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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 One: Floating Net Asset Value

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* ("Proposed Recommendations" or "Release"); specifically, "*Alternative One: Floating Net Asset Value.*"¹ The Release would require money market mutual funds ("MMFs") to have a floating net asset value ("NAV") per share, and would also require MMFs to initially re-price their shares to \$100.00 each. In conjunction with this alternative, the Release also proposes to rescind Securities and Exchange Commission (SEC) Rules 22e-3 and 17a-9, which were adopted as part of the SEC's 2010 reforms responding to the financial crisis.

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

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

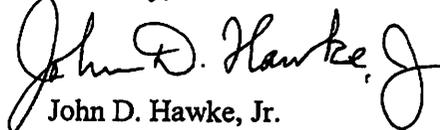
- (1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating "runs." There is no data to support this proposition and, indeed, the data show just the opposite.
- (2) The floating NAV proposal is based on an unproven notion of "first-mover advantage," the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.
- (3) A stable NAV does not create an arbitrage opportunity for MMF shareholders.
- (4) The elimination of the stable NAV is wholly unnecessary to address the perceptions of investors, who know and understand that MMFs are investments that are "not FDIC insured" and "may lose value."
- (5) A floating NAV would not reflect a measurably more "accurate" valuation of MMF shares than the amortized cost accounting method currently used by MMFs.
- (6) A floating NAV, with a mandated \$100.00 initial share price, would not be "consistent with the requirements that apply to all other mutual funds" but rather would be arbitrary and punitive, and would destroy MMFs as a product.
- (7) A floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate MMFs as a viable cash management tool by destroying their principal liquidity function.

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- (8) A floating NAV, for the sake of showing minute variations in value that cancel out over time, also would impose significant operational, accounting and tax burdens on users of MMFs and destroy their utility.
- (9) A floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.
- (10) A floating NAV, because of the operational burdens, costs, and other impediments, would substantially shrink the assets of MMFs.
- (11) A floating NAV would therefore contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.
- (12) A floating NAV would force current MMF users to less regulated and less transparent products.
- (13) A floating NAV would accelerate the flow of assets to "Too Big to Fail" banks, further concentrating risk in that sector.
- (14) The Council's proposal to rescind Rules 22e-3 and 17a-9 would remove important 2010 reforms designed to protect investors.
- (15) Instead of focusing on the floating NAV, regulators should consider how MMF's enhanced liquidity has proved to be effective in absorbing heavy redemption requests, and how it has improved the characteristics of the marketplace from 2008.

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.

Enclosure

ARNOLD & PORTER LLP

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

**Proposal for a Floating NAV for Money Market Mutual Funds:
Ineffective in Protecting Against Runs in a Crisis;
Harmful to Investors and the Economy**

Comment Submitted for Docket No. FSOC-2012-0003

January 25, 2013

**Proposal for a Floating NAV for Money Market Mutual Funds:
Ineffective in Protecting Against Runs in a Crisis;
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 One: Floating Net Asset Value.*” Under this alternative, money market mutual funds (“MMFs”) would be required to have a floating net asset value (“NAV”) per share and would not be allowed to use amortized cost accounting and/or penny rounding to maintain a stable NAV.³ The Release states that the value of MMFs’ shares “would not be fixed at \$1.00 and would reflect the actual market value of the underlying portfolio holdings, consistent with the requirements that apply to all other mutual funds.”⁴ The Release describes this alternative as requiring that MMFs re-price their shares to \$100.00 per share (or initially sell them at that price), in order to be “more sensitive to fluctuations” in the value of the portfolio’s underlying securities.⁵ The Release proposes a potential transition period of up to five years, in which the Securities and Exchange Commission (“SEC”) would prohibit new share purchases in grandfathered stable NAV funds after a pre-determined date, and any new share purchases would have to be made in floating NAV funds.

While all of the restrictions of Rule 2a-7 would remain, the Release proposes to rescind two existing SEC rules, adopted as part of the SEC’s 2010 reforms responding to the financial crisis. The first is Rule 22e-3, which currently allows an MMF board to suspend redemptions

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 Release at 69466.

