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555 Twelfth Street, NW
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January 25, 2013

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

Re: President's Working Group Report on Money Market Fund Reform; Rel. No. IC-29497; File No. 4-619; Comment submitted on the Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket No. FSOC-2012-0003); Alternative Two: Minimum Balance at Risk

Dear Ms. Murphy:

Enclosed is a copy of comments we submitted today on behalf of our client, Federated Investors, Inc., to the Financial Stability Oversight Council (the "Council") on the Council's recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform*; specifically, "*Alternative Two: NAV Buffer and Minimum Balance at Risk.*" We ask that our comments be made a part of the Commission's record.

Sincerely,

John D. Hawke, Jr.

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555 Twelfth Street, NW
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January 25, 2013

The Honorable Timothy Geithner
Chairman, Financial Stability Oversight Council
c/o Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003);
Alternative Two: Minimum Balance at Risk

Dear Secretary Geithner:

We are writing on behalf of our client, Federated Investors, Inc., and its subsidiaries ("Federated"), to provide comments in response to the Financial Stability Oversight Council's (the "Council's") recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform* ("Release"); specifically, "*Alternative Two: NAV Buffer and Minimum Balance at Risk*."[1] The proposal in Alternative Two would require money market mutual funds ("MMFs") to hold capital to serve as an "NAV buffer" of up to 1 percent based on the nature of the fund's assets, paired with an MBR requirement. The MBR would require that 3 percent of a shareholder's highest account value in excess of $100,000 over the previous 30 days be held back (not available for redemption) for a period of 30 days.

As discussed in greater detail in our letter of December 17, 2012, we believe the Council has arbitrarily and improperly invoked its Dodd-Frank Section 120 authority, in an attempt to pressure the SEC to move forward on proposals that a majority of its commissioners found unsupported by data or economic analysis and potentially risky to the financial system. The Council ignored the overwhelming public comments in the SEC docket raising substantial concerns about the very proposals the Council put forward

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[1] Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) ("Release"). This comment addresses Alternative Two of the Council's proposals. Separate letters filed this same date comment on Alternatives One and Three.

in its Release. We do not believe Congress intended the Section 120 process to be used arbitrarily and in disregard of agency processes, in circumstances where an agency is continuing to grapple with a regulatory issue under its direct jurisdiction, simply because, in this case, the agency's former chair could not muster the votes for proposals that clearly would be ineffective in achieving their primary purpose, would introduce more risk to the system, and would impose significant costs to issuers and investors.

We, nonetheless, appreciate the opportunity to provide comments and, again, call to the Council's attention the significant flaws in the proposed reforms, which should have been abundantly clear from the comment letters, reports and surveys complied in the SEC's docket and available to the Council before it issued its Release.

As discussed in the enclosed paper, the Council should not recommend that the SEC adopt the proposal described in Alternative Two, for the following reasons:

(1) Imposing an MBR requirement on MMFs would do nothing to advance the stated regulatory goal of eliminating or decreasing the risk of "runs."

(2) The MBR requirement would be counter-productive and increase systemic risk under some circumstances by triggering preemptive runs.

(3) The MBR and subordination requirement is unfair and confusing to investors.

(4) The MBR/capital buffer proposal is based on an unproven notion of "first-mover advantage," the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.

(5) The requirement for an MBR and capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.

(6) Implementation of the MBR would impose significant operational and cost burdens on a range of users of MMFs and intermediaries, as well as MMF sponsors, and would destroy MMFs' utility.

(7) Because of these cost and operational challenges and uncertainties, investors would be unwilling to invest in MMFs with MBR and subordination features, and assets of MMFs would shrink dramatically.

(8) Implementation of the MBR would prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

(9) If an MBR requirement is imposed, MMF assets would migrate to less regulated and less transparent products and to "Too Big to Fail" banks, harming the economy and increasing systemic risk.

We urge all members of the Council to review the comments submitted in response to its Release and to give careful thought to the issues discussed in the attached paper as well as those raised by other commenters. We further urge the Council to withdraw its Release.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

Enclosure

cc: Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
Elisse B. Walter, Chairman of the U.S. Securities and Exchange Commission
Thomas J. Curry, Comptroller of the Currency
S. Roy Woodall, Jr., Independent Member with Insurance Expertise
John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions
John Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Michael McRaith, Director of the Federal Insurance Office
Eric Froman, Office of the General Counsel, Department of the Treasury
Amias Gerety, Deputy Assistant Secretary for the Financial Stability Oversight Council
Sharon Haeger, Office of the General Counsel, Department of the Treasury
Mary Miller, Under Secretary of the Treasury for Domestic Finance
Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission
Troy A. Paredes, Commissioner, U.S. Securities and Exchange Commission
Daniel M. Gallagher, Commissioner, U.S. Securities and Exchange Commission
Diane Blizzard, Deputy Director, Division of Investment Management, U.S. Securities and Exchange Commission
Norman B. Champ, Director, Division of Investment Management, U.S. Securities and Exchange Commission
David W. Grim, Deputy Director, Division of Investment Management, U.S. Securities and Exchange Commission
Craig Lewis, Director and Chief Economist, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission
Penelope Saltzman, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission

ARNOLD & PORTER LLP

Proposal for a Minimum Balance at Risk and NAV Buffer for Money Market Mutual Funds: Ineffective in Protecting Against Runs in Periods of Stress; Harmful to Investors and the Economy

Comment Submitted for Docket No. FSOC-2012-0003

January 25, 2013

Prepared by Arnold & Porter LLP on behalf of Federated Investors, Inc.

