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August 9, 2012

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Federal Reserve Bank of New York Staff Report on Minimum Balance at Risk

Dear Chairman Schapiro:

We are writing on behalf of our client, Federated Investors, Inc., to supplement comments we and others have submitted on the subject of proposed money market fund (MMF) "holdback" or minimum balance requirements and to address, in particular, the recent Federal Reserve Bank of New York (FRBNY) Staff Report, entitled "The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds" (FRBNY Staff Report or Report).[1]

The FRBNY Staff Report acknowledges that proposals such as requiring MMFs to float their net asset values (NAVs), hold capital, or impose redemption fees or holdbacks would *not* remove the risk of MMF "runs" and, if adopted, could have major adverse impacts on MMF investors and the capital markets and could even precipitate runs.[2] The Report instead focuses on the FRBNY Staff's Minimum Balance at Risk (MBR) proposal, which it says will deter MMF runs by penalizing MMF investors with the potential loss of principal when they exercise their right to redeem their shares from a troubled MMF.[3] But, while the FRBNY Staff Report says the proposal will lead "rational" MMF investors in a crisis to leave their funds in a troubled MMF, the proposal suffers from the same problems the Report attributes to other proposals: its impact

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[1] Federal Reserve Bank of New York Staff Report, *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds* (July 2012) (Available: http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf) (Report).

[2] Report at 6-7.

[3] We understand that the FRBNY Staff's proposal may be similar in many respects to a proposal drafted by the Commission's staff and currently pending before the Commission as a draft proposing release.

in reducing "runs" is speculative and unproven; it could and likely would precipitate runs under certain circumstances; it will punish MMF investors by layering costs and operational impediments upon their access to funds; it will make MMFs unavailable to investors who are precluded by state law or fiduciary requirements from investing in funds with minimum balance or subordination features; it will, in light of these costs and inefficiencies, drive MMF investors to less regulated and less transparent cash management vehicles or to systemically important banks – in either case increasing systemic risk; and it will reduce the participation of MMFs in the market for commercial paper and state and local government debt, thereby increasing funding costs for corporations and public entities. We discuss the impact of the proposal further below.

The Continuing False Narrative on MMFs and the Financial Crisis. In its efforts to make the case for penalizing MMF investors who seek to redeem from any troubled MMF, the FRBNY Staff Report continues to promote the false narrative that MMFs were at the heart of the financial crisis. The Report refers to "the severity of the damage to financial stability caused by the run in 2008"[4] and states that outflows from MMFs "were a key factor in the freezing of short-term funding markets and broader curtailment of credit supply"[5] that required "unprecedented government interventions to support MMFs in order to halt the run."[6] But, as we and others have addressed in comment letters, congressional testimony, and other publications,[7] the financial crisis had been underway for more than a year before it entered a turbulent 10-day period beginning September 7, 2008, when the government seized control of Fannie Mae and Freddie Mac. Thirteen months earlier in August 2007, the Federal Reserve, in recognition of banks' unwillingness to lend to each other and the deterioration of conditions in the financial markets at that time, began taking extraordinary steps to inject liquidity into the financial markets.[8] In

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4 Report at 48.

5 *Id.* at 1.

6 *Id.*

7 *See, e.g.,* Letter from John Hawke to SEC (Jul. 12, 2012) (Available: http://www.sec.gov/comments/4-619/4619-212.pdf); *Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Comm. on Banking, Housing and Urban Affairs*, 112th Cong. (Jun. 21, 2012) (testimony of Paul Schott Stevens, President, Investment Company Institute) (Available: http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc73189c9c0&Witness_ID=71b4f932-0cf4-4fcf-a761-8a41531b0e6e) (providing a summary of the causes of the financial crisis); Paul Schott Stevens, *Three Gaps in the FSOC's Account of Money Market Funds in the Financial Crisis* (Jul. 25, 2012) (Available: http://www.ici.org/viewpoints/view_12_pss_mmfs_fsoc).

8 That month, Senate Banking, Housing, and Urban Affairs Committee Chairman Christopher Dodd called a meeting with Chairman Bernanke and Treasury Secretary Henry Paulson to discuss overall market conditions and push the Federal Reserve's use of all available policy tools to ease the growing credit crunch. Emily Kaiser & Mike Peacock, Fed keeps tools handy and calms Wall Street, Reuters (Aug. 21, 2007) (Available: http://www.reuters.com/article/2007/08/21/us-economy-credit-idUSPEK14997020070821). *See also* Press Release, Federal Reserve Board (Aug. 17, 2007) (Available: http://www.federalreserve.gov/newsevents/press/monetary/20070817b.htm) ("Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth

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December 2007, it launched the Term Auction Facility, the first of over a dozen special liquidity programs. Programs initiated in March 2008 to support the funding of primary dealers – the Primary Dealer Credit Facility (PDCF) and Term Securities Lending Facility (TSLF) – were expanded by the Federal Reserve September 14, 2008 when it announced new measures to make more cash available to investment banks, lowered its standards regarding the quality of collateral used for borrowing under the two programs, and allowed financial companies to borrow from their insured depository institutions – measures necessary to address the seizing up of credit announced two days before the Reserve Fund broke the buck.[9] After a week of rumors and uncertainty, on Monday, September 15, Merrill Lynch was forced to sell itself, Lehman Brothers declared bankruptcy, and rumors were circulating about the ability of other large investment banks and financial institutions to fund themselves – the cost of protecting Morgan Stanley's debt through credit default swaps had doubled from the Friday before.[10] The Dow Jones Industrial Average plunged over 500 points that day.

At 9:00 p.m. on September 16, hours after the announcement that the Reserve Primary Fund had "broken the buck," the Government announced that AIG, which had received investment grade ratings only one day earlier, needed $85 billion in government money just to avoid collapse.[11] The government had shocked investors by *not* rescuing Lehman; but less than 48 hours later reversed itself by bailing out AIG. In its analysis of the financial crisis, Treasury Strategies, Inc., a treasury consulting firm to corporations and financial institutions, marks the

Footnote continued from previous page
going forward. . . . The [Federal Open Market] Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets."). Press Release, Federal Reserve Board (Aug. 10, 2007) (Available: http://www.federalreserve.gov/newsevents/press/monetary/20070810a.htm) ("In current circumstances, depository institutions may experience unusual funding needs because of dislocations in money and credit markets. As always, the discount window is available as a source of funding.").

[9] Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* at 354 (Available: http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf) (FCIC Report).

[10] *Id.* at 353-60. The pressure on investment banks and financial institutions as a result of credit conditions and rumors affecting their ability to fund themselves was so great during the summer of 2008 that the SEC on July 15, invoked its emergency authority – for the first time since the terrorist attacks on September 11, 2001 – and imposed pre-borrow restrictions on short sales of the stocks of 17 primary dealers as well as Fannie Mae and Freddie Mac. Press Release, Securities & Exchange Commission, SEC Enhances Investor Protections Against Naked Short Selling (Jul. 15, 2008) (Available: http://www.sec.gov/news/press/2008/2008-143.htm). Goldman Sachs and Morgan Stanley on September 21, 2008 announced that they would convert to banks, giving them access to deposits and the Federal Reserve discount window. Press Release, Federal Reserve Board (Sep. 21, 2008) (Available: http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm).

[11] FCIC Report at 349-50.

AIG announcement as the tipping point, when the financial markets "skidded into a total liquidity collapse."[12]

In response to these shocks, the government undertook a series of extraordinary actions. But, the measures taken by the government on September 19 to provide funding for banks' purchases of commercial paper from MMFs (the Asset-Backed Commercial Paper MMF Liquidity Facility, or AMLF) and guarantee MMF balances as of that date were small in size and duration compared to the massive government liquidity programs addressing the broader market problems.[13] Over the life of the program, the amount loaned under the AMLF constituted less than 2% of the government's total emergency funds outstanding on a weighted average monthly basis.[14] In fact, the AMLF was one of the smaller and shorter-lived liquidity programs of the Federal Reserve and Treasury during the financial crisis, it had no losses, and the Federal Reserve earned $543 million from its advances.[15] The Treasury's temporary guarantee program for MMFs also was limited in size and duration, was never called upon, and earned the Treasury $1.2 billion in premiums.[16] In contrast, the Transaction Account Guarantee program, providing unlimited amounts of deposit insurance for banks, has continued for more than three and one-half years, and, to date, estimated losses under the program total approximately $2.5 billion.[17]

MMFs were the first institutions to recover from the financial crisis, as evidenced by the fact that after September 19, when the temporary guarantee program was capped, MMF investors poured a net $170 billion in *uninsured* investments back into prime MMFs by year end 2008.[18] Banks and other institutions continued to draw from Federal and Treasury borrowing programs,

[12] Treasury Strategies, *Dissecting the Financial Collapse of 2007-2009* at 8 (Available: http://www.sec.gov/comments/4-619/4619-188.pdf) (filed as a comment letter with SEC Jun. 1, 2012).