⁴ *Id.*

⁵ *Id.* The requirement for MMFs to price their shares at \$100.00 per share is *not* “consistent with the requirements that apply to all other mutual funds.” This issue is addressed extensively in a Letter from Stephen Keen to the Council. Letter from Stephen A. Keen to Financial Stability Oversight Council (Nov. 26, 2012), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0004>. No current law or regulation requires an investment company under the Investment Company Act of 1940 to offer its shares at a particular price.

and begin an orderly liquidation if the fund has broken or is about to break the buck.⁶ The Release rationalizes that a floating NAV diminishes the need for MMF sponsors or boards to suspend redemptions or otherwise intervene upon share price declines.⁷ The second is Rule 17a-9, which allows affiliates of an MMF to purchase portfolio securities from an MMF, which the Release says “typically” is used to support an MMF’s stable price per share.⁸ The Release rationalizes that since a floating NAV fund is designed to fluctuate in value, allowing this type of support would be unnecessary.⁹

The Release describes the benefits of this proposal as (1) reducing the perception that shareholders do not bear any risk of loss in an MMF; (2) making MMFs operate like other mutual funds, showing day-to-day fluctuations; (3) removing uncertainty or confusion regarding who bears the risk of loss in an MMF; and (4) reducing “first-mover advantage.”¹⁰ The Release acknowledges, however, that a floating NAV “would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future”¹¹ In short, a floating NAV will not remove the risk of “runs.” It also acknowledges, but does not size or attempt to address, significant tax, accounting, and operational costs that would result from the proposal.¹²

In its perfunctory statement of the benefits and costs associated with a floating NAV, the Council largely ignores the extensive record of public comments in the SEC’s docket on this subject.¹³ As these comments explain, the stability, diversification, and high credit quality of MMFs over the years has enabled millions of individuals, businesses, nonprofits, and state and local governments to invest significant portions of their liquid assets in these funds – with total

⁶ Release at 69466. See 17 C.F.R. § 270.22e-3.

⁷ Release at 69466.

⁸ *Id.* See 17 C.F.R. § 270.17a-9.

⁹ Release at 69466.

¹⁰ *Id.* at 69466-67.

¹¹ *Id.* at 69467.

¹² *Id.*

¹³ These comments were filed over a three-year period in response to the SEC’s 2009 proposed rule on Money Market Fund Reform, the SEC’s request for comment on the 2010 Report of the President’s Working Group on MMF Reform Options, and the public statements made by former SEC Chairman Mary Schapiro in which she outlined what she believed a further formal proposed rule would include. 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> (letters dated 2010 or later) or the SEC’s Request for Comment on a Proposed Rule: Money Market Fund Reform, File No. S7-11-09, <http://www.sec.gov/comments/s7-11-09/s71109.shtml> (letters dated 2009).

shareholder balances today exceeding \$2.7 trillion.¹⁴ Individual investors rely upon the convenience of the one dollar per share pricing, which is why investors throughout the U.S. have opposed proposals to require MMFs to “float” their NAV. As the AARP has stated, “the requirement of floating net asset values would radically and detrimentally alter the role and function of money market funds, discourage the use of money market funds for individual investors, and disrupt the financial market landscape for investors.”¹⁵

In addition, many institutional users of MMFs – corporations, state and local governments, and trustees, cannot (by law or investment guidelines) or will not (because of cost, operational, tax, or accounting considerations) use a floating NAV MMF. Indeed, the one dollar per share pricing is critical to the utility of MMFs for a variety of applications involving automated accounting and settlement systems and is incorporated into many automated systems and the interfaces used in these systems.¹⁶

Although the Release contains several footnote references to isolated letters and surveys in the SEC’s comment file, the vast majority of comments were not referenced in the Release and apparently not considered by the Council. The hundreds of individually distinct public comment letters in the SEC’s docket contained substantial research, data, reports, surveys and other analyses developed over a period of almost two years. Commenters put forward data and research regarding the adverse impact of requiring MMFs to adopt a floating NAV; they also argued strongly that, based on their analysis of the data, the proposal not only would fail to prevent or reduce the risk of runs in a crisis, it in fact could precipitate runs and increase systemic risk.¹⁷ The Federal Reserve Bank of New York (“FRBNY”) in a recent report highlighted these same concerns,¹⁸ as did the President’s Working Group on Financial Markets

¹⁴ Investment Company Institute (ICI), *Money Market Mutual Fund Assets, Week ending January 9, 2013* (Jan. 10, 2013), http://www.ici.org/research/stats/mmf/mm_01_10_13.

¹⁵ Letter from AARP to SEC (Sept. 8, 2009).

¹⁶ These uses, discussed extensively in the Appendix, include the following: bank trust accounting systems; corporate payroll processing; corporate and institutional operating cash balances; federal, state and local government cash balances; municipal bond trustee cash management systems; consumer receivable securitization cash processing; escrow processing; custody cash balances and investment manager cash balances; 401(k) and 403(b) employee benefit plan processing; broker-dealer and futures dealer customer cash balances; and cash management type accounts at banks and broker-dealers. Of course, MMFs and their transfer agents are required to have the capacity to redeem and sell securities based on a net asset value reflecting current market conditions, which must include the ability to redeem and sell securities at prices that do not correspond to the stable NAV per share. 17 C.F.R. § 270.2a-7(c)(13).