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Proposal for a Minimum Balance at Risk and NAV Buffer for Money Market Mutual Funds: Ineffective in Protecting Against Runs in Periods of Stress; Harmful to Investors and the Economy

We are submitting this paper on behalf of our client, Federated Investors, Inc., and its subsidiaries ("Federated"). Federated has served since 1974 as an investment adviser to money market mutual funds ("MMFs").[1]

This paper responds to the release issued by the Financial Stability Oversight Council ("Council") requesting comment on *Proposed Recommendations Regarding Money Market Mutual Fund Reform* ("Release");[2] specifically, "*Alternative Two: NAV Buffer and Minimum Balance at Risk.*" While this paper briefly discusses the net asset value ("NAV") buffer as an adjunct to the minimum balance at risk ("MBR") proposal, the subject of MMF capital requirements is addressed extensively in a separate comment entitled, "Proposal for a Capital Requirement for Money Market Mutual Funds," filed with the Council this same date. The proposal in Alternative Two would require MMFs to hold capital to serve as an "NAV buffer" of up to 1 percent based on the nature of the fund's assets,[3] paired with an MBR requirement. The MBR would require that 3 percent of a shareholder's highest account value in excess of $100,000 over the previous 30 days be held back (not available for redemption) for a period of 30 days.[4] The Release states that this proposal is designed to address the so-called "first-mover advantage" that the Release contends causes MMF investors to "redeem their shares at the first indication of any perceived threat to an MMF's value or liquidity."[5] The Release states that the capital would absorb day-to-day fluctuations in the value of the funds' portfolio securities and allow the fund to maintain a stable NAV. In the event that an MMF suffers losses that exceed the capital, the losses would be borne first by the MBRs of shareholders who have redeemed in

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[1] Federated has thirty-nine years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

[2] Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) ("Release").

[3] No capital would be held against cash, Treasury securities, and Treasury repos; .75 percent capital would be held against other daily liquid assets (or weekly liquid assets in the case of tax-exempt funds); and 1.00 percent capital would be held against all other assets. The Release states that an MMF would be permitted to use any funding method or combination of methods to build the required capital, including contributions from an MMF sponsor held in escrow, issuance of a class of subordinated equity securities, and retention of earnings by an MMF. Release at 69469-70.

[4] Release at 69470.

[5] *Id.* at 69456.

the 30-day period prior to the loss and then by the MBRs of other shareholders. The Release says this will create a disincentive to redeem and provide protection for shareholders who remain in the fund. The MBR requirement would not apply to investors with account balances below $100,000. Treasury MMFs would not be subject to the capital or MBR requirements.[6]

The Release states that the MBR/NAV buffer requirement would reduce the first-mover advantage, make explicit a sponsor's support of a fund, impose additional discipline on fund managers by requiring changes in portfolio management if the NAV buffer falls below required levels, permit funds to sell distressed securities more easily, force redeeming shareholders to share in losses caused by redemptions and thus discourage them from redeeming during periods of stress, and provide protection for non-redeeming shareholders during periods of stress.[7] The Release acknowledges that the NAV buffer would reduce investor yields, present operational and/or technology costs – which the Release acknowledges "could be substantial,"[8] potentially present regulatory capital problems for sponsors, and could reduce investor demand for MMFs.[9] It also states that the MBR "likely would not be sufficient to stop a run on an MMF if investors anticipate very large losses" or stop a run on other funds if investors anticipated that large losses would be incurred across funds.[10]

The proposed MBR and capital buffer is virtually identical to a proposal put forward in July 2012 by the Staff of the Federal Reserve Bank of New York (FRBNY Staff Report).[11] The FRBNY Staff and the Council both take the position that the MBR/capital proposal would 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, the prediction that an investor, when faced with the potential for closure of a fund, will forgo immediate access to cash in order to avoid a small loss of principal, is sheer conjecture, and wholly at odds with the evidence

[6] Treasury MMFs invest at least 80% of their assets in cash, Treasury securities and Treasury repos. Release at 69469.

[7] Release at 69471-72.

[8] *Id.* at 69472. The Release fails to estimate these costs, however.

[9] *Id.*

[10] *Id.* at 69471.

[11] 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), http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf (FRBNY Staff Report). While the Release proposes the MBR/capital requirement as one of three alternatives, the FRBNY Staff Report promoted the MBR/capital proposal as superior to any of the other proposals then being discussed, including a floating NAV and capital requirements *Id.* at 6-7. The FRBNY Staff Report acknowledged 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.

concerning the behavior of investors in a crisis. As discussed in more detail below, the MBR proposal will not advance the regulatory goal of preventing or decreasing the risk of runs, but it could and likely would precipitate runs under certain circumstances; it would harm MMF investors by layering costs and operational impediments upon their access to funds and requiring them to carry excess liquid assets at MMFs; it would 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 would, 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 would 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.