[13] *See* Federal Reserve, *Credit and Liquidity Programs and the Balance Sheet* (Nov. 2011) (Available: http://www.federalreserve.gov/monetarypolicy/bst.htm).

[14] Federated Investors, *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, American Banker, Jan. 19, 2012 at 8. *See* Office of the Inspector General, Board of Governors of the Federal Reserve System, *The Federal Reserve's Section 13(3) Lending Facilities to Support Overall Market Liquidity: Function, Status, and Risk Management* at 5 (Nov. 2010) (Available: http://www.federalreserve.gov/oig/files/FRS_Lending_Facilities_Report_final-11-23-10_web.pdf) (AMLF utilization peaked at $152.1 billion.).

[15] *Id.*

[16] Press Release, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 19, 2009), http://www.treasury.gov/press-centeripress-releases/Pages/tg293.aspv.

[17] Letter from Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation to Hon. Shelley Moore Capito (Jun. 29, 2012) (Available: http://www.aba.com/Issues/Index/Documents/FDICResponsetoCapitoonTAG.pdf).

[18] *See* Treasury Strategies, *Dissecting the Financial Collapse of 2007-2009* at 3 (Available: http://www.sec.gov/comments/4-619/4619-188.pdf) (filed as a comment letter with the SEC Jun. 1, 2012).

including more than $1.45 trillion through the discount window and special liquidity programs set up by the Federal Reserve during the financial crisis,[19] $204.9 billion in funds distributed under the TARP's Capital Purchase Program to a total of 707 depository institutions, and even $80 billion in funding to bail out the automobile industry.[20]

Therefore, while it is accurate to state that MMFs ultimately were hit by the financial crisis, it is not accurate to suggest that MMFs were its cause or at its core. MMFs were the last to be hit, the first to recover, and the first to be subject to comprehensive new regulation – the SEC's carefully focused 2010 amendments to its MMF rules, which directly addressed and enhanced MMF liquidity, credit quality, transparency, and regulatory monitoring, making MMFs more resilient to future market turmoil. As a result of these changes, as confirmed in reports of the FRBNY Staff and the Financial Stability Oversight Council, U.S. MMFs effectively weathered large-scale redemptions during the summer of 2011 related to the European debt crisis, the U.S. debt ceiling standoff and the downgrading of U.S. debt.[21]

The FRBNY Staff Report not only overlooks data contrary to its narrative about the causes of the financial crisis, it omits altogether any assessment of MMFs post-2010 reforms versus MMFs in 2008. The Report uses data from MMF NAVs in 2008 and past incidences of sponsor support to project "the principal and liquidity losses that investors might expect when MMFs encounter serious strains" in the future,[22] without making any effort to assess the impact of enhancements to MMF credit quality, liquidity, disclosure, reporting, board authorities and responsibilities, and Commission oversight following the 2010 amendments to MMF regulations. Post 2010 reforms, MMF portfolios are required to have significantly shorter weighted average maturities, weighted average lives, daily liquidity of 10% or more and weekly liquidity of 30% or more of assets under management. Thirty percent was selected by the SEC as the new

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[19] Federal Reserve Board, *Why did the Federal Reserve lend to banks and other financial institutions during the financial crisis?* (Available: http://www.federalreserve.gov/faqs/why-did-the-Federal-Reserve-lend-to-banks-and-other-financial-institutions-during-the-financial-crisis.htm) (The $1.45 trillion does not include the AMLF but does include the following liquidity facilities: Term Auction credit, primary credit, secondary credit, seasonal credit, Primary Dealer Credit Facility, Term Asset-Backed Securities Loan Facility, Commercial Paper Funding Facility, and central bank liquidity swaps.). The numbers reflected above are as reported by the Federal Reserve and other government sources, but as most loans were short term or even overnight, these numbers significantly understate the aggregate liquidity provided during this period, which totaled in the trillions.

[20] Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress* at 87, 146 (Jul. 25, 2012) (Available: http://www.sigtarp.gov/Quarterly%20Reports/July_25_2012_Report_to_Congress.pdf).

[21] Report at 46; Financial Stability Oversight Council, *2012 Annual Report* at 134-35 (Available: http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf).

[22] *See* Report at 3, 27-34. The Report also simply repeats statements concerning the number of MMF sponsor interventions, with no independent analysis. Report at 28. *See* Letter from Dreyfus Corporation to SEC (Aug. 7, 2012) (Available: http://www.sec.gov/comments/4-619/4619-221.pdf).

minimum weekly liquidity standard because that percentage is roughly *double* the percentage of MMF shares redeemed during the week of September 2008 that followed the bankruptcy of AIG. Post 2010 reforms, MMFs are required to conduct an assessment of their shareholders' anticipated redemptions and hold even greater liquidity to meet those anticipated needs. As of January 2012, MMFs held in excess of $1 trillion in 7-day liquid assets out of $2.6 trillion in total assets.[23] In addition, post 2010 reforms, MMFs are required to be far more transparent with portfolio composition and are required to publish, among other things, weekly "shadow prices" of shares, so that investors are far better informed about portfolio composition, risk and valuation. The more recent, more detailed and more relevant data on MMF portfolios from 2010 to the present is readily available to the FRBNY and the public from the SEC, ICI and various databases, and is the appropriate data to analyze before any further changes to MMF are suggested. There is no reason to rely upon 2008 MMF liquidity and portfolio data to analyze the current or future performance of MMFs or develop suggestions for further reforms. The 2007-2009 Financial Crisis was fundamentally a liquidity crisis, as has been the case with many prior financial panics. The 2010 amendments to the SEC's regulations governing MMFs profoundly increased the liquidity of MMFs in order to prevent future recurrences of the problems that surfaced in 2008. The baseline for assessing whether further reform is necessary must be the state of MMF portfolios and regulations in 2012, and not 2008.

Further changes to MMF regulation – particularly changes that would alter the essential character of MMFs and drive investors to less regulated alternatives or systemically important banks – are unwarranted at this time. A false narrative of MMFs' role in the financial crisis cannot justify such changes.

FRBNY Staff Criticism of Major Proposals for MMF Reform. Before examining the specific proposal put forward by the FRBNY Staff, it is useful to review the Report's critical observations about other MMF reform proposals that have been widely promoted as solutions to the "structural weaknesses" of MMFs that make them "susceptible to runs."

With respect to proposals for a floating NAV, the FRBNY Staff Report states what we and many others have been saying for years: requiring MMFs to transact purchases and redemptions on the basis of a floating NAV will not remove the risk of MMF "runs" but could "lead to a precipitous decline in MMF assets and in these funds' capacity to provide short-term funding," further leading to a flow of MMF assets to less regulated, less transparent stable NAV products, which would "continue to pose systemic risks," or cause a flow of MMF assets to "the banking system [which] might experience a large increase in uninsured 'hot money' deposits."[24] Astonishingly, while acknowledging that a floating NAV cannot be relied upon to address the

[23] Letter from Fidelity Investments to SEC (Mar. 1, 2012) (Available: http://www.sec.gov/comments/4-619/4619-125.pdf).

[24] *Id.* at 6.

potential for MMF runs, and further noting the potential for significant adverse economic consequences if such a proposal were adopted, the Report nonetheless suggests that regulators could give investors a choice between two types of MMFs: floating NAV funds alongside others that would have stable NAVs but be required to maintain minimum balances subject to subordination.[25] This provides no choice for investors; floating NAV funds are available today, and investors who need the stability and liquidity of MMFS have rejected them. In our view, it is time to take the option of requiring MMFs to float their NAVs wholly off the table. If it will not achieve the central purpose of its proponents – to reduce the risk of runs – then surely it is not worth the adverse economic consequences it will bring about.[26]

With respect to proposals for MMFs to hold capital, the FRBNY Staff Report acknowledges that a small buffer will not prevent investors from fleeing in a crisis but could nonetheless create moral hazard by "blunt[ing] portfolio managers' incentives for prudent risk management and investors' incentives to monitor risks in their funds."[27] The Report further acknowledges that raising sufficient capital for a large enough buffer to effectively absorb losses would be "challenging," and present "complications" regardless of its source (according to the Report, capital derived from fund income would take years to build; capital from third parties would require creation of a new, untested security; capital provided by the fund industry would potentially lead to further consolidation of the industry among affiliates of large, systemically important financial institutions, shifting risk from MMFs to those institutions).[28] Thus, it is time to put to rest proposals to require MMFs to hold capital, such as those promoted by academics in the Squam Lake Group, former Federal Reserve Chairman Volcker, and other current and former bank regulators who for years have challenged the legitimacy of MMFs and argued that MMFs should be more like banks.