¹⁷ Arnold & Porter filed a letter with the SEC on July 17, 2012, copying all members of the Council, in which we detailed the comments, surveys, reports and other data filed with the SEC as of that date. Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (July 17, 2012).

¹⁸ The Federal Reserve Bank of New York stated, “[B]ecause a floating NAV requirement would eliminate what appears to be a key attraction for many MMF investors, such a change might lead to a precipitous decline in MMF assets and in these funds’ capacity to provide short-term funding. . . . [S]table-value investment vehicles would

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in its 2010 report on MMFs (“PWG Report”).¹⁹ As stated above, in its own Release, the Council itself acknowledges that “while a floating NAV would remove the ability of a shareholder to redeem shares at \$1.00 when the market value is less than \$1.00, it would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future, consistent with the incentive that exists today for other types of mutual funds.”²⁰

Moreover, although the Release states the transition period would “reduce potential disruptions and facilitate the transition to a floating NAV for investors and issuers,”²¹ this contention wholly ignores the asset flows of the MMF industry. MMF investors use MMFs as cash management accounts. Given that 50% or more of the assets held in MMFs may turn over in under a month, the structure of the transition period ensures that most users will have very little time to adjust to the floating NAV.²² As a result, MMF users will rapidly feel the effects of

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continue to pose systemic risks if assets migrate to other, less regulated, less transparent stable-NAV products (such as offshore MMFs and some private liquidity funds). Alternatively, if institutional investors move cash to banks, the banking system might experience a large increase in uninsured, ‘hot money’ deposits. . . . [A] floating NAV might lead to a steep decline in investor demand for MMF shares and a migration of assets to less regulated vehicles that continue to offer stable NAVs. Moreover, even if MMFs with floating NAVs remain sizable, they might continue to be vulnerable to runs, since investors in distressed funds still would have strong incentives to redeem.” Patrick E. McCabe, et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 6, 54 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> (“FRBNY Staff Report”). Astonishingly, while acknowledging that a floating NAV cannot be relied upon to address the potential for MMF runs, and further noting the potential for significant adverse economic consequences if such a proposal were adopted, the FRBNY Staff Report nonetheless suggested 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. *Id.* at 54. 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.

¹⁹ The 2010 report warned that adopting a floating NAV would make MMFs a less desirable or even useless product for certain kinds of investors, the redemptions from which may cause deleterious and unintended consequences for a variety of users and credit markets as a whole. The report also said that the very shift to a floating NAV could cause major disruptions: “MMFs are the dominant providers of some types of credit, such as commercial paper and short-term municipal debt, so a significant contraction of MMFs might cause particular difficulties for borrowers who rely on these instruments for financing. If the contraction were abrupt, redemptions might cause severe disruptions for MMFs, the markets for the instruments the funds hold, and borrowers who tap those markets.” Report of the President’s Working Group on Financial Markets: Money Market Fund Reform Options at 21 (Oct. 2010), <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf> (“PWG Report”).

²⁰ Release at 69467.

²¹ *Id.* at 69466.

²² 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

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the burdens associated with the shift to a floating NAV, and the change itself is likely to bring about dislocations in short-term credit markets and the broader economy.

As discussed in more detail below, the Council should not propose that the SEC require a floating NAV for MMFs for the following reasons:

- (1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating “runs.” There is no data to support this proposition and, indeed, the data show just the opposite.
- (2) The floating NAV 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.
- (3) A stable NAV does not create an arbitrage opportunity for MMF shareholders.
- (4) The elimination of the stable NAV is wholly unnecessary to address the perceptions of investors, who know and understand that MMFs are investments that are “not FDIC insured” and “may lose value.”
- (5) A floating NAV would not reflect a measurably more “accurate” valuation of MMF shares than the amortized cost accounting method currently used by MMFs.
- (6) A floating NAV, with a mandated \$100.00 initial share price, would not be “consistent with the requirements that apply to all other mutual funds” but rather would be arbitrary and punitive, and would destroy MMFs as a product.
- (7) A floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate MMFs as a viable cash management tool by destroying their principal liquidity function.
- (8) A floating NAV, for the sake of showing minute variations in value that cancel out over time, also would impose significant operational, accounting and tax burdens on users of MMFs and destroy their utility.

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redemptions in the five largest MMFs by month for 2011). Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012) (describing the various specialized uses of MMFs that require daily liquidity); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012) (supplying estimates of the amount of assets held for those specialized purposes).