The MBR would penalize investors who wish to redeem their MMF shares, whether or not the redemption is prompted by an investor's wish to "run" from an MMF in which the investor fears a loss, or to simply redeem MMF shares for the purpose of meeting payroll or purchasing products or equipment – as business owners do every day, or purchasing a home or making an investment in the case of an individual or trustee. The withdrawal of liquidity and the imposition of a penalty through subordination is directly contrary to the purpose and intent of the Securities and Exchange Commission's ("SEC's") 2010 MMF reforms, which were designed to enable MMFs to fully meet investor redemption requests, in order to avoid the panic that occurs when investors fear a potential loss of liquidity.[12] The MBR requirement will convert MMFs from a simple, easy-to-understand investment product in which all shareholders are treated equally and have ready access to liquidity, into a complex product in which investors' rights are dictated by the timing of their redemptions in relation to other events. The MBR/capital buffer will undermine market discipline and increase systemic risk.

The specific elements of the MBR proposal were addressed by a number of comment letters, surveys and reports previously filed with the SEC and available in its public comment file.[13] The Council had access to these reports and comments – but wholly ignored comments and surveys that described, addressed, and raised serious concerns about the very type of

[12] As a result of those reforms, MMF portfolios are required to have significantly shorter weighted average maturities and weighted average lives, daily liquidity of 10% or more and weekly liquidity of 30% or more of assets under management. MMFs are required to conduct an assessment of their shareholders' anticipated redemptions and hold even greater liquidity to meet those anticipated needs. These requirements, in addition to managing to a stable NAV, publishing portfolio holdings and valuations, and operating without the "net" of capital – exert powerful discipline on MMF managers.

[13] Unless otherwise stated, all letters cited in this paper were filed in response to the SEC's Request for Comment on the President's Working Group Report on Money Market Fund Reform, File No. 4-619, http://www.sec.gov/comments/4-619/4-619.shtml.

minimum balance restriction put forward in the Release.[14] Arnold & Porter filed a letter on August 9, 2012, which addressed the FRBNY proposal; that letter identified and reported on comments of numerous other users and market participants.[15]

As discussed in more detail below, the Council should not propose that the SEC adopt the MBR/Capital requirement, for the following reasons:

(1) Imposing an MBR requirement on MMFs would do nothing to advance the stated regulatory goal of eliminating or decreasing the risk of "runs."

(2) The MBR requirement would be counter-productive and increase systemic risk under some circumstances by triggering preemptive runs.

(3) The MBR and subordination requirement is unfair and confusing to investors.

(4) The MBR/capital buffer proposal is based on an unproven notion of "first-mover advantage," the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.

(5) The requirement for an MBR and capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.

(6) Implementation of the MBR would impose significant operational and cost burdens on a range of users of MMFs and intermediaries, as well as MMF sponsors, and would destroy MMFs' utility.

(7) Because of these cost and operational challenges and uncertainties, investors would be unwilling to invest in MMFs with MBR and subordination features, and assets of MMFs would shrink dramatically.

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[14] Letter from ICI to SEC (Jun. 20, 2012); Letter from American Benefits Council to SEC (Jun. 19, 2012); Letter from Federated Investors to SEC (Mar. 16, 2012); Treasury Strategies, *Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective & Crippling Regulation*, http://www.sec.gov/comments/4-619/4619-172.pdf (filed as a comment letter with the SEC Apr. 27, 2012); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012); Letter from DST Systems, Inc. to SEC (Mar. 2, 2012); Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117; Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012); Letter from John D. Hawke, Jr. on behalf of Federated Investors to Financial Stability Oversight Council (Dec. 15, 2011) (filed with SEC).

[15] Letter from John D. Hawke, Jr. on behalf of Federated Investors, Inc. to SEC (Aug. 9, 2012). This letter also was sent to each member of the Council.

(8) Implementation of the MBR would prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

(9) If an MBR requirement is imposed, MMF assets would migrate to less regulated and less transparent products and to "Too Big to Fail" banks, harming the economy and increasing systemic risk.

(1) Imposing an MBR requirement on MMFs would do nothing to advance the stated regulatory goal of eliminating or decreasing the risk of "runs."

The Release states that the MBR is "designed to dampen investors' incentive to redeem quickly in a crisis, because they cannot entirely avoid imminent losses simply by redeeming."[16] The subordination feature is designed to create a "disincentive to redeem when an MMF is under stress."[17] This disincentive would kick in when an investor believes a fund "is at risk of suffering losses that an investor expects will be less than the NAV buffer plus the MBR. An investor with an account balance greater than $100,000 in such a fund could minimize or potentially avoid entirely any expected losses by not redeeming and not subordinating a portion of its MBR."[18]

This theory ignores the fact that an MMF shareholder may not have the choice of foregoing a redemption, such as in the case of a corporation meeting payroll, or trustee releasing funds from escrow, or an individual meeting a closing deadline for a down payment on a home and other expenses. Indeed, the fact that this penalty would be extracted from ordinary course redeemers is the reason we believe investors would not invest in an MMF with MBR/subordination features.

But, even in cases where an investor does not have an immediate need for cash, there is no assurance that an investor would leave cash in a troubled MMF with MBR features. The FRBNY Staff, which promoted the MBR proposal, conceded in its report last year that, "notwithstanding shareholders' incentives *not* to redeem in a crisis from an MMF with an MBR, investors' irrational fears may cause them to do so anyway."[19] It rightly observed that "accurate predictions of irrational behaviors in a crisis are difficult."[20] Indeed, as noted earlier, the

[16] Release at 69470.

