Money Market Funds, Systemic Risk

and the Dodd-Frank Act

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This paper was prepared for a symposium sponsored by the American Enterprise Institute (AEI) entitled "Do Money Market Funds Create Systemic Risk?" The answer to the question is "no" for the reasons that follow.

I. INTRODUCTION

Money market funds ("MMFs") are pooled investment vehicles that invest in high quality, short-term securities and aim to preserve principal and provide liquidity while maintaining a $1.00 net asset value (NAV). Their simple structure enables them to operate efficiently and pay their shareholders a market rate of return.

Millions of individual investors use MMFs as a safe repository for liquid assets in their investment portfolios. Corporate treasurers, municipal controllers, pension fund managers, and other institutional investors use MMFs as a safe and convenient cash management tool in lieu of uninsured bank deposits. MMFs provide a cost-effective source of short-term funding for businesses, state and local governments, municipal projects, financial institutions, and other institutional borrowers.

MMFs are subject to comprehensive regulation by the Securities and Exchange Commission ("SEC"). They are registered as investment companies under the Investment Company Act of 1940, their securities are issued pursuant to the Securities Act of 1933, and their shares are sold to investors subject to the investor protection provisions of the Securities Exchange Act of 1934 and rules of the Financial Institutions Regulatory Authority ("FINRA"). MMF investment advisers are registered under the Investment Advisers Act of 1940 and are treated as fiduciaries. MMFs are required to disclose their portfolios holdings, redeem their shares upon demand, and maintain their assets with regulated custodians. A host of other regulatory requirements and restrictions apply to MMFs.

SEC regulations limit the portfolio investments of MMFs to high quality, short-term investments such as government securities, municipal securities, bank CDs, and highly rated commercial paper with no more than minimal credit risk. SEC regulations require MMFs to have an average weighted maturity of no more than 60 days and be able to convert into cash 10 percent of their assets in one day and 30 percent in five business days.

MMFs are permitted to offer their shares at $1.00 per share provided their net asset value based on the market value of their portfolio does not fluctuate by more than one half a penny above or below $1.00 per share. Because of these and other regulatory restrictions, MMFs necessarily are risk-averse. They maintain a high degree of flexibility to respond to changing market conditions and can exit troubled markets quickly. Their agility and risk-averse attributes are what make them so valued as investment vehicles for liquid assets.

Ironically, the risk-averse features of MMFs have attracted recent criticism by Federal Reserve officials and a handful of academic economists who have said MMFs are "subject to runs," a source of "systemic risk," and part of the "shadow banking system." This criticism stems from events during the financial crisis of 2007-2008 when the housing bubble imploded, major financial institutions failed, and investors lost confidence that the Fed had the ability to avert a total collapse of the financial system.

Fed officials have created a narrative about the crisis that casts blame on MMFs for destabilizing the financial system and causing or exacerbating the financial turmoil. In furtherance of its narrative, which downplays the role of banks, the Fed has urged the SEC to adopt regulatory changes that would alter the defining features of MMFs that make them so agile and efficient. Industry experts have said that the Fed's proposals would make it impossible for MMFs to operate as they do now and bring about the demise of the industry.

If the SEC does not adopt the Fed's proposals, reports are that the Fed will seek to exercise direct regulatory authority over them through the Financial Stability Oversight Council ("FSOC"). The FSOC was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") as an interagency body with the purpose of exercising systemic oversight, promoting market discipline, and responding to emerging threats to the stability of the United States. Among other things, FSOC has authority to subject certain systemically risky nonbank financial institutions (so-called "SIFIs") to "more stringent" supervision by the Fed. The Secretary of the Treasury chairs FSOC, which is composed of all of the federal financial regulatory agencies, including the Fed, and some state regulators.

This paper argues that, contrary to assertions by the Fed, MMFs pose no systemic risk to the financial stability of the United States and require no supervision by the Fed. This paper shows that MMFs did not cause the financial crisis, are not subject to runs, and are not part of the "shadow banking system." To the contrary, this paper shows that MMFs are subject to more stringent regulation than applies to banking organizations, have a record of safety far superior to that of banks, and that the Fed's proposals to subject MMFs to bank-like regulation would increase, not decrease, systemic risk. Moreover, despite suggestions otherwise, the Dodd-Frank Act provides no legal basis for the Fed to supervise MMFs. MMFs are comprehensively regulated by the SEC and nothing in the Dodd-Frank Act suggests that any change in their regulation is needed. Congress did not intend MMFs to be treated as SIFIs supervised by the Fed and nothing in the language of the Act requires or permits them to be so treated.

II. MMFs Do Not Pose Systemic Risk

Federal Reserve Chairman Bernanke has stated that "systemic risk" is the "risk that disruptions occurring in one firm or financial market may spread to other parts of the financial system, with possibly serious implications for the performance of the broader economy."[1]

This broad definition generally describes what happened during the financial crisis of 2007-2008 when disruptions occurred at financial institutions engaged in undercapitalized risk-taking, excessive leveraging, and over-reliance on short-term funding for subprime mortgages, supported by government policies. When these troubled financial institutions could not meet their obligations to uninsured depositors and investors, including some MMFs, disruption spread to other parts of the financial system as market participants en masse lost confidence in the financial markets and sought safety in government securities or MMFs that invested only in government securities.

As described below, MMFs did not create this systemic risk. MMFs may have been part of a collective response to the systemic shock that

[1] Ben S. Bernanke, Chairman, Federal Reserve Board, "GSE Portfolios, Systemic Risk, and Affordable Housing," Speech before the Independent Community Bankers of America's Annual Convention and Techworld, March 6, 2007.

occurred when the systemic risk erupted, but they did not create the underlying risk that shook the system.

A. MMFs Did Not Cause the Financial Crisis

Federal Reserve officials have made statements suggesting that MMFs are to blame for the financial turmoil that occurred in September of 2008 after the Fed startled the financial markets by allowing Lehman Brothers to declare bankruptcy, knowing that the impact on the financial markets would be catastrophic.[2] In particular, the Fed claims that a "run" on MMFs destabilized the commercial paper market and led to the freezing up of the short-term credit markets and near collapse of the entire financial system. Fed statements claim that MMFs are "susceptible to runs" and should be subject to bank-like capital requirements and other restrictions to prevent them from destabilizing the financial system in the future.

My paper entitled "Shooting the Messenger: The Fed and Money Market Funds" examines in detail the Fed's narrative concerning the role of MMFs in the financial crisis and finds it to be flawed and misleading. My paper entitled "How To Reduce the Risk of Runs on Money Market Funds" focuses on assertions that MMFs are susceptible to runs, which it similarly finds unjustified. The analysis in both papers concludes that MMFs were not a weakness in the financial system that contributed to the underlying causes of the crisis. Rather, excessive leveraging and over-reliance on short-term funding to finance long-term assets by banks and other institutions, and the failure of regulators to require these institutions to maintain sufficient capital, were leading causes of the crisis. Contrary to the Fed's version of events which casts MMFs as culprits, MMFs acted responsibly to protect their shareholders' assets and provided an important source of liquidity and safety

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[2] Fed Chairman Bernanke told the Financial Crisis Inquiry Commission: "We knew—we were very sure that the collapse of Lehman would be catastrophic. We never had any doubt about that. It was going to have huge impacts on funding markets. It would create a huge loss of confidence in other financial firms. It would create pressure on Merrill and Morgan Stanley, if not Goldman, which it eventually did. It would probably bring the short-term money markets into crisis, which we didn't fully anticipate; but, of course, in the end it did bring the commercial paper market and the money market mutual funds under pressure. So there was never any doubt in our minds that it would be a calamity, catastrophe. . . ." Testimony by Ben Bernanke before the Financial Crisis Inquiry Commission, Transcript dated Nov. 17, 2009.

for millions of investors. MMFs contributed strength, not weakness, to the financial system during the crisis.

Among other things, my papers agree with others who have studied the financial crisis and found that it commenced not in 2008 but in 2007 when mortgage defaults increased and the housing market began to implode after years of government policies that fueled an unsustainable bubble. Investors lost confidence in the credit ratings assigned to asset-backed commercial paper ("ABCP"), particularly bank-sponsored ABCP, which was thought to be contaminated with toxic subprime mortgages. Investors, including MMFs, refused to renew their holdings of this commercial paper, forcing banks, which had guaranteed much of this paper, to take it onto their own balance sheets, which depleted their capital. These events, which have been characterized as a classic "run" on ABCP, left the banking system temporarily insolvent, requiring the Fed to launch extensive emergency liquidity facilities for banks and dramatic monetary easing.

MMFs did not cause the 2007 commercial paper crisis. MMFs did not make subprime mortgages, package them into off-balance sheet ABCP, pay the credit rating agencies to assign it a high rating, and sell it to investors. Banks did that, not MMFs. MMFs did not leverage their capital, engage in regulatory arbitrage, or invest in complex financial derivatives. Bank did that, not MMFs.

In withdrawing from the commercial paper market, MMFs responded as responsible money managers in the interests of their shareholders. They acted to protect their portfolios and remain in compliance with SEC regulations that allow MMFs to incur only minimal credit risk. There was no "run" on MMFs in 2007. The only "run" was a run on bank-sponsored ABCP that became too risky for MMFs. Banks were unable to withstand this run because they had inadequate capital. They had inadequate capital because banking regulators reduced the capital requirements for bank ABCP in 2004, leading to regulatory arbitrage, a mushrooming of ABCP, and undercapitalized risk-taking by banks.

Notwithstanding the Fed's emergency liquidity facilities for banks, the 2007 commercial paper crisis left them weakened and ill-prepared for the next phase of the financial crisis. That phase unfolded with the bailout of Bear Stearns, the failure of several major banks, and the government takeover of Freddie Mac and Fannie Mae—all stemming from unsound lending practices and the making of too many mortgages with lax underwriting standards, encouraged by government policies.

MMFs, in contrast, steadily gained assets during 2007 as investors sought safety for their cash. Only when the Fed appeared unable to manage the growing financial turmoil during the week of September 15, 2008 immediately following the Lehman bankruptcy did MMF investors, along with the stock market as a whole, panic. It is true that one MMF "broke a dollar" due its holdings of Lehman commercial paper—the Reserve Primary Fund. That event, which was only the second time a MMF ever had broken a dollar, occurred in the midst of unprecedented chaos and uncertainty caused by the Fed's unexpected failure to rescue Lehman.[3]

Institutional MMF investors, responding to the general panic, rapidly reallocated their assets from prime MMFs that invested in commercial paper to MMFs that invested only in government securities or to direct investments in government securities. The reallocation of MMF assets caused a further contraction in the commercial paper market as MMFs were unwilling to roll over their holdings of commercial paper or were unable to do so due to heavy redemption activity. Consequentially, banks faced an avalanche of demands on letters of credit and other guarantees they had provided to support their own sponsored short-term commercial paper as it came due. In their weakened condition, banks could not meet these demands. They stopped lending to each other and market liquidity evaporated. As Chairman Bernanke later told the Financial Crisis Inquiry Commission, of the 13 largest U.S. financial institutions, 12 were in danger of failing within a period of a week or two.[4]

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[3] Among other things, Lehman's London assets were immediately frozen under the law of the United Kingdom, creating chaos in the global financial markets as traders could not unwind positions. Lehman's was the largest and most complex bankruptcy ever in the United States. The Fed's $85 billion bailout of AIG less than 24 hours after Lehman's bankruptcy created further uncertainty and panic.

[4] Testimony of Ben Bernanke before the Financial Crisis Inquiry Commission, Transcript dated Nov. 17, 2009 at 24 ("As a scholar of the Great Depression, I honestly believe that September and October of 2008 was the worst financial crisis in global history, including the Great Depression. . . . out of maybe the 13—13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two.").

The events in the commercial paper market prompted the Fed to purchase commercial paper itself in order to ease pressure on bank sponsors and issuers of commercial paper. The Treasury Department also temporarily insured MMFs to stem redemptions from prime funds and thereby slow the liquidation of commercial paper holdings by the funds.[5] Dire conditions in the banking system and the broader financial markets led the Fed and Treasury Department to request emergency powers from Congress to purchase toxic assets from banks and recapitalize the banking system. In addition, the FDIC announced that it would provide unlimited deposit insurance and guarantee bank debt.

MMFs did not cause the chain of events that resulted in what Fed Chairman Bernanke has described as the "worst financial crisis in global history, including the Great Depression."[6] The financial crisis had many causes, chief among which were government policies that encouraged irresponsible lending, regulatory arbitrage and undercapitalized risk-taking by banks and their affiliates.

Former Treasury Secretary Paulson, in his book on the financial crisis, admitted that the government was "not well equipped" to address the pullback of MMFs from the short-term credit markets after the Lehman bankruptcy in 2008.[7] Yet, the same scenario had occurred just one year earlier when MMFs pulled back from the commercial paper market after doubts arose about the credit quality of asset-backed commercial paper. The government's lack of preparedness to address a highly predictable response by MMFs to market instability was not the fault of MMFs. Fed Chairman Bernanke has acknowledged that policymakers knew that Lehman's bankruptcy would destabilize the markets.[8] The government's failure to anticipate the reaction of MMFs and their shareholders is not a reason to blame MMFs for the financial crisis or to subject MMFs to inappropriate structural changes, especially when such changes will not prevent a similar pullback from market instability in the future.

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[5] This program was not used but earned the Treasury $1.2 billion in fees paid by MMFs. MMFs cost the taxpayers nothing during the crisis.

[6] Testimony of Ben Bernanke, supra.

[7] Henry Paulson, On the Brink, at 449-450.

[8] Testimony by Ben Bernanke before the Financial Crisis Inquiry Commission, Transcript dated Nov. 17, 2009.

MMFs are not on the list of plausible causes of the crisis. Rather, MMFs performed in accordance with their regulatory mandate and provided a safe haven for investors seeking shelter for their liquid assets during the crisis. MMFs assisted the Fed in restoring liquidity to the short-term credit markets by resuming their purchases of commercial paper once the markets calmed.

Only one MMF broke a dollar during the crisis, and it returned 99 cents on the dollar to its shareholders when its assets were liquidated. If the Fed had not taken action to unfreeze the financial markets, other MMFs might have broken a dollar. But their shareholders also likely would have recovered most of their assets. MMFs emerged from the crisis more resilient than ever as investors continued to seek safety in MMFs. Investors added more than $1.0 trillion in uninsured assets to MMFs following the financial crisis. In contrast, hundreds of banks failed, as they have during nearly every other financial crisis in the past.

B. MMFs Are Not Susceptible to "Runs"

The financial crisis did not prove that MMFs are subject to "runs." Rather, it showed that in periods of extreme financial distress when financial markets are collapsing, MMFs shareholders will reallocate their assets from prime MMFs to government-only MMFs or other available lower risk asset classes.[9] The crisis showed that MMFs will act to protect the assets of their shareholders amid market uncertainty and will comply with applicable regulations that limit their investments to those with minimal credit risk. Such actions by MMFs are those of responsible money managers that owe fiduciary duties to those whose money they manage.

No evidence has been presented showing that MMFs are inherently susceptible to runs in circumstances other than a full-scale panic such as occurred in September of 2008. No "run" on MMFs occurred during the bank commercial paper crisis in 2007, the near failure of Bear Stearns, or at any of the other destabilizing events that preceded the Fed's decision to let

[9] See Treasury Strategies, Inc., "Dissecting the Financial Collapse of 2007-2008: A Two-Year Flight to Quality," attached to letter dated June 1, 2012 posted on the Securities and Exchange Commission's web site at http://www.sec.gov/comments/4-619/4-619.shtml.

Lehman fail. With respect to the 2007 commercial paper crisis, a Fed research report found:

> [D]espite the exposures of many MMFs to troubled ABCP, MMF investors responded with only a modest pullback from prime MMFs in August 2007…. prime MMFs, which mainly invest in private debt instruments such as ABCP, saw only very small net outflows (about $14 billion, or 0.8 percent of assets) in the three weeks ending August 29, 2007.[10]

Some MMF sponsors—mainly bank-affiliated sponsors—acquired distressed ABCP from their funds during the crisis or otherwise provided financial backing to protect their funds from losses. This action may have prevented some funds from breaking a dollar, but sponsor support is not evidence of a "run" on the funds.

SEC Chairman Schapiro recently testified to Congress that MMF sponsors have voluntarily provided support to their funds on approximately 300 occasions during the entire history of MMFs since the 1970s.[11] She cited as causes of this sponsor support a number of commercial paper defaults, bankruptcies, and other credit events that exposed MMF portfolios to potential losses that might otherwise have resulted in MMFs breaking the dollar. Yet, Chairman Schapiro did not say that any of these instances was accompanied by a run on MMFs. There is no support for the implication that, in the absence of sponsor support, runs would have occurred or the funds would have broken a dollar. Indeed, in the only instance apart from

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[10] Patrick E. McCabe, Senior Economist, Federal Reserve Board, "The Cross Section of Money Market Fund Risks and Financial Crises," Finance and Economics Discussion Series 2010-51 (2010) at 8.

