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July 3, 2012

Via SEC Internet Comment Form

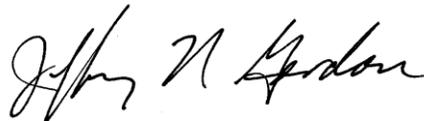
Ms. Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

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

To the Commission:

This letter transmits a written submission that I made to the Senate Banking Committee in connection with its June 21, 2012 hearings on “Perspectives on Money Market Mutual Fund Reforms.” I was asked about testifying but had previously committed to be overseas on that date in connection with an academic conference. I received permission to make a written submission instead. Since the matter is still under consideration by the Commission, I respectfully request that this submission be included in the record of the Commission’s rule-making in this area.

Very truly yours,



Jeffrey N. Gordon  
Richard Paul Richman Professor of Law  
Co-Director, Center for Law and Economic Studies  
Columbia Law School

cc: Chairwoman Mary L. Schapiro  
Commissioner Luis A. Aguilar

Commissioner Daniel M. Gallagher  
Commissioner Troy A. Paredes  
Commissioner Elisse B. Walter  
Division of Investment Management Director Eileen Rominger  
Division of Investment Management Associate Director Robert E. Plaze

**Submission by Jeffrey N. Gordon**

**Richard Paul Richman Professor of Law and Co-Director, Center for Law and  
Economic Studies, Columbia Law School**

**Perspectives on Money Market Mutual Fund Reform**

**Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate**

**June 21, 2012**

Chairman Johnson, Ranking Member Shelby, and other members of the Committee, thank you for the opportunity to address the topic of money market fund reform through this written submission. I have studied the money market fund problem since the fall of 2008. This has resulted in two detailed comment letters to the SEC, one in September 2009 and the other in August 2011, both of which are attached to this submission. A co-author and I have also conducted empirical analysis of the relative run risks of floating vs. fixed net asset value (“NAV”) funds, based on a “natural experiment” involving off-shore dollar-denominated money market funds during “Lehman week” in September 2008. These self-regulated funds generally follow the SEC rules on portfolio composition but are available in both fixed and floating NAV. We find that the fixed/floating distinction does not explain the variation in the run rate across funds; rather, the relative risk of the fund, proxied by yield prior to Lehman week, is the crucial fund-level explanatory variable. (We are in the process of finishing a draft of this research, which should be public shortly.)

For the record, none of my research in this area has been supported by any party other than Columbia Law School as part of the customary research funding it provides to faculty members.

Based on this cumulative work, my views are the following:

- Money Market Mutual Funds (“MMFs”) are like banks, except they have no provision for bearing loss and internalize none of the systemic risk costs of their activities.
- MMFs present a unique “two-sided” run problem that makes them an unstable source of credit. Since most MMF credit is now extended to banks, this makes MMFs a significant vector for financial crisis.
- These problems can be addressed through requiring MMF investors to acquire bundles of Class A/Class B shares, in which fixed NAV is preserved for the Class A shares.

To elaborate on these views:

First, a money market mutual fund is like a bank in that it holds a portfolio of risky assets (non-U.S. Treasury), yet, unlike a bank, holds no capital nor any other first-loss protection. Its NAV will fall below \$1 upon the default of virtually any appreciable portfolio holding, unless the sponsor decides to step in to cover the loss. The fact that sponsors frequently have provided such support provides no assurance that a particular sponsor(s) will have sufficient resources or willingness to provide support in the midst of a financial crisis.

The Reserve Primary Fund illustrates the problem of sponsor incapacity for a large fund, and at only \$60 billion, this fund was hardly the largest. Moreover, it is simply false that sponsors provided sufficient support to protect their MMFs during September 2008. The entire industry received massive federal support that consisted not only of the well-known Treasury guarantee (for which a fee was paid) but also a Federal Reserve guarantee of the most problematic MMF assets, for which no fee was paid. This guarantee took place through the terms on which the Fed offered to extend credit through its “Asset-Backed Commercial Paper MMF Liquidity Facility”: lend to MMFs (through back-to-back bank loans) at par on a non-recourse basis to finance the weakest assets in the MMF portfolio. Approximately \$150 billion was drawn down on this facility in the first 10 days following the Reserve Primary Fund default. Nine of the ten largest MMFs, representing two-thirds of all MMF assets, used the AMLF. Only Vanguard did not use the emergency credit facility.<sup>1</sup>

Second, the lack of capital or any other first-loss protection means that MMFs are exposed to a “two-sided run problem.” One side of the run problem is well understood: MMF fund investors who perceive a risk of default will want to be first in line at the withdrawal window. If other investors perceive a similar risk, the best strategy is to withdraw first and ask questions later, producing a run. The second side of the run problem is less well-understood but equally important. MMFs provide short term finance to financial institutions (especially banks) as well as to non-financial commercial paper users. Precisely because they have no first loss protection against default of portfolio securities, MMFs will be extremely sensitive to the risk of default by the parties they finance. This means, for example, if a bank runs into financial distress, MMFs will either shorten the maturity of the obligations from this counterparty or refuse to rollover the obligations altogether. In other words, because of the first run problem, the MMF depositor run risk, MMFs in turn create a run problem for parties that depend on MMF financing. Because of the threat that depositors will run on the MMFs, the MMFs may run on their counterparties.