[17] *Id.*

[18] *Id.* at 69472.

[19] FRBNY Staff Report at 46. The FRBNY contends, however, that an MBR with subordination clearly would diminish or reverse pressures on *rational* investors to exit MMFs during crises.

[20] *Id.*

prediction that an investor, when faced with the potential for closure of a fund, would forgo immediate access to cash in order to avoid a small loss of principal, is sheer conjecture, and wholly at odds with the evidence concerning the behavior of investors in a crisis.[21]

The Council's Release acknowledges that investors may not be deterred by the MBR from running if they expect larger losses, in their own fund or across other funds: "While the combination of the NAV buffer and the 3-percent MBR likely would not be sufficient to stop a run on an MMF if investors anticipate very large losses in that fund, such a combination may be large enough to stem runs on most other funds *unless investors expect that very large losses would be incurred across MMFs*."[22]

Since the goal of new MMF regulation is to prevent or reduce the threat of runs in a crisis, it is mind boggling that regulators are proposing a solution that they believe will work only where there is *no* crisis.

BlackRock addressed this issue in a 2012 paper,[23] reporting on the results of a survey of over 40 of institutional clients who were questioned about a proposal to require a minimum balance of 3 percent:

> [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.[24]

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[21] Jonathan R. Macey, *Money Market Funds: A Vital Source of Systemic Stability* (Fall 2012) at 41-42 (citing various studies) (Macey 2012).

[22] Release at 69471 (emphasis added).

[23] Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), 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* FRBNY Staff Report at 62.

[24] Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* at 4 (March 2012),

Footnote continued on next page

Here BlackRock did what neither the FRBNY nor Council has done: It tested the assumptions with actual users of MMFs. Their clients stated the obvious. Faced with the prospect that they may lose access to their liquidity, few investors will forego the certainty of immediate access to 97% of their cash and opt for the uncertain prospect of the return of a greater portion of their principle many months later.

The Council's Release acknowledges that the SEC adopted important reforms to Rule 2a-7 in 2010, but it glosses over the impact of those enhancements by referring to the circumstances of 2008 to conclude that only "structural" changes to MMF regulation (such as an MBR requirement and creation of a new class of subordinated capital) will prevent similar runs from occurring in the future. It is *liquidity*, however, that prevents runs.[25] The SEC acted to significantly enhance the liquidity of MMFs in 2010, so that MMFs are now better able to withstand heavy redemptions. The fact that MMFs today hold liquidity even in excess of requirements under the 2010 amendments to Rule 2a-7 demonstrates that MMFs are far more resilient than was the case in 2008.[26] The Council's MBR proposal would restrict the very liquidity that assures investors they do not need to run, and, as discussed in Section 2 of this paper, could actually increase the likelihood of preemptive runs, rather than prevent them.

Footnote continued from previous page
https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117.

[25] Hal Scott, *Interconnectedness and Contagion, Committee on Capital Markets Regulation* at 222-24 (Nov. 20, 2012), http://www.capmktsreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Stephan Jank & Michael Weddow, *Sturm und Drang in Money Market Funds: When Money Market Funds Cease to be Narrow*, Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No. 20/2008 (2008); Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp. This conclusion is consistent with the analysis in an FDIC Staff paper that insufficient liquidity, rather than capital, is the best predictor of financial panics in the banking system. *See* Kathleen McDill and Kevin Sheehan, *Sources of Historical Banking Panics: A Markov Switching Approach*, FDIC Working Paper 2006-01 (Nov. 2006), http://www.fdic.gov/bank/analytical/working/wp2006_01/wp2006_01.pdf.

[26] *See* Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 20-22 (Nov. 30, 2012), http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf; Letter from Fidelity Investments to SEC (Mar. 1, 2012); Letter from ICI to SEC (Feb. 16, 2012). *See also* Robert Comment, *Do Money Market Funds Require Further Reform?* (Nov. 23, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2174125; David W. Blackwell, Kenneth R. Troske & Drew B. Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk*, U.S. Chamber of Commerce Center for Capital Markets Competitiveness (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_ smalltosend.pdf; Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp.

(2) The MBR requirement would be counter-productive and increase systemic risk under some circumstances by triggering preemptive runs.

The Release states that the 30-day delay is "designed to provide protection against preemptive runs while not unnecessarily inconveniencing redeeming shareholders or blunting the role of redemptions in imposing market discipline."[27] It says, "[The] 30-day period likely would be long enough to prevent a shareholder from avoiding a specific anticipated loss by preemptively redeeming."[28]

Experts who have considered this proposal take a different view. Treasury Strategies, in a report filed with the SEC last year, stated,

> 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 rewarded and their actions possibly triggering a firestorm run on the day of the U.S. sovereign downgrade.[29]

The success of MMFs' handling of high levels of redemptions in the summer of 2011 affirmed that the SEC's liquidity requirements for MMFs are working as intended. MMFs fully met investor redemptions. No fund broke the buck. The SEC'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 2011 were not a run; they reflected the discipline of investors assessing their

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[27] Release at 69471. See also FRBNY Staff Report at 45. Investors in an MMF with an MBR would not have incentives to run in advance of triggering events that might restrict or penalize redemptions.

[28] *Id.*

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

MMFs' portfolios. But, as the Treasury Strategies report 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.