[11] Mary L. Schapiro, Testimony on "Perspectives on Money Market Mutual Fund Reform," before the Senate Committee on Banking, Housing and Urban Affairs, June 21, 2012. This number seems remarkably small over a period of some 40 years during which the nation experienced a wide range of systemically destabilizing events. The Investment Company Institute believes that more than half of these support instances occurred prior to 1994 and that all but one of these instances occurred before the SEC's 2010 MMF reforms. See Sean Collins, "Is SEC Data Misleading the Public on Sponsor Support of Money Market Funds?" June 21, 2012, available at:

http://www.ici.org/viewpoints/view_12_mmfs_fund_support.

the Reserve Primary Fund in which a MMF ever broke a dollar, no run occurred.[12]

Chairman Schapiro has not released any data or details concerning the instances of sponsor support she mentioned. However, a review of SEC exemptive letters approving sponsor support during the financial crisis of 2007-2008 shows that nearly all of the substantial MMF support arrangements involved bank-affiliated funds, and nearly all banking organizations that sponsored MMFs supported one or more of their funds. The apparent disproportionate need for financial support by bank-affiliated MMFs suggests the possibility that some of these funds may have been managed to less rigorous credit standards than funds that were not bank-affiliated and did not need support. One plausible explanation for this disproportion is the moral hazard that may arise if fund managers know their investment decisions will be backed by an affiliate with deep pockets or the government.[13] A Fed staff research paper has concluded that these support agreements may have created moral hazard and systemic risk:

> Bank-affiliated money funds were more likely to receive sponsor support and to hold distressed ABCP in their portfolios. . . . Hence, sponsor support has likely increased investor risk for MMFs. The fact that funds with bank sponsors were more likely to have held distressed ABCP and to have received sponsor bailouts in the wake of the ABCP crisis also suggests that the possibility of sponsor support may undermine incentives for prudent asset management.
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> . . . Furthermore, during the run in 2008, concerns about the ability of sponsors to support their MMFs

[12] Moreover, Chairman Shapiro did not indicate whether any MMF sponsors suffered losses as a result of providing support to their funds. Anecdotal evidence suggests that fund sponsors provide support to their funds for a variety of reasons and generally have not suffered material losses on their support arrangements.

[13] The Reserve Primary Fund broke a dollar in September of 2008, for example, because its portfolio managers held commercial paper of Lehman Brothers in the mistaken belief that the government would rescue Lehman, as it did Bear Stearns—a clear manifestation of moral hazard created by the Fed.

> evidently prompted heavier redemptions from money funds with weaker sponsors, and thus transmitted the sponsors' strains to off-balance-sheet MMFs and into short-term funding markets. Thus, by fostering expectations of implicit recourse to sponsors, past support actions had created a channel for the transmission during crises of strains between entities that should not have been related. Whether or not such support was actually delivered, it may have contributed to financial strains.[14]

The Fed research paper does not conclude, as Chairman Schapiro does, that draconian measures need to be taken to prevent any MMF from ever breaking the buck again. Rather, it concludes that regulators should consider the systemic risks posed by sponsor support of MMFs—particularly support by banking organizations of their affiliated MMFs.[15] The paper suggests that MMFs—particularly bank-sponsored MMFs—might not have needed sponsor support had stricter controls been imposed on sponsor support earlier.

Acting contrary to the suggestion in the Fed research paper, the SEC in 2010 made it easier for banking organizations and other sponsors to provide implicit and explicit support to their affiliated MMFs by amending its rules to allow sponsors to purchase defaulted and other portfolio securities from the funds, subject to certain conditions. The SEC acknowledged that such support "might also give a competitive advantage to funds that receive it because they may be more willing to invest in securities with higher risk and higher yields."[16]

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[14] Patrick E. McCabe, Senior Economist, Federal Reserve Board, "The Cross Section of Money Market Fund Risks and Financial Crises," Finance and Economics Discussion Series 2010-51 (2010) at 34-35.

[15] *Id.* at 2-3 ("The link between sponsor risk and holdings of distressed paper during the ABCP crisis indicates that the sponsor-support option may distort incentives for portfolio managers, and the role of sponsor risk in channeling concerns about financial institutions to their off-balance-sheet MMFs during the 2008 run suggests that expectations for such support may contribute to transmission of financial shocks. These concerns at least warrant greater attention to the systemic risks posed by the MMF industry's reliance on sponsor support.").

[16] 75 Fed. Reg. 10060, 10105 (March 4, 2010).

Fed Chairman Bernanke has expressed concern about sponsor support for MMFs and said that FSOC will address sponsor support and consider options that could materially change the nature of such support.[17] The President's Working Group has posited that, if MMF sponsors had not been permitted to support their funds in recent years, MMF investors might have had more realistic expectations and been less inclined to run:

> If MMFs with rounded NAVs had lacked sponsor support over the past few decades, many might have broken the buck and diminished the expectation of a stable $1 share price. In that case, investors who nonetheless elected to hold shares in such funds might have become more tolerant of risk and less inclined to run.[18]

As suggested in my paper "How Can the Risk of Runs on Money Market Funds Be Reduced?" to the extent the risk of runs on MMFs is a concern, it might be reduced if the SEC and federal banking regulators were to prohibit or restrict sponsor support for MMFs.

Apart from the system-wide panic in 2008, there is no evidence to suggest that MMFs are susceptible to runs. There is no evidence of any prior run by MMF shareholders. Only two MMFs in the 40-year history of MMFs ever have broken a dollar. In both cases, shareholders got back nearly their full investment in the funds. One reason why MMFs have not experienced runs is likely that MMF investors have confidence that MMFs are professionally managed and subject to SEC liquidity, credit quality, diversification, stress testing, disclosure, and other requirements designed to promote their safety.

MMFs create a risk filter that few investors acting on their own can duplicate. MMFs are more capable of evaluating risk and acting to reduce

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[17] See Letter dated Dec. 9, 2010 from Federal Reserve Board Chairman Ben S. Bernanke to Anthony J. Carfang, Treasury Strategies, Inc., attached to Letter dated Dec. 17, 2910 from Anthony J. Carfang to Securities and Exchange Commission Chairman Mary L. Schapiro, comments on SEC File No. 4-619, available at http://www.sec.gov/comments/4-619/4-619.shtml.

[18] Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 11.

risk than most investors acting independently. MMFs have more comprehensive market information, monitoring and analysis capability and are more likely to identify risks at an earlier stage and take action to avoid them or liquidate holdings in a timely manner. By the time an individual investor discovers risks, MMFs already have acted on them. Individual investors, knowing they have less sophisticated market information, may be more likely to panic than MMF shareholders.

If MMFs ceased to exist, many investors that currently invest in MMFs would invest in commercial paper and other short-term money market instruments directly. Such investors predictably will retreat from the market in a contagion, just as they did in September 2008. Without MMFs as a risk buffer, both retail and institutional investors may believe their investments are more exposed and thus be more likely to flee at the onset of market stress. Investors in MMFs, on the other hand, may not be as fearful of market shocks to the extent they have confidence the fund manager will act responsively. They also may feel there is "safety in numbers" in a MMF. Few investors have access to the sophisticated risk management skills and tools of MMF managers and may be more "skittish" about their individual investments, increasing the potential for runs. The Fed has nothing in its toolkit to stop a run by individual investors, whereas the Fed can purchase assets from MMFs in a major crisis and thereby channel liquidity to stabilize the markets.

It is true that the collective withdrawal of MMFs from the short-term credit markets amid a crisis may reduce credit availability in those markets. But, as discussed below, MMFs cannot be expected to prop up the credit markets at the expense of their shareholders, which include tens of millions of investors who rely on MMFs to safeguard their short-term liquid assets. Government policies that seek to prevent MMFs from withdrawing from unstable markets will compromise the ability of MMFs to provide liquidity to those investors and the broader economy during times of stress with far more negative systemic consequences.[19]

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[19] Moreover, it is by no means clear that the unimpeded flow of credit is desirable in all economic scenarios. Market instability can signal economic disturbances that warrant a reduction in credit availability. For example, the Fed took sudden and drastic action in the early 1980s to require financial institutions to curb the flow of credit in order to control inflation notwithstanding significant economic hardship and market volatility at the time.

The financial crisis demonstrated that it is not possible to eliminate the risk of runs on banks. As explained in my paper "How to Reduce the Risk of Runs on Money Market Funds," despite the existence of deposit insurance, the Fed's discount window, and comprehensive prudential supervision and regulation, U.S. banks experienced at least four separate and distinct runs during 2007-2008 that destabilized not only themselves but the entire financial system. Unless the U.S. government is prepared to fully insure all bank deposits—which it is not—or prohibit banks from accepting uninsured deposits—which it is not—then the risk of bank runs in the United States will persist.

If it is not possible to eliminate bank runs with all of the government infrastructure supporting the banking system, it is hardly likely that the potential for runs by MMF shareholders, small though it is, can be eliminated. Nor should it be. Regulations that aim to that make banks or MMFs absolutely run-free (assuming that were even possible) inevitably would increase moral hazard, which would increase systemic risk in the financial system. Moreover, making MMFs risk-free is not an appropriate goal as a matter of public policy. The President's Working Group report on MMFs rejected the idea of making MMFs risk-free as a policy objective.[20]

My paper "How to Reduce the Risk of Runs on Money Market Funds" discusses in further detail why it is misleading to assume that MMFs are susceptible to runs and why such a supposition does not support proposals of the type advocated by the Fed to change the structure of MMFs.

C. MMFs Contribute Systemic Stability, Not Risk

MMFs are a source of systemic safety and liquidity, not risk. They provide security of principal, liquidity, professional money management, diversification, transparency, and a market-based rate of return in addition to ease of administration and accounting and tax reporting efficiencies. They are an important source of short-term funding for businesses, state and local governments, municipal projects, banks, and other issuers of debt. They

[20] Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 4. The PWG consists of the Secretary of the Treasury and the chairmen of the Federal Reserve Board, Securities and Exchange Commission, and Commodity Futures Trading Commission.

provide an element of diversity, transparency, and market discipline in the U.S. financial system otherwise dominated by banking organizations that by nature are opaque, systemically risky, and less efficient than MMFs.

1. MMFs Serve Millions of Investors

MMFs serve a diffuse array of investors. MMFs had approximately 30 million accounts at year-end 2011. MMF shareholders include approximately 57 million retail investors who safekeep their liquid assets and retirement funds in MMFs. These individuals include middle class families, wage earners, retirees, veterans, farmers, shopkeepers, entrepreneurs, and others who find MMFs safe, useful, and convenient. Many of these individuals have individual retirement accounts or 401(k) accounts with MMFs.

MMF shareholders also include trustees of large pension funds and charitable foundations, bank trust departments, corporate treasurers, and controllers of state and local governments. These fund shareholders are responsible for billions of dollars crucial to the well-being of millions of American citizens. They invest on behalf of beneficiaries and are subject to fiduciary duties that require them to seek safety for their cash during times of financial instability.

Of the approximately $2.6 trillion in MMF assets as of year-end 2011, $861 billion was held by institutional investors and $1.8 trillion by household accounts, including retirement and savings accounts.[21] MMF portfolio managers owe a fiduciary duty to safeguard the assets of these investors. That duty requires them to withdraw from financial markets that become unstable and risky.

2. MMFs Are Safe, Diversified, and Efficient

MMFs are safe. It is a rare occurrence for a MMF to be unable to pay its shareholders $1.00 per share ("breaking the dollar"). If a MMF does

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[21] Investment Company Institute, 2012 Mutual Fund Fact Book at 191 and 124. Corporate treasurers and other business-related shareholders held $452 billion of MMF assets, financial institutions (including banks, credit unions, and insurance companies) held $301 billion, nonprofit organizations held $46 billion, and other institutional investors held $62 billion. *Id.* at 191.

break a dollar, it will be closed immediately and not generate further losses.[22] The fund's shareholders do not lose their investment but are entitled to a pro rata share of the fund's assets upon liquidation. Only two MMFs ever have broken a dollar and investors in those cases got back substantially all of their investment.[23]

Although MMFs are not government guaranteed or insured, they have a history of safety that that far exceeds that of federally insured banks, which failed by the hundreds recently and during past crises.[24] The safety record of MMFs reflects their inherent risk-aversion based on SEC Rule 2a-7, which requires MMFs to invest only in high quality securities that mature in 13 months or less and that pose "minimal" credit risk. The required weighted average maturity of a MMF is 60 days or less. At least 97 percent of a MMF's portfolio must be invested in U.S. government securities or other securities that either have the highest short-term rating or are of comparable quality. Rule 2a-7 also imposes liquidity and other requirements that help to ensure MMFs' safety.

MMFs are diversified. Under SEC rules, MMFs can invest no more than five percent of their portfolios in securities of any one issuer. In addition, they can invest no more than one-half of one percent of their portfolios in securities of any one issuer of "second tier" securities, which can comprise no more than three percent of their portfolios.

MMFs are efficient. Due to their limited activities and simple structure, MMFs are streamlined and have lower operating costs than banks. For this reason, they can offer higher rates of return than banks can pay on deposits under normal market conditions.

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[22] A MMF that breaks a dollar theoretically could operate with a floating NAV but would not be competitive as a practical matter. It thus is expected that any MMF that breaks a dollar will close.

[23] Investors in the Reserve Primary Fund got back 99 cents on the dollar. Investors in the other fund that broke a dollar in 1996 got back 96 cents on the dollar.

[24] Fitch Ratings has studied MMFs and found that they have remained stable through the recent European debt crisis due to the high credit quality of their portfolios, heightened risk-aversion by MMF shareholders and managers, and increased liquidity. Fitch Ratings, Inc., "Study of MMF Shadow NAV Shows Stability," June 14, 2012.

MMFs provide professional money management at a reasonable cost to small investors who otherwise would not have affordable access to such services. For large investors, MMFs offer a service that banks cannot provide—a highly-liquid, high quality, diversified cash investment vehicle that is safer than uninsured bank deposits. For treasurers and other institutional cash managers, MMFs provide a safe and efficient cash management tool with greater diversification and liquidity at a much smaller cost than could be achieved by a treasurer managing an individual portfolio of short-term investments.

3. MMFs Contribute Market Fluidity and Efficiency

The use of MMFs by institutional and individual investors contributes to the overall fluidity and efficiency of the financial markets by affording quick and easy access to cash for a variety of business transactions and investment purposes. Market fluidity makes our economy more efficient with widespread benefits beyond only those who invest in MMFs.

The stable $1.00 NAV maximizes the efficiency of MMFs. Without it, MMF shareholders would be required to determine the cost basis and gain or loss on each transaction, eliminating the ease of administration that makes MMFs so useful. Moreover, without a $1.00 NAV, many corporate and municipal investors would not be able to use MMFs due to statutory and other restrictions on their investment authority. Without MMFs, the short-term credit markets would operate less efficiently.

4. MMFs Are Highly Liquid

Whereas a bank's assets are held largely in the form of illiquid assets—such as loans that cannot be liquidated to meet depositor withdrawals—MMF assets are limited to high quality, short-term assets that can be readily sold off to meet redemption requests. Unlike bank deposits, every dollar invested in a MMF is invested in an asset that can be readily liquidated in a short period of time. MMF assets match their $1.00 NAV for all practical purposes dollar for dollar. That is why MMFs have operated so successfully without deposit insurance and discount window access. MMFs are required to hold 10 percent of their assets in instruments that can be liquidated within one business day and 30 percent in instruments that can be liquidated within five business days. Banks are not subject to comparable daily or weekly liquidity requirements.

5. MMFs Provide a Safe Haven During Times of Stress

MMFs provide a safe haven for investors during times of stress as well as during periods of normalcy. Total net assets of MMFs increased by approximately $1.5 trillion during the financial crisis as investors sought safety and liquidity.[25] Without MMFs, millions of investors would have been forced to invest in bank deposits or buy and hold government securities through securities brokerage accounts. Investing in uninsured deposits is risky and managing a portfolio of government securities with different maturities is cumbersome.

No financial institution is immune from instability amidst a crisis of the type the nation experienced in 2008. But MMFs demonstrated that they are among the most resilient and trusted of all financial institutions.

6. MMFs Contribute Competition and Diversity

MMFs provide an important element of competition and diversity that has served our financial system well for over forty years. MMFs have led to innovations in financial products that otherwise would not have developed or been delayed. Competition from MMFs in the 1980s forced federal regulators to remove antiquated restrictions on the ability of banks to pay interest on demand deposits, thereby enhancing competition in the financial marketplace and benefitting consumers of financial products.