- (9) A floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.
- (10) A floating NAV, because of the operational burdens, costs, and other impediments, would substantially shrink the assets of MMFs.
- (11) A floating NAV would therefore contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.
- (12) A floating NAV would force current MMF users to less regulated and less transparent products.
- (13) A floating NAV would accelerate the flow of assets to “Too Big to Fail” banks, further concentrating risk in that sector.
- (14) The Council’s proposal to rescind Rules 22e-3 and 17a-9 would remove important 2010 reforms designed to protect investors.
- (15) Instead of focusing on the floating NAV, regulators should consider how MMF’s enhanced liquidity has proved to be effective in absorbing heavy redemption requests, and how it has improved the characteristics of the marketplace from 2008.

(1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating “runs.” There is no data to support this proposition and, indeed, the data show just the opposite.

As stated above, the Release acknowledges that a floating NAV for MMFs would not achieve the regulatory goal of eliminating a shareholder’s incentive to redeem in a crisis.²³ Although the primary justification for moving to a floating NAV is to reduce the “susceptibility” of the funds to runs, the Council offers no empirical evidence to support this view. Indeed, the evidence suggests just the opposite, a point made in numerous letters in the SEC’s comment file, borne out in the experience of floating NAV funds during the crisis, and acknowledged by the

²³ Release at 69467. See also FRBNY Staff Report at 54; 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* (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf (citing recent scholarly papers on MMF regulation confirming that a floating NAV will not stop runs); Hal Scott, *Interconnectedness and Contagion, Committee on Capital Markets Regulation* at 224 (Nov. 20, 2012), http://www.capmksreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf (“[A] floating NAV does not address the risk of contagion among MMMF investors.”).

Council in the Release.²⁴ As Professors Jill Fisch, of the University of Pennsylvania Law School, and Eric Roiter, of the Boston University School of Law, have written:

Ultra-short bond funds are a near equivalent to money market funds but for the fact that they maintain a floating NAV. . . . While their share of assets pales in comparison to MMFs, ultra-short bond funds faced waves of redemptions comparable in respective magnitude to what MMFs faced. Indeed, contractions of ultra-short bond funds likely exacerbated the freeze in the short term credit markets. By the end of 2008, assets in these funds were 60% below their peak level in 2007. In Europe, both types of money market funds – those with stable NAVs and those with floating NAVs – have co-existed for years. Floating NAV money market funds suffered substantial redemptions during the credit crisis in 2008, leading more than a dozen of them to suspend redemptions temporarily and four of them to close altogether. French floating NAV money market funds lost about 40% of their assets during a three month period in the summer of 2007.²⁵

Fidelity Investments also has pointed out the lack of “empirical evidence to support the belief that in a period of market turmoil, funds with [Variable] NAVs would be at lower risk of significant redemptions from shareholders. In fact, during the financial crisis, VNAV funds in Europe experienced redemption pressures similar to [Constant] NAV funds.”²⁶

A recent paper by three finance and economics professors that surveyed recent scholarly papers on MMF regulation stated, “All of the papers point out problems with the [floating] NAV proposal,” and emphasized that “MMFs reporting floating NAVs can still experience runs.”²⁷

²⁴ See Letter from Invesco to IOSCO, filed with SEC (May 25, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Dec. 15, 2011) (filed with the SEC); Letter from Fisch & Roiter to SEC (Dec. 2, 2011); Letter from Jacksonville Chamber to SEC (Jan. 31, 2011); Letter from Cincinnati Chamber to SEC (Jan. 13, 2011); Letter from ICI to SEC (Jan. 10, 2011); Letter from The Dreyfus Corporation to SEC (Jan. 10, 2011); Letter from Crane Data LLC to SEC (Jan. 10, 2011); Letter from Wells Fargo Funds Management to SEC (Jan. 10, 2011); Letter from T. Rowe Price to SEC (Jan. 10, 2011); Letter from Institutional Money Market Funds Association to SEC (Jan. 10, 2011); Letter from Vanguard to SEC (Jan. 10, 2011); Letter from Invesco Advisors to SEC (Jan. 10, 2011); Letter from SIFMA to SEC (Jan. 10, 2011); Letter from Fidelity to SEC (Jan. 10, 2011); Letter from European Fund and Asset Management Association to SEC (Jan. 10, 2011); Release at n.72 (acknowledging data submitted by commenters).

²⁵ Letter from Fisch & Roiter to SEC (Dec. 2, 2011) (internal citations omitted). See also Letter from Institutional Money Market Funds Association to SEC (Jan. 10, 2011).

²⁶ Letter from Fidelity Investments to IOSCO (May 30, 2012) (filed with the SEC) (citing Stephen Jank and Michael Wedow, *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).

²⁷ 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* (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf.