While we understand concerns that a credit event affecting an MMF may create the potential for unfair treatment of shareholders, those concerns are more fairly and effectively addressed under the rigorous requirements of SEC Rule 2a-7 and MMF board intervention, which are designed to assure fair treatment of shareholders and thereby reduce, not create, the incentive to run, as the MBR would do. These requirements are discussed in more detail in Section 4, below.

(3) The MBR and subordination requirement is confusing and unfair to investors.

The Release concedes that the MBR "may be confusing to some investors . . . and may be unattractive to those who have come to expect immediate and full liquidity . . . ."[30] We agree. The MBR would convert a simple, transparent product, the fundamental characteristic of which is equal and fair treatment of shareholders, into a complex and opaque product, in which investors rights are uncertain and dictated by the size of their redemption and the timing of their redemptions in relation to other events. The MBR is inconsistent with fundamental principles underlying the Investment Company Act of 1940: fair and equitable treatment of shareholders and the ability to readily redeem their shares.

The example given in the Release perfectly illustrates the complex and arbitrary nature of the proposed MBR subordination.[31] In the example, a shareholder with a $200,000 account redeems $120,000. Although the shareholder receives the full amount of this redemption, if the fund suffers a loss during the 30 days following the redemption, up to $619 would be deducted from the shareholder's account. The $619 subordinated amount is calculated using a formula with three variables and four operations. If the shareholder redeemed $150,000, the subordinated amount would increase to $1546. This means that a 25% increase in the redemption amount would increase the subordinated amount by 150%. To characterize such results as "confusing" and "unattractive" is an understatement. Shareholders are likely to find the arrangement intolerable and opt for alternative investments.

While the MBR/subordination requirement has been promoted as a way to promote fairness to investors by eliminating "first-mover" advantages, the requirement in fact would penalize any shareholder who needs to redeem an amount in excess of the available balance at any time, for whatever reason. The MBR rule's impact on costs, yields and liquidity would

[30] Release at 69473.

[31] *Id.* at 69471, n. 94.

penalize all MMF shareholders all of the time, to address what even proponents of the MBR admit is a "remote" chance of loss.[32] Moreover, while the stated purpose of the subordination element of the MBR is to provide a disincentive to "first-movers" and thereby provide greater fairness to investors,[33] 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.

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 over $100,000 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 in a first loss position to non-redeeming shareholders. This is not an MMF user "running" in order to get a first-mover advantage on other investors; it is simply a business using an MMF to meet ordinary expenses. Prime funds easily exceed redemptions of 50% or more of fund assets each month.[34] 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 an MMF loss, is unfair and does nothing to achieve regulators' goal of enhancing MMF stability.

Although the Release proposes that the first $100,000 of an investor's redemptions would not be subject to the MBR requirement, this provides little benefit for 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 $100,000.

The Council never recognizes the fundamental unfairness of penalizing MMF investors 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.

[32] Release at 69469, 69472.

[33] FRBNY Staff Report at 21-23.

[34] Professor David W. Blackwell, Professor Kenneth R. Troske, and Professor Drew B. Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Liquidity, Increased Transparency, and Lower Credit Risk* at 44 (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf (tracking redemptions in the five largest MMFs by month for 2011).

(4) The MBR/capital buffer proposal is based on an unproven notion of "first-mover advantage," the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.

The Council in its Release relies heavily on a theory that MMFs are susceptible to a so-called "first-mover advantage" in which investors have an incentive "to redeem their shares at the first indication of any perceived threat to an MMF's value or liquidity."[35] This has happened only once in history, when the Reserve Fund failed to suspend redemptions after the bankruptcy of Lehman Brothers. According to the Release, "Because MMFs lack any explicit capacity to absorb losses in their portfolio holdings without depressing the market-based value of their shares, even a small threat to an MMF can start a run. In effect, first movers have a free option to put their investment back to the fund by redeeming shares at the customary stable share price of $1.00, rather than at a price that reflects the reduced market value of the securities held by the MMF."[36] Indeed, addressing the purported dangers associated with the "first-mover advantage" concept is a foundation of each of the three proposals in the Release. But the Council's armchair theorizing about a "first-mover advantage" is flatly contradicted by the recent report by the SEC's Division of Risk, Strategy, and Financial Innovation (RiskFin Report), as well as the requirements of Rule 2a-7 itself, which the Council ignores.

As the RiskFin Report has pointed out, a fund's amortized cost valuation "closely tracks" the fund's shadow price.[37] In many cases, the two are identical. In the absence of a credit event involving one or more of an MMF's assets (such as a downgrade or default) which would disrupt this close tracking, there is simply not enough of variation between the amortized cost NAV and the fund's shadow price to create the incentive the Council now claims exists.

Moreover, Rule 2a-7 places a number of detailed remedial obligations on the board of an MMF whenever a credit event occurs. These obligations are designed to prevent the first-mover advantage from developing. In the event that a portfolio security is downgraded, Rule 2a-7 requires an MMF's board to "reassess promptly whether such security continues to present minimal credit risks and [to] cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders" unless the fund

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[35] Release at 69456.

[36] *Id*. The Release also states that "[r]ounding obscures the daily movements in the value of an MMF's portfolio and fosters an expectation that MMF share prices will not fluctuate. Importantly, rounding also exacerbates investors' incentives to run when there is risk that prices will fluctuate. When an MMF that has experienced a small loss satisfies redemption requests at the rounded $1.00 share price, the fund effectively subsidizes these redemptions by concentrating the loss among the remaining shareholders." *Id.* at 69461.