Banks are not a substitute for MMFs. Banks generally cannot pay optimum market rates of return on their deposits due to their substantially greater operating costs from lending operations and other activities requiring a large number of employees, infrastructure, and organizational complexity. Deposit insurance, access to the discount window, and layers of banking supervision and regulation adds to their costs. Banks have a dismal record of safety compared to MMFs and their uninsured deposits are not as safe as MMFs. Banks cannot provide funding to commercial paper issuers or

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[25] MMF net assets have decreased by nearly as much since the financial crisis, largely due to the availability of unlimited federal deposit insurance on noninterest bearing checking accounts, which is scheduled to expire on December 31, 2012. As noted elsewhere herein, the increase in deposit insurance has vastly expanded the federal safety net and concentrated liquid financial assets in a small number of large banks, thereby increasing systemic risk and risk to taxpayers.

municipalities with as much efficiency due to their cumbersome structure and regulatory capital structure. They cannot pass through the tax-exemption of municipal securities to investors as can MMFs.

The elimination of MMFs would increase the concentration of assets in the banking system. As a result, more of the financial system would be subject to banking regulation, the mistakes of banking regulators, and the risk of bank failures. As commentators elsewhere have described at length, regulatory action and inaction by U.S. banking regulators contributed in significant ways to the buildup of risks in the banking system prior to the crisis. A diversity of regulators, along with a diversity of institutions, may foster a healthier financial system in the long run.

7. MMFs Reduce the Size of the Federal Safety Net

By holding short-term assets outside the banking system, MMFs reduce the size of the federal safety net and lower the exposure of taxpayers to instability at banks. MMFs are not federally insured or guaranteed. They resulted in no costs to the taxpayers during the financial crisis.

In contrast, massive government intervention was required to stabilize the banking system. Congress increased temporarily, and then permanently, the amount of deposit insurance from $100,000 to $250,000 per depositor. In addition to the emergency liquidity facilities established by the Fed, the FDIC provided *unlimited* insurance for noninterest bearing business checking accounts at banks and guaranteed debt issued not only by banks but by their holding companies. The unlimited deposit insurance resulted in a substantial increase in potential loss exposure to the FDIC insurance fund, covering $1.4 trillion in uninsured deposits in excess of the $250,000 insured amount as of year-end 2011.[26] The debt guarantee program covered $346 billion in debt issued by banks and their holding companies as of May 2009.[27] In addition, Congress appropriated $750 billion for the TARP program, which the government used to recapitalize banks. Direct borrowing by banks from the

[26] Federal Deposit Insurance Corporation, Quarterly Banking Profile, 2012, vol. 6, no. 1 at 16. Most of these uninsured deposits have been placed by banks with the Federal Reserve System as excess reserves on which the banks earn 25 basis points. The unlimited insurance is scheduled to end on December 31, 2012.

[27] Federal Deposit Insurance Corporation, Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program.

Federal Reserve exceeded this amount. Even with these programs in place, hundreds of banks did not survive the financial crisis.

A Federal Reserve research paper has shown that these and related government support actions have substantially increased the federal safety net's coverage from approximately 45 percent of all financial firm liabilities in 1999 to approximately 59 percent of such liabilities at the end of 2009.[28]

If MMFs did not exist, the federal safety net would increase even more. Much of the $2.6 trillion currently in MMF assets would end up in banks. The size of the banking system and the federal safety net would swell, increasing taxpayer exposure to systemic risk.

8. MMFs Exert Useful Market Discipline

Because of their risk-averse attributes, MMFs are a major contributor of market discipline. They exert market discipline on issuers of short-term liabilities whose debt is subject to rigorous credit analysis by MMF portfolio managers. SEC Rule 2a-7 requires MMF managers to perform an independent credit analysis of every security they purchase—they may not rely on credit ratings as the sole basis for an investment. The short-term nature of MMF portfolios requires ongoing and continual credit analysis, subject to strict credit quality standards under Rule 2a-7 as well as redemption activity by MMF shareholders. MMF investment decisions can signal areas of emerging weakness that warrant financial supervisors' attention. MMFs are indicators of collective market sentiment regarding the health of individual issuers and the financial markets as a whole that can be of use to financial supervisors in monitoring systemic risk.

[28] Nadezhda Malysheva and John R. Walter, "How Large Has the Federal Financial Safety Net Become?" Federal Reserve Bank of Richmond, Economic Quarterly, Vol. 96, No. 3, 10-03, March 10, 2010.

Fed Chairman Bernanke has said, "market discipline is a powerful and proven tool for constraining excessive risk-taking."[29] Market discipline is the third "pillar" in the Basel II supervisory framework. One of the key purposes of the Financial Stability Oversight Council is "to promote market discipline."[30] Rather than seek to incapacitate MMFs, the Fed should do everything possible to preserve them as market discipliners.

The ability of MMFs to engage in agile risk-management is a hallmark of their success and a reason why investors have entrusted so much of their cash to MMFs. It is one of the great ironies of financial regulation that the Fed believes MMFs are too proficient in risk management and market discipline.

III. MMFS ARE NEITHER BANKS NOR "SHADOW BANKS"

Fed officials have erroneously characterized MMFs as part of the "unregulated shadow banking system."[31] As described in detail below, MMFs are neither unregulated nor shadow banks.

A. MMFs Have None of the Defining Features of Banks

MMFs have none of the defining characteristics of banks, including the moral hazard and systemic risks posed by large banks. MMFs do not take deposits or make commercial loans. Nor do they leverage their capital in the way banks do or create off-balance sheet liabilities by securitizing their assets. They have operated successfully for decades without federal insurance or the need for central bank liquidity facilities.

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[29] Ben S. Bernanke, Chairman, Federal Reserve Board, "Financial Regulation and the Invisible Hand," Remarks at the New York University Law School, April 11, 2007. See also Kevin Warsh, former Governor, Federal Reserve Board, "Regulation and Its Discontents," Remarks to the New York Association for Business Economics, Feb. 3, 2010 ("We must resurrect market discipline as a complementary pillar of prudential supervision.").

[30] Dodd-Frank Wall Street Reform and Consumer Protection Act § 112.

[31] See Statement by Ben S. Bernanke, Chairman, Federal Reserve Board, before the Financial Crisis Inquiry Commission, Sept. 2, 2010.

1. MMFs Are Not Operating Companies

MMFs are investment companies, not operating companies like banks. They consist of pools of securities. A MMF does not exist independently of or have activities apart from its pool of securities. Securities in the pool are bought and sold as investors buy and sell shares of the pool. Unlike banks, which are corporations, MMFs typically are organized as trusts. Each MMF is governed by a board of trustees or a board of directors, which acts on behalf of the fund's shareholders subject to fiduciary duties.

Unlike banks, which have offices open to the public, MMFs generally have no public offices. Investors in a MMF generally purchase their shares through an intermediary, such as a broker-dealer or bank, or directly from the fund online. Unlike banks, MMFs have no employees. A MMF is managed by an investment adviser, typically assisted by other service providers. A custodian provides safekeeping for fund assets. A transfer agent records purchases and sales of fund shares. A distributor, assisted by intermediaries, assists shareholders in buying and selling fund shares and provides related administrative services.

2. MMFs Do Not Take Deposits

Unlike banks, MMFs do not take deposits. Rather, they issue securities. Deposits are debt obligations whereas securities constitute an equity interest. MMF securities are registered with the SEC pursuant to the Securities Act of 1933. MMFs have shareholders, not depositors. Each MMF shareholder receives an equity interest in the fund's assets entitling them to a proportionate share of the fund's assets upon liquidation. A MMF shareholder is not entitled to a return of 100 cents on the dollar, unlike depositors who are the equivalent of creditors of a bank.

Whereas banks rely on the proceeds of loans and other illiquid assets to repay their depositors, MMFs liquidate securities in their portfolio to repay their shareholders, usually on a dollar for dollar basis.

Shares of a money market fund are not considered to be deposits for purposes of the Glass-Steagall Act because fund shares constitute an equity interest rather than a debtor-creditor relationship as in a deposit.[32] Section 21 of the Glass-Steagall Act, which has not been repealed, prohibits entities other than banks from receiving deposits.[33]

MMFs provide a service similar to that of bank deposits to the extent they provide a repository for liquid assets with daily access. Retail funds may offer investors a checking account option, subject to a minimum amount on each check. But the nature of the investor's claim is fundamentally different from a deposit.

3. MMFs Do Not Make Loans

Unlike banks, MMFs do not make loans. MMFs are not permitted to offer residential mortgages or make commercial or consumer loans. MMFs only invest in securities and debt instruments. MMFs may invest in highly rated asset-backed securities where the underlying collateral consists of a pool of loans. But they do not originate or hold loans directly. They do not perform the same credit underwriting or servicing functions of banks or assume the same credit risks. Banks are chartered for the purpose of supplying loans to the economy and taking credit risks. MMFs are permitted only to invest in securities and to take only minimal credit risk on the securities in which they invest. MMFs invest in highly rated commercial paper, which has characteristics similar to a short-term loan, but nonetheless is a security.[34]

4. MMFs Do Not "Create Money"

Banks are regulated differently from other financial institutions largely because they "create money." They do this by loaning out more than the deposits they take in. Banking regulations allow banks to generate loans and other assets equal to approximately ten times their capital. The business

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[32] *See* Letter dated Dec. 18, 1979, from the Assistant Attorney General, Criminal Division, U.S. Department of Justice, to M. Lybecker, Associate Director, Division of Marketing Management, SEC, interpreting section 21 of the Glass-Steagall Act as applied to MMFs.

[33] 12 U.S.C. § 378.

[34] See Securities Industry Association v. Board of Governors, 468 U.S. 137 (1984) (rejecting argument by Federal Reserve Board that commercial paper is a loan rather than a security for purposes of the Glass-Steagall Act).

model of banks thus relies on an inherently unsound mismatch between assets and liabilities. Banks are permitted to operate this way in order to support economic growth. Federal deposit insurance helps banks attract deposits and ensures that banks will be able to repay insured depositors notwithstanding loan losses under normal circumstances. Banks also are given access to central bank liquidity through the Fed's discount window in the event they need help meeting deposit withdrawals or loan demands. Because they have the full faith and credit of the U.S. government behind them, it has been said that banks are "special."[35] They and their holding companies are subject to supervision and regulation in special ways that other companies are not.

MMFs do not "create money" in the way that banks do. MMFs generally are permitted to hold only $1.00 in assets for every $1.00 of capital. They are not permitted to leverage their capital as banks do. Nevertheless, MMFs play an important role in the economy and are subject to comprehensive regulation appropriate to their activities. Their regulation in major respects is stricter than that which applies to banking organizations, as described later.

5. MMFs Do Not Create Moral Hazard

Unlike banks, MMFs are not federally insured and do not have daily access to central bank liquidity facilities. Accordingly, they are not affected by the moral hazard that allows banks to take risks they otherwise would avoid if they had no access to the federal safety net. Moral hazard fueled irresponsible lending and other risk-taking in the banking system that ultimately led to the downfall of many banks and the near collapse of the entire financial system in 2008.

Unlike banks, MMFs are permitted to assume no more than minimal credit risks. The limitations on their portfolio investments are designed to avoid risk and loss. MMFs thoroughly evaluate the credit risk of issuers whose securities they purchase, but they do not anticipate losses on investments, unlike banks. Banks have no comparable limits on the risk content or maturity of their loan portfolios or proprietary investment portfolios and routinely take risks that would be impermissible for a MMF.

[35] See, e.g., E. Gerald Corrigan, "Are Banks Special? A Revisitation," Federal Reserve Bank of Minneapolis, Banking and Policy Issues Magazine, March 2000.

Banks thus are part of a regulatory framework that creates moral hazard in the financial system; MMFs are not.

MMFs have existed for decades without the need for deposit insurance or access to Federal Reserve liquidity facilities. The highly liquid nature of their portfolios enables them to meet shareholder withdrawals without resort to central bank liquidity facilities. Banks require routine access to the Federal Reserve's discount window because their deposits are invested in loans and other assets they cannot readily liquidate and because they make ten times more loans than their deposits.

6. MMFs Are Not FDIC Insured

Unlike banks, MMFs are not FDIC-insured. The federal government does not insure or guarantee MMFs. A MMF shareholder does not have an insured depositor's claim against the insurance fund. In the event a MMF cannot pay its shareholders $1.00 per share, its shareholders are entitled to receive only a pro rata share of the fund's assets upon its liquidation.

During the financial crisis, the U.S. Treasury established a temporary, partial guarantee program for MMFs, for which it charged MMFs $1.2 billion in fees. This program was neither asked for nor used by MMFs. Neither the Treasury nor the taxpayers paid a nickel to support MMFs during the crisis. In the Dodd-Frank Act, Congress effectively prohibited the Treasury from implementing a similar program in the future.

7. MMFs Are Not Implicitly Guaranteed

Some Fed officials have said that MMFs are "implicitly guaranteed" because some investors erroneously believe that MMFs are guaranteed by the government or that the government will insure MMFs in the event of another financial crisis. No "implicit guarantee" of MMFs exists. MMFs are required to disclose that their shares are not FDIC insured or guaranteed by the government and that investors may lose money by investing in MMFs.

MMFs have no implicitly guaranteed access to the Fed's discount window. During the financial crisis, the Fed established a temporary facility that indirectly purchased bank-sponsored asset-backed commercial paper from prime MMFs to ease pressure on bank sponsors and guarantors of such paper and to help absorb MMF liquidations of commercial paper as they responded to redemption requests, but that facility was limited to the extraordinary circumstances of the financial crisis.

Institutional investors know that MMFs are not guaranteed. Retail investors have no excuse for not knowing the same, and are not a source of "runs" on MMFs in any event.

8. MMFs Are Self-Liquidating

When a bank fails and is closed, its shareholders typically are wiped out, creditors are not fully repaid, and if the FDIC cannot find a buyer for the bank, depositors are lucky to receive back more than 50 percent of their deposits in excess of the insurance limit.[36] In contrast, in the one instance when a MMF broke a dollar during the financial crisis, fund shareholders got back more than 99 percent of their money. Because banks typically extend loans equal to ten times their capital, the receivership of a failed bank is a complicated undertaking, requiring hundreds of FDIC employees and bank liquidation specialists in a process than can take years.

MMFs, in contrast, are self-liquidating and can be closed in a relatively simple process involving the pro rata distribution of the fund's assets as they mature. If a MMF's NAV falls below $1.00 or is about to do so, the fund's board of directors is required to determine whether to operate the fund without a $1.00 NAV—which as a practical matter would make the fund noncompetitive—or liquidate the fund and make a pro rata distribution of the liquidation proceeds. MMF directors also may suspend redemptions in advance of a liquidation in order to ensure that all shareholders are treated

[36] See failure of IndyMac Bank, for example: http://www.fdic.gov/bank/individual/failed/IndyMac.html.

fairly. Several MMFs underwent orderly liquidations during the financial crisis.[37]

9. MMFs Have Never Cost the Taxpayers a Dime

MMFs have never cost the taxpayers a dime. The Treasury earned $1.2 billion in fees from MMFs for the temporary insurance program established by the Treasury in 2008. That program was established upon the Treasury's initiative and was neither asked for nor used by MMFs. It terminated without any losses. Banks, in contrast, have cost the taxpayers hundreds of billions of dollars during the most recent crisis and in earlier crises.

B. MMFs Lack the Features of "Shadow Banks"

The term "shadow banking" emerged shortly after the financial crisis as a catchall phrase for unregulated financial activities that destabilized the banking system and occurred outside of what the Fed considers the "traditional banking system." Various definitions of "shadow banking" have been articulated, most of which include MMFs and most of which are misleading. The chairman of the Fed has described shadow banks as follows:

> Shadow banks are financial entities other than regulated depository institutions (commercial banks, thrifts, and credit unions) that serve as intermediaries to channel savings into investment. Securitization vehicles, ABCP vehicles, money market funds, investment banks, mortgage companies, and a variety of other entities are part of the shadow banking system. Before the crisis, the

[37] For example, one MMF announced that its board of trustees on February 20, 2009, had approved the liquidation of the fund, which would be closed to new investors and additional purchases by existing investors as of May 1, 2009, and that the fund would be liquidated as of the close of business on or about May 15, 2009. Investors were permitted to either exchange into other funds of the sponsor without sales charges or to redeem at any time prior to liquidation. Investors who did not exchange or redeem their shares were told their shares would be liquidated and they would be paid liquidation proceeds. See Calamos Government Money Market Fund 2009 prospectus, p. 9. See also Binyamin Appelbaum, "Putnam Closes $12B Money-Market Fund," Washington Post, Sept. 18, 2008.

> shadow banking system had come to play a major role in global finance; with hindsight, we can see that shadow banking was also the source of some key vulnerabilities. . . . Critically, shadow banks were, for the most part, not subject to consistent and effective regulatory oversight.[38]

Fed researchers have described the shadow banking system as a "network" of market-based credit intermediation channels other than traditional banks and including MMFs.[39] The Financial Stability Board similarly has defined shadow banking as "credit intermediation involving entities and activities outside the regular banking system."[40]

These definitions are both under-inclusive and over-inclusive. They are over-inclusive in that they capture highly regulated financial institutions whose activities pose no inherent systemic risk—such as MMFs. They are under-inclusive in that they fail to recognize that banks themselves and their affiliates engage in extensive shadow banking activities.