Third, the two-sided run problem has very important (negative) macro implications. A little background is necessary. The main function of MMFs currently is to provide diversified portfolios of credit-screened short-term claims on financial firms to

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<sup>1</sup> See Ben Levisohn & Daisy Maxey, *Absent Help, More Funds Might Have Broken Buck*, Wall St. J Online, Dec. 1, 2010.

cash-holding institutions seeking safety and liquidity. For example, an operating company with large cash reserves could deposit the funds in a bank or itself assemble a portfolio of money market instruments. An MMF is better than these two alternatives, because a diversified portfolio of financial firm claims is safer than a deposit in a single bank (given the cap on deposit insurance), and the MMF can achieve scale economies in producing diversified, screened portfolios of such claims. In the evolution of MMFs from the 1980s until the present, the largest users have become institutional, and the mix of MMF assets has moved overwhelmingly to claims on financial firms (and related financing entities). Such financial sector claims constitute an estimated 80 percent of all non-U.S. government assets held by prime MMFs. Although it is true that MMFs are the dominant source of commercial paper issued by non-financial firms, such CP issuances have become an increasingly unimportant part of the MMF balance sheet.

Two implications follow. First, MMFs have become a major vector for financial sector distress. Because the credit-worthiness of financial firms is highly correlated, if a single financial firm defaults on its money market issuances, MMFs will take this as a signal of the likelihood of other defaults in the financial sector and will thus run on many other financial firms by refusing to roll over credit. This will provoke an immediate funding crisis throughout the financial sector. Second, even without an outright default, as the threat of financial distress looms, MMFs will restrict the terms on which they extend credit, for example, shortening maturities and refusing to rollover credit for certain financial firms. The knock-on effects are significant: Responding to their MMF funders, banks will behave accordingly in their own credit extensions, to avoid a liquidity shortfall. Loans will not be made; maturities will shorten. Recent press accounts, which describe the shortening of MMF credit extensions to banks and the MMFs' withdrawal from lending to European banks alongside the corresponding contraction in bank assets, show that this effect is not hypothetical. A constriction of credit is obviously a negative for economic growth.

Here is the policy-relevant structural point: A significant fraction of this particular vicious circle is the direct result of the fragility of the MMFs themselves as presently designed. To repeat: The MMFs have no capacity to bear default on any portfolio security. Thus, much of the wholesale short term funding mechanism dances to the MMFs' short-rigged tune.

Fourth, it is possible to design an MMF that will preserve the benefits currently associated with MMFs but reduces some of the systemic risk and other negative effects. My August 2011 comment letter extensively presents such a proposal. The main feature is this: Institutions that invest in MMFs buy two classes of MMF stock, Class A and Class B, as a Class A/Class B bundle, in a ratio of roughly 95% to 5%.<sup>2,3</sup> Class A shares carry fixed NAV and thus can be used transactionally without tax or accounting consequences; Class B may float in value and may bear loss. An investor can withdraw Class A shares at will. Class B shares can be withdrawn only upon a 7-day (or 30-day) lag, a holdback.

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<sup>2</sup> I treat retail funds differently, but they could be handled the same way.

<sup>3</sup> I pick 5% because that is the largest allowable portfolio position for a single issuer under Rule 2a-7.

The proceeds of Class A and Class B shares will be invested identically by the MMF. In ordinary times, the investors face no costs, except some loss of liquidity on the 5%. But the Class B shares do bear the risk of loss in a default of a portfolio security that is not covered by a sponsor, or losses occurring in a fire sale of assets to raise cash for redemptions. Other details are spelled out in the comment letter.

There are three advantages. First, this arrangement significantly enhances MMF stability, which will reduce not only their systemic risk potential but will also change MMF behavior in periods of financial stress, like right now. Because MMFs will have first loss protection, their own funding decisions need not be on hair trigger, with positive effects throughout the short term funding process. This may encourage bank extensions of credit to non-financial borrowers.

Second, the structure of the Class A/Class B bundle protects not only against portfolio defaults but also against run risk. That is because a Class A holder also owns Class B. Class A holders will therefore be far less likely to run, because a run that leads the MMF to sell assets at fire-sale values and thus to break the buck will be costly for the holder's Class B shares. Before a run was "free" to the holder; now there will be potential costs.

Third, the cost of this arrangement is borne by the MMF users, not the sponsors or the taxpayers. This proposal will not drive the MMF industry out of business. The fact is, institutional MMF investors have no better alternative. Short term bond funds, of course, have floating NAV. Bank deposits carry risk if uninsured. This proposal merely requires institutional MMF investors to internalize the cost of systemic stability for MMFs rather than relying on implicit guarantees from the rest of the financial sector and the U.S. government (and the taxpayers).

Thank you very much for your attention.

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August 12, 2011

Via SEC Internet Comment Form

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

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

To the Commission:

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

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

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

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

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

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

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

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<sup>2</sup> In the event that the combination of default losses and market value losses exceed the Class B buffer, then the fund should suspend redemptions and liquidate. See below.