As Professor Hal Scott further explained, requiring MMFs to adopt a floating NAV would not change the characteristics of the product itself: “MMMFs would still provide the same degree of maturity and liquidity transformation. A floating NAV does not reduce the underlying risk of MMMF investments, including interest rate risk, credit risk and liquidity risk.”²⁸

One investment adviser warned that the shift to a floating NAV “could precipitate a destabilizing flood of preemptive withdrawals by investors seeking to guarantee the return of their principal. This would bring about the very result that the measure was intended to prevent in the first place: a run on funds triggering a liquidity crisis and potentially destabilizing financial markets through widespread, forced sales of portfolio holdings.”²⁹ If investor confusion is a concern and investor protection is a regulatory goal, to promote the idea to investors that a floating NAV MMF is more safe and less run-prone is itself misleading.

Although the Council presumes to revive the regulatory process after the former SEC Chairman’s unsuccessful attempt to garner sufficient votes for an SEC staff proposal to require, among other regulations, a floating NAV for MMFs, the Council, like the SEC, fails to offer any data to suggest that adopting a floating NAV would achieve the regulatory goal of reducing the risk of runs. The Council also fails to address the significant body of evidence to the contrary. As a result, the criticism of the SEC staff’s proposal by SEC Commissioners Gallagher and Paredes applies equally to the Council’s Release: “[T]he necessary analysis has not been conducted to demonstrate that a floating NAV . . . would be effective in crisis.”³⁰ Further, the Commissioners pointed to the “predominant incentive of investors in a crisis to flee risk and move to safety,” stating,

As for the floating NAV proposal, even if there is no stable \$1.00 NAV – i.e., even if, by definition, there is no “buck” to break – investors will still have an incentive to flee from risk during a crisis period such as 2008, because investors who redeem sooner rather than later during a period of financial distress will get out at a higher valuation.³¹

²⁸ Hal Scott, *Interconnectedness and Contagion*, Committee on Capital Markets Regulation at 224 (Nov. 20, 2012), http://www.capmktreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf.

²⁹ Letter from Invesco Advisors to SEC (Jan. 10, 2011). *Accord* PWG Report at 22 (“MMFs’ transition from stable to floating NAVs might itself be systemically risky. For example, if shareholders perceive a risk that a fund that is maintaining a \$1 NAV under current rules has a market-based shadow NAV of less than \$1, these investors may redeem shares preemptively to avoid potential losses when MMFs switch to floating NAVs. Shareholders who cannot tolerate floating NAVs probably also would redeem in advance. If large enough, redemptions could force some funds to sell assets and could make concerns about losses self-fulfilling.”).

³⁰ Daniel M. Gallagher and Troy A. Paredes, Commissioners, Securities and Exchange Commission, Statement on the Regulation of Money Market Funds (Aug. 28, 2012), <http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm>.

³¹ *Id.*

Even if the Council recommends that the SEC require MMFs to float their NAVs, the SEC will need to provide data concerning the benefits of such a change – namely, whether the change would reduce the likelihood of MMF runs, versus the costs of such a change, including its impact on competition, efficiency, and capital formation. If the SEC does not “support its predictive judgments” with respect to the impact of a floating NAV, which to date it has been unable to do, it may find itself yet again on the losing end of another rule challenge.³²

(2) The floating NAV 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.”³³ 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.”³⁴ 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.³⁵ In many cases, the two are identical. In the absence of a credit event

³² *Business Roundtable v. SEC*, 647 F.3d 1144, 1149 (D.C. Cir. 2011).

³³ Release at 69456.

³⁴ *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.

³⁵ 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

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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 is able to dispose of the security (or it matures) within five days of the event.³⁶ 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.³⁷ 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.³⁸ 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."³⁹ 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.⁴⁰ Further, Rule 2a-7 provides that in the event that the extent of an MMF's deviation from the mark-to-market NAV exceeds 1/2 of 1 percent, the board must "promptly consider what action, if any, should be initiated . . ."⁴¹ 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

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and fair valuation of portfolio instruments where market quotations are not available. This is discussed in greater detail in section 5 of this paper.

³⁶ 15 C.F.R. § 270.2a-7(c)(7)(i)(A).

³⁷ 15 C.F.R. § 270.2a-7(c)(7)(ii).

³⁸ 15 C.F.R. § 270.2a-7(c)(7)(iii).

³⁹ 15 C.F.R. § 270.2a-7(c)(1).

⁴⁰ 15 C.F.R. § 270.2a-7(c)(8)(ii)(C).

⁴¹ 15 C.F.R. § 270.2a-7(c)(8)(ii)(B).