With respect to proposals for restrictions or fees on redemptions, the Report states, "A redemption fee that is charged in all circumstances would negate the principal stability that is critical for many MMF investors . . . [and] an unconditional delay of *every* redemption would undermine the liquidity of shares that is established in the Investment Company Act for all

[25] *Id*. at 54.

[26] The other argument for a floating NAV – that it is needed because MMF investors after 40 years of disclosures regarding MMF risks and more recent postings of all MMF shadow NAVs still do not appreciate the fact that MMF shares are not guaranteed and may lose value – is just not credible. As the Maryland State Treasurer recently testified at a Senate hearing on MMFs, "[O]n behalf of many of the investors . . . [w]e do read the prospectus and we know it's an investment. . . . So I think this treating us sort of like children is really not appropriate." *Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 112th Cong. (Jun. 21, 2012) (testimony of Nancy Kopp, State Treasurer, Maryland) (Available: http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc73189c9c0).

[27] Report at 6.

[28] *Id.* at 6-7.

mutual funds…. [and] [e]ither change, if applied at all times, would likely have the impacts similar to the consequences of a floating NAV."[29] The Report further acknowledges that "conditional fees or restrictions might *increase* the vulnerability of MMFs to runs."[30] These ideas, too, should be put to rest.

The Minimum Balance at Risk/Subordination Proposal. Thus, the authors of the FRBNY Staff Report recommend what they call a "new" approach, the minimum balance at risk proposal. The proposal would work as follows:

- Each MMF shareholder would have a minimum balance at risk (MBR) which would be a percentage (such as 5%, used in the Report) of the highest daily balance in the shareholder's account ("high water mark") over the preceding 30-day period.

- The MBR would be restricted from redemption by the shareholder for a period of time (such as 30 days, used as the example and recommended in the Report).

- The remaining amount would be a free balance to the shareholder – the investor's available balance for redemption. That is, transactions in the account for amounts that would not tap the MBR (e.g., redemptions up to 95% of the balance) could be conducted freely.

- Transactions for amounts greater than the available balance would have an amount held back for 30 days sufficient to maintain the MBR (e.g., 5% of the high water mark for the investor over the prior 30 days); the shareholder would have to wait for 30 days to receive the full amount.

- If the MMF suffers a loss, the loss would be absorbed in the held back amounts (the 5% MBR of each shareholder's balance) before hitting any of the unrestricted balances.

- The FRBNY Report states that the MBR would could "work particularly well in tandem with a capital buffer."[31] (The various examples provided in the Report all carry a 50 basis points capital buffer, although the Report, inexplicably, does not price the capital buffer in as a cost to investors or sponsors that could affect the viability of MMFs with these features.)

- If a shareholder redeems any shares in the 30 days prior to the fund incurring a loss (presumably the loss causes the fund to break the buck and suspend redemptions), then a

[29] *Id.* at 7.

[30] *Id.*

[31] *Id.* at 10.

proportionate amount of any redeeming shareholder's MBR – which has been held back from the redemptions – would be in a first loss position to shareholders who did not redeem).

- The proportion of the MBR that is in this first loss position would be determined, based upon the level of a redeeming shareholder's remaining available balance after redemption. The subordinated amount of the MBR could be an amount directly proportional to the amount of redemptions from the shareholder's free balance. (As a simple, rounded example, if a shareholder with a $1,000 high water mark and a $50 MBR redeemed half of his balance just ahead of the fund's closure due to a loss, half of his $50 MBR would be subordinated to other investors and would incur losses ahead of other investors.) Or it could be a lesser proportion of the MBR.

- Losses in a fund would be allocated first to the capital buffer (50 basis points in the examples given) once the buffer is exhausted, losses would be absorbed on a pro rata basis by the subordinated MBR of shareholders who had redeemed shares in the prior 30-day period; any additional losses would be absorbed by nonredeeming shareholders' MBR; and any additional losses would be divided on a pro rata basis over all other shares in the fund.[32]

In arriving at its basic assumptions about how the above model will deter MMF investors from redeeming from a troubled MMF, the Report makes assumptions about the anticipated level of losses if a fund breaks the buck, and establishes that level as two percent.[33] The Report also projects the "liquidity costs" an investor might incur by leaving his/her investment in a MMF that closes and concludes,

> [T]he opportunity costs of lost liquidity to investors in a closed MMF are probably material and significant, although they are difficult to measure. Based on the indicators we have reviewed here, we believe than an MBR should be designed to withstand redemption pressures that incorporate investors' incentives to avoid lost-liquidity costs of at least 50 basis points.[34]

The Report projects a length of delay for redemption of the MBR based on the proposition that "[t]he delay period should be, at a minimum, long enough to inhibit 'preemptive' runs, but not so

[32] *Id.* at 11.

[33] Here, the Report examines data submitted by certain MMFs during the financial crisis that reported to regulators. Based on the underlying NAV levels of those MMFs and eliminating the impact of sponsor support, the Staff determines that a fund could be expected to incur losses of two percent of assets. *Id.* at 28-31.

[34] *Id.* at 34-35.

long as to unnecessarily inconvenience shareholders or impede market discipline for MMFs."[35] The Report settles on a delay of 30 days as optimum.

The FRBNY concludes that the MBR requirement with subordination features as described will prevent or significantly deter MMF runs and, indeed, is the only proposal to date that will do so.

FRBNY False Premises, Assumptions and Assertions Regarding the MBR Proposal. Although the FRBNY Staff describe the approach as "new," and it is true that the MBR recommendation did not appear in the President's Working Group Report on MMF Reform Options or in earlier reform proposals, the specific elements of the MBR proposal have been addressed by a number of comment letters, surveys and reports previously filed with the Commission and available in its public comment file. The FRBNY Staff had access to these reports and comments – indeed, the Staff specifically referenced two surveys filed with the Commission that the FRBNY Staff said were not relevant to their proposal, because the surveys asked investors about transaction-based redemption restrictions and not minimum balance requirements.[36] Yet the FRBNY Staff wholly ignored comments and surveys that described, addressed, and raised serious concerns about the very type of minimum balance restriction put forward in the Report. These include: a detailed study published by the Investment Company Institute (ICI), the national association of U.S. investment companies;[37] a comment letter filed by DST Systems, Inc., a information processing service provider to the global asset management, insurance, retirement, brokerage and healthcare industries;[38] a report published by Blackrock, a leading asset management company;[39] a comment letter filed by the American Benefits Council an association representing 350 organizations that either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans;[40] an analysis of operational impediments and state law impediments to minimum balance requirements filed by Federated Investors, the third largest MMF manager in the U.S.;[41] a report addressing various

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[35] *Id.* at 40.

[36] *Id.* at n. 49 (referring to investor surveys conducted by Fidelity Investments and Treasury Strategies).

[37] Letter from ICI to SEC (Jun. 20, 2012) (Available: http://www.sec.gov/comments/4-619/4619-207.pdf).

[38] Letter from DST Systems, Inc. to SEC (Mar. 2, 2012) (Available: http://www.sec.gov/comments/4-619/4619-128.pdf).

[39] Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012) (Available: https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117).

[40] Letter from American Benefits Council to SEC (Jun. 19, 2012) (Available: http://www.sec.gov/comments/4-619/4619-204.pdf).

[41] Letter from Federated Investors to SEC (Mar. 16, 2012) (Available: http://www.sec.gov/comments/4-619/4619-140.pdf).

types of redemption restrictions, including minimum balance restrictions, filed by Treasury Strategies, Inc., a consulting firm advising corporate and institutional treasurers;[42] three letters Arnold & Porter filed on behalf of Federated Investors, which describe in detail the various uses of MMFs and the impact of redemption restrictions, including minimum balance restrictions, as well as the estimated size of the various MMF users that would be impacted by restrictions on investor redemptions;[43] and others. These reports, surveys and commentary raise significant questions about the underlying assumptions and assertions in the Report, discussed below.