<sup>3</sup> See Squam Lake Group, *Reforming Money Market Funds* (Jan. 14, 2011).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

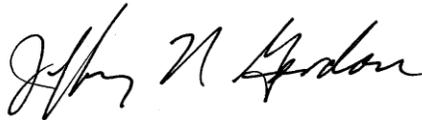
*Government Funds.* Government money market funds present a special case because of the negligible default risk and the pattern demonstrated in fall 2008 that in a financial crisis investors run *toward* government funds. Thus government funds do not present the same systemic risk concerns as other MMFs.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

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

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

Very truly yours,

A handwritten signature in black ink, appearing to read "Jeffrey N. Gordon". The signature is fluid and cursive, with the first name "Jeffrey" being the most prominent.

Jeffrey N. Gordon  
Richard Paul Richman Professor of Law  
Co-Director, Center for Law and Economic Studies  
Columbia Law School

cc: Chairwoman Mary L. Schapiro  
Commissioner Luis A. Aguilar  
Commissioner Kathleen L. Casey  
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Division of Investment Management Director Eileen Rominger  
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Sept. 9, 2009

Via SEC Internet Comment Form

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

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

Dear Ms. Murphy:

This letter is submitted by me personally in response to the SEC's request for comments on its proposed Money Market Reform Rule announced in Release No. IC-28807. This letter proposes a different direction to reform, one that begins with the division between retail and institutional money market funds and that takes account of the different motives and needs of the investors in each.

"Reform" is of course timely in light of the fragility of Money Market Funds ("MMFs") revealed in the financial distress that followed the failure of Lehman Brothers. As the Commission describes quite well in the Release, Lehman's failure unexpectedly led to the "busting of the buck" by the Reserve Fund, which held a large amount of Lehman's commercial paper in its portfolio. The problems at the Reserve Fund in turn triggered a "run" especially by institutional investors on non-Treasury MMFs that was staunch only by an extraordinary MMF guarantee program provided by Treasury and by the creation of a special MMF liquidity facility by the Federal Reserve. It is also widely believed that FDIC decisions in addressing bank failures – whether or not to protect bank creditors – were influenced by concerns about the solvency of MMFs that held bank paper. Various MMFs undertook their own safeguards against the risk of runs, principally by selling off commercial paper (that is, making use of the Fed's facility) and by shifting their portfolio composition towards Treasury instruments (Federal agency debt for the adventurous) and by shortening maturities. These measures had their own consequence, namely a sharp contraction in the demand for commercial paper and other short term credit instruments that industrial and financial firms had come to rely upon in their corporate finance plans. The Federal Reserve responded with another special liquidity facility in which the Fed's became a buyer of last resort of commercial paper.

In response to this very unsettling episode, a near-calamitous run on a form of financial intermediary that accounts for nearly \$4 trillion in assets, the SEC has come up with a quite modest set of

reform proposals: improve the quality of MMF portfolio securities, shorten maturities, enhance portfolio liquidity, and provide a smoother resolution process for occasions when an MMF has “busted the buck.” With all respect, I think the SEC has failed to grapple with the fundamental problems with MMFs that last fall’s financial crisis revealed and, in the main, its proposals will exacerbate systemic fragility, not reduce it.

Rather, the SEC should be preparing the way for serious consideration of proposals like those made by the Group of Thirty in February 2009, which call for a sharp division between funds that offer “withdrawals on demand at par, and assurances of maintaining a stable net asset value” and those that offer a “conservative investment option ... with no explicit or implicit assurances to investors than funds can be withdrawn on demand at stable NAV.” The former accounts should be offered through special banks that include government deposit insurance. The latter accounts might be styled as “money market funds,” subject to customary mutual fund valuation rules and no promise of a stable NAV.<sup>1</sup>

Barring such a wholesale rethinking, a minimum reform strategy should begin with a sharp division between MMFs sold to retail investors, “retail MMFs,” and those that are sold to corporations, life insurers, pension funds and other large purchasers, “institutional MMFs.” Retail MMFs should be covered by deposit insurance that is funded by risk-adjusted premiums. Institutional MMFs should give up the promise of a fixed NAV, and disclosure rules should replace mandatory portfolio composition rules. These changes will reduce the systemic risk created by the present MMF regulatory structure both by reducing the risk of “runs” and by reducing distortions in short term credit markets.

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It is widely appreciated that MMF holders receive an unpaid-for benefit through an implicit, if imperfect, government guarantee of their accrued balances. The flaw with the SEC’s approach is that the regulatory effort to substitute for the absence of explicit deposit insurance and to limit the implicit subsidy through restrictions on MMF portfolios adds systemic risk to financial intermediation by heightening the pressure on short-term money markets in the critical function of maturity transformation. This flaw turns out to be fundamental and requires a rethinking of the general MMF framework.