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.⁴² The rule, adopted as part of the SEC’s 2010 reforms, is designed to prevent investor panic and prevent the type of 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. The rule is designed to address the potential for runs regardless of their cause – whether liquidity-driven (such as the 2008 crisis),⁴³ credit-driven, or interest-rate driven. 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.⁴⁴ But, as discussed earlier in this paper, the Council itself admits that a floating NAV would fail to remove the risk of runs in a crisis; experts and experience from the past financial crisis confirm this as well. Thus, the Release not only ignores and fails to acknowledge the multitude of SEC requirements designed to assure that MMF boards take appropriate action to treat all investors equally and fairly, it recommends rescinding a key 2010 reform that addresses exactly the type of “run risk” the Council states it wishes to prevent.

(3) A stable NAV does not create an arbitrage opportunity for MMF shareholders.

It has been suggested that the use of a stable NAV creates an opportunity for shareholders to profit through “arbitrage” of the difference between the “shadow NAV” and \$1.00 per share price. There is no way to profit, however, from purchasing MMF shares at \$1.00 per share and redeeming at \$1.00 per share. MMF shares are not offered for sale at below \$1.00 per share. There is no opportunity to buy below \$1.00 per share and sell at a higher price. There is no market for short-selling MMF shares. Indeed, there is no secondary market for sales of MMF at all – they can only be disposed of by redeeming the shares from the MMF, and the price is the fund’s NAV.

⁴² 17 C.F.R. § 270.22e-3.

⁴³ Of course, in addition to an MMF board’s authority to suspend redemptions in the event of a liquidity-driven crisis, the SEC’s 2010 amendments focused extensively on enhancing the resiliency of MMFs by strengthening the liquidity of MMF portfolios. Rule 2a-7’s liquidity requirements are discussed in detail in Section 15 of this paper.

⁴⁴ Release at 69466. Of course, an MMF could still seek an order from the SEC permitting the fund to suspend redemptions and liquidate.

At most, under the theories espoused in the Release, an investor in an MMF might in rare cases avoid a potential loss on the investment by getting out ahead of other investors before a price decline. In the past, MMF shareholders would have had only two chances to have “profited” by avoiding a loss on MMF shares. The first such instance was in connection with the closure of the Community Bankers U.S. Government Fund, which in 1994 repaid its investors 96 cents on the dollar. The second was the Reserve Primary Fund, which was forced to liquidate in September 2008 as a result of a run triggered by Lehman’s bankruptcy and the fund’s holdings of Lehman commercial paper. The Reserve Primary Fund has returned to shareholders more than 99 cents on the dollar. In order to have gained the “benefit” from these events, MMF shareholders would have had to invest in several hundred MMFs over a period of forty years. Moreover, the “profit” from those transaction would not have been making money, but avoiding a loss of nine tenths of one cent per share in one case, and four cents per share in the other. It is hard to understand what would motivate an investor to purchase shares in an MMF to seek out this “arbitrage opportunity” to, at best, not *lose* money.

Thus, the proposition that an investor could profit from arbitraging a stable value MMF, when the investor transacts in and out of the fund at one dollar per share, is meritless. Given that many MMFs are now voluntarily publishing their shadow prices on a daily basis, the SEC will have the opportunity to assess this theoretical “arbitrage” possibility.

(4) The elimination of the stable NAV is wholly unnecessary to address the perceptions of investors, who know and understand that MMFs are investments that are “not FDIC insured” and “may lose value.”

If requiring MMFs to adopt a floating NAV will not achieve its regulatory purpose and may even precipitate runs, what then is the point of requiring a floating NAV in the first instance? The Release suggests that the goal may be to remove uncertainty as to who bears the risk of loss in an MMF. According to the Release, MMF investors have the “perception that shareholders do not bear any risk of loss when they invest in an MMF.”⁴⁵ Requiring a floating NAV “would make gains and losses on MMF investments a regular occurrence,” “would accustom investors to changes in the value of their MMF shares,” and would “reinforce the principle that investors, not fund sponsors or taxpayers, are expected to bear the pro rata risk of loss in MMFs, as they do with other investment vehicles.”⁴⁶ The Release further suggests that although MMF prospectuses are required to disclose to investors that their shares may lose value, past support by fund sponsors “may have obscured some investors’ appreciation of MMF risks

⁴⁵ *Id.*

⁴⁶ *Id.* at 69466-67.

and caused some investors to assume that MMF sponsors will absorb any losses, even though sponsors are under no obligation to do so.”⁴⁷