A. FRBNY Staff Report False Premise: The MBR with subordination will prevent MMF runs.

The fundamental premise upon which the FRBNY Staff bases its assertion that the MBR construct will prevent or significantly reduce the risk of MMF runs is as follows:

> [A]s long as the MBR and potential subordination are large enough, incentives to redeem *diminish* as the fund's distress becomes more apparent. Because redemptions cause a portion of a shareholder's MBR to be subordinated, the implicit cost of redemptions rises as losses appear more likely.[44]

The FRBNY concedes, however, that shareholders may not act rationally in a crisis:

> [I]t is possible that, notwithstanding shareholders' incentives *not* to redeem in a crisis from a MMF with an MBR, investors' irrational fears may cause them to do so anyway. . . . [A]ccurate predictions of irrational behaviors in a crisis are difficult. Notwithstanding this uncertainty, an MBR with subordination clearly would diminish or reverse pressures on *rational* investors to exit MMFs during crises.[45]

The above is the entirety of the FRBNY Staff's case. If their assumption about rational investor behavior falls, then their entire proposal is useless, other than as a measure to make

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[42] Treasury Strategies, *Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective & Crippling Regulation* (Available: http://www.sec.gov/comments/4-619/4619-172.pdf) (filed as a comment letter with the SEC Apr. 27, 2012).

[43] Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012) (Available: http://www.sec.gov/comments/4-619/4619-143.pdf); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012) (Available: http://www.sec.gov/comments/4-619/4619-122.pdf); Letter from John D. Hawke, Jr. on behalf of Federated Investors to FSOC (Dec. 15, 2011) (Available: http://www.sec.gov/comments/4-619/4619-112.pdf) (filed with SEC).

[44] Report at 46.

[45] *Id.*

MMFs so unappealing to users that MMF assets are dramatically reduced. The FRBNY Staff assumes that investors – the same investors that some high-level regulators have said do not understand that MMFs are not guaranteed and can fluctuate in value below $1.00 per share – will calmly assess their options under the MBR/subordination structure during a crisis of September 2008 proportions. The FRBNY also assumes that those who act rationally, faced with the prospect that a MMF will break the buck and suspend redemptions, will forego the certainty of immediate access to 95% of their cash and, instead, opt for the uncertain prospect of the return of a greater portion of their principle many months or a year or more later.

In a paper directly on point, released in March of this year, BlackRock reported on the results of a survey of over 40 of its institutional clients who were questioned about a proposal identical to the FRBNY's proposal, using a minimum balance of 3%.[46] BlackRock reported the following:

> BlackRock does not believe this structure will work for three critical reasons: i) Clients will not invest in MMFs with these redemption restrictions; ii) this approach may increase the likelihood of a run; and iii) there are enormous operational challenges in implementing this structure. . . .
>
> [T]he most telling input we received from clients was that they believed this approach would *increase* their likelihood of running in a financial crisis. Many of them told us that with a portion of their balance held back for 30 days *and* subordinated, they would choose to redeem much sooner – at the slightest sign of nervousness in the markets. The economists' theory that clients would calmly weigh the costs and benefits of redeeming is contrary to what we heard in our discussions (and is contrary to the sometimes irrational behavior we observed in 2008). In this model, we believe clients would not take the time to navigate the complex structure and would be more likely to redeem earlier – and in this model, 97% of balances are open for redemption. Rather than preventing runs, we believe this approach would act to accelerate a run.[47]

We doubt that a MBR of 5%, as used in the FRBNY Staff modeling, versus the 3% amount used by BlackRock in its client survey, would changes the above responses (it might provide a larger inconvenience in normal times and arguably a larger disincentive

[46] Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012) (Available: https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117). Interestingly, the FRBNY Staff Report cites in its list of references two earlier publications by BlackRock, but omits any reference to BlackRock's March 2012 report, which analyzes the exact proposal put forward in the FRBNY Staff Report. *See* Report at 62.

[47] *Id.* at 4.

to redeem in troubled times), but here BlackRock did what the FRBNY Staff did not do: it tested the assumptions with actual users of MMFs. The FRBNY Staff's incomplete and narrow "game theory" should not be the basis for restructuring a $2.6 trillion dollar industry without further inquiry into how the players in the game will, in fact, react. Research and data about MMF users is a missing element in the FRBNY Staff proposal that must be addressed.

B. FRBNY Staff Report False Premise: The MBR will not trigger preemptive runs.

Another important premise of the FRBNY proposal is that, unlike other proposals for redemption restrictions, the MBR proposal, coupled with subordination and a delay on redemptions, will not trigger preemptive runs. The Report states:

> The MBR rules that we propose are fundamentally different from conditional restrictions, since the delay for disbursements of the MBR [a recommended 30 days] would *always* be in place. Hence, investors in an MMF with an MBR would not have incentives to run in advance of triggering events that might restrict or penalize redemptions.[48]

In addition to BlackRock's survey response, discussed above, the issue of preemptive redemptions was addressed in a report filed with the Commission earlier this year by Treasury Strategies:

> A thirty day holdback provision essentially requires investors to look ahead thirty days and ask whether it is possible for certain conditions to deteriorate to the point at which an institution might be in distress. If the answer is "yes" or "maybe", then the threat of a holdback encourages the investors to sell. This definitely creates a first mover advantage. It also precipitates a prolonged run in which assets leave the fund, at first slowly, accelerating into a full-fledged run.
>
> Had this provision been in place during any number of recent events, investors would have invoked the thirty day look-ahead and exited perfectly healthy and well functioning MMFs. For example, during the summer of 2011, at the height of the European debt crisis and the U.S. budget impasse, investors could have pre-emptively sold their MMF investments in order to assure themselves of liquidity. August of 2011 would have seen the worst of both worlds: all of the first movers

[48] Report at 45.

> rewarded and their actions possibly triggering a firestorm run on the day of the U.S. sovereign downgrade.[49]

The success of MMF's handling of high levels of redemptions in the summer of 2011 affirmed that the Commission's liquidity requirements for MMFs are working as intended. The FRBNY Staff Report and the FSOC's 2012 Annual Report acknowledge that MMFs fully met investor redemptions. No fund broke the buck. The Commission's enhanced MMF disclosure requirements gave investors greater insight into MMF portfolio holdings; investors took appropriate action consistent with their risk tolerance. The redemptions experienced by MMFs in the summer of 2011was not a run; it reflected the discipline of investors assessing their MMFs' portfolios. But, as Treasury Strategies points out, had the MBR requirement been in place at that time, it could have triggered a wave of preemptory redemptions and a wholly unnecessary firestorm run. We should not use the FRBNY Staff's game theory to put a rule in place with the potential for such dire consequences.

C. <u>FRBNY Staff Report False Assertion: The MBR will not be burdensome</u>.

The Report states that implementation of the MBR requirement "could be fairly straightforward, as a fund would only have to track two additional variables for each investor – her minimum balance at risk and any portion of her MBR that she has requested to redeem."[50] Further,

> [The MBR] would have no effect on most transactions in a fund, particularly during normal times . . . . Because the chance of loss in an MMF is almost always remote [the subordination element] normally would be immaterial. . . ."[T]he subordination rule [would] be in effect at all times without imposing an undue burden on a fund and its investors. Only in the event that a fund experienced problems would the disincentive become large enough to offset powerful incentives to redeem.[51]

Although the Report minimizes the burdens of the proposal, the MBR requirement will require funds and intermediaries to compile and track a vast amount of data. It will require daily balance information for every account for every business day during the 30-day delay period, easily hundreds of millions of records. MMFs cannot avoid maintaining this amount of data,

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[49] Treasury Strategies, *Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective & Crippling Regulation* at 5-6 (Available: http://www.sec.gov/comments/4-619/4619-172.pdf) (filed as a comment letter with the SEC Apr. 27, 2012).

[50] Report at 2-3.

[51] Report at 8.

because the delay period will be a rolling period. A fund cannot, for example, simply compare the current balance to the previous highest balance, because the previous highest balance will eventually fall outside of the delay period, and the fund will then have to review every day in the delay period to determine which balance is now the highest.[52] It will need to compute the minimum balance available on a daily basis as well as the proportionate amount of the MBR that is subordinated, based on the investor's redemption amounts over the applicable 30-day period.