To understand this objection, it is necessary to appreciate the origin and consequences of MMF growth in the financial system. MMFs arose in the 1970s as an evasion of the regulatory ceiling on interest rates that depository institutions, banks and thrifts, could offer to depositors, so-called “Reg Q.” At a time of high short interest rates, MMFs provided retail savers access to money market rates and became a substitute for both savings and checking accounts. The industry and the SEC understood this substitution. As a marketing tool, as consumer protection, and presumably as systemic risk mitigation, the industry and the SEC collaborated on a series of portfolio constraints, principally to limit maturities and to assure credit quality, in order to lower the risk that MMF shares would fall below a fixed net asset value, typically \$1 a share. The SEC also provided a form of regulatory forbearance that permitted MMFs to use “hold to maturity” rather than “mark to market” valuations to smooth over small deviations from par. The SEC also from time to time has granted regulatory relief to permit MMF sponsors to support \$1 net asset values through buying distressed securities in MMF portfolios. The limitations of

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<sup>1</sup> Group of Thirty, Financial Reform: A Framework of Financial Stability 29 (Feb. 2009).

these SEC-crafted substitutes for deposit insurance became apparent in the financial market distress of fall 2008.

The deposit insurance gap for MMFs is relatively well-understood and appears to animate the SEC's reform proposal. Portfolios of shorter maturities and higher credit quality should be less exposed to default risk; this enhanced security partially substitutes for explicit deposit insurance in bolstering investor confidence. What is not appreciated is how MMFs have distorted financial intermediation by shifting the process of maturity transformation from banks to securities markets, which are prone to seize-up at times of financial distress. Indeed, by shortening maturities the SEC proposal will increase rather than reduce the fragility of these markets because it makes it easier for MMFs to "run" at a time of financial distress.

What is "maturity transformation?" It is the conversion of the short term liquidity needs of depositors into long-term funding commitments for borrowers. Banks have traditionally performed this function. Depositors put funds into checking accounts and savings accounts and certificate of deposit, which can be withdrawn from the bank on demand, though perhaps with some notice in the case of savings accounts and the forfeiture of some interest in the case of CD's. In turn, the bank lends these deposited funds to borrowers on typically much longer-lived terms, whether to fund specific projects or asset purchases, or by way of a long term lending commitment. This bank activity thus "transforms" short term liabilities into long term assets, hence "maturity transformation." Under this arrangement, the bank will not necessarily have cash immediately available in the event of unexpected depositor withdrawals. But the bank can borrow money from other financial institutions on the security of its assets, and, in the case of systemic liquidity pressure, can borrow from a "lender of last resort," like the Federal Reserve. The process by which the different time horizons of depositors and borrowers are nevertheless matched up is at the core of a successful system of financial intermediation.

The entry of MMFs shifts the process of maturity transformation away from banks and into the short term securities markets, the money market. This is because the issuers of MMF-qualified debt under the SEC rules – commercial paper, for example – often use money market proceeds to fund long term projects or long term assets, counting on their ability to refinance, or "roll-over," their short term obligations as they come due. There are "demand" side reasons for the increasing use of money markets in this way. If the yield curve is "upward sloping," meaning that short run rates are less than long term rates, a borrower may be able to finance a long term asset more cheaply through successive rollovers than through a bank loan. The borrower can deal with the possibility of interest changes through interest rate swaps and other hedging techniques. But there are also "supply side" reasons for the turn to money markets to finance long term commitments, linked to the regulatory set up of MMFs. First, MMF investors do not pay for the implicit government guarantee, which means that MMFs have a pricing advantage over banks in competing for deposits. This increases the supply of short term finance. Second, the NAV stability requirements imposed by the SEC artificially limit MMF purchases to short term instruments, currently a weighted average portfolio maturity of 90 days but more broadly, instruments of approximately one year or less. This augments the supply of short term finance generally. Third, the "weighted average" rules permits funds to balance off longest maturity instruments that pay highest interest with shortest maturity instruments; this increases the supply of the instruments like overnight repurchase agreements. Fourth, the "quality" requirements for MMF-eligible instruments favor the highest rating securities; this gives issuers a reason to create credit vehicles that can receive high ratings from the credit rating agencies. MMFs thus provide a stimulus to the creation of short term instruments

through “structured finance.” In sum, the regulatory set-up of MMFs increases the supply of short term credit and also distorts its particular forms.

Last fall vividly illustrates the consequence of shifting maturity transformation towards the money markets. At a time of financial distress, commercial paper and other forms of short term debt did not “roll.” Maturity transformation abruptly broke down as credit suppliers simply stopped lending. Money market funds were major participants in a “run” on the financial system. Not only did investors in money market funds, especially investors in so-called “institutional funds, cash out of their MMF positions, which required MMF liquidation of credit positions, but the MMFs independently withdrew from the commercial money market in favor of government money markets. This in turn contributed to the immediate crisis for investment banks, which were highly dependent on short term finance, resolved in the case of Goldman Sachs and Morgan Stanley only by their conversion to bank holding companies. It also contributed to the funding crisis faced by commercial issuers, resolved by the Federal Reserve’s creation of the special credit facilities referred to previously.<sup>2</sup> It is worth repeating that the SEC’s proposal to shorten average portfolio maturities will make it easier for MMFs to run in the future, simply by refusing roll over credits. Moreover, the pressure on MMFs to maintain a \$1 NAV adds to the impetus to run both by converting current holdings to cash and by shifting purchases from commercial paper to government instruments.