[37] Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 83 (Nov. 30, 2012), http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf. A fund's shadow price is based upon market quotations for portfolio securities where they are available and fair valuation of portfolio instruments where market quotations are not available.

is able to dispose of the security (or is matures) within five days of the event.[38] In the event of a default, the fund must dispose of the security "as soon as practicable consistent with achieving an orderly disposition" unless the board finds that disposal would not be in the best interest of the fund.[39] Rule 2a-7 also requires prompt notice to the SEC if securities accounting for 1/2 of 1 percent or more of an MMF's total assets default (other than an immaterial default unrelated to the issuer's financial condition) or the securities become subject to certain events of insolvency.[40] In its notice, the board must state the actions the MMF intends to take in response to such event.

An MMF is only permitted to price its shares at $1.00 using the amortized cost method "so long as the board of directors believes that it fairly reflects the market-based net asset value per share."[41] If the board believes any deviation from MMF's amortized cost price per share "may result in material dilution or other unfair results to investors or existing shareholders," the board is required to cause the fund to take action to eliminate or reduce the effect of the dilution or unfair results.[42] Further, Rule 2a-7 provides that in the event that the extent of an MMF's deviation from the mark-to-market NAV exceeds ½ of 1 percent, the board must "promptly consider what action, if any, should be initiated . . . ."[43] In other words, in the event of a material credit event involving one or more of its portfolio securities, the fund would be required to go off amortized cost for the affected portfolio securities and value its shares based on the current NAV (as defined under SEC rules) as other mutual funds do. If immediate recognition of the credit problem causes the MMF to break the buck, a redeeming shareholder would receive the current NAV for each share redeemed, rather than $1.00. That shareholder would not be receiving the benefit of $1.00 per share by redeeming before other shareholders. Unless the fund board and its pricing service fail to do their jobs in pricing fund shares, there is no "first-mover advantage."

In addition to the above requirements, Rule 22e-3 currently gives an MMF board significant authority to intervene to protect investors, by suspending redemptions and beginning an orderly liquidation if an MMF has broken or is about to break the buck.[44] The rule, adopted as part of the SEC's 2010 reforms, is designed to prevent investor panic and prevent the type of

[38] 15 C.F.R. § 270.2a-7(c)(7)(i)(A).

[39] 15 C.F.R. § 270.2a-7(c)(7)(ii).

[40] 15 C.F.R. § 270.2a-7(c)(7)(iii).

[41] 15 C.F.R. § 270.2a-7(c)(1).

[42] 15 C.F.R. § 270.2a-7(c)(8)(ii)(C).

[43] 15 C.F.R. § 270.2a-7(c)(8)(ii)(B).

[44] 17 C.F.R. § 270.22e-3.

run that could potentially reward first movers, by assuring that the board has the authority to suspend redemptions in order to treat all investors fairly in a liquidation.[45]

(5) The requirement for an MBR and capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.

The Council's proposal for a 3 percent capital buffer, discussed in a separate paper submitted by Arnold & Porter this same date titled "Proposal for a Capital Requirement for Money Market Funds," and its MBR/NAV buffer proposal, discussed in this paper, would each have significant implications for market discipline – for MMF managers and MMF investors.

MMFs currently operate under the discipline of (1) managing to a stable NAV and publishing the market NAV and every portfolio holding periodically; (2) operating without the "net" of any capital buffer and therefore managing the portfolio to avoid undue credit or interest rate risk; and (3) managing to regulatory liquidity requirements and even higher in order to meet customer demands under a scenario where large customers may redeem 100% of their holdings on demand. In addition, MMF sponsors must continuously know and anticipate the cash needs of their investors – not simply because SEC regulations require it, but because it is critical to maintaining an MMF's liquidity and maintaining a stable NAV. MMF sponsors are further disciplined by the knowledge that a misjudgment regarding an asset purchased for the MMF could result in a cost to the sponsor (who may determine to purchase or provide other support for the asset), reputational damage (and the consequent loss of assets as a result of shareholder redemptions), or closure of the fund if its valuation drops only ½ of one cent per share. MMF shareholders are further disciplined by the knowledge that MMFs operate without any safety net of capital and, therefore, investors cannot passively sit on their hands and abandon their monitoring responsibilities.

The Release states that the availability of the NAV buffer "would give the fund an explicit form of support" that, "[u]nlike . . . discretionary sponsor support . . . during times of stress would not be in question."[46] But, by replacing the uncertainty of sponsor support with the assurance of capital, the NAV buffer would diminish investors' incentives to closely monitor the fund.

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[45] The Council, however proposes to rescind Rule 22e-3, rationalizing that a floating NAV diminishes the need for MMF sponsors or boards to suspend redemptions or otherwise intervene upon share price declines, except under the most extreme market circumstances. Release at 69466. We discuss this in detail in a separate comment, entitled, "Proposal for a Floating NAV for Money Market Mutual Funds," filed with the Council on this same date.

[46] Release at 69472.