Nowhere in the Report is there any reference to the operational challenges and costs posed by a MBR requirement for omnibus accounts, sweep accounts, and other uses involving intermediaries and systems that extend beyond the control of MMFs themselves. These challenges are described in detail in a 35-page study submitted to the Commission by the ICI, which analyzed an anticipated minimum balance proposal based on a shareholder's high water mark, restricted for 30 days, subject to subordination if and to the extent the shareholder redeemed within the 30 days prior to a fund breaking the dollar – exactly the proposal put forward by the FRBNY staff. According to the ICI, which described the proposal as an anticipated SEC proposal,[53]

> Implementing the SEC's proposed freeze on shareholders' assets would require changes to a myriad of systems that extend well beyond those under the control of the funds themselves. Fund complexes, intermediaries, and service providers have developed complex systems that allow them to communicate and process significant volumes of money market fund transactions on a daily basis through a variety of mechanisms on behalf of investors. To apply continuous redemption restrictions accurately and consistently across all investors in money market funds, each of these entities, including a host of intermediaries, would need to undertake intricate and expensive programming and other significant costly system changes.
>
> In many cases, daily redemption restrictions would simply render money market funds useless for offerings and services that investors and intermediaries value. Intermediaries and funds that can and choose to continue to provide money market funds would be required to make extensive and burdensome changes throughout their operational structure. The evidence of this paper indicates, however, that the costs of these changes could be prohibitive and that the industry would be unlikely to undertake them, particularly if the SEC's changes result in shrinking the asset base of money market funds.[54]

[52] *See* Letter from Federated Investors to SEC (Mar. 16, 2012) (Available: http://www.sec.gov/comments/4-619/4619-140.pdf).

[53] Letter from ICI to SEC (Jun. 20, 2012) (Available: http://www.sec.gov/comments/4-619/4619-200.pdf).

[54] *Id.* at 2.

The ICI's report describes how MMF shareholders buy and sell shares using a range of services offered by intermediaries and fund sponsors and involving a wide array of platforms, portals, and financial intermediaries such as broker-dealers and retirement plans. In its analysis, ICI found that at a minimum, modifying the infrastructure to process MMF transactions subject to the new requirements would require changes to: (1) shareholder servicing interfaces for inquiry and transaction processing and for other servicing interfaces (such as portals, telephone voice response units, and the Internet) used by customers; (2) transfer agent and intermediary recordkeeping systems and ancillary systems that will compute, age, and track restricted share balances; (3) systems to identify and process redemption transactions that take into account restricted share balances in order to avoid transactions being rejected because they are "not in good order," which could raise transaction costs significantly; (4) systems to track and process restricted share balances for pending redemption requests once the restricted shares have fully aged; (5) systems to provide restricted share balance data (including aging information) on both automated and manual account transfers for MMF assets moving between funds and intermediaries or between intermediaries; (6) reconciliation and control functions to include daily reporting of restricted share balances that will ultimately be used for cash and portfolio management, fund accounting, and financial reporting purposes; (7) NSCC systems (e.g., Fund/SERV and Networking) to incorporate the impacts of restricted share balance on transaction, acknowledgment, activity (including transfers), settlement, and reconciliation processing for both networked and omnibus accounts; (8) investor documentation and communications that explain redemption restrictions, as investors will likely find the calculation and application of restricted share balances difficult to understand; and (9) processes and procedures, as well as training, for shareholder servicing representatives, transaction processing personnel, reconciliation and treasury management, internal audit, legal, and compliance staff charged with implementing and servicing restricted share balance requirements on investor accounts.[55]

The operational impact of a MBR requirement also was assessed by DST Systems, Inc, in a March 2, 2012 letter to the Commission.[56] DST assumed a 3% minimum balance requirement based on a look back of the shareholder's average account balance over the past 30 days and assumed that the minimum account balance would be recalculated and reset monthly (it did not consider and factor in the additional element of tracking the proportionate amount of the minimum balance subject to subordination, based on the shareholder's recent redemption activity). It concluded:

[55] *Id.* at 26-27.

[56] Letter from DST Systems, Inc. to SEC (Mar. 2, 2012) (Available: http://www.sec.gov/comments/4-619/4619-128.pdf).

- [A] minimum account balance approach would . . . require pervasive and expensive systems and operational changes for a wide variety of parties that deliver money market mutual funds to investors. Additional tracking systems for calculating and reporting minimum balances would require significant programming.

- Cash reconciliation processes would need to be enhanced to incorporate minimum balance requirements, likely at the account, CUSIP, and portfolio level. All of the changes would require programming, training, and additional operational procedures.

- …[I]nstitutional investors would be dramatically impacted with a minimum balance requirement. The very nature of sweep accounts would be rendered impossible in money market mutual funds, driving clients with these objectives to other vehicles that are further removed from core investor delivery systems, requiring costly conversions and reduction of service to end investors.

- Automated processing routines in place through the DTCC connecting broker dealers, transfer agents and other record keepers would require edits to incorporate minimum balance restrictions and tracking.

- The omnibus accounting layers that exists in the mutual fund shareholder recordkeeping environment would provide further complexity with a minimum balance requirement. Understanding the duties and responsibilities to assure parties jointly are not duplicating or inaccurately applying the regulatory requirement on the same end investor, and reconciliation with multiple layers of servicing parties involved in these arrangements would entail significant legal, compliance, operational, and systems burdens.

- Check writing or debit card requests to redeem the balance below the minimum amount would require additional programming, operational changes, and increase investor inconvenience.

. . .

- Certain aspects of transaction requests to redeem an entire account balance would be problematic with transaction or account based redemption restrictions. The number of transaction requests considered 'not in good order' would spike. Not in good order transactions bear a significant cost in terms of multiplying the number of times the investor must be inconvenienced, or the touch points needed, to successfully complete the transaction request. A minimum balance environment would increase the work and cost involved in providing rejected transaction correspondence. Costs would increase for transfer agents, intermediaries, representatives for the investor and all other parties involved in servicing money market fund shareholders.

- Transaction or account based redemption restrictions would result in a widespread, ongoing additional training and investor education process. The added complexity would increase training of shareholder servicing representatives, transaction processing personnel, cash reconciliation staff, portfolio accounting, audit, legal and compliance. Shareholder telephone servicing call times would increase along with the volume of questions, concerns, and complaints.

- Additional communications disclosures would be required in all forms of media including confirmations, statements, websites, applications and forms, and prospectuses and statements of additional information. All of these requirements will increase costs.

- Cash availability reporting relied on by portfolio managers to make investment decisions would require enhancement to carry and reflect funds encumbered for held back redemptions restricted. These amounts would change daily and increase the operating cash balances in the fund not invested while adding additional complexity to the reporting process.

- Duties and responsibilities of parties would be exacerbated in an omnibus environment with either form of redemption restrictions. Transparency and reporting regarding which party applied the restrictions, amounts of funds held in reserve, amounts of transactions delayed still representing a future draw on funds, and reconciliation are all challenges that would be faced by systems and operations of funds and their service providers.[57]

Arnold & Porter, on behalf of Federated Investors, also filed an extensive comment letter describing the ranges of systems that currently use MMFs to hold short-term cash balances and further describing how a redemption holdback or minimum balance requirement would add layers of complexity and costs and undermine the utility of MMFs for those purposes.[58] Those include: corporate payroll processing; corporate and institutional operating cash balances; bank trust accounting systems; federal, state and local government cash balances; municipal bond trustee cash management systems; consumer receivable securitization cash processing; escrow processing; 401(k) and 403(b) employee benefit plan processing; broker-dealer customer cash

[57] *Id.* at 5-6.

[58] Letter from John Hawke to SEC (Feb. 24, 2012) (Available: http://www.sec.gov/comments/4-619/4619-122.pdf).

balances; futures dealer customer cash balances; investment of cash collateral for cleared and uncleared swap transactions; cash-management type accounts at banks and broker-dealers; portfolio management; and 529 plans.[59] A separate letter field by Arnold & Porter on behalf of Federated Investors provided estimates of the MMF assets used in various segments of specialized commercial users of MMFs.[60]

The above commentaries, surveys and reports have been publicly available for review by all regulators working on proposals to further limit MMFs. Yet none of the information provided in these materials regarding the impact of an MBR requirement were addressed or even mentioned in the FRBNY Staff Report. There is not a single reference in the FRBNY Staff Report to omnibus accounts, sweep accounts, escrow accounts, or the various uses of MMF investors that would be impact by an MBR requirement. By ignoring existing evidence, and making no independent assessment of the costs and operational challenges presented by its proposal, the FRBNY Staff Report has no basis for its statements that the MBR rule's "implementation could be fairly straightforward,"[61] that it is "unlikely" that the requirement would cause "a sudden shift to alternative products"[62] or that, as a result of the adoption of its proposal, demand for MMFs would be reduced only "somewhat."[63] Indeed, as discussed below, there is ample evidence in the Commission's comment file that investors who currently use MMFs for cash management – including businesses, state and local governments, fiduciaries and others – either will not use, or will sharply reduce their use of, MMFs with a MBR requirement. And there is further evidence that a MMF industry reduced in size would increase the cost of funding for issuers who rely upon MMF demand for commercial paper, and would increase costs for state and local government users who rely upon MMFs to purchase their debt at a lower cost than available alternatives.