To the extent the concept of "shadow banking" has any relevance at all, a more meaningful definition would focus on the activities that destabilized the financial system—undercapitalized leveraged lending through securitization and other nontraditional means funded by excessive reliance on the issuance of short-term debt in the capital markets. Lending is the activity that destabilized the financial system during the financial crisis, not deposit-taking or deposit-like activities. Leveraged lending with insufficient capital was the force that brought down so many financial institutions, including banks.

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[38] Statement by Ben S. Bernanke, Chairman, Federal Reserve Board, before the Financial Crisis Inquiry Commission, Sept. 2, 2010.

[39] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, "Shadow Banking," Federal Reserve Bank of New York Staff Reports, Staff Report no. 458, July 2010.

[40] Financial Stability Board, "Shadow Banking: Strengthening Oversight and Regulation," Oct. 27, 2011 at 1. The Financial Stability Board is an international body of financial regulators from major industrial economies, including the United States. See also European Commission, Green Paper: Shadow Banking, March 19, 2012.

1. MMFs Are Not Leveraged

Unlike banks, MMFs are unleveraged. They do not issue debt and do not engage in leveraged lending. They do not make loans, let alone borrow funds to make loans. They issue shares and use the proceeds to purchase securities on behalf of their shareholders—i.e., their "depositors" who are the source of their equity capital. They have 100 percent equity capital and do not borrow against their capital to expand their assets. Every dollar of equity in a MMF supports one dollar of assets. Banks, in contrast, are permitted to leverage their capital 10 to 1 or greater.[41] For every dollar of bank shareholder equity or other capital, a bank generally may acquire $10 of assets, funded by deposits or other debt, such as commercial paper. MMFs, in contrast, invest only the amount of equity they receive from their shareholders on an almost dollar-for-dollar basis and no more. MMFs are not a source of leverage in the financial system and are not "shadow banks."

2. MMFs Are Highly Transparent

MMFs are the most transparent of all financial institutions. They are required to make extensive disclosures about their operations, activities, investments, risks, service providers, fees, and other matters in prospectuses and other information filed with the SEC and made available to shareholders. They also are required to disclose detailed information about each investment in their portfolios, including the name of the issuer, category of investment, CUSIP number, principal amount, maturity date, final legal maturity date, coupon or yield, and amortized cost value. Banks are not required to publicly disclose any information concerning the composition of their loan or investment portfolios. MMFs regularly value their portfolios at market prices and publicly disclose their market priced net asset value to four decimal points. Banks value a substantial portion of their assets at book value, making

[41] Prior to the financial crisis, banking organizations were even more heavily leveraged. The Financial Crisis Inquiry Commission found that, "from 2000 to 2007, large banks and thrifts generally had $16 to $22 in assets for each dollar of capital, for leverage ratios between 16:1 and 22:1. For some banks, leverage remained roughly constant. JP Morgan's reported leverage was between 20:1 and 22:1. . . . Citigroup's increased from 18:1 to 22:1, then shot up to 32:1 by the end of 2007. . . . Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Jan. 2011, at 65.

it difficult for depositors, investors, and even regulators to know their true condition at any given time.

3. MMF Maturity Transformation is Miniscule

Maturity transformation is sometimes said to be a "shadow banking" activity. Banks transform assets with maturities of as long as 30 years into demand liabilities through their normal lending activities. They also engage in maturity transformation through nontraditional shadow banking activities involving the pooling of long-term loans in ABCP conduits and other securitization vehicles, which they fund by issuing short-term liabilities. Banking organizations are major issuers and sponsors of ABCP.

The maturity transformation function of MMFs is miniscule compared to that of banks. Unlike banks, which transform 30-year illiquid assets into demand liabilities, MMFs transform highly liquid short-term assets with maturities of 60 days or less on average into securities with daily redeemability. SEC rules require MMFs to maintain a weighted average portfolio maturity of 60 days or less. The assets MMFs transform are mainly commercial paper, government securities, municipal securities, and other assets that, unlike mortgages and other loans, mature quickly and can be liquidated in the secondary market if necessary. MMFs may hold no more than five percent of their assets in illiquid securities (i.e., that cannot be liquidated at approximately the value ascribed to them by the fund in seven days).

4. MMFs Do Not Create Off-Balance Sheet Liabilities

Unlike banks, MMFs do not have the ability to create off-balance sheet liabilities by transferring their assets to securitization trusts or other structured vehicles. All of their assets are carried on-balance sheet. The securitization of toxic long-term assets in complex structured vehicles was instrumental in causing the financial crisis. MMFs do not have the ability to create such vehicles.

5. MMFs Do Not Own Securities Subsidiaries

Unlike banking organizations, MMFs are not permitted to own operating companies or other subsidiaries. SEC rules generally prohibit a MMF from investing more than five percent of its assets in the securities of any one issuer whereas banks can and do own dozens, sometimes hundreds, of subsidiaries. MMFs specifically are prohibited from owning companies engaged in securities activities. The Investment Company Act generally prohibits MMFs from acquiring securities of broker-dealers, underwriters, and investment advisers. This prohibition reflects concerns by Congress regarding a MMF's exposure to the entrepreneurial risks of securities-related issuers and the potential for conflicts of interest, self-dealing, and reciprocal practices. Banking organizations, in contrast, are permitted to own subsidiaries engaged in securities brokerage, underwriting and dealing and over the course of the past 20 years have acquired all of the major securities broker-dealers in the United States.

6. MMFs Have Stricter Limits on Affiliate Transactions

MMFs are subject to stricter limits on transactions with affiliates than banks. Under section 23A of the Federal Reserve Act, a bank may make loans to and purchase securities issued by an affiliate and engage in other transactions with affiliates, in amounts up to ten percent of its capital and up to 20 percent of its capital for affiliates in the aggregate. Under section 23B, a bank may sell assets to an affiliate provided the sale is on market terms.

MMFs, in contrast, may not make any loans to or purchase any securities issued by or from an affiliated person, absent an exemption by the SEC. The Investment Company Act restricts a wide range of transactions and arrangements involving funds and their affiliates. The Act's provisions protect MMFs and other registered investment companies from self-dealing and overreaching by affiliated persons. Among other things, the Act prohibits any affiliated person of a MMF from knowingly purchasing securities or other property from the fund and prohibits a MMF from engaging in any transaction in which an affiliate is a joint participant unless allowed by SEC rules.

C. Banks and Their Affiliates Are the True "Shadow Banks"

The definition of "shadow banking" adopted by the Fed and other sources reflects the erroneous view that the shadow banking system exists outside of the regulated banking system. In fact, banks and their affiliates engage in extensive shadow banking activities and form the backbone of the shadow banking system. Banking organizations operate the shadow banking system and to a large extent *are* the shadow banking system.

Without banks and their affiliates, the shadow banking system would not exist, at least not on a scale capable of threatening the entire financial system. Economist Gary Gorton has said:

> [T]he shadow banking system is essentially how the traditional banking, regulated, banking system is funded. The two banking systems are intimately connected. This is very important to recognize. It means that without the securitization markets the traditional banking system is not going to function.[42]

My paper "Shooting the Messenger: The Fed and Money Market Funds" describes the shadow banking activities of banking organizations and shows how they are the fulcrum of the shadow banking system.

More recently, Fed Chairman Bernanke appears to have modified his view of the shadow banking system and acknowledged that banking organizations engage in shadow banking activities, which he says occur "at least partly outside of the traditional banking system."[43]

1. Banks Engage in Major Maturity Transformation Using Non-Deposit Liabilities

Banks and their affiliates engage in major maturity transformation not only by using deposits to fund long-term loans but by issuing commercial paper and sponsoring asset-backed commercial paper conduits and other securitization vehicles that issue short-term paper to fund loans, loan receivables, and other term assets. Banks are the principal sponsors of asset-backed commercial paper. In the years leading up to the financial crisis, banks sponsored and/or guaranteed the bulk of the paper issued in the $1.4 trillion ABCP market. Through their shadow banking activities, banks and their affiliates transform long-term assets into short-term liabilities.

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[42] Gary Gorton, "Questions and Answers About the Financial Crisis," prepared for the U.S. Financial Crisis Inquiry Commission, Feb. 20, 2010, at 8.

[43] Ben S. Bernanke, "Fostering Financial Stability," Speech before the 2012 Financial Markets Conference Sponsored by the Federal Reserve Bank of Atlanta, April 9, 2012.

2. Banking Organizations Highly Leveraged

Banking organizations leverage their capital roughly ten to one. For every dollar of capital, they make approximately ten times or more the amount in loans or other assets.[44] They can do this because they are required to maintain capital equal to only approximately 10 percent of their assets. For every dollar of bank shareholder equity or other capital, a bank generally may acquire $10 of assets, funded by deposits or other debt, such as commercial paper.

3. Banks Securitize the Bulk of Their Loans

Banks no longer engage principally in the business of making long-term loans that they hold on their books. Nearly all bank loans are transferred to securitization trusts, which pool the loans and sell interests to investors, or are sold to government-sponsored enterprises. Fed researchers have found that the shadow banking system grew out of bank securitization activities and that securitization was at the heart of the financial crisis by enabling banks to leverage their assets:

> The shadow banking system is organized around securitization and wholesale funding.[45]
>
> The current financial crisis has highlighted the growing importance of the "shadow banking system," which grew out of the securitization of assets and the integration of banking with capital market developments. . . Securitization was intended as a way to transfer credit risk to those better able to absorb losses,

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[44] Prior to the financial crisis, banking organizations were even more heavily leveraged. The Financial Crisis Inquiry Commission found that, "from 2000 to 2007, large banks and thrifts generally had $16 to $22 in assets for each dollar of capital, for leverage ratios between 16:1 and 22:1. For some banks, leverage remained roughly constant. JP Morgan's reported leverage was between 20:1and 22:1. . . . Citigroup's increased from 18:1 to 22:1, then shot up to 32:1 by the end of 2007. . . . Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Jan. 2011, at 65.

[45] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, Hayley Boesky, "Shadow Banking," Federal Reserve Bank of New York Staff Reports, Staff Report no. 458, July 2010 (rev. Feb. 2012), at 10.

> but instead it increased the fragility of the entire financial system by allowing banks and other intermediaries to "leverage up" by buying one another's securities.[46]

4. Bank Holding Companies Issue Short-Term Paper

Bank holding companies fund themselves by issuing short-term commercial paper. They are the largest issuers of commercial paper in the economy. Of approximately $1.0 trillion in commercial paper outstanding as of June 13, 2012, $476 billion was financial (mainly issued by banking organizations), $329 billion was asset-backed commercial paper (mainly sponsored by banking organizations), and $202 billion was nonfinancial.[47] Bank holding companies downstream the proceeds of this commercial paper to their subsidiary banks, broker-dealers, mortgage companies, and other subsidiaries.

5. Banks Engage in Complex Derivatives Transactions

Banking organizations engage in swaps and other complex derivatives trading activities. These activities are intended mainly to hedge credit and interest rate risk, but sometimes can result in significant losses.[48] The Office of the Comptroller of the Currency reported that, as of year-end 2011, the notional amount of derivatives held by insured U.S. commercial banks was $231 trillion.[49] MMFs do not engage in such activities.

6. Bank Balance Sheets Are Opaque

Bank balance sheets do not disclose details concerning the type, amount and maturity of bank loans or investments. Banks and their holding companies do not value all of their assets at market and do not disclose their asset values. Their balance sheets are opaque.

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[46] Tobias Adrian, Hyun Song Shin, Federal Reserve Bank of New York Staff Reports, "The Shadow Banking System: Implications for Financial Regulation," Staff Report no. 382 (July 2009).

[47] Source: Federal Reserve Board, Commercial Paper, Outstanding Levels.

[48] See Wall Street Journal, "J.P. Morgan Flags $2 Billion Trading Loss," May 11, 2012.

[49] OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2011.

IV. FED PROPOSALS WOULD INCREASE SYSTEMIC RISK

A. The Fed Wants to Restructure MMFs to Assume More Risk

One of the Fed's arguments as to why MMFs need to be subjected to bank-like regulation is that they are overly risk-averse and therefore have a tendency to withdraw from the short-term credit markets during times of stress, forcing banks and other borrowers to find other sources for their highly leveraged "shadow banking" activities.[50] The Fed appears to expect MMFs to remain invested in unstable markets, retain potentially toxic assets, and place at risk the assets of their shareholders, which include millions of American citizens, retirees, businesses, municipalities, and others who rely on MMFs for safety of principal and liquidity. The Fed seems to want MMFs to act contrary to their fiduciary duty, contrary to SEC rules under the Investment Company Act, and contrary to the interests of their shareholders.

Despite what the Fed implies, it is not the job of MMFs to support the credit markets or the "shadow banking" activities of banks and their affiliates during times of crisis at the risk of MMF shareholders. That responsibility resides with the Fed and the Treasury Department, not MMFs. MMFs are not guarantors of the credit markets, or banks.

Banks are meant to be the mainstays of credit availability in the financial markets—it is their charter function to make term loans. Banks are given deposit insurance, access to the Fed's discount window, and federal supervision and regulation for this purpose. They maintain capital and loan loss reserves to absorb credit losses. If banks cannot fulfill their core lending function, then something is drastically wrong with their regulation or the basic bank business model.

Moreover, if banks become incapacitated, it is the role of the Fed to act as the lender of last resort to the economy. MMFs are not suited for such a purpose. MMFs are designed to be safe and liquid. They do not have insured deposits or access to the discount window. SEC regulations do not

[50] See Eric S. Rosengren, President, Federal Reserve Bank of Boston, "Money Market Mutual Funds and Financial Stability," remarks at the Financial Markets Conference sponsored by the Federal Reserve Bank of Atlanta, April 11, 2012.

permit MMFs to invest in assets with more than minimal credit risk. Unlike banks, MMFs are required to be risk-averse and are valued by millions of investors for their risk-averse attributes. The Fed seems to want to alter their structure to serve a purpose for which they were not intended and that would put at risk millions of MMF shareholders who entrust their assets to MMFs. Rather than distort the regulation of MMFs to serve a purpose that can only result in the permanent withdrawal of MMFs from the short-term credit markets, the Fed should find ways of enhancing the resiliency of those markets by bolstering the role of banks as lenders.

The Fed's MMF proposals are unlikely to accomplish its objective of maintaining the flow of credit from MMFs to unstable credit markets during a crisis. Neither a capital buffer nor floating NAV would prevent MMFs or their shareholders from withdrawing from unstable markets. Nor would delayed redemption rights for MMF shareholders. MMFs still would act in the interest of their shareholders during times of stress by reallocating their assets to lower risk asset classes. MMFs still would comply with the requirements of SEC rules under the Investment Company Act that limit their investments and impose fiduciary duties on their investment advisers. Risk-averse investors always should be expected to seek safety for their assets during a crisis.

Even if the Fed could force MMFs to provide funding to the short-term credit markets during periods of uncertainty or stress, such action would increase rather than decrease systemic risk. Participants in the short-term credit markets, knowing that funding is assured, would have a reduced incentive to act prudently or to decrease their reliance on short-term funding. Excessive reliance on short-term credit to fund long-term assets is the reason why many banks failed during the financial crisis.

The Fed's criticism of MMFs for withdrawing from the short-term credit markets, both in the United States and in Europe, is ironic in view of the fact that banking regulators have encouraged banks to do just the same. Indeed, the Fed and banking regulators since the financial crisis have discouraged banks from making either short-term or long-term loans other than in accordance with (some would say) overly strict credit underwriting standards, even though the purpose of banks is to assume credit risk and economic revival depends on bank credit.

B. Fed Proposals Would Impair MMFs Without Benefit

1. A Capital Buffer Will Not Prevent MMFs or Their Shareholders from Avoiding Risk

Fed officials have proposed that MMFs be required to maintain capital buffers for the rare instance when they may suffer a portfolio loss, such as occurred when Lehman declared bankruptcy and its paper, held by some MMFs, became almost worthless. The Fed's rationale presumably is that it would be better for a MMF to absorb losses than to liquidate, which might cause shareholders at other MMFs to reallocate to lower risk assets and cause a more pronounced withdrawal from the short-term credit markets.

A capital buffer is a bank regulatory concept inapposite to the structure and nature of MMFs. Banks are in the business of creating risk and absorbing credit losses. Their balance sheets are structured to absorb credit losses. Credit loss absorption is a fundamental part of their purpose and business model. MMFs are not in the business of creating risk but avoiding it. Unlike banks, they do not leverage their capital and may invest only in short-term, high quality instruments that pose minimal credit risk. A capital buffer would alter the nature of MMFs and saddle them with a cost burden they are not structured to bear.