The Release goes on to say this capital buffer "could impose additional discipline on fund managers by ensuring that small losses which today are not reflected in funds' share prices, force changes in portfolio management," because if a buffer fell below the required amount the fund would be required to limit its new investments to cash, Treasury securities, and Treasury repos.[47] Here, the proposal removes the purest form of discipline for managers – the potential cost to the sponsor or prospect of fund closures as a result of a blown credit – and replaces it with the uncertain disciplining effect of an asset limitation.

The Release states that the 30-day redemption delay in the MBR proposal is "designed to provide protection against preemptive runs while not unnecessarily inconveniencing redeeming shareholders or blunting the role of redemptions in imposing market discipline."[48] It then says, "The MBR may also enhance market discipline by causing MMF investors to monitor more carefully MMF operations and risk-taking and redeem shares from a poorly run MMF well in advance of any specific problems developing in the fund's portfolio because investors would be unable to redeem quickly during a crisis to avoid losses."[49] But, MMF investors already closely monitor MMFs because MMFs have no capital – and no buffer for error. It makes no sense to require a capital buffer, state that the purpose of the buffer is to assure investors and deter them from running, and then rationalize that investors will be incentivized to monitor an MMF with an MBR, because they will be unable to quickly redeem shares withheld.

(6) Implementation of the MBR would impose significant operational and cost burdens on a range of users of MMFs and intermediaries, as well as to MMF sponsors, and would destroy MMFs' utility.

The MBR requirement would require funds and intermediaries to compile and track a vast amount of data. It would require daily computation of free balance information (based on the high water mark for the prior 30 days and the balance in the account) for every account for every business day during the 30-day delay period. MMFs could not avoid maintaining this amount of data, because the delay period would be a rolling period. A fund could not, for example, simply compare the current balance to the previous highest balance, because the previous highest balance would eventually fall outside of the delay period, and the fund would then have to review every day in the delay period to determine which balance was now the highest.[50] It would 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.

[47] *Id.*

[48] *Id.* at 69471.

[49] *Id.*

[50] *See* Letter from Federated Investors to SEC (Mar. 16, 2012).

The MBR requirement poses significant operational challenges and costs for omnibus accounts, sweep accounts, and other uses involving intermediaries and systems that extend beyond the control of MMFs themselves. These challenges were described in detail in a 35-page study submitted to the SEC in June of last year 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 buck – exactly the proposal put forward by the Release. According to the ICI, which described the proposal as an anticipated SEC proposal,

> 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.
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> 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.[51]

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

[51] Letter from ICI to SEC at 2 (June 20, 2012).

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.[52]

The operational impact of the MBR requirement also was described by DST Systems, Inc, in a March 2, 2012 letter to the Commission.[53] 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:

- [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

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

[53] Letter from DST Systems, Inc. to SEC (Mar. 2, 2012).

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 exist 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.[54]

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.[55] 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 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.[56] 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.[57]

Subordination of the MBR is subject to the same legal impediments as the use of subordinated equity for the capital buffer. Because the Investment Company Act does not permit mutual funds, including MMFs, to issue preferred shares, the charters of existing MMFs do not provide for any form of subordination. Existing MMFs therefore would have to amend their

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

[55] Letter from John D. Hawke, Jr. on behalf of Federated Investors, Inc. to SEC (Feb. 24, 2012).

[56] *Id.*

[57] Letter from John D. Hawke, Jr. on behalf of Federated Investors, Inc. to SEC (Mar. 19, 2012).

charters and other organizational documents in order to provide for the contingent subordination of MBR shares that correspond to redemptions during the preceding 30-day period. To accomplish this, it would be necessary to obtain MMF board approval, provide notice and disclosure to existing investors and obtain approval of the changes by shareholder vote, and amend the prospectuses and registration statements of the MMFs. There is a significant economic cost involved in this process, including legal and accounting fees, documentation costs, printing, mailing, use of proxy solicitors and other steps needed to bring the matter to a vote and obtain the required approvals. The unprecedented nature and complexity of the MBR subordination is likely to overwhelm shareholders and deter them from voting in favor of the necessary amendments.

The concerns raised in the above commentaries, surveys and reports have been publicly available for review by all regulators working on proposals to further limit MMFs. The Release briefly footnotes some of them. Yet none of these operational and cost concerns regarding the impact of an MBR requirement were addressed in the Release. It neither weights the costs nor assesses the impact of an MBR requirement on omnibus accounts, sweep accounts, escrow accounts, or the various uses of MMF investors that would be impacted by an MBR requirement. The Release ignores existing evidence and makes no independent assessment of the costs and operational challenges presented by its proposal. As discussed below, there is ample evidence in the SEC'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.

(7) Because of the cost and operational challenges, investors would be unwilling to invest in MMFs with MBR and subordination features, and assets of MMFs would shrink dramatically.

The Release acknowledges that the proposal "could make the funds less appealing . . . by diminishing the net yields that the funds pay to investors and by placing constraints on the liquidity currently available to MMF shareholders.[58] It further acknowledges that some investors could reduce or eliminate their investment in MMFs with MBR features, and some MMF sponsors may be less willing to offer MMFs subject to these requirements.[59]

There is no doubt that investor demand for MMFs would shrink dramatically for MMFs with the MBR feature. BlackRock reported after surveying 40 of its institutional clients,

[58] Release at 69473.

[59] *Id.*

> 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 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.[60]

DST Systems, after evaluating the operational challenges presented by the MBR structure, 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.[61]

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

[61] Letter from DST Systems, Inc. to SEC at 7 (Mar. 2, 2012).