The Release’s commentary on the misperceptions of investors follows former SEC Chairman Schapiro’s numerous statements to the same effect. Former Chairman Schapiro stated that MMF investors “don’t appreciate that these are investments, these are not cash instruments, they’re investments and when they break the buck, the impetus to run is enormous.”⁴⁸ She said that a floating NAV would “reinforce what money market funds are – an investment product”⁴⁹ and would “cause shareholders to become accustomed to fluctuations in the funds’ share prices, and thus less likely to redeem en masse if they fear a loss is imminent, as they do today.”⁵⁰ She further commented, “The stable \$1.00 share price has fostered an expectation of safety, although money market funds are subject to credit, interest-rate and liquidity risk. . . . As a result, when a fund breaks the dollar, investors lose confidence and rush to redeem.”⁵¹

To be clear, not only are MMFs uninsured, Congress in 2009 specifically prohibited the Department of the Treasury from using the Exchange Stabilization Fund to support a program to guarantee MMF shareholders, as it did in the financial crisis in 2008.⁵² MMF investors neither rely upon a government guarantee nor do they seek it. Indeed, perhaps the strongest evidence of this fact is that in the midst of the financial crisis, MMF investors poured a net \$170 billion in *uninsured* investments back into prime MMFs at the end of 2008.⁵³ At that time, it was

⁴⁷ *Id.* at 69462.

⁴⁸ *Oversight of the Securities and Exchange Commission: Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services* (Apr. 25, 2012) (archive of hearing webcast), <http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=290689>.

⁴⁹ Chairman Mary L. Schapiro, Remarks at SIFMA’s 2011 Annual Meeting (Nov. 7, 2011).

⁵⁰ *Perspectives on Money Market Mutual Fund Reforms: Hearing Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 112th Cong. 12 (Jun. 21, 2012) (Testimony of Chairman Mary L. Schapiro), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc73189c9c0. See also Chairman Mary L. Schapiro, Remarks at the Society of American Business Editors and Writers Annual Convention (Mar. 15, 2012) (A floating NAV would “desensitize investors to the occasional drop in value” of MMFs.).

⁵¹ *Perspectives on Money Market Mutual Fund Reforms: Hearing Before the U.S. Senate Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 10 (Jun. 21, 2012) (Testimony of Chairman Mary L. Schapiro), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc73189c9c0.

⁵² Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 131(b), 122 Stat. 3765, 3797-98 (2008) (“The Secretary is prohibited from using the Exchange Stabilization Fund for the establishment of any future guaranty programs for the United States money market mutual fund industry.”).

⁵³ Treasury Strategies, *Dissecting the Financial Collapse of 2007-2009* at 3, <http://www.sec.gov/comments/4-619/4619-188.pdf> (filed as a comment letter with the SEC June 1, 2012); Press Release, *Treasury Announces Guaranty Program for Money Market Funds* (Sept. 19, 2008), <http://www.treasury.gov/press-center/press-releases/Pages/hp1147.aspx>.

abundantly clear to investors that an MMF could break the buck. It was also clear that MMF shares purchased after September 19, 2008 were not covered by the Treasury guarantee program.

As discussed below, institutional investors are clearly aware of the risks of investing in MMFs, and, according to surveys of retail investors, the vast majority of these users also are well aware of these risks.⁵⁴ The Release offers no data to support its statements that investors may be confused or uncertain regarding the nature of MMFs, and offers no rebuttal to the survey data and individual letters that fill the SEC's comment file stating the opposite.

It's not appropriate for regulators to treat investors "like children." In a hearing before the Senate Committee on Banking, Housing, and Urban Affairs, the Treasurer of the State of Maryland responded to former Chairman Schapiro:

[O]n behalf of many of the investors . . . [w]e do read the prospectus and we know it's an investment. It's not a savings account. And the reforms of 2010 and the experience of 2008 I think has brought that home very clearly. So I think this treating us sort of like children is really not appropriate.⁵⁵

The National Association of State and Local Treasurers made similar comments in a letter filed with the SEC, stating that it "does not accept the statement that investors believe that money market funds are 'risk free cash equivalents.' On the contrary, NAST believes that investors realize that money market funds have an inherent risk, albeit a small one."⁵⁶ An investor, in a comment letter to the SEC, stated, "I think you underestimate American's abilities to comprehend the investment risks that they're taking. And those of us that do understand the risks should not have to suffer poorer investments options . . ."⁵⁷ These views are borne out in surveys of retail investors. For example, Fidelity Investments, after conducting a survey of its retail customers, reported that 75% of retail investors surveyed understood that MMFs are not guaranteed by a government entity. Only 11% of those surveyed believed MMF were guaranteed, while 14% were unsure.⁵⁸

⁵⁴ Letter from Fidelity Investments to SEC (Feb. 3, 2012) (citing survey data of retail and institutional investors).