The capital buffer idea effectively imposes a tax on MMFs, their shareholders, and investment advisers against the remote possibility of another Lehman event. The Lehman loss was extraordinary in that the Fed had signaled it would not let a systemically important firm like Lehman fail and, when it did, Lehman's commercial paper went from investment grade to an accounting value of zero overnight and the markets were gripped with fear that the Fed had lost the ability to prevent a wholesale financial collapse. Other instances have occurred in which MMFs incurred losses, but the funds were able to absorb the losses or fund sponsors purchased assets from their funds or took other action—including liquidation—to prevent the funds from breaking a dollar.

Sponsor support is not an optimal solution to losses at MMFs to the extent it creates moral hazard, as was highlighted in the Fed study referred to earlier.[51] Requiring MMFs to maintain a buffer against losses they are unlikely to incur may create even more moral hazard. A capital buffer could create pressure on MMF managers to manage fund portfolios with incrementally more risk in order to gain yield, knowing that the buffer would absorb any losses. A capital buffer is unlikely to stem "runs" by MMF shareholders, who would seek to reallocate their assets in anticipation of an event that might cause a MMF's buffer to be tapped, fearing they would be charged to replenish the buffer.

As a practical matter, the cost of a buffer likely would make MMFs uneconomical for their sponsors and shareholders. An analysis by the Investment Company Institute has shown that it would take decades for fund sponsors to recoup the cost of a capital buffer of 1.5 to 3.0 percent.[52] MMF shareholders have responded negatively in surveys testing their receptivity to paying for a capital buffer. Any buffer concept that would deny MMF shareholders access to the full value of their assets particularly is rejected by them.

The President's Working Group highlighted significant difficulties with a MMF capital buffer requirement. Among other things, the PWG cautioned that:

> If asset managers or other firms were unwilling or unable to raise the capital needed to operate the new SPBs, a sharp reduction in assets in stable NAV MMFs might diminish their capacity to supply short-term credit, curtail the availability of an attractive investment option (particularly for retail investors), and motivate institutional investors to shift assets to unregulated vehicles. . . . [A] substantial mandatory capital buffer for MMFs would reduce their net yields and possibly motivate institutional investors to move assets from MMFs to unregulated alternatives (particularly if

[51] Patrick E. McCabe, Senior Economist, Federal Reserve Board, "The Cross Section of Money Market Fund Risks and Financial Crises," Finance and Economics Discussion Series 2010-51 (2010).

[52] Investment Company Institute, The Implications of Capital Buffer Proposals for Money Market Funds, May 16, 2012.

regulatory reform does not include new constraints on such vehicles).[53]

Increased liquidity normally is what is needed to stop a "run," not capital. As a result of the SEC's 2010 changes in Rule 2a-7, the Investment Company Institute has reported that prime MMFs now have combined daily and weekly liquidity of approximately $1.4 trillion—far more than the level of outflows they experienced in the week following Lehman's bankruptcy in 2008. A capital buffer on top of this amount of liquidity seems unnecessary to avoid a run on MMFs, which is a remote prospect in any event.

2. Redemption Restrictions Are Unacceptable to MMF Shareholders

In conjunction with a capital buffer, Fed officials have suggested imposing redemption limitations, forfeiture provisions or other restrictions that would prevent MMF shareholders from redeeming the full amount of their shares in the event of a crisis. MMF shareholders have responded negatively to any proposal that would deprive them of daily access to the full value of their shares. Such proposals likely would substantially diminish the utility of MMFs and their ultimate viability.

In the interests of logic and competitive equality, any restrictions on the ability of MMF shareholders to withdraw their assets should be matched by similar restrictions on the ability of bank depositors to withdraw their deposits in the event of a crisis. Bank depositors undoubtedly would have the same objections as MMF shareholders to any such restrictions.

3. A Floating NAV Will Not Prevent MMFs or Their Shareholders from Avoiding Risk

Fed officials also have proposed that MMFs no longer be permitted to offer their shares at a rounded $1.00 price per share but instead be required to "float" their price according to the daily market net asset value of their portfolios calculated in fractions of a penny. Thus, a MMF would be required to price its shares at $0.9999 one day and $1.0001 the next, for example, instead of a constant $1.00.

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[53] Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, 33-35.

Current SEC rules permit a MMF to price its shares at a stable $1.00 per share provided its market net asset value remains within a narrow range of $0.995 to $1.005. Small changes in a MMF's NAV may occur due to fluctuations in interest rates, changes in the maturity of the fund's portfolio, net inflows or outflows, or losses in the fund's portfolio. MMFs generally are able to stay within the permitted range by using the amortized cost accounting method authorized under SEC rules. MMFs are required to disclose their NAVs based on actual market value to four decimal places on a monthly basis. They must cease pricing their shares at a stable $1.00 if their market NAV goes outside the permitted range at any time.

Eliminating the stable $1.00 NAV would remove the administrative, accounting and tax conveniences offered by MMFs. Investors would need to calculate gains and losses on transactions involving MMFs in fractions of pennies rather than dollars. Many corporate and municipal treasurers no longer would be able to use MMFs for cash management due to legal restrictions that require them to utilize $1.00 cash instruments only.

The Fed's idea of requiring MMFs to "float" the price of their shares would deprive MMF shareholders of the key feature that makes MMFs so useful to investors. The proposal thus seems calculated to diminish their value as an alternative to bank deposits. Yet, a floating NAV would not prevent investors from retreating from unstable financial markets in a crisis. Shareholders of short-term floating rate funds similar to MMFs fled those funds during the 2008 financial crisis, as did uninsured depositors from banks. By removing MMFs as an alternative to uninsured bank deposits amidst a financial crisis, the Fed's proposal would increase, not decrease, systemic risk.

The concept of a floating NAV was considered by the President's Working Group on Financial Markets and largely rejected for these and other reasons. The Group cautioned that elimination of MMFs' $1.00 stable NAV might "increase systemic risks, rather than mitigate them, and make such risks more difficult to monitor and control."[54]

[54] *Id.* at 20-22 (footnotes omitted).

C. Fed Proposals Would Have Adverse Systemic Consequences

1. Unstable Bank Deposits Would Increase

If MMFs are impaired or disappear due to the imposition of a capital buffer, redemption restrictions, floating NAV, or other proposals, the likely result would be a substantial increase in uninsured bank deposits as MMF shareholders seek an alternative for their liquid assets. MMFs currently hold approximately $2.6 trillion in liquid assets. Much of this amount likely would end up in banks, notwithstanding the loss of efficiency and safety.

In the absence of loan demand, banks in turn would place this cash on deposit with the Fed in the form of excess reserves on which the Fed pays banks interest or use it for their own investment purposes. Excess reserves have increased from practically nothing before the financial crisis to approximately $1.5 trillion. Most of this amount has come from MMFs. Record low interest rates and unlimited deposit insurance have resulted in an outflow of cash from MMFs to banks and into the Fed's vault where it has offset the Fed's purchases of government securities and mortgage-backed securities in its "quantitative easing" policy. But rather than pay interest to MMFs and their shareholders, the Fed is paying interest to banks.

Because a large portion of the deposits would be uninsured and in the form of unstable brokered deposits, the banking system would become more vulnerable to runs. Uninsured depositors typically are highly risk-sensitive and an increase in uninsured deposits thus would increase systemic risk.

2. Banking Concentration Would Increase

If regulatory changes result in the transfer of cash from MMFs to banks, concentration in the banking system will increase significantly. The largest banks have become even larger as a result of the financial crisis. A shift of cash from MMFs to banks would cause them to become larger still, exacerbating the "too-big-to-fail" problem.

Of the $2.5 trillion increase in insured deposits since 2008, the FDIC has reported that $1.4 trillion is in deposits in excess of $250,000, which are covered by unlimited insurance until the end of this year.[55] Of this $1.4 trillion, $1.07 trillion is concentrated in 19 banks with assets of over $100 billion, and $128 billion is concentrated in 18 banks with assets of $50-100 billion.[56] Excess deposit insurance has resulted in excess deposits at banks which they are not lending but in some cases using for proprietary trading activities.[57]

The loss of MMFs also would mean that the commercial paper market would become more concentrated and highly dependent upon a handful of large banks as purchasers of commercial paper. The Fed needs to address how the commercial paper market would function without MMFs, which currently hold approximately one-half of all commercial paper issued in the United States. Banks cannot purchase the same volume of commercial paper as MMFs because of Basel capital requirements under which commercial paper is risk-weighted and subject to a leverage ratio. More business financing would occur in the form of bank loans, as was the case before the commercial paper market developed. That model is more costly to borrowers than the efficient commercial paper market. Moreover, given the shrinking number of banks, credit risk would be concentrated in fewer banks, increasing the financial system's vulnerability to systemic risk.

It also is doubtful that banks could provide the same level of municipal finance as MMFs. Unlike banks, MMFs are able to pass through the tax exempt status of municipal securities to investors, thus making those securities attractive to investors.

3. The Federal Safety Net Would Expand

The federal safety net and taxpayer exposure to the banking system would expand dramatically if MMFs cease to exist and the banking system correspondingly increases in size. MMFs currently reduce the size of the federal safety net by holding short-term assets outside the banking system. The federal safety net already has expanded dramatically as a result of

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[55] Federal Deposit Insurance Corporation, Quarterly Banking Profile, 2012, Vol. 6, No. 1, Table 1.

[56] *Id.*

[57] See Wall Street Journal, "J.P. Morgan Flags $2 Billion Trading Loss," May 11, 2012.

government actions since the financial crisis. If some or all of the assets currently held in MMFs end up in banks, the safety net will be even larger, along with the exposure of taxpayers to the banking system.

4. The Financial System Would Lose Diversity

The disappearance of MMFs would remove an important element of competition and diversity from the financial system. Competition from MMFs forced federal regulators to remove antiquated restrictions on the ability of banks to pay interest on demand deposits, thereby enhancing competition in the financial marketplace. Because of their different structure, MMFs provide benefits that banks cannot offer—they are more diversified, efficient, and safe for large cash investors. MMFs have become a cost-efficient tool for institutional cash managers, providing greater diversification and liquidity at a smaller cost than could be obtained by a treasurer managing an individual portfolio of short-term investments or moving deposits among multiple banks.

For decades, MMFs have counterbalanced weaknesses in the banking system and, because of their risk-averse nature, exerted an element of market discipline within the financial system. The concentration of financial assets in the banking system exposes those assets to political pressures regarding the allocation of credit in the economy. For example, banks are subject to regulations—including capital requirements—that encouraged excessive credit allocation to the household sector and over-leveraging by American consumers. These regulations contributed to the housing bubble that fueled the recent financial crisis and regulatory arbitrage that resulted in undercapitalized risk-taking by banks. Loss of this diversity could increase systemic vulnerability to risk.

The concentration of financial assets in the banking sector would mean that more of the financial system would be subject to banking regulation and the mistakes of banking regulators. As commentators elsewhere have described, regulatory action and inaction by U.S. banking regulators contributed in significant ways to the buildup of risks in the banking system prior to the crisis. A diversity of regulators, along with a diversity of institutions, may foster a healthier financial system in the long run.

5. Market Discipline Would Suffer

MMFs are a barometer of risk in the financial system and exert useful market discipline on the short-term credit markets in which they invest. If MMFs cease to exist, an important source of market discipline will be lost.

Market discipline has been recognized as an important means of regulating risk in the financial system. Among the regulatory reforms promoted by Congress in the Dodd-Frank Act is increased reliance on market discipline. Market discipline is one of the three pillars of the Basel II capital framework[58] and one of three express purposes of the Financial Stability Oversight Council created by the Dodd-Frank Act.[59] Increased market discipline has been highlighted as a policy goal by the President's Working Group on Financial Markets.[60] Federal Reserve Chairman Bernanke and other Fed governors have remarked on the utility of market discipline in mitigating risk in the financial system:

> In recent decades, public policy has been increasingly influenced by the insight that the market itself can often be used to achieve regulatory objectives.[61]

> Market discipline can improve financial stability by aligning risks and rewards more closely.[62]

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[58] Bank for International Settlements, Basel Committee on Banking Supervision, Consultative Document, Pillar 3 (Market Discipline), Supporting Document to the New Basel Capital Accord, Issued for comment by 31 May 2001.

[59] Dodd-Frank Act § 112(a); 12 U.S.C. § 5322. The three purposes are to identify risks to the stability of the United States, to promote market discipline, and to respond to emerging threats.

[60] President's Working Group on Financial Markets, "Policy Statement on Financial Market Developments," March, 2008. The report made recommendations to address weaknesses in the global financial markets, with the overriding goal to "strengthen market discipline, enhance risk management, and improve the efficiency and stability of capital markets."

[61] Ben S. Bernanke, Chairman, Federal Reserve Board, "Financial Regulation and the Invisible Hand," Remarks at the New York University Law School, April 11, 2007.

[62] Kevin Warsh, Governor, Federal Reserve Board, "Financial Markets and the Federal Reserve," Remarks at the New York Stock Exchange, Nov. 21, 2006.

> We must resurrect market discipline as a complementary pillar of prudential supervision.[63]

> [T]he regulatory system has much to gain from increasing market discipline in financial markets.[64]

MMFs are important contributors of market discipline through the investment decisions of their investment managers who apply rigorous credit analysis to each portfolio investment in order to ensure they incur no more than minimal credit risk and otherwise meet the requirements of SEC Rule 2a-7 that limit MMF investments to high quality instruments. The loss of MMFs as a source of market discipline would increase systemic risk in the financial system.

D. The Fed Should Pursue Reforms That Address the Real Problem

The real problem the Fed is attempting to address is potential systemic instability resulting when banking organizations rely excessively on short-term funding other than insured deposits to finance long-term assets. Instability can result when short-term funding suddenly becomes unavailable, as occurred in 2007 and 2008 when MMFs and other investors no longer would roll over their holdings of commercial paper issued by bank-sponsored asset-backed commercial paper conduits and other securitization vehicles due to concerns they were contaminated with toxic subprime mortgages. When markets are stressed, banks also can lose funding from short-term uninsured depositors and fail, as occurred in 2008.

The way to reduce over-reliance on short-term funding practices by banks is not by requiring MMFs to assume more risk. The answer is not to impose unnecessary regulatory burdens and costs that will drive MMFs out of business and thereby increase systemic risk. The answer is to pursue measures that address bank reliance on unstable short-term funding directly, which the

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[63] Kevin Warsh, Governor, Federal Reserve Board, "Regulation and Its Discontents," Remarks to the New York Association for Business Economics, Feb. 3, 2010.

[64] Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve Board, "Involving Markets and the Public in Financial Regulation," remarks at the Council of Institutional Investors, April 13, 2010.

government can do in at least two ways, neither of which is without drawbacks but which at least aim at the real problem.

First, the government can increase deposit insurance to increase the core deposit base. The government already has done that in the Dodd-Frank Act by increasing the insured deposit amount from $100,000 to $250,000. The Dodd-Frank Act also authorized the FDIC to temporarily provide unlimited deposit insurance to noninterest bearing checking accounts, which will terminate at the end of this year. These measures, while assuring larger amounts of stable funding for banks, have vastly inflated the federal safety net than funds that were not bank-affiliated and did not need support. One plausible explanation for this disproportion is the moral hazard that may arise ks have not been able to fully deploy these excess deposits in the economy and in some cases appear to be using them in risky derivatives trading activities for their own account. A further increase in deposit insurance would seem only to increase, rather than decrease, systemic risk.

Second, the government can impose direct limits on the ability of banking organizations to fund their loans and activities using short-term financing. The Fed and other banking regulators already have done this in several indirect ways. Among other things, they have prevented banks from sponsoring asset-backed commercial paper conduits with insufficient capital by requiring them to consolidate the conduits on their balance sheets. They also are in the process of implementing provisions of the Dodd-Frank Act requiring banks that securitize assets to retain some of the risk. The general increase in Basel capital standards for banking organizations also likely will reduce bank reliance on short-term financing for long-term assets. New liquidity requirements will help banks withstand a reduction in the availability of short-term funding for their activities. These measures, while reducing the vulnerability of banks to over-reliance on short-term funding, may result in an overall reduction in the availability of credit to the economy.

The government will need to balance the economic costs of these alternatives against the desired goal of increasing the resiliency of the banking system and reducing systemic risk. The difficulty of the relevant policy options may make it plain that eliminating all risk from the banking system is not an achievable goal. But the government should not divert its focus from the difficult policy decisions that need to be made by proposing unnecessary and counterproductive measures to address nonexistent and non-threatening problems at MMFs when the real problem lies elsewhere.

V. MMFs Already Are Highly Regulated

Some proponents of inappropriate structural changes for MMFs have made statements reflecting the mistaken belief that these entities somehow have evaded regulation during their 40 years of existence. To the contrary, MMFs are subject to a comprehensive regulatory framework under the securities laws that has fostered their safe and efficient operation for many years.