D. <u>FRBNY Staff Report False Assertion: The MBR rule will not dramatically dampen demand for MMFs</u>.

The Report makes a number of assumptions about the impact of an MBR rule on investor demand for MMFs and concludes that the impact would be minimal. It states that the rule would "modestly reduce investors' liquidity and make investing in MMFs somewhat more complicated . . . [but] although reforms may reduce demand somewhat, in light of the limitations of other cash management opportunities available for MMF investors, a sudden shift to alternative

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59 *Id.*

60 Letter from John D. Hawke to SEC (Mar. 19, 2012) (Available: http://www.sec.gov/comments/4-619/4619-143.pdf).

61 Report at 2.

62 *Id.* at 48.

63 *Id.*

products appears unlikely."[64] According to the Report, "the overall impact of the MBR rule on demand for MMFs likely would be far less stark than the effect of a floating NAV requirement for all MMFs.[65]

This is sheer speculation, as is the Report's statement that MMFs with MBR requirements could be "*more* attractive" to investors concerned about safety.[66]

The Report includes no assessment of the costs and operational challenges described above, nor has the FRBNY Staff interviewed or surveyed current MMF users about the way they use MMFs or their willingness to invest in a product with the untested features of the MBR requirement. Indeed, the Report is dismissive of the views of investors, stating, "Perhaps not surprisingly, investors who respond to surveys about MMF reform options generally show little enthusiasm for *any* option."[67] It also dismisses the findings of investor surveys conducted by Fidelity Investments and Treasury Strategies, each of which undertook to size the impact of redemption restrictions on investor behavior, but which did not present investors with the specific MBR structure proposed by the FRBNY Staff.[68]

We, as well as other fund companies who know their customers, believe it is highly likely that investor demand for MMFs would shrink dramatically for MMFs with the MBR feature. As BlackRock reported after surveying 40 of its institutional clients about the identical MBR features proposed by the FRBNY Staff,

> They were unequivocally negative on the idea, for a number of reasons. Importantly, many clients do not naturally remain above a minimum account balance. Analysis of our client base showed that 43% of institutional clients dropped below a 3% minimum account balance (based on prior 30-day average) at least once in 2011. 10% of clients did so regularly (i.e., more than five times in the year). Many of these clients go below the minimum account balance because

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[64] *Id.*

[65] *Id.* at 54.

[66] *Id.* at 49.

[67] Report at 48-49.

[68] Report at 49. In a survey of more than 200 corporate institutional MMF users conducted by Treasury Strategies for the ICI, 90% of institutional users said they would decrease or stop using a MMF if the instrument contained a holdback. Of those, 55% said they would stop using MMFs entirely. *See* Letter from ICI to SEC (Apr. 19, 2012) (Available: http://www.sec.gov/comments/4-619/4619-166.pdf). In a survey of its retail MMF users, Fidelity Investments found that 52% of retails users would decrease their use of or altogether stop using their MMF if each redemption were subject to a 3% holdback. The results were nearly identical (51% would decrease or stop using altogether) if the 3% holdback were only in place during periods of market stress. Letter from Fidelity Investments to SEC (Feb. 3, 2012) (Available: http://www.sec.gov/comments/4-619/4619-116.pdf).

> of the nature of their business, which calls for a ramp-up of assets and then a redemption to zero. In addition, many clients operate under guidelines that prohibit them from using funds with redemption restrictions. For example, sweep accounts and collateral accounts must have access to 100% of their funds. Many clients also strongly dislike the fact that their balances could be subordinated to other shareholders and object to being "punished" for a redemption made in the regular course of business that happens to occur at a time of loss (the "innocent bystander" problem). Finally, clients find the structure difficult to understand and virtually without exception said that this model would cause them to abandon MMFs in favor of bank deposits or direct investments (in the case of larger clients). Liquidity is a key feature of MMFs, and an absolute necessity for many investors. Without full liquidity (at least in normal market environments), our view is that investors would not continue to invest in MMFs, resulting in substantial contraction of the industry.[69]

DST Systems, after evaluating the operational challenges presented by the specific MBR structure contained in the FRBNY Staff Report assessed investor acceptance as follows:

> Beyond the additional layer of cost involved, key benefits that draw shareholders to money market funds would be removed with either a transaction or an account based redemption restriction. Shareholder liquidity, high velocity and volume capability for institutional investors, flexibility to fully respond to changes in market opportunities, and a straightforward ability to write checks or use debit cards would all be critically hampered. Added complexity for all parties, increases in transaction work volumes, impacts on asset allocation models and dollar cost averaging routines, are additional negatives to this reform option. Cumulatively these reasons could effectively cause a flight of investors to competing products outside of the capability set currently enjoyed in money market funds by IRAs and other retirement plans, 529 accounts, institutional investors, sweep arrangements, and retail investors.[70]

Federated Investors, which has served its clients' cash management needs for more than 40 years through a variety of intermediaries, portals and other institutions, warned the SEC in a letter filed earlier this year,

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[69] Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* at 4 (March 2012) (Available: https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117).

[70] Letter from DST Systems, Inc. to SEC at 7 (Mar. 2, 2012) (Available: http://www.sec.gov/comments/4-619/4619-128.pdf).

> [I]mposition of unique and costly Minimum Balance requirements will deter many intermediaries from offering money market funds altogether. Unless the revenue earned by an intermediary from a money market fund share omnibus account exceeds the cost of imposing a Minimum Balance on the underlying accounts, the intermediary will stop offering money market funds to its clients. For example, it may not be cost effective for an administrator to invest in the system necessary to impose Minimum Account balances on 401(k) plan accounts, which may cause the plans to replace money market funds with stable-value collective funds, which would not be subject to any redemption restrictions. There is no reason to suppose that such an arbitrary limitation of investment options would be beneficial to investors.[71]

Moreover, apart from investors who choose not to use the product based on its features, or who will not have access to the product because funds and intermediaries determine they cannot bear the additional costs, many investors may not have the choice to use an MMF with MBR features, because state laws or fiduciary requirements may preclude them from investing in any instrument that does not return 100% of principal on redemption or that subjects shareholders to disparate rights. Nowhere does the FRBNY Staff Report even acknowledge the existence of such legal impediments. But, as stated in a letter filed with the SEC by the American Benefits Council,

> [T]hese changes could cause difficulties for ERISA fiduciaries that the Commission has not considered. Shares "held back" or restricted would continue to be considered ERISA "plan assets." The proposal under consideration, we understand, would require that "held back" or restricted shares would be used to make the fund whole if a fund cannot maintain its $1.00 NAV. . . . It simply is not clear that an ERISA fiduciary could allow the plan's assets to be invested under these conditions consistent with regulation of plan assets under ERISA.[72]

Federated Investors undertook an analysis of state corporate and trust laws and found that several states, including Delaware, may prevent funds from instituting a minimum balance requirement or a redemption holdback. It explained,

> As the Commission is aware, money market funds are in the first instance creatures of state law, organized as trusts or corporations, and then registered under the Investment Company Act of 1940 (the "1940 Act") and the Securities

[71] Letter from Federated Investors to SEC at 4 (Mar. 16, 2012) (Available: http://www.sec.gov/comments/4-619/4619-140.pdf).

[72] Letter from American Benefits Council to Mary L. Schapiro at 3 (Jun. 19, 2012) (Available: http://www.sec.gov/comments/4-619/4619-204.pdf).

> Act of 1933. Such state laws govern, *inter alia*, shareholder rights, preferences, dividends and distributions, and will, as a matter of corporate law, determine the extent to which a money market fund may charge losses or expenses against amounts held back from redemptions. Such laws may even limit the fund's ability to hold back anything in the first instance. As the Commission does not have any authority to modify state laws or fund organizational documents, it cannot resolve these issues through regulations. Although some of the limitations might be addressed with shareholder consent, there is no reason to suppose that shareholders will be any more willing to consent to these changes than they would be willing to continue to use the funds after the redemption requirements were imposed.
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> . . .
>
> The problem is that most state laws and/or fund organizational documents do not permit funds to treat shares held as a Minimum Balance differently from other shares or to treat redeeming shareholders differently from remaining shareholders. Such laws and documents require losses (as well as gains and dividends) to be allocated *equally* among the funds *outstanding* shares. This prevents funds from subordinating shares representing a Minimum Balance to other outstanding shares of the same class or series.[73]

Federated's letter also explained that even if state law is silent on the issue, a fund's organizational documents are likely to require equal treatment of all shares within a given class or series. An effort to amend these documents, which would require fund sponsors to conduct shareholder meetings for each fund and solicit proxies, would be costly and perhaps even futile, since many shareholders may be unwilling to approve a new and complex proposal designed to substantially alter the rights of shareholders and remove provisions protective of their interests.[74]

The FRBNY Staff Report reflects no consideration of any of the above concerns; it has no basis to speculate that its proposal, if adopted, will have a minimal impact on demand for MMFs.