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,

> [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.[62]

(8) Implementation of the MBR would prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

Apart from investors who choose not to use the product based on its features, or who would 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. As stated in a letter filed with the SEC 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:

> [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.[63]

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[62] Letter from Federated Investors to SEC at 4 (Mar. 16, 2012).

[63] Letter from American Benefits Council to SEC at 3 (Jun. 19, 2012).

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,

> [M]oney 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 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 [SEC] 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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> . . .
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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.[64]

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.[65]

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[64] Letter from Federated Investors to SEC at 4-5 (Mar. 16, 2012).

[65] *Id.* at 9.

(9) If an MBR requirement is imposed, MMF assets would migrate to less regulated and less transparent products and to "Too Big to Fail" banks, harming the economy and increasing systemic risk.

Although the Release acknowledges that investor demand for MMFs with an MBR requirement may shrink, it makes no effort to size the shrinkage or to determine where assets would flow or the impact of the migration of assets on systemic risk.

Yale Law School Professor Jonathan Macey in a recent article argued,

> To burden funds – which are already highly liquid, well capitalized, and comprised of high-quality assets – with capital buffers and redemption requirements, would be of next to no benefit in making the already-stable MMFs even more so. . . . Investors may return to the inefficiency of individually managed investment accounts, or, more likely – due to the difficulties inherent in investing individually in money market instruments – flow to riskier banks, or less transparent and less regulated options such as privately offered funds. The financial system is not one of disparate silos. All of these alternatives are interconnected, and damaging MMFs' competitiveness will mean that money will flow instead to products that lack MMFs' quality of assets, avoidance of leverage, absence of derivatives, and high liquidity.[66]

A joint letter filed with the Commission by the Independent Directors Council and the Mutual Fund Directors Forum expressed similar concerns, stating, "[F]undamental 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."[67] Members of Congress and others have written the Commission expressing similar concerns.[68]

Federated, Arnold & Porter, and numerous other commenters have urged policy makers to consider the impact of the migration of MMF assets to banks and other providers in terms of the cost of financing for businesses and state and local governments. For example, banks are far less efficient than MMFs in providing funding to corporate and government borrowers in the

[66] Macey 2012 at 36-37.

[67] Joint Letter from Independent Directors Council and Mutual Fund Directors Forum to SEC at 4 (May 2, 2012).

[68] 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); Letter from Mutual Fund Directors Forum to SEC (Mar. 29, 2012); Letter from Texas Association of Business to SEC (Feb. 27, 2012); Letter from ICI to SEC (Feb. 16, 2012); Letter from State Street to SEC (Feb. 24, 2012).

money markets. MMFs are significant purchasers of commercial paper, short-term state and local government debt, and short-term Treasury and federal agency securities. [69] If funding from MMFs disappeared and was replaced by bank lending, the higher cost of borrowing would translate directly into less economic growth and higher costs to government borrowers.

The addition to bank balance sheets of a large portion of the $2.7 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[70] 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 MMFs and into bank deposits would 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 would run from banks at the first sign of trouble. Professor Macey underscored this concern: "MMFs serve as the higher quality substitute to riskier options. To lessen market diversity and drive assets back into banks would destabilize the financial system, despite regulators' best intentions."[71]

The 2012 FRBNY Staff Report proposing an MBR requirement suggested that some institutional investors might leave MMFs with MBR features and elect to purchase money market instruments directly. It reasoned 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."[72] 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 MMFs 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 MMFs as a buffer against the nervous impulses of institutional investors that are loaded up on paper from underlying issuers.

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[69] Report of the President's Working Group on Financial Markets: Money Market Fund Reform Options at 7 (Oct. 2010), http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf ("PWG Report").

[70] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203.

[71] Macey 2012 at 37.

[72] FRBNY Staff Report at 52.

The Release's economic analysis 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,[73] bank-sponsored short-term investment funds,[74] individually managed accounts that invest directly in money market instruments,[75] and large denomination bank deposits.[76] During a period of uncertainty, there would always be an investor "flight to quality" that would constrain liquidity in the underlying short-term credit markets, no matter what cash management vehicle is selected. This would result in the same "rollover risk" for issuers that obtain funding in the money markets and that the Council attributes only to MMFs. Hobbling MMFs would 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 Release does not address these issues, because it generally assumes that MMF investors would not shift significant assets to other alternatives. This is unsupported speculation, and not a sound basis for policy.

Conclusion. The premises and assumptions on which the Council 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 Council suggests that the MBR proposal would lead MMF investors 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 would treat investors unfairly, and it would undermine market discipline for both investors and managers. It would layer costs and operational impediments upon MMF investors' access to funds – costs the Release does not even begin to recognize or calculate. It would make MMFs unavailable to investors who are

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

[74] *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).

[75] Charles W. Calomiris, *Is the Discount Window Necessary? A Penn-Central Perspective*, NBER Working Paper Series, Paper No. 4573 at 37-41 (Dec. 1993), 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), http://www. research.stlouisfed.org.

[76] FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES at 365-71 (Jan. 2011).

precluded by state law or fiduciary requirements from investing in funds with minimum balance or subordination features – another consideration not evaluated in the Release. It likely would, 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.

For these reasons, the Council should not recommend that the SEC adopt the proposal for an MBR and capital buffer.