market fund regulation that has the effect of fundamentally changing the nature of the product would send enormous sums of money into the banking system. Ironically, much of the global financial regulatory overhaul of the last few

[10] IOSCO Consultation Report, p. 22.
[11] IOSCO Consultation Report, p. 9

years has been focused on trying to reduce the concentration of assets among a very few, very large, multinational financial institutions. Yet, here is a potential regulatory outcome that would accomplish the exact opposite by reducing choice and concentrating assets in the banking sector. Of course, the track record of banks pales in comparison to money market funds. Where just 2 money market funds have broken the buck in the United States since the 1970s, more than 500 U.S. banks and credit unions have failed just in the past four years. It is hard to fathom why IOSCO and its member nations would want to push a regulatory outcome that leads to large financial institutions getting larger and more systemically risky.

Second, we believe that a significant regulatory change that renders money market funds a less appealing investment option could itself be a systemically risky event, by triggering massive redemption requests immediately prior to the regulations taking effect. The Report acknowledges this in the context of a switch to a variable net asset value product[12], but virtually all of the reform options raised in the Report would have a similar effect, in our view.

Conclusion

While the IOSCO Consultation Report is a thorough analysis of the money market fund universe, we reject the fundamental premise under which it was drafted: that money market funds are a menace to the global financial system and require an immediate and drastic global response. In the United States, a strong regulatory response to the unprecedented circumstances of the 2008 crisis has restored investor confidence and made money market funds more transparent and liquid. We believe that an analysis of fund performance in the wake of the SEC's 2010 amendments to Rule 2a-7 will demonstrate that the money market funds are not systemically risky. Moreover, we believe that IOSCO should be a leader in calling for global regulatory harmonization so that money market funds in other jurisdictions are subject to similar requirements as they are in the United States.

Finally, we are struck by the amount of energy being put into the regulatory regime of money market funds, a product through which more than $450 trillion[13] has flowed in and out since 1983, given the funds' track record of safety and soundness. The Consultation Report is more than 70 pages of analysis and discussion, prompted essentially by the fact that a single fund paid investors 99% of what they invested, instead of 100%, during the most severe financial crisis since the Great Depression. We wonder how much safer our global financial system would be if the same degree of scrutiny was applied to some of the more risky elements of the financial sector. There appears to be little appetite, however, for applying stricter requirements, particularly in the area of bank balance sheet transparency, despite the fact that bank failures have outpaced money market fund failures by a margin of greater than 500-to-1 since 2008.

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[12] "In the U.S. especially, transition to a VNAV paradigm may itself be systemically risky, by potentially generating pre-emptive runs by investors seeking to avoid potential losses, or by the outflow of institutional investors who transfer assets to less regulated or unregulated cash management vehicles…which are not subject to the protections of the Investment Company Act." IOSCO Consultation Report, p. 14.

[13] "Money Market Funds in 2012," Investment Company Institute. Available at http://www.ici.org/pdf/12_mmf_inv_econ.pdf.

Thank you very much for the opportunity to offer our perspective on this important issue. We would be pleased to provide additional information or respond to questions.

Sincerely,

Marie Chandoha

Marie Chandoha
President, Charles Schwab Investment Management

cc: The Honorable Mary L. Schapiro, Chairman, US Securities and Exchange Commission
The Honorable Luis A. Aguilar, US Securities and Exchange Commission
The Honorable Daniel M. Gallagher, US Securities and Exchange Commission
The Honorable Troy A. Paredes, US Securities and Exchange Commission
The Honorable Elisse M. Walter, US Securities and Exchange Commission