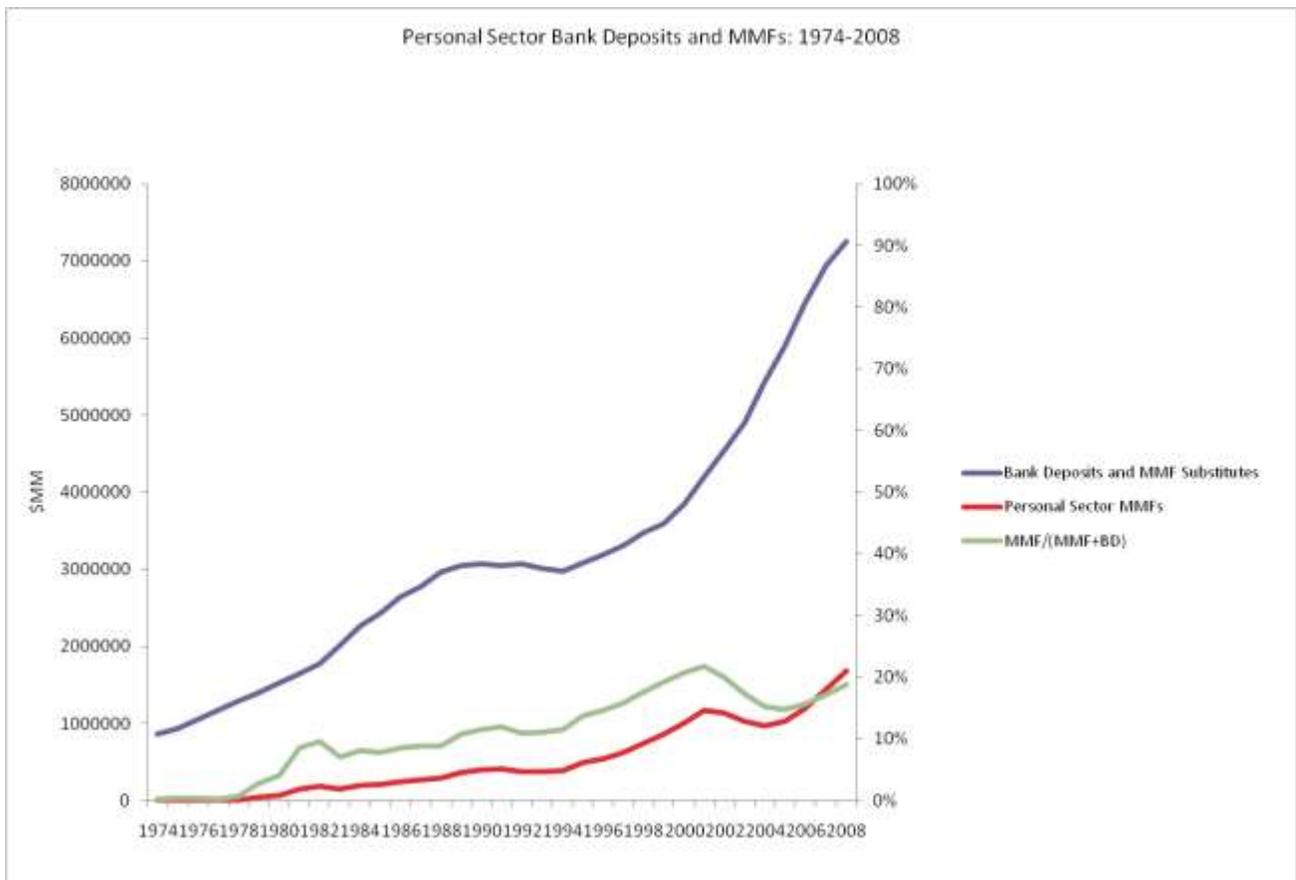
These analytic points can be buttressed by looking at the data relating to patterns of MMF growth and practices over the past 35 years, drawn from data compiled by the Federal Reserve in its Flow of Funds reports.

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<sup>2</sup> In some cases regular commercial paper issuers were able to turn to back-up lines of credit at banks but this in turn took funds that banks might have otherwise provided to other borrowers at a time of credit rationing.

Figure 1 shows the substitution of money market funds for retail bank deposits, now at the rate of approximately 20 percent. The top line reflects (on the left y-axis) the sum of “personal sector” bank deposits plus retail MMFs, what might be thought of as bank deposits plus MMFs that substitute for bank deposits. The second line shows (on the left y-axis) the dollar amount of retail MMFs, and the third line (which is in the middle line during most of the time period) shows (on the right y-axis) the percentage of bank deposits and substitutes represented by MMFs. Figure 1 shows that retail MMFs have steadily increased over the 1974-2008 period, now amounting to nearly \$1.5 trillion. The figure also shows the substitution effect, which has also increased throughout most of the period, leveling off in the 20 percent range.