A. Numerous Federal Laws Govern MMFs

1. Investment Company Act of 1940

The Investment Company Act of 1940 regulates the structure and operations of MMFs as well as other investment companies. The Act requires each MMF to register with the SEC and to provide required information concerning its organization, management, and operations. Among its many provisions, the Act regulates permissible fund investments, restricts conflicts of interest, and imposes duties on MMF boards of directors. The Act prohibits convicted felons and other wrongdoers from employment with a MMF. MMFs are required to register with the SEC not only when they are created but when they cease operations. The SEC may issue an order prescribing the terms and conditions under which a fund may cease operations if necessary for the protection of investors.

2. Investment Advisers Act of 1940

Investment advisers to MMFs also are subject to SEC supervision and regulation under both the Investment Company Act and the Investment Advisers Act of 1940. The Advisers Act contains provisions requiring fund advisers to meet recordkeeping, custodial, reporting, and other regulatory responsibilities. Investment advisers are treated as fiduciaries under the Act and are subject to fiduciary duties in their fund management. No person may serve as an investment adviser to a MMF except pursuant to a written agreement approved by a majority of the fund's shareholders. The investment advisory agreement must be approved annually by the fund's independent board of directors or by a majority vote of the fund's shareholders. The advisory agreement must include terms providing that it may be terminated at any time, without penalty, by the board of directors or a majority vote of the fund's shareholders on not more than 60 days' written notice, and may be terminated automatically if the agreement is assigned to another person.

3. Securities Act of 1933

MMF shareholders are protected by the Securities Act of 1933, which requires the registration of MMF shares and imposes disclosure requirements. The Act requires each MMF to provide a prospectus to investors giving information about the fund, its investment adviser, investment objectives, fees, and other information to investors.

4. Securities Exchange Act of 1934

MMF investors also are protected by the Securities Exchange Act of 1934, which includes anti-fraud and other investor protections. Rules of the Financial Industry Regulatory Authority ("FINRA") govern the sale of MMF shares by brokers and further protect MMF shareholders. State securities laws provide additional protection to MMF investors.

B. The SEC Comprehensively Regulates MMFs

The Securities and Exchange Commission ("SEC") supervises and regulates MMFs under the governing statutes. The SEC is an independent agency created by Congress to serve as the "watchdog" of the securities markets. Several divisions of the SEC regulate MMFs. The Division of Investment Management has primary oversight responsibility for MMFs and fund investment advisers and is responsible for writing rules to implement the Investment Company Act and Investment Advisers Act. Rule 2a-7 is the principal SEC rule governing the structure and operation of MMFs. The Division of Trading and Markets has rulemaking and oversight responsibility with respect to broker-dealers that sell MMF shares. The Division of Corporation Finance oversees disclosure information provided by MMFs. The Office of Compliance Inspections and Examinations examines MMFs and their advisers. The Division of Enforcement investigates alleged violations of the securities laws and brings civil actions to enforce the laws.

The SEC has comprehensively regulated MMFs for decades. As the financial markets have evolved, the SEC from time to time has adopted regulatory enhancements. The SEC gave high priority to reviewing its MMF regulations following the financial crisis. In early 2010, it adopted changes to Rule 2a-7 and other rules that make MMFs even more safe and resilient than before. The changes enhanced the credit quality of MMF portfolios, shortened portfolio maturities, improved liquidity, and gave MMFs increased flexibility to suspend redemptions and process transactions during a crisis.[65]

C. MMF Regulation Is Stronger Than Banking Regulation

The SEC's regulation of MMFs is stronger than the regulation of banking organizations in certain key respects.

1. Stronger Governance

Independent Boards of Directors

MMFs are governed by boards of directors or trustees. The Investment Company Act prohibits any MMF from having a board of directors or trustees more than 60 percent of whose members are "interested persons" of the fund. In practice, most large MMF complexes have boards that are 75 percent independent. Unlike MMFs, banks and bank holding companies are not required to have independent boards of directors.

Fiduciary Investment Advisers

MMFs are organized and operated by investment advisers who have the status of fiduciaries and owe fiduciary duties to MMF shareholders. Banks do not owe a fiduciary duty to their depositors.

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[65] Fitch Ratings has found that the SEC's 2010 reforms have helped increase the ability of MMFs to withstand financial crises. Fitch Ratings, Inc., "Study of MMF Shadow NAV Shows Stability," June 14, 2012 ("We believe the stability shown by MMFs is due to high credit quality of portfolio holdings, heightened risk-aversion by MMF shareholders and managers, and, importantly, the introduction of MMF regulatory reform (Rule 2a-7 amendments) by the Securities and Exchange Commission (SEC) in May 2010.").

Shareholder Approval for Contracts

MMFs must obtain the approval of their shareholders for certain of their key operations. For example, fund shareholders must approve the fund's contract with its investment adviser. Fund shareholders also must approve any changes in a MMF's investment policy. Bank depositors have no ability to control a bank's policies concerning the investment of their deposits.

Segregation of Assets

The custody of MMF assets is regulated under SEC rules. MMFs generally must place all of their assets in a segregated safekeeping account in the custody of a bank supervised by federal or state regulatory authorities. Banks are not required to segregate deposits from their other activities and indeed may use deposits to invest for their own accounts.

2. Stricter Portfolio Limits

Minimal Credit Risk

SEC rules limit MMF portfolio investments to high quality, short-term money market instruments that pose minimal credit risk. Banks have no similar limitations on the investment of their deposits. Bank holding companies also have no similar limitations on their portfolio investments.

Limited Portfolio Maturity

MMFs are required to maintain a weighted average portfolio maturity of 60 days or less and a weighted average portfolio life of 120 days or less. Banks and bank holding companies are subject to no such limitations.

Market Valuation

MMFs are required to calculate the market value of their assets on a regular basis. Although Rule 2a-7 permits them to value their portfolio securities at acquisition cost as adjusted for amortization of premium or accretion of discount—the so-called amortized cost method of account—MMFs nevertheless also are required to value their assets based on market values—called "shadow pricing." In this regard, MMFs must adopt written procedures requiring the periodic calculation of "the extent of deviation, if any, of the current net asset value per share calculated using available market quotations . . . from the money market fund's amortized cost price per share."

If any deviation from the fund's amortized cost price per share may result in material dilution or other unfair results to investors, the fund must take such action as is reasonably practicable to eliminate or reduce the dilution or unfair results.

Banks, in contrast, value a substantial portion of their assets at book value, making it difficult for their depositors, investors, and even regulators to know the true value of their loans, investments, and other assets.

No Leverage

MMFs are not permitted to leverage their equity capital to inflate their assets. Banks are permitted to extensively leverage their deposits and capital.

No Complex Derivative Transactions

MMFs do not engage in swaps or other derivatives transactions. Banks, in contrast, are major participants in the derivatives markets.

3. Greater Liquidity Requirements

MMFs are required to maintain liquidity sufficient to meet foreseeable redemption requests. Banks have no similar requirements with respect to their deposits. MMFs are required to hold 10 percent of their portfolios in assets that can be liquidated within one day and 30 percent in assets that can be liquidated within one week.[66] Banks have no such requirements. MMFs may hold no more than five percent of their assets in illiquid securities (i.e., that cannot be liquidated at approximately the value ascribed to them by the fund in seven days). Banks have no such requirement.

4. Counterparty Limits

MMFs are permitted to hold no more than five percent of their assets in the securities of any one issuer. They may hold no more than three percent of their assets in securities of "second tier" issuers rated less than investment grade and no more than one-half of one percent of their assets in such

[66] Fitch reported that, as of April 2012, prime MMFs in practice held more than 30 percent of their assets in daily liquid instruments and over 43 percent of their assets in weekly liquid instruments. Fitch Ratings, "Study of MMF Shadow NAV Shows Stability," June 14, 2012.

securities of any one issuer. Banks and bank holding companies are not subject to equivalent limits.

5. Greater Transparency

In addition to prospectuses that provide detailed information about each MMF's operations, MMFs are required to post on their web sites information regarding every investment in their portfolios. Such information includes the name of the issuer, the category of investment, the CUSIP number, principal amount, maturity date, final legal maturity date, coupon or yield, amortized cost value, and a link to the SEC's web site where a user may obtain the most recent 12 months of publicly available information filed by the fund. Banks are not required to provide their depositors or shareholders with equivalent information regarding their loan portfolios or investment portfolios.

6. Shareholder Equality

MMFs are required to treat all shareholders of the same class of fund shares equally. They are prohibited from issuing senior securities or otherwise treating shareholders of the same class disparately. Each share of a MMF must have equal voting rights with all other shares in the fund. Banks, in contrast, are permitted to treat their depositors differently and routinely do so. For example, banks are permitted to give some depositors preferential interest rates on loans depending on the size of the customer's deposits or use of the bank's other banking services.

VI. Dodd-Frank Requires No Changes to MMF Regulation

A. The Dodd-Frank Act Was Not Aimed at MMFs

The Dodd-Frank Act includes no provisions requiring any changes in the regulation or structure of MMFs. MMFs are not specifically addressed in any substantive provisions of the Dodd-Frank Act.

The Act includes voluminous provisions designed to reform and strengthen the regulation of banking organizations and other kinds of financial institutions other than MMFs. It includes dozens of provisions specifically aimed at banks, bank holding companies, savings and loan holding companies, mortgage brokers, derivatives dealers, hedge fund advisers, insurance companies, clearing and settlement facilities, credit rating agencies, securitizers, municipal securities advisers, securities broker-dealers, and other elements of the financial system. Conspicuously absent are any provisions specifically requiring any changes in the regulation of MMFs.

B. Dodd-Frank Requires No Further MMF Reforms

It is reasonable to surmise from the absence of provisions addressing MMFs that Congress did not perceive the need for any changes in their regulation or structure. That MMFs were not a cause the financial crisis undoubtedly was apparent to Congress. Unlike banking organizations, MMFs did not make subprime loans, leverage their assets, or engage in securitization or other off-balance sheet activities that led to the financial crisis.

It is reasonable to infer that Congress was satisfied that the regulatory framework governing MMFs under the Investment Company Act of 1940 adequately ensures their safety. The Dodd-Frank Act by its terms requires no change in the regulation of MMFs and nothing in the Act suggests that Congress intended the SEC, FSOC, or Federal Reserve to make any such changes.

In particular, nothing in the Dodd-Frank Act suggests that Congress intended MMFs to be treated like banks or be subject to bank-like regulation. Nothing in the Act suggests that Congress intended to deprive MMFs and their shareholders of the $1.00 stable NAV or impose inappropriate capital requirements or other substantive changes in the regulation of MMFs.

VII. MMFs Are Not SIFIs Under Dodd-Frank

The Dodd-Frank Act authorizes FSOC to determine, by a 2/3's vote, that a nonbank financial company shall be subject to more stringent prudential standards under Fed supervision if "material financial distress" at the company or the "nature, scope, size, scale, concentration, or interconnectedness, or mix of the activities" of the company "could pose a threat to the financial stability of the United States." Such companies are referred to informally as nonbank "SIFIs" (systemically important financial institutions).

A. Dodd-Frank Does Not Mandate SIFI Treatment of MMFs

Nothing in the language or legislative history of the Dodd-Frank Act mandates the treatment of MMFs as SIFIs. The Act designates certain bank holding companies as SIFIs—i.e., those with total consolidated assets of $50 billion or more. The Act does not so designate MMFs. Nor does the Act require that MMFs even be considered for SIFI designation.

The Dodd-Frank Act authorizes FSOC to consider whether a nonbank financial company should be designated as a SIFI based on specific criteria set forth in the Act. But the Act does not mandate that such criteria be applied to MMFs. Indeed, the language of the criteria and the Act itself indicate that MMFs should *not* be designated as SIFIs.

B. The Act's Language Shows That Congress Did Not Intend MMFs to be Designated as SIFIs

Before FSOC may designate a nonbank financial company as a SIFI, the Dodd-Frank Act requires FSOC to determine that "material financial distress" at the company, or "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of the company "could pose a threat to the financial stability of the United States."

There is no indication in the language or legislative history of the Dodd-Frank Act that Congress viewed MMFs as posing "a threat to the financial stability of the United States." Moreover, the history of MMFs shows that the nature of MMFs is such that rarely, if ever, are they under "material financial distress." The only historical instance of significant "distress" at MMFs occurred during the collapse of the financial system in 2008. Although the financial stability of the United States was threatened at that time, MMFs were not the cause. Rather, the cause was undercapitalized risk-taking and over-leveraging by inadequately supervised banking organizations, the Fed's failure to maintain a consistent lender of last resort policy, and other causes having nothing to do with MMFs.

Moreover, it cannot be said that what MMFs experienced during the crisis was "material financial distress." Prime MMFs experienced heavy redemption volume from shareholders who reallocated their assets to lower risk portfolios, but at no time was any MMF in danger of becoming insolvent, bankrupt, or unable to meet its obligations to its shareholders. MMFs by their nature and structure never become insolvent or go bankrupt. Some MMFs elected to close and distribute their assets pro rata. One MMF was unable to maintain a net asset value of $1.00 per share and was forced to liquidate. But MMFs are under no obligation to pay their shareholders $1.00 per share. They are obligated to distribute their assets on a pro rata basis when they liquidate. The fund that "broke a dollar" distributed its assets on a pro rata basis to its shareholders, who received 99 cents on the dollar.

Congress included specific provisions in the Dodd-Frank SIFI designation criteria that strongly suggest Congress did not intend FSOC to designate MMFs as SIFIs. In particular, FSOC is required to consider "the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse." In addition, FSOC is required to consider "the degree to which the company is already regulated." MMFs are highly regulated by the SEC, their assets are managed rather than owned, and the ownership of their assets under management is diffuse. The language of the Act thus strongly suggests that Congress did not intend FSOC to designate MMFs as SIFIs.

C. The Act's Legislative History Shows That Congress Did Not Intend MMFs to be Designated as SIFIs

The legislative history of the Dodd-Frank Act supports the view that Congress did not intend FSOC to designate MMFs as SIFIs. Senator Dodd, after whom the Act is named, specifically addressed the Act's applicability to MMFs during the Senate debate on the Act. In the following colloquy, Senator Dodd confirmed that only a limited number of "high-risk" nonbank financial companies would be designated as SIFIs under the Act, not including mutual funds:

> Mr. KERRY. Mr. President, the conference report to accompany H.R. 4173, the Dodd-Frank Wall Street reform bill, creates a mechanism through which the Financial Stability Oversight Council may determine that material financial distress at a U.S. nonbank financial company could pose such a threat to the financial stability of the United States that the company should be supervised by the Board of Governors of the

> Federal Reserve System and should be subject to heightened prudential standards. It is my understanding that in making such a determination, the Congress intends that the council should focus on risk factors that contributed to the recent financial crisis, such as the use of excessive leverage and major off-balance-sheet exposure. The fact that a company is large or is significantly involved in financial services does not mean that it poses significant risks to the financial stability of the United States. **There are large companies providing financial services that are in fact traditionally low-risk businesses, such as mutual funds and mutual fund advisers. We do not envision nonbank financial companies that pose little risk to the stability of the financial system to be supervised by the Federal Reserve.** Does the chairman of the Banking Committee share my understanding of this provision?
>
> Mr. DODD. **The Senator from Massachusetts is correct.** Size and involvement in providing credit or liquidity alone should not be determining factors. The Banking Committee intends that only a limited number of high-risk, nonbank financial companies would join large bank holding companies in being regulated and supervised by the Federal Reserve.[67]

There is no legislative history indicating that the view of Senator Dodd, who was chairman of the Senate Banking Committee, did not reflect the prevailing view of other members of Congress who voted in favor of the Dodd-Frank Act.

D. MMFs Do Not Meet the SIFI Criteria

In making a SIFI designation, FSOC is required to consider a number of criteria, none of which suggest that any MMFs should be treated as SIFIs.

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[67] Congressional Record (July 10, 2010) at Page S5902-03. http://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/pdf/CREC-2010-07-15-pt1-PgS5902.pdf #page=2

1. MMFs Have No Leverage

The first criterion FSOC must consider is "the extent of the leverage of the company." MMFs have no material leverage and thus do not meet this criteria.

2. MMFs Have No Off-Balance Sheet Exposures

The second criterion requires FSOC to consider "the extent and nature of the off-balance sheet exposures of the company." MMFs have no off-balance sheet exposures and thus do not meet this criteria.

3. MMF Transactions and Relationships With Other Companies Do Not Warrant SIFI Treatment

The third criterion requires FSOC to consider "the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies."