E. <u>FRBNY Staff Report False Assertion: The MBR rule will not impact financial stability</u>.

The Report's assumption (for the reasons cited above) that an MBR rule will not significantly reduce investor demand for MMFs enables it to draw the conclusion that such a rule

[73] Letter from Federated Investors to SEC at 4-5 (Mar. 16, 2012) (Available: http://www.sec.gov/comments/4-619/4619-140.pdf).

[74] *Id.* at 9.

will not impact financial stability. The Report states, "[T]he net effect of an MBR on investor demand for MMFs is difficult to predict, but the likelihood that shifts in investors' money would undermine financial stability seems small."[75] It further reasons that investors "whose primary aim is to preserve principal probably would not be motivated to shift money away from MMFs with MBRs," since "lightly regulated or unregulated alternatives to MMFs" have "safety drawbacks that limit their potential as substitutes for MMFs."[76]

Others are not so assured. For example, a joint letter filed with the Commission by the Independent Directors Council and the Mutual Fund Directors Forum stated, "fundamental changes to money market funds currently being considered by the SEC," including restricting investor redemptions, "would render these funds substantially less attractive to investors and will likely result in investors moving their cash to less-regulated and/or less-transparent products."[77] Members of Congress and others have written the Commission expressing similar concerns.[78]

The FRBNY Staff Report has no basis for its conclusion that imposing an MBR requirement on MMFs will not cause a shift to less regulated alternatives, particularly where the Report earlier states that another reform proposal – requiring MMFs to float their NAVs – could lead to a migration of MMF assets to other "less regulated, less transparent stable-NAV products (such as offshore MMFs and some private liquidity funds)" which would "continue to pose systemic risk."[79] The Report has no basis for differentiating MMF investors' responses to the two alternatives or minimizing the potential impact of the approach it favors.

The Report goes on to say,

> Even bank deposits have safety disadvantages for large institutional investors whose cash holdings typically exceed by orders of magnitude the caps on deposit insurance coverage; for these investors, deposits are effectively large, unsecured

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75 Report at 52.

76 *Id.* at 51.

77 Joint Letter from Independent Directors Council and Mutual Fund Directors Forum to SEC at 4 (May 2, 2012) (Available: http://www.sec.gov/comments/4-619/4619-173.pdf).

78 Letter from 33 Members of Congress to SEC (May 1, 2012) (Members signing this letter have all served as former state and local government officials and, among other things, expressed concerns about the impact of holdback requirements and other requirements on leading investors to less-regulated products, while depriving states and municipalities of a critical funding source); Letter from Treasury Strategies to SEC (Apr. 27, 2012) (Available: http://www.sec.gov/comments/4-619/4619-172.pdf); Letter from Mutual Fund Directors Forum to SEC (Mar. 29, 2012) (Available: http://www.sec.gov/comments/4-619/4619-156.pdf); Letter from Texas Association of Business to SEC (Feb. 27, 2012) (Available: http://www.sec.gov/comments/4-619/4619-138.pdf); Letter from ICI to SEC (Feb. 16, 2012) (Available: http://www.sec.gov/comments/4-619/4619-119.pdf); Letter from State Street to SEC (Feb. 24, 2012) (Available: http://www.sec.gov/comments/4-619/4619-124.pdf).

79 Report at 6.

> exposures to a bank. MMF shares – which represent claims on diversified, transparent, tightly regulated portfolios – would continue to offer important safety advantages relative to bank deposits.[80]

We agree that MMFs provide greater safety for large depositors than uninsured bank deposits and, indeed, we have made this very point repeatedly in correspondence with regulators regarding the need to preserve MMFs in their current form.[81] But we do not believe the Report has a basis for its further statement that most risk-averse and run-prone institutional investors likely would remain invested in MMFs with MBRs, because the "MBR could provide protection from runs."[82] Indeed, if the FRBNY Staff is wrong that investors, when faced with the potential closure of a MMF will forgo the opportunity to pull 95% if their balances from funds and, instead, calmly decide not to redeem, with the hope (but no certainty) that they will receive more than a 95% return of principal several months or a year or more down the road, then the entire premise of the proposal falls apart. Instead, we believe the commentaries by Treasury Strategies and BlackRock, discussed earlier, provide just as likely scenario of investor behavior, particularly in a crisis. Moreover, for all of the reasons stated earlier in this paper, it is highly likely that many investors will forgo investing in MMFs with MBR features all together.

The Report nonetheless takes a cavalier approach to the potential consequences for financial stability if, in fact, MMF assets flow into systemically important banks. It states,

> To some extent, current law mitigates concerns about large, uninsured deposits by providing greater capacity and flexibility to deal with liquidity strains in the banking sector than elsewhere; for example, banks have discount-window access that reduces their vulnerability to deposit outflows in a crisis.[83]

In other words, the Federal Reserve's discount window will be available to bail everyone out.

The fact is, the addition to bank balance sheets of a large portion of the $2.6 trillion currently invested in MMFs would require a significant amount of new equity capital in banks to offset the added leverage of the new deposits, just as banks are scrambling to increase capital for the balance sheet sizes they currently carry. Moreover, the net result would be to greatly increase the size of the federal safety net, to the extent deposits are FDIC-insured deposits. One of the fundamental purposes of the Dodd-Frank Act is to scale back the size of the federal safety net and the amount that taxpayers are on the hook for in the future. Forcing investors out of

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[80] *Id*. at 52.

[81] *See, e.g.*, Letter from John D. Hawke, Jr. to FSOC (Dec. 15, 2011) (Available: http://www.sec.gov/comments/4-619/4619-112.pdf) (filed with SEC).

[82] Report at 52.

[83] Report at 53.

MMFs and into bank deposits will have the perverse effect of increasing the size of the federal safety net, to the extent these deposits are insured, or in creating large uninsured deposits that will run from banks at the first sign of trouble.

The Report suggests that some institutional investors might leave MMFs with MBR features and elect to purchase money market instruments directly. It reasons that this development could be stabilizing, because "direct investments do not share some of the features of MMFs that make them vulnerable to runs. In particular, unlike MMF shareholders, direct investors who choose to sell assets in a crisis bear the liquidity costs of their own actions and have no ability to transfer risks and losses directly to those who do not sell assets."[84] But for retail investors and smaller businesses and institutions that do not have a large, sophisticated treasury desk, this is not a realistic alternative. For larger corporations and institutional investors with a large treasury function, this may simply transform the risk of institutional runs on Money Funds to a risk of runs by investors on particular issuers of commercial paper. This would not protect the commercial paper market and the financing needs of issuers; instead, it might amplify the problem and trigger more insolvencies of issuers of commercial paper by removing Money Funds as a buffer against the nervous impulses of institutional investors that are loaded up on paper from underlying issuers.

The flawed assumption in the FRBNY Staff Report that dramatic changes to MMF regulation will have little impact upon the amount of money that investors of cash balances will place in MMFs as opposed to alternatives gives rise to the Report's inadequate game theory model for assessing investor behavior and the systemic risks of those options in a crisis. The FRBNY Staff Report game theory model fails to take account of shifts of balances by MMF investors into other cash management vehicles, the behavior in a crisis of investors in those alternatives, and the impact on market liquidity of those alternatives, such as private funds that operate as MMF alternatives without being subject to MMF rules,[85] bank-sponsored short-term investment funds,[86] individually managed accounts that invest directly in money market

[84] Report at 52.

[85] President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* at 10-22 (Apr. 1999) (Available: http://www.treasury.gov/press-center/press-releases/Pages/report3097.aspx).

[86] *See* In the Matter of State Street Bank and Trust Company, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, SEC File No. 3-13776 (Feb. 4, 2010); In the Matter of John P. Flannery and James D. Hopkins, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Exchange Act of 1933, Section 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisors Act of 1940, and Section 9(b) of the Investment Company Act of 1940, SEC File No. 3-14081 (Sep. 30, 2010).

instruments,[87] and large denomination bank deposits.[88] During a period of uncertainty, there will always be an investor "flight to quality" that will constrain liquidity in the underlying short-term credit markets, no matter what cash management vehicle is selected. Hobbling MMFs will not prevent that from occurring, it will simply shift balances to other cash management alternatives that are less liquid, less stable, and far more systemically risky than are MMFs. The Report does not address these issues, because it simply assumes that MMF investors will not shift assets to other alternatives because of the safety features of the MBR. This is unsupported speculation, and not a sound basis for policy.