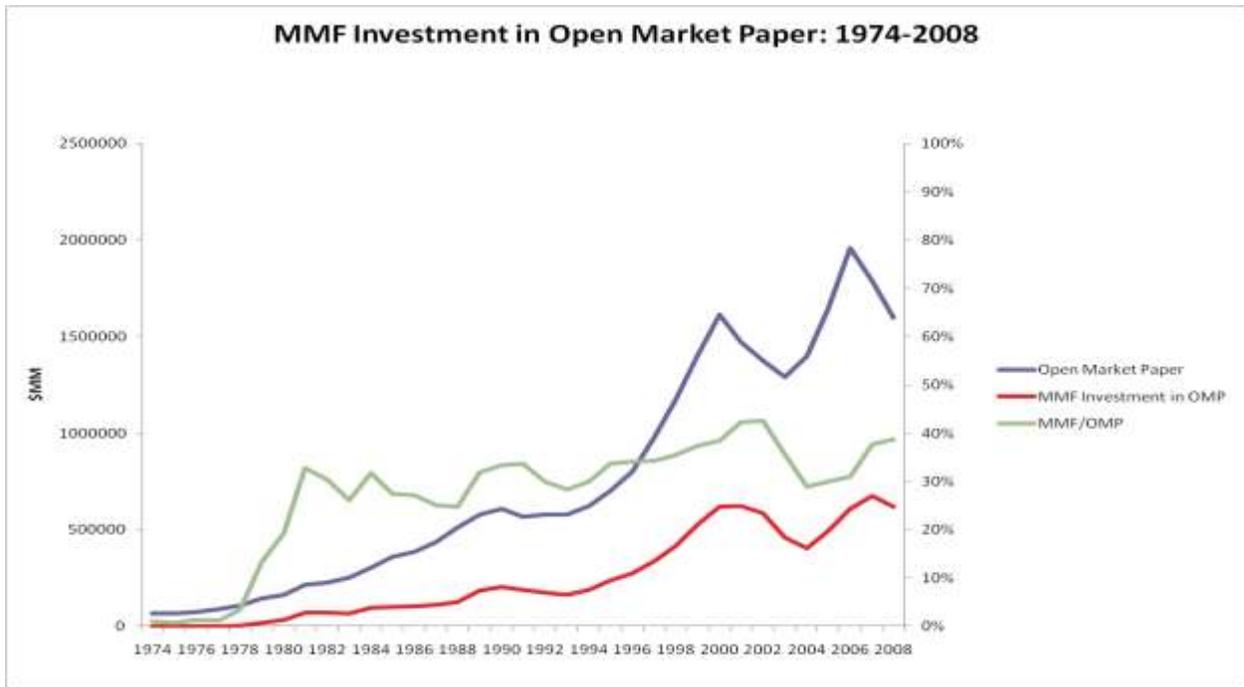
**Figure 1**



Source: Federal Reserve, Flow of Funds, Table L.5 (2009).

Figure 2 shows how the growth of MMFs has contributed to the expansion of money markets more generally, here categorized as “Open Market Paper” (principally commercial paper). The growth of the commercial paper market over the 1974-2008 period (top line, left y-axis) has been matched by the growth of MMF investment in commercial paper (bottom line, left y-axis). The fraction of MMF participation in the commercial paper market has remained at 30 percent or more from early in the period, peaking at 40 percent (middle line, right y-axis).