MMFs purchase short-term debt—primarily commercial paper—issued by significant financial companies, including bank holding companies and other financial institutions. They typically do so only on terms assuring minimal credit risk and repayment on a short-term basis. Among other things, a MMF may not purchase securities of any one issuer in an amount exceeding five percent of its total assets. MMFs do not have any debt outstanding to any of these companies—MMFs are not borrowers. Some significant financial companies and bank holding companies are shareholders of MMFs, acting both for their own account and for their customers' accounts, but a MMF's obligation to these shareholders is the same as to other institutional and non-institutional shareholders.

These transactions and relationships do not suggest that MMFs should be treated as SIFIs. To the extent FSOC believes that short-term funding is a threat to the financial stability of the United States, it can recommend regulatory action to discourage or limit over-reliance on short-term funding by banking organizations and other financial institutions. Designating MMFs as SIFIs will remove them as an important source of liquidity in the short-term markets and as efficient investment vehicles for banking organizations and other institutional and retail investors.

4. MMFs Are Intermediaries of Credit and Liquidity

The fourth SIFI criterion looks at "the importance of the company as a source of credit for households, business, and state and local governments and as a source of liquidity for the United States financial system." MMFs are intermediaries that provide a safe way for their shareholders to provide credit to American business and government. MMF shareholders are the source of the credit; MMFs help transmit it efficiently to the economy.

MMFs currently hold $2.6 trillion in high-quality short-term credit instruments on behalf of their shareholders. MMFs channel short-term credit to businesses by purchasing commercial paper issued by corporations. MMFs indirectly channel credit to households to the extent they purchase asset-backed commercial paper used to finance receivables relating to consumer goods and services and home mortgages. MMFs also channel credit to municipalities, holding more than one-half of all short-term municipal securities.

Much of the commercial paper purchased by MMFs is issued by banking organizations as a means of obtaining funds for their bank and nonbank credit activities. MMFs also hold significant amounts of bank certificates of deposit. In this sense, MMFs and their shareholders are like depositors who provide funds to banks that in turn allocate credit to their borrowers in accordance with credit underwriting standards.

MMFs also are a source of liquidity to the financial system. Their assets are short-term and can be liquidated quickly to meet the cash needs of their shareholders. They provide a safe repository for liquid assets. While insured deposits are a source of liquidity for many depositors, the $250,000 limit on deposit insurance limits the utility of deposits for most institutional depositors. Moreover, banks hold assets that cannot be liquidated readily. Banks have failed by the hundreds recently whereas only two MMFs ever have failed to return $1.00 per share.

The importance of MMFs as an efficient source of credit and liquidity in the financial system weighs heavily against subjecting them to SIFI designation and inappropriate regulation by the Fed that would impede their ability to continue serving credit and liquidity needs.

5. MMFs Provide a Source of Funding for Low-Income, Minority, and Underserved Communities

The fifth SIFI designation criterion is "the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities." This criterion does not weigh in favor of SIFI status for MMFs. MMF shareholders are a source of credit for low-income, minority, or underserved communities to the extent these communities issue high quality tax-exempt municipal securities that MMFs purchase. It is not known what percentage of municipal securities are issued by such communities, but MMFs are among the largest purchasers of short-term municipal securities. If MMFs cease to exist because of SIFI designation and inappropriate Federal Reserve regulation, these communities will need to rely on banks and other financial institutions to purchase their securities and will face higher funding costs and loss of efficiency.

6. MMF Assets are Managed Rather than Owned, and Their Ownership is Diffuse

The sixth SIFI criterion requires FSOC to consider "the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse." MMF assets are managed rather than owned and their ownership is diffuse.

MMFs typically are organized as business trusts that hold assets for the benefit of their shareholders. The beneficial ownership resides with the shareholders, not the fund itself. Each MMF's assets are managed by an investment adviser registered under the Investment Company Act of 1940 and Investment Advisers Act of 1940, which impose fiduciary duties on fund advisers. As fiduciaries, MMF advisers must manage fund portfolios in accordance with the duties of loyalty and prudence. In addition, MMF advisers have a duty to manage fund portfolios in accordance with the requirements of Rule 2a-7, which limit fund portfolios to high quality, short-term investments and impose liquidity, maturity, diversification, and other requirements designed to ensure the safety of MMFs. The duties imposed upon MMF managers make it highly unlikely that any MMF could pose a threat to the financial stability of the United States.

Moreover, the ownership of MMFs is diffuse. As of year-end 2011, MMFs had approximately 30 million shareholder accounts and 57 million retail investors. The diffusion of MMF ownership means that millions of fund shareholders have the benefit of professional money management subject to fiduciary duties and the protections of Rule 2a-7.

7. The Nature, Scope, Size, Scale, Concentration, Interconnectedness and Mix of MMF Activities Do Not Warrant SIFI Designation

The seventh SIFI criterion requires FSOC to consider whether "the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities" of a company could threaten the financial stability of the United States. This criterion does not suggest that MMFs should be treated as SIFIs.

MMFs by nature are risk-averse and, for all of the reasons discussed above, are a source of financial strength and stability rather than risk. The activities of each MMF are limited by law to those of an investment company investing on behalf of its shareholders in high quality, short-term investments subject to fiduciary duties. MMFs do not leverage their assets or engage in off-balance sheet activities. They are not permitted to engage in any other activities or mix of activities that could threaten the financial stability of the United States.

The approximately $2.6 trillion in assets currently held by MMFs is spread among roughly 630 MMFs. The ten largest MMF sponsors manage approximately 75 percent of total MMF assets, but these assets are held in numerous separate funds that are distinct legal entities. Only a small number of MMFs hold assets in excess of $50 billion. MMF assets are held on behalf of nearly 30 million accounts by custodians that are regulated banks or trust companies. These assets are managed by registered investment advisers subject to fiduciary duties.

There is no correlation between the size of a MMF and its ability to threaten the financial stability of the United States. All MMFs are subject to the same regulations that limit their investments, require liquidity, and impose other requirements that help ensure their safety. The one MMF that broke a dollar in 2008 had over $50 billion in assets, including $785 million in Lehman paper, but its shareholders recovered 99 cents on the dollar. The size of that fund did not cause the financial crisis or threaten the financial stability of the United States. The same global financial crisis would have occurred had the fund had $1.0 billion in assets and held $5 million in Lehman paper.

MMFs are interconnected with other companies to the extent MMFs invest in debt securities issued by other companies. In order to minimize the possibility that MMFs may be affected by financial difficulties experienced by other companies, MMFs are required to limit their holdings to only short term debt securities that have minimal credit risk in accordance with Rule 2a-7. MMFs also are subject to concentration limits under which no more than five percent of a MMF's assets may be invested in securities of any single issuer and no more than one-half of one percent of its assets may be invested in securities of an issuer of "second tier" securities, which in total cannot exceed more than three percent of a MMF's portfolio.

MMFs often are interconnected with other MMFs to the extent their shareholders have the ability to exchange shares of one MMF for shares of other mutual funds offered by the same sponsor. This feature gives investors flexibility to allocate their assets efficiently and contributes liquidity, not risk, to the financial system.

The nature, scope, size, scale, concentration, and interconnectedness of MMFs do not create a threat to the financial stability of the United States but rather contribute financial stability, diversity, and efficiency.

8. MMFs Are Highly Regulated by the SEC

The eighth SIFI criterion requires FSOC to consider the "degree to which the company is already regulated by one or more primary financial regulatory agencies." MMFs already are highly regulated by the SEC, as described in detail above. This criterion strongly indicates that Congress did not intend MMFs to be designated as SIFIs.

9. The Amount and Nature of MMF Financial Assets Do Not Warrant SIFI Designation

The ninth criterion requires FSOC to consider "the amount and nature of the financial assets of the company." The amount of MMF assets currently is approximately $2.6 trillion. The nature of these assets is high quality, short term, diversified, transparent, held by independent custodians for the benefit of millions of investors, and managed by registered investment advisers subject to fiduciary duties. MMF assets by nature and regulation carry no more than minimal credit risk. The amount and nature of these assets do not pose a threat to the financial stability of the United States. These assets are safe and liquid assets that contribute financial stability.

10. MMFs Generally Have No Liabilities and Do Not Rely on Short-Term Funding

The tenth criterion requires FSOC to consider "the amount and types of the liabilities of the company, including the degree of reliance on short-term funding." MMFs generally have no liabilities. They are obligated to redeem shares daily and pay each shareholder's pro rata share of the fund's assets upon liquidation of the fund, but these are not liabilities to debt holders. MMFs generally are not permitted to borrow or rely on short-term funding. This criterion thus is irrelevant to MMFs.

VIII. DODD-FRANK LIMITS FSOC AUTHORITY OVER NON-BANK FINANCIAL COMPANIES

Based on the foregoing, there is no basis in the Dodd-Frank Act's SIFI criteria for FSOC to designate MMFs as SIFIs. In any event, the Dodd-Frank Act does not authorize FSOC to subject a nonbank financial company to Fed supervision absent any evidence that the application of "more stringent" prudential standards to the company is needed to prevent harm to the U.S. financial system. The Dodd-Frank Act does not authorize either FSOC or the Fed to exercise ongoing supervisory jurisdiction over a nonbank financial company absent such a need, particularly a company that is subject to comprehensive regulatory oversight by another federal regulatory agency.

A. FSOC's Duties Are Non-Regulatory

The oversight duties of the Council are strictly non-regulatory in nature and include the following:

- To collect information, assess risks to the financial stability of the United States, and provide direction to a new Office of Financial Research;

- To monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;
- To monitor domestic and international financial regulatory proposals and developments and to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;
- To facilitate information sharing and coordination among the financial regulatory agencies regarding policy, rulemaking, examinations, reporting requirements, and enforcement actions;
- To recommend general supervisory priorities and principles;
- To identify gaps in regulation that could pose risks to financial stability;
- To require supervision by the Federal Reserve Board for any nonbank financial company that it determines poses risks to the financial stability of the United States in the event of the company's material financial distress or failure pursuant to section 113 of the Dodd-Frank Act;
- To make recommendations to the Federal Reserve Board concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies;
- To identify systemically important financial market utilities and payment, clearing and settlement activities;
- To make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading

among bank holding companies, nonbank financial companies, and U.S. financial markets;

- To review and submit comments to the SEC and any standard-setting body with respect to accounting principles, standards, or procedures;
- To provide a forum for discussion and analysis of emerging market developments and financial regulatory issues and resolution of jurisdictional disputes; and
- To report annually to Congress on its activities, significant financial market and regulatory developments, and potential emerging threats to the financial stability of the United States.

None of these duties authorizes FSOC to examine, supervise or regulate any nonbank financial company.

The Dodd-Frank Act created an Office of Financial Research to collect and analyze data on behalf of the Council through a Data Center and Research and Analysis Center. The Office is authorized to require the submission of periodic and other reports from any financial company "for the purpose of assessing the extent to which a financial activity or financial market in which the financial company participates, or the financial company itself, poses a threat to the financial stability of the United States."[68] The Office is required to first coordinate with the primary regulator of any such company and, whenever possible, rely on information available from such regulator. This authority to require reports does not give FSOC general supervisory authority over any company.

B. FSOC Cannot Blindly Designate Nonbank Companies as SIFIs Without Assessing What Standards Will Apply

FSOC's authority to require Fed supervision of SIFIs is subject to section 113 of the Dodd-Frank Act. That section authorizes FSOC to determine that a nonbank financial company shall be supervised by the Fed and shall be subject to prudential standards "in accordance with this title."[69]

[68] Dodd-Frank Act § 154, 12 U.S.C. § 5344.

[69] Dodd-Frank Act § 113(a)(1); 12 U.S.C. § 5323(a)(1).

"This title" is title I of the Act, which limits the scope of the Fed's supervisory jurisdiction over SIFIs and does not authorize the Fed to exercise general supervision over nonbank SIFIs, especially those that already are supervised by a federal agency. Title I authorizes the Fed to impose on a SIFI only "more stringent" prudential standards than otherwise would apply.

FSOC's authority to designate nonbank SIFIs is not a license for it to blindly make such designations without having some understanding of the prudential standards the Fed will impose on such a company and analyzing whether such standards will meet the statutory requirements that they be "more stringent" than standards otherwise applicable. Such action would be arbitrary and capricious and subject rescission upon judicial review.[70] This is particularly so in the case of MMFs, which Congress did not intend to be designated as SIFIs and which already are subject to stringent regulation.

IX. DODD-FRANK DOES NOT AUTHORIZE DUPLICATIVE MMF SUPERVISION BY THE FED

A. Only More Stringent Standards Are Authorized

The Fed has interpreted its authority over SIFIs under the Dodd-Frank Act very broadly:

> To address any potential risks to U.S. financial stability posed by these companies, the Dodd-Frank Act authorizes the Council to determine that certain nonbank financial companies will be subject to supervision by the Board of Governors and prudential standards.[71]

Contrary to the Fed's expansive view of its authority, the Dodd-Frank Act authorizes the Fed to supervise SIFIs and impose prudential standards only "in accordance with this title."[72] As just noted, "this title" is title I of the Act, which limits the scope of the Fed's supervisory jurisdiction and does not authorize the Fed to exercise general supervision over nonbank SIFIs that

[70] See Dodd-Frank Act § 113(h).
[71] 77 Fed. Reg. 21637 (April 11, 2012).
[72] Dodd-Frank Act § 113(a)(1); 12 U.S.C. § 5323(a)(1).

already are supervised by a federal agency or to impose general prudential standards on them. Specifically, title I of the Act states, in relevant part:

> [T]he Board of Governors shall, on its own or pursuant to recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that [A] are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and [B] increase in stringency . . . ."[73]

Thus, the Fed's authority is limited to imposing "more stringent" prudential standards on SIFIs. Moreover, the "more stringent" standards must "increase in stringency."

The Act specifically prescribes what "more stringent" standards the Fed must apply. These must include risk-based capital standards, liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements, and concentration limits.[74] In addition, the Fed may establish "additional" prudential standards that include a contingent capital requirement, enhanced public disclosures, short-term debt limits, and such other prudential standards as the Fed determines are appropriate.[75] The "additional" standards are in addition to, and not in lieu of, the "more stringent standards."

The "more stringent" requirement thus ensures that SIFI designation will result in meaningful regulation that otherwise is lacking and not regulation that is not duplicative, unnecessary, or irrelevant.

None of the mandatory "more stringent" SIFI requirements required by the Dodd-Frank Act are appropriate for MMFs. MMFs already have a

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[73] Dodd-Frank Act § 165, 12 U.S.C. § 5365 (emphasis added).
[74] Dodd-Frank Act § 165(b); 12 U.S.C. § 5365(b).
[75] *Id.*

100 percent capital to assets ratio, strict liquidity requirements, risk management requirements, and diversification and concentration limits. They are self-liquidating and do not require elaborate resolution plans. They have no credit exposure and thus credit exposure reports are irrelevant to them. Similarly, the additional prudential standards are inapposite. MMFs are subject to extensive public disclosure requirements. They do not issue debt and thus short-term debt limits are not relevant.

The Dodd-Frank Act does not authorize the Board to exercise general supervisory jurisdiction over MMFs, which already are federally supervised. SIFI designation is not a license for the Fed to duplicate the prudential supervision and regulation already provided by the SEC. SIFI designation is authorized only when FSOC determines that "more stringent" supervision and regulation of a nonbank financial company by the Fed is needed to mitigate threats to the financial stability of the United States.

FSOC itself may make recommendations to the Fed for prudential standards applicable to nonbank SIFIs, but such recommendations similarly are limited to prudential standards that are "more stringent" than those otherwise applicable and that "increase in stringency."[76]

B. The Fed's Standards Are Less Stringent

The Fed has proposed a series of rules to implement the enhanced prudential standards required for SIFIs under the Dodd-Frank Act.[77] The enhanced standards apply to bank holding companies with total consolidated assets of $50 billion or more (which automatically are treated as SIFIs by the Dodd-Frank Act) as well as nonbank financial companies that may be designated as SIFIs. The standards include risk-based capital and leverage requirements, liquidity standards, requirements for overall risk management, single-counterparty credit limits, stress test requirements, and a debt-to-equity

[76] Dodd-Frank Act § 115; 12 U.S.C. § 5325. In the case of risk-based capital and leverage requirements, the Fed is authorized to apply alternative "similarly stringent risk controls" if it determines that alternative requirements are more appropriate due to a company's activities (such as investment company activities or assets under management) or structure.

[77] 77 Fed. Reg. 594 (Jan. 5, 2012).

limit for companies that FSOC has determined pose a "grave threat" to financial stability.

The Fed's proposed SIFI standards are less stringent than those applicable to MMFs under SEC rules pursuant to the Investment Company Act. In some cases, they are completely irrelevant to MMFs.