F. FRBNY Staff Report False Assertion: The MBR rule will not have a large effect on yields.

In making the case that the MBR rule is superior to other variations of MMF reform proposals, the Report asserts that "an MBR rule itself likely would have only minor effects on MMF expenses and yields."[89] It explains,

> One advantage of an MBR rule is that it probably would have only a very minor effect on the market-based net yields that investors receive. Unlike a capital buffer, which would have ongoing funding costs, the costs associated with an MBR itself would likely be limited to one-time changes in the way that MMFs and financial services firms track investor's balances. For example, the transfer agents that normally handle MMF transactions, or fund distributors that handle MMF accounts, would have to develop systems to track each investor's MBR and ensure that redemptions of investors' MBRs are subject to the appropriate delay. Once those systems are in place, however, ongoing costs presumably would be very small.[90]

As discussed above, the systems impact on MMFs and intermediaries will be far-reaching and very costly, but the Report wholly avoids any analysis of the various uses of MMFs and intermediaries through which transactions are affected, and it makes no attempt to calculate the costs of implementation. It has no basis for the statement that the MBR would have only "minor effects on MMF expenses."

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[87] Charles W. Calomiris, *Is the Discount Window Necessary? A Penn-Central Perspective*, NBER Working Paper Series, Paper No. 4573 at 37-41 (Dec. 1993) (Available: http://www.nber.org/papers/w4573); Richard G. Anderson and Charles S. Gascon, Federal Reserve Bank of St. Louis *Review, The Commercial Paper Market, the Fed, and the 2007-2009 Financial Crisis* at 597-98 (Nov/Dec. 2009) (Available: http://www. research.stlouisfed.org).

[88] FCIC Report at 365-71.

[89] Report at 56.

[90] *Id.* at 50.

The Report sets forth a number of graphs and examples to demonstrate how the MBR requirement would work when accompanied by 50 basis points of capital. In fact, each of the 20 separate graphs demonstrating the effect of an MBR on investor losses assumes a 50 basis points capital buffer; the Report provides no demonstration of how the MBR would work in the absence of 50 basis points of capital. But not once does the Report address the source or cost of this capital in assessing the viability of the MBR approach. Yet, in its criticism of other reform proposals, the Report discusses the drawbacks of a capital buffer that would be large enough to absorb most foreseeable losses in terms of its cost: The Report notes that, based on the size of the MMF industry at the end of May 2012, "each percentage point of capital as a share of MMF assets would require up to $29 billion in capital, depending on the scope of the capital requirement."[91] This suggests that a 50 basis points capital buffer to accompany an MBR would require up to $14.5 billion in capital from the industry or investors. The Report, however, fails to include this cost in its assessment of the viability of any of its models.[92]

G. <u>FRBNY Staff Report False Assumption: The MBR is fair to investors</u>.

While the Report states that the MBR rule would "modestly reduce investors' liquidity and make investments in MMFs somewhat more complicated," [93] the rule in fact would penalize any shareholder who needs to redeem an amount in excess of the available balance at any time. The MBR rule's impact on costs, yields and availability would penalize all MMF shareholders all of the time, to address what the Report admits is a "remote" chance of loss.[94] Moreover, while the Report states that the purpose of the subordination element of the MBR is to provide a disincentive to "first movers" and thereby provide greater fairness to investors,[95] the subordination element is anything but fair. It applies indiscriminately to, and places a penalty upon, *any* investor who redeems within a 30 day period prior to a fund's losses, regardless of whether the investor is simply redeeming in the normal course, or whether the investor is "running" out of fear that the fund will break the buck – the behavior the proposal seeks to deter.

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[91] Report at 55.

[92] Quite apart from neglecting to address the cost and source of the assumed 50 basis points capital buffer, the Report also fails to explain why stand-alone capital creates moral hazard by "blunt[ing] portfolio managers' incentives for prudent risk management and investors' incentives to monitor risks in their funds," but capital with an MBR requirement does not present the same risks. Report at 6. Is not it reasonable to expect that portfolio managers with the backstop of *both* capital and a penalty for investors who redeem might have even *less* incentives for prudent risk management, and investors who are assured that a MMF has such a buffer and that the penalty for redemption will deter other investors from redeeming also will have *fewer* incentives to monitor risks in their funds? The Report wholly fails to address these questions.

[93] Report at 48.

[94] Report at 8.

[95] Report at 21-23.

For example, many businesses use MMFs to hold cash balances for corporate payroll processing or hold other cash balances generated from receivables and operations to meet payment obligations as they arise. A business that withdraws *any* amount of its MMF free balance during the 30-day period prior to a fund experiencing losses – whether to meet payroll or to fund operating costs or buy equipment and supplies – would have the proportionate amount of its MBR subordinated to other investors in a first loss position. This is not a MMF user running in order to get a first mover advantage on other investors; it is simply a business using a MMF to meet ordinary expenses. In fact, the Report cites data from the ICI showing that monthly redemptions in MMFs from 2009 to 2011 averaged 45% of fund assets. While the Report cites this data for the purpose of arguing that the subordination penalty will not fall solely on one or a small number of investors, the data should lead the FRBNY Staff to the opposite conclusion: Imposing a penalty on a large number of investors who redeem in the normal course but at a time that happens to be within 30 days of a MMF loss, is unfair and does nothing to achieve regulators' goal of enhancing MMF stability.

Although the Report suggests a modification that would exempt the first $50,000 of an investor's redemptions from subordination in order to "protect investors who make incidental redemptions from triggering subordination of their MBRs,"[96] the Report does not recognize that a redemption amount that may be "incidental" for some individual investors has no relevance to institutional investors such as businesses, state and local government entities, and others who use MMFs for cash management, as well as individual investors who have cash needs in excess of whatever "incidental" amount regulators deem appropriate for exemption.

The Report suggests other variations on the application of subordination, such as setting the ratio of the subordinated amount of the MBR at less than 100% of the ratio of redemptions to an investor's free balance.[97] But, although the Report suggests ways to lessen the impact of the subordination element, it never recognizes the fundamental unfairness that MMF investors will be penalized simply for using their MMF for day-to-day transactions. For this reason, and other reasons stated above, it is doubtful that MMF investors would wish to remain invested in MMFs with these characteristics.

Conclusion. The premises and assumptions on which the FRBNY Staff Report bases its MBR proposal are speculative and faulty. The proposal seeks to deter MMF runs by penalizing MMF investors with the potential loss of principal when they exercise their right to redeem their shares from a troubled MMF. But, while the FRBNY Staff says their proposal will lead "rational" MMF investors in a crisis to leave their funds in a troubled MMF, this is speculative and unproven; the MBR requirement could and likely would precipitate runs under certain circumstances, according to MMF users and other experts who have reviewed its elements. It

[96] Report at 25.

[97] *See* Report at 24-25 (discussing an "Effective" MBR).

will layer costs and operational impediments upon MMF investors' access to funds – costs the Report does not even begin to recognize or calculate. It will make MMFs unavailable to investors who are precluded by state law or fiduciary requirements from investing in funds with minimum balance or subordination features – another consideration not even mentioned in the Report. It likely will, in light of these costs and inefficiencies, drive MMF investors to less regulated and less transparent cash management vehicles or to systemically important banks, in either case increasing systemic risk – a potential impact the Report minimizes and dismisses. The shrinkage of MMF assets that likely will result if an MBR requirement is adopted will reduce the participation of MMFs in the market for commercial paper and state and local government debt, thereby increasing funding costs for corporations and public entities – an adverse impact we simply should not risk in the current environment.

The FRBNY Staff Report provides an important service in acknowledging the limits of other proposals made to date, by stating that proposals such as requiring MMFs to float their NAVs, hold capital, or impose redemption fees or holdbacks would *not* remove the risk of MMF "runs" and, if adopted, could have major adverse impacts on MMF investors and the capital markets and could even precipitate runs. Indeed, the Report as a whole substantiates the need for a course of action we and others have been advocating the Commission to undertake for some time: Defer action on various proposals that would place additional limits on MMFs and alter their essential characteristics – all of which threaten adverse economic impacts on investors and the broader economy. Study the impact of the enhancements to MMF regulation adopted by the Commission in 2010. Continue to monitor MMFs with the important tools gained by the Commission in 2010. Do no harm to an industry that has provided an important product to investors for the past 40 years, with a record of safety far superior to any other regulated financial product.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

cc: Hon. Luis A. Aguilar
Commissioner

Hon. Daniel Gallagher
Commissioner

Hon. Troy A. Paredes
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Hon. Elisse B. Walter
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