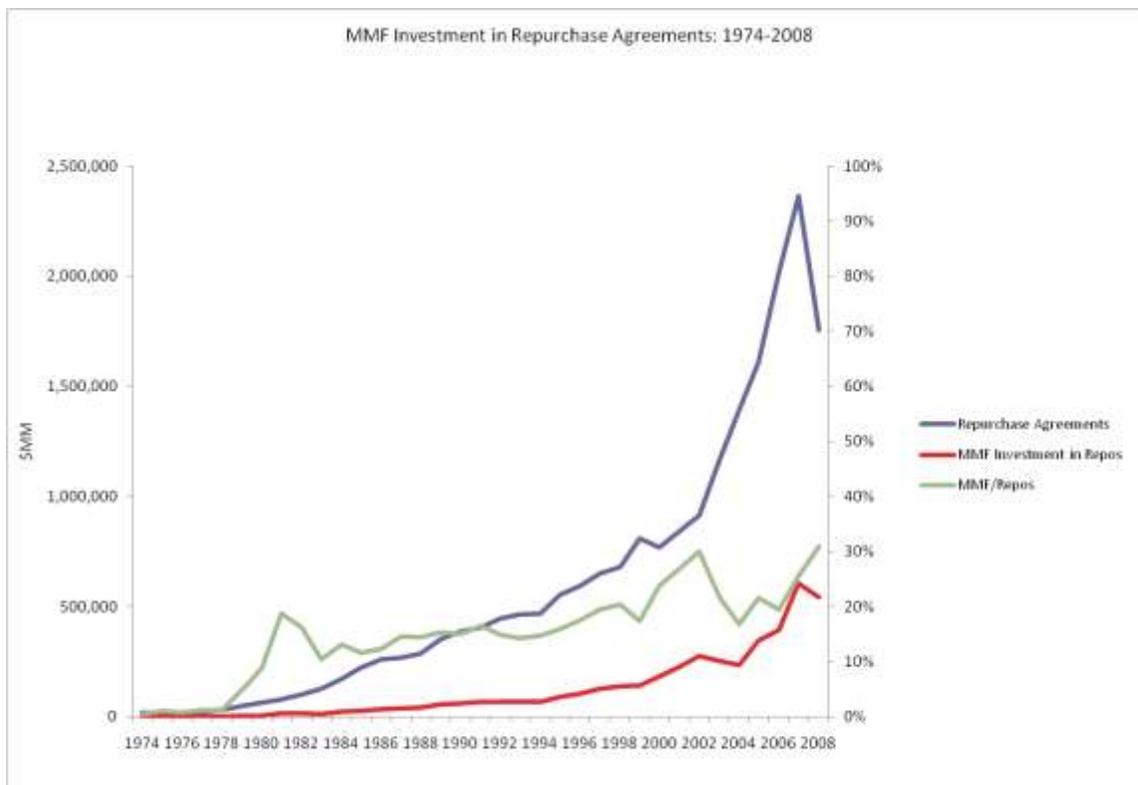
**Figure 2**



Source: Federal Reserve, Flow of Funds, Table L. 208 (2009)

The contribution of MMFs to the fragility of financial firms is reflected in Figure 3, which shows the MMF share of repurchase agreements, a form of very short term finance often rolled over nightly. Repurchase agreements are commonly used by investment banks and other financial institutions. As Figure 3 (top line, left y-axis) reflects, in the post-2000 period investment banks increasingly turned to overnight funding of their balance sheets, which increasingly came to include long-duration mortgage-backed securities. This is a classic case in which the money markets were employed for maturity transformation. Figure 3 (bottom line, left y-axis) shows the dollar increase in MMF participation in the repo market; the middle line, showing the ratio (right y-axis), has been 20 percent or more since early in the period, peaking at 30 percent. This regularity reflects the role of MMFs in a burgeoning financial practice that misfired in the face of financial distress. At the critical moment in fall 2008, the repo market simply froze; the buy-side participants “ran” by refusing to roll over their purchases. To be sure, many financial actors refused to roll over repo loans, but the pressure on MMFs to protect the \$1 NAV gave MMFs special reason to act preemptively.

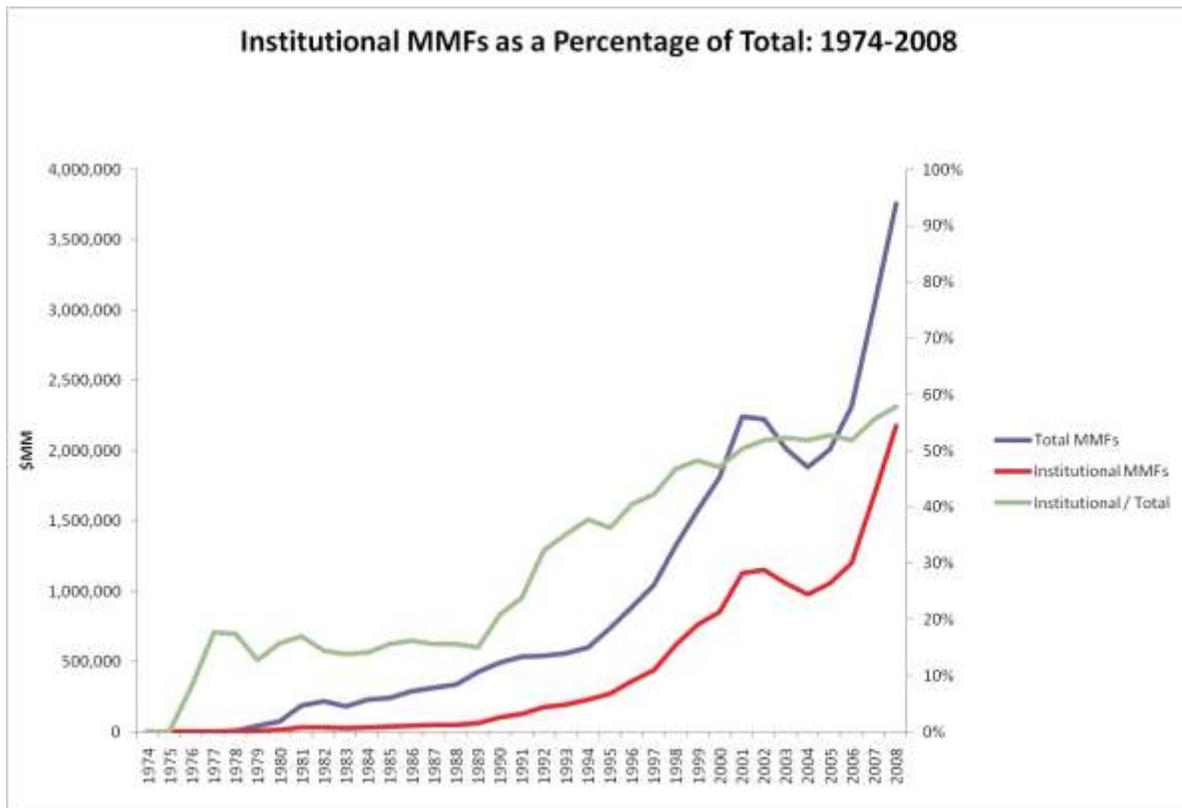
**Figure 3**



Source: Federal Reserve, Flow of Funds, Table L. 207 (2009)