1. MMFs Have More Capital Than SIFIs

The Fed's proposed SIFI standards require a nonbank SIFI to calculate its minimum risk-based and leverage capital requirements as if it were a bank holding company. Such a company is required to hold capital sufficient to meet a tier 1 risk-based capital ratio of 4 percent and a total risk-based capital ratio of 8 percent, and a tier 1 leverage ratio of 4 percent. This capital requirement is inapposite to MMFs. MMFs maintain a ratio of equity capital to assets of 100 percent, far in excess of the amount required of bank holding companies. For every dollar of equity capital in a MMF, the fund holds one dollar of assets. Bank holding companies, on the other hand, hold roughly ten times the amount of assets for each dollar of equity capital and thus have capital equal to only about 10 percent of their assets. The Fed's proposed capital is not "more stringent" when applied to MMFs.

2. MMFs Have More Liquidity Than SIFIs

The Fed's proposed rules require a SIFI to maintain a liquidity buffer sufficient to meet projected net cash outflows.[78] The Fed's rule does not impose any specific liquidity buffer amount and is not "more stringent" than the liquidity rules applicable to MMFs.

MMFs are subject to stricter liquidity standards than would apply under the Fed's rule. SEC rules require MMFs to maintain at least 10 percent of their assets in instruments that can be converted to cash in one day (the daily liquidity requirement) and at least 30 percent of their assets in

[78] The Fed's SIFI standards also require a nonbank SIFI to maintain a liquidity buffer sufficient to meet the projected loss or impairment of existing funding sources for thirty days. This provision is inapposite to MMFs as they do not rely on funding sources. The liquidity buffer must consist of highly liquid assets that are unencumbered. Interestingly, under the definition of "highly liquid assets" in the rule, corporate bonds and asset-backed commercial paper could qualify as a highly liquid asset but MMFs would not.

instruments that can be converted to cash in five business days (the weekly liquidity requirement). Bank holding companies are not subject to such liquidity requirements.

In addition, each MMF is required to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions (the general liquidity requirement), which may require a fund to maintain greater liquidity than the daily or weekly requirements. Each MMF and its board of directors is required to evaluate the fund's liquidity needs, considering a variety of factors that could affect those needs:

> For example, some shareholders may have regularly recurring liquidity needs, such as to meet monthly or more frequent payroll requirements. Others may have liquidity needs that are associated with particular annual events, such as holidays or tax payment deadlines. A fund also would need to consider the extent to which it may require greater liquidity at certain times when investors' liquidity needs may coincide. In addition, a volatile or more concentrated shareholder base would require a fund to maintain greater liquidity than a stable shareholder base consisting of thousands of retail investors.[79]

Each MMF is required to adopt "know your customer" policies and procedures designed to ensure that a MMF can identify the risk characteristics of its shareholders and plan for "hot money" or volatility events. The Fed's proposed SIFI rules do not include such a requirement.

3. MMFs Already Are Subject to Stress Testing

The Fed's proposed rules require each SIFI to regularly stress test its cash flow projections and to use the results in determining the size of its liquidity buffer and contingency funding plan. The stress test, among other things, must address the potential impact of market disruptions and the potential actions of other market participants experiencing liquidity stresses.

[79] 75 Fed. Reg. at 10060, 10075 (March 4, 2010).

MMFs already are subject to stress testing requirements under SEC rules. Each MMF is required to adopt procedures that provide for the periodic testing of the fund's ability to maintain a stable net asset value per share based on certain hypothetical events including: an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on portfolio securities, and a widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. The SEC expects a MMF to conduct weekly stress tests if its net asset value decreases to less than $0.9975. The SEC's rule requires MMFs to take into consideration the results of their stress testing in assessing their liquidity needs.

4. MMFs Do Not Fund Their Activities With Debt

The Fed's proposed rule requires each SIFI to establish a contingency funding plan that sets out the company's strategies for addressing liquidity needs during liquidity stress events. This provision is inapposite to MMFs to the extent MMFs do not borrow to fund their activities. Moreover, as noted above, MMFs are subject to specific liquidity requirements—a 10 percent daily liquidity requirement and a 30 percent weekly liquidity requirement—that are more strict than the Fed's proposal for SIFIs.

5. MMFs Have Stricter Counterparty Limits

The Fed's proposed SIFI rules impose aggregate net credit exposure limits on SIFIs. The rules limit such exposure to no more than 25 percent of the company's consolidated capital stock. MMFs are subject to stricter counterparty limits. Under SEC rules, no more than five percent of the capital (assets) of a MMF may be invested in securities issued by any one issuer.[80] In addition, a MMF may invest no more than one-half of one percent of its assets in "second tier" securities (which are other than investment grade securities) which may constitute no more than three percent of a MMF's total assets. Thus, the Fed's SIFI standards are not "more stringent" than those applicable to MMFs under SEC rules.

[80] SEC Rule 2a-7(c)(4).

C. Fed Supervision Is Subject to Other Limitations

Unless the Fed has a reasonable basis to impose the mandatory "more stringent" prudential standards on a nonbank SIFI, it has no legitimate basis for exercising any other supervisory jurisdiction over the company.

The Fed's jurisdiction over nonbank SIFIs is subject to other significant limitations. For example, the Fed is authorized, upon request by FSOC, to conduct an examination of a nonbank financial company being considered for SIFI designation. Such an examination is "for the sole purpose of determining whether the . . . company should be supervised by the Board of Governors for purposes of this title." The phrase "for the purposes of this title" are for the purposes of imposing "more stringent" prudential standards.[81]

After FSOC officially designates a nonbank company as a SIFI, the Fed is authorized to examine the company, but the Fed's examination authority is limited. First, in conducting such an examination, the Fed must rely "to the fullest extent possible" on examination reports by the primary financial regulator of the company. Second, the scope of the examination is limited to that needed to inform the Fed of the nature of the operations and financial condition of the company; the financial, operational, and other risks of the company that may pose a threat to the safety and soundness of such company or to the financial stability of the United States; and compliance by the company with the requirements of Title I of the Dodd-Frank Act.

After a nonbank company becomes a SIFI, the Fed may require it to file reports. Such reports are limited to those needed to keep the Fed informed as to the financial condition of the company; systems of the company for monitoring and controlling financial, operating, and other risks; and the extent to which the activities and operations of the company pose a threat to the financial stability of the United States. The Fed must rely on reports and supervisory information that the company has been required to provide to other regulatory agencies, information that is otherwise required to

[81] Dodd-Frank Act § 112; 12 U.S.C. § 5322(d)(4). FSOC may request the Fed to conduct such an examination if FSOC is unable itself to determine whether the company poses a financial stability threat.

be publicly reported, and externally audited financial statements of such a company.

In exercising both its limited examination and reporting authority, the Fed is required to "avoid duplication of examination activities, reporting requirements, and requests for information, to the fullest extent possible."

In the case of MMFs, the Fed already has access to all of the information it could possibly need in order to determine whether MMFs pose a threat to the financial stability of the United States and to address relevant concerns under the Dodd-Frank Act. Such information is posted on MMF web sites and is provided to the SEC. As noted earlier, MMFs are required to disclose detailed information regarding each of their portfolio securities, including the name of the issuer, the category of investment, the CUSIP number, principal amount, maturity date, final legal maturity date, coupon or yield, amortized cost value, and a link to the SEC's web site where a user may obtain the most recent 12 months of publicly available information filed by the fund. It is unclear what additional information the Fed would need to inform itself regarding whether a MMF poses a threat to the financial stability of the United States or other relevant matters concerning MMFs.

Unless the Fed imposes "more stringent" prudential standards on MMFs that are not arbitrary and capricious, it has no proper basis for exercising any supervisory jurisdiction over them.

D. Dodd-Frank Does Not Authorize Fed Restructuring of MMFs

1. Only SEC Can Prohibit MMF Activities or Practices

Section 120 of the Dodd-Frank Act authorizes FSOC to provide for "more stringent regulation" of a financial activity by issuing recommendations to the primary financial regulators to apply "new or heightened standards and safeguards" for a financial activity or practice conducted by financial companies under their respective jurisdictions. The recommended "heightened standards" may include "prescribing the conduct of the activity or practice in specific ways (such as by limiting its scope, or applying particular capital or risk management requirements to the conduct of the activity) or prohibiting the activity or practice."

Before issuing any such recommendations, FSOC first must make a determination that "the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities." FSOC must consult with the primary financial regulatory agencies and provide notice to the public and opportunity for comment. Any recommended standards or safeguards must take into account long-term economic growth.

The Dodd-Frank Act does not authorize FSOC to impose such standards on any entity. The Act provides that only the primary financial regulatory agency may impose such standards on those entities for which it is the primary regulator and enforce compliance therewith. The primary regulator is not required to impose any standards recommended by FSOC if it explains in writing to FSOC within 90 days why the agency has determined not to follow the recommendation. The agency may determine not to follow FSOC's recommendations for a variety of reasons, including the agency's views that the recommendations are inappropriate.

Thus, only the SEC may impose heightened standards recommended by FSOC on MMFs, and it may choose not to do so if it explains in writing to FSOC why it has determined not to do so.

FSOC has no authority to force any agency to adopt its recommended actions. Rather, it is required to report to Congress on any recommendations for heightened standards and on the implementation of, or failure to implement, such recommendation on the part of a primary financial regulatory agency.

There is no indication that Congress intended FSOC to recommend regulations that would incapacitate or destroy an entire financial services industry. An FSOC recommendation to the SEC to require MMFs to stop offering their shares at $1.00 per share would be tantamount to a recommendation to incapacitate the entire MMF industry. Similarly, an FSOC recommendation to banking regulators to require banks to stop offering uninsured deposits or to require bank holding companies to stop issuing commercial paper would incapacitate the banking industry. The latter recommendation might serve the Dodd-Frank Act's purpose in reducing the risk of significant liquidity, credit and other problems spreading among bank holding companies and financial markets. Elimination of the $1.00 NAV of MMFs, in contrast, would exacerbate such risks.

2. Non-Uniform SIFI Standards Are Inapt for MMFs

MMFs are homogenous entities whose operations and features are highly uniform. There is little variation between one MMF and the next apart from the specific composition of its portfolio holdings, which still are uniformly regulated under Rule 2a-7 and have similar risk features—namely, all MMF portfolios must pose minimal credit risk and must have a weighted average maturity of 60 days or less, daily liquidity of 10 percent, and weekly liquidity of 30 percent. It is difficult to imagine what factors FSOC could rely on to designate one MMF as a SIFI but not another without acting arbitrarily and capriciously.

Moreover, it is difficult to imagine what "more stringent" prudential standards the Fed could impose on a MMF designated as a SIFI beyond those that already apply under Rule 2a-7. Instead of a 10 percent daily liquidity requirement, for example, would the Fed impose a 12 percent requirement? Instead of a 30 percent weekly liquidity requirement, a 34 percent requirement? What would be the basis of such a requirement that would justify the Fed rather than the SEC making such a determination?

Any variation in the Rule 2a-7 standards for one MMF versus another would have the effect of either giving the MMF a competitive advantage over other MMFs during times of market stress (because it would be perceived as safer and "implicitly guaranteed" by the Fed) or putting it at a competitive disadvantage at other times (by increasing its expenses and thereby decreasing its yield). Imposing a regulatory capital requirement or shareholder redemption restrictions on one or a handful of MMFs designated as SIFIs, but not others, would force those MMFs out of business. Similarly, selectively prohibiting certain MMFs from maintaining a stable $1.00 NAV would force those funds out of business.

The Dodd-Frank Act does not authorize either FSOC or the Fed to rewrite the rules governing MMFs or to go on regulatory fishing expeditions that single out some MMFs for disparate regulatory treatment, regulatory experimentation, or elimination. Any attempt to do so would be arbitrary and capricious and subject to rescission upon judicial review.

3. Bank Regulatory Standards Are Inappropriate for MMFs

The Fed's proposed SIFI standards are designed to impose bank regulatory standards on SIFIs, including MMFs. In particular, the Fed's proposed standards reflect its view that the application of bank holding company regulations to nonbank SIFIs is the best way to prevent another financial crisis. In the Federal Register notice of the final rule establishing SIFI designation standards for nonbank financial companies, the Fed stated as much:

> In the recent financial crisis, financial distress at certain nonbank financial companies contributed to a broad seizing up of financial markets and stress at other financial firms. Many of these nonbank financial companies were not subject to the type of regulation and consolidated supervision applied to bank holding companies. . . .[82]

The Fed's proposed SIFI rules would apply the same standards to both bank holding company SIFIs and nonbank SIFIs:

> This proposal would apply the same set of enhanced prudential standards to covered companies that are bank holding companies and covered companies that are nonbank financial companies.[83]

Whether a symptom of regulatory myopia or arrogance, the idea that bank holding company regulation should be applied to entities bearing little resemblance to banks or bank holding companies and that have operated safely and successfully for decades under a different regulatory framework is flawed. MMFs withstood the financial crisis far better than did many banking organizations. As this paper has shown, the regulation of MMFs under the framework of the Investment Company Act of 1940 and related

[82] 77 Fed. Reg. 21637 (April 11, 2012).
[83] 77 Fed. Reg. 594, 597 (Jan. 5, 2012).

statutes is far more stringent in key respects than the regulation of banks and bank holding companies.

Bank holding company regulation was designed for entities with very different structural operations, activities, and risk profiles than MMFs. Bank holding companies could not comply with many of the regulations that make MMFs safer than banks. They would not survive the application of MMF regulation to their activities. For example, neither banks nor bank holding companies could continue operating if they were required to limit their investments to short-term instruments with only minimal credit risk, were prohibited from borrowing to fund their activities, and were required to maintain a capital to assets ratio of 1:1. Just as it would be inappropriate to apply MMF regulation to banks or bank holding companies, the application of bank and bank holding company regulatory concepts to MMFs is inappropriate.

4. The Fed Lacks the Expertise or Proper Mindset to Supervise MMFs

It would be a mistake to entrust the supervision of MMFs—which have operated successfully for decades under SEC governance—to an agency lacking in expertise with respect to MMF operations and regulation under the Investment Company Act and related statutes. Apart from a wasteful duplication of government resources and questionable legal basis, regulation of MMFs by the Fed would result in unnecessary costs to MMFs and their shareholders and likely increase rather than decrease systemic risk. The Fed has no demonstrated regulatory proficiency relevant to MMFs, and its proposals to alter the structure of MMFs indicate that it wants to eliminate MMFs rather than make them more resilient.

My paper "Shooting the Messenger: The Fed and Money Market Funds" suggests reasons why the Fed might want to eliminate MMFs, including a long-standing institutional bias against MMFs and a belief that MMFs unfairly divert deposits away from banks. Any agency so grounded in bank and bank holding company regulation with such blatant partiality for the bank holding company model of regulation can only be expected to do damage to MMFs, which have operated successfully for decades under SEC regulation and contributed safety, liquidity, diversity, and transparency to the financial system. The idea that banking supervision by the Fed, which failed so dismally in the years preceding the financial crisis, would do anything but harm MMFs and the financial system is not credible.

The Fed has available to it all the information it needs to monitor MMFs in the financial system. If it needs additional information, the SEC can provide it. The Fed does not need to subject MMFs to inappropriate bank holding company regulation that has no relevance to their operations and that would burden them with duplicative and unnecessary regulatory requirements, increasing their expenses and causing their demise. As shown above, MMFs already are subject to more stringent regulation than the Fed has proposed for nonbank SIFIs under the Dodd-Frank Act.

E. Dodd-Frank Requires the Fed to Adopt Exemptive Criteria

Section 170 of the Dodd-Frank Act requires the Fed, on behalf of and in consultation with FSOC, to promulgate regulations setting forth criteria for exempting certain types or classes of SIFIs from supervision by the Fed. Although such regulations are mandatory and not optional, the Fed to date has not proposed or promulgated any such regulations.

In developing the criteria for exemptions, the Dodd-Frank Act requires the Fed to consider the factors that FSOC is required to consider in determining whether to designate a nonbank financial company as a SIFI. Because those factors as applied to MMFs show that MMFs are not appropriate candidates for SIFI status, MMFs warrant an exemption. An exemption would remove uncertainty concerning the intentions of FSOC and the Fed with respect to the future regulation of MMFs. Such uncertainty has resulted in substantial cost to the industry and confusion among its shareholders, and diverted the attention of regulators at both the Fed and the SEC from far more pressing regulatory matters that require their attention.

X. CONCLUSION

MMFs do not create systemic risk. To the contrary, they contribute systemic stability, liquidity, diversity, transparency, and market discipline—all without cost to the taxpayers. MMFs are structurally distinct from banks and other financial institutions and are not susceptible to "runs" or part of an unregulated "shadow banking system." They are highly regulated by the SEC under a regulatory framework that imposes stricter limits and requirements than those that apply to banks, bank holding companies or SIFIs under the Fed's proposed SIFI rules. Banking regulation is inappropriate for MMFs and would end MMFs as we know them at great cost to the millions of investors who value them for their efficiency and safety, and to the financial system as a whole. The Dodd-Frank Act does not mandate additional regulation of MMFs and specifically does not mandate or authorize their supervision by the Fed.