Figure 4 shows another critical feature of MMF evolution that is not sufficiently reflected in the SEC’s reform proposal: the increasing institutional use of MMFs to make money market investments. Figure 4 (top line, left y-axis) shows the growth of money market funds over the 1974-2008 period; the bottom line (left y-axis) shows the growth of institutional MMFs. Particularly important is the steadily increasing asset share of institutional MMFs, which reached nearly 60% of the total by 2008. This is a remarkable development. MMFs started as a vehicle for pooling small depositors’ funds to provide access to money market instruments that otherwise would have been unavailable or uneconomic for them to acquire. But the most important purchasers of institutional funds, large business entities, can participate in money markets directly. Thus the MMF plays a different function for the two investor classes: For the retail investor, the MMF is a risk-free (but higher yielding) substitute for a bank account covered by deposit insurance; for the business investor, the MMF is a low-cost specialized provider of a corporate treasury function. In other words, the functional substitute for the business user of an MMFs is not a bank account covered by deposit insurance; rather, it’s the entity’s direct purchase of money market instruments. Yet institutional MMFs are covered by the same safety and soundness rules as retail MMFs: the portfolio maturity, credit quality, and NAV rules that exacerbate fragility in financial distress and that distort maturity transformation. Whatever the consumer protection arguments for such protections in the case of retail MMFs (despite the distortions), no such arguments pertain for institutional MMFs. There the distortions present only costs, no benefits.

**Figure 4**



Source: Federal Reserve, Flow of Funds, Table L.206 (2009).

Where does this lead in terms of MMF reform? A minimum reform strategy should create a sharp divide between retail MMFs (“RMMFs”) and institutional MMFs (“IMMFs”). For IMMFs, the SEC should fundamentally change the rules. IMMFs should not be permitted to vary standard valuation methodology to protect a fixed NAV. IMMFs should be freed of mandatory portfolio composition rules, including maturity and credit quality rules. Instead, IMMFs should be required to make detailed disclosure of their internally generated investment rules and make weekly web-site disclosure of their portfolio composition. At most the SEC should facilitate the creation of a number of “standard form” IMMFs that vary in particular portfolio features to economize on disclosure and search costs. Opting into one of these forms upon establishing an IMMF should be voluntary. The expectation is that NAV may fluctuate, but not very much, and probably much less than the package of money market instruments that IMMF purchasers would have assembled if acting independently. This avoids the need to provide a resolution process for IMMFs that “bust the buck,” which is likely to be cumbersome, costly, and slow, if only because of the presumed infrequency of its use.

The result of these IMMF reforms should be to reduce systemic risk. IMMFs will not face special pressure to retain a fixed NAV. The end of mandatory portfolio restrictions should reduce supply side distortions in short term credit markets.

A minimum reform strategy for retail MMFs would impose deposit insurance on RMMFs as a condition for maintaining a fixed NAV. This would both reduce systemic risk (by reducing the likelihood that individual RMMF investors will “run”) and eliminate supply side distortions in money markets by making RMMF purchasers internalize the cost of systemic risk reduction. Banks and RMMFs will compete for deposits on more level ground. Deposit insurance necessarily entails some regulation of portfolio composition to avoid moral hazard. One approach might be a risk-adjusted insurance fee rather than direct regulation of portfolio composition. Unlike in the case of banks, the short-term, market-traded nature of many RMMF-held instruments should make the assessment of a risk-adjusted fee relatively easy. Setting the fee, which should be assessed ex ante so as to avoid a search for a funding source at a time of systemic stress, will be a challenge in light of the infrequency with which MMFs have “busted the buck.” One could imagine setting a cap on a fund that would accrue over time, scaled to the size of the industry, with a risk-adjusted “recycling” procedure that would rebate excess funding to lower risk funds while still collecting fees from higher risk funds. As with any guaranteed deposit system, the SEC would need to establish a resolution procedure that presumably it would administer.

This reforms should be adopted in lieu of the SEC proposals, which do not address the implicit deposit guarantee subsidy nor the supply-side distortions in money markets of the present regulatory structure.

The broader question is whether RMMFs should continue to receive regulatory sanction, or whether, following the proposal of the Group of 30, RMMFs should become limited purpose banks. Assuming that RMMFs paid appropriate risk-adjusted levels of deposit insurance, the remaining advantage of such a far-reaching proposal is to eliminate a regulatory structure that artificially shifts maturity transformation towards short term securities markets, principally with the objective of reducing systemic risk. (Presumably the convenience of RMMFs as part of a package of services offered by a mutual funds provider could be preserved by permitting establishment of a limited purpose bank within the fund family structure.) In this regard the history of the RMMF is important: It was invented as a work-around of interest-rate ceilings imposed by regulation and it has flourished under a regulatory

umbrella that has provided implicit, subsidized deposit insurance. The money market distortions created by its portfolio structure contributed to the systemic break of fall 2008, a very serious cost.

What is the continuing value of the RMMF, a peculiar form of non-bank bank? In the spirit of the Treasury's white paper on financial regulatory reform, it seems to me that's the inquiry that the SEC's MMF reform proposal should now undertake.

Sincerely,

s/Jeffrey N. Gordon

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