⁵⁵ *Oversight of the Securities and Exchange Commission: Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services* (Apr. 25, 2012) (archive of hearing webcast), <http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=290689> (Testimony of Maryland State Treasurer Nancy Kopp in response to questions posed by Senator Toomey).

⁵⁶ Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010) (internal citations omitted).

⁵⁷ Letter from Scott O'Reilly to SEC (Aug. 16, 2012).

⁵⁸ Letter from Fidelity Investments to SEC (Feb. 3, 2012).

In addition to surveys of retail investors, which tell us a great deal, the vast majority of MMF investors are institutional investors, and it simply is not credible to assert they do not understand the nature of MMFs, including the nature of sponsor support. MMFs clearly disclose that they are “Not FDIC Insured” and “May Lose Value.”⁵⁹ The variable “shadow” price of each MMF and each individual instrument in the fund is reported monthly to the SEC, which makes it publicly available on its website, clearly reflecting the fluctuations (however minute) in the underlying valuation of each MMF.⁶⁰

Neither the Council in its Release nor the SEC has provided survey or other data supporting the view that investors believe there is “implicit” support for MMFs or that they are unaware of the small fluctuations in underlying market value of MMF shares. Moreover, while taking the position that investors may misperceive the risks of MMFs, the Council fails to address the results of Fidelity’s extensive survey of retail investors demonstrating that a large majority of retail investors understand that MMFs are unguaranteed investment products. Oddly, the Release cites that *very* survey for other purposes in the Release.⁶¹ Without data of their own, and without responding to evidence to the contrary, the Council’s and the SEC’s statements regarding investor perceptions are “mere speculation.”⁶²

(5) A floating NAV would not reflect a measurably more “accurate” valuation of MMF shares than the amortized cost accounting method currently used by MMFs.

In its Release, the Council states that after requiring MMFs to adopt a floating NAV “the value of MMFs’ shares would reflect the market value of the underlying portfolio holdings, consistent with the valuation requirements that apply to all other mutual funds under the Investment Company Act.”⁶³ The Release echoes earlier statements to the same effect by former Chairman Schapiro⁶⁴ and Treasury Secretary Timothy Geithner.⁶⁵ These statements suggest a

⁵⁹ 15 U.S.C. § 80a-34. *See also* 17 C.F.R. § 270.34b-1; 17 C.F.R. § 230.482 (requiring all MMF advertisements to include the following statement: “An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund.”).

⁶⁰ MMFs, in turn, provide links from their websites to the portfolio information presented on the SEC’s website.

⁶¹ Release at n.80.

⁶² *Business Roundtable v. SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011).

⁶³ Release at 69466.

⁶⁴ In a statement last year, former Chairman Schapiro argued that MMFs should “float the NAV and use mark-to-market valuation like every other mutual fund.” Mary Schapiro, Chairman, Securities and Exchange Commission, Statement on Money Market Fund Reform (Aug. 22, 2012), <http://www.sec.gov/news/press/2012/2012-166.htm>.

⁶⁵ In his letter of September 27, Treasury Secretary Timothy Geithner argued that a floating NAV would “allow the value of investors’ shares to track more closely the values of the underlying instruments held by MMFs and eliminate the significance of share price variation in the future.” Letter from Timothy F. Geithner, Secretary of the

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view among regulators that, if MMFs redeemed shareholders securities at a floating or variable NAV, that price would be a truer indication of the MMF's "mark-to-market" value.

The Myth of "Marking-to-Market" to Arrive at a Floating NAV. What is left out of these statements by regulators – perhaps because they may not be familiar with the nature of the instruments held in MMF portfolios – is that there are no daily reported prices for many of the instruments held in a prime MMF portfolio.⁶⁶ Because of their short-term nature, money market instruments generally are purchased and held to maturity (which is the general basis under GAAP⁶⁷ for the use of amortized cost accounting used by MMFs to value portfolio assets). In a lengthy analysis of the performance of stable and floating NAV funds, Professors Fisch and Roiter point out that "[v]ery short-term money market instruments like commercial paper or bank CDs ordinarily lack readily available market prices."⁶⁸

Commercial paper and other instruments for which there are no readily available market prices are priced based on their "fair valuation" – a reasonable estimate of the price at which the instrument could be sold in a current trade. Thus, these valuations are not necessarily "mark-to-market" prices. An MMF's board, like the board of any mutual fund, in valuing the fund's portfolio assets, must use the market value for securities or other assets for which market quotations are readily available, and with respect to other securities and assets, must use their "fair value as determined in good faith by the board of directors."⁶⁹ As Professors Fisch and Roiter point out, the SEC has provided extensive guidance on the issue.⁷⁰ But the SEC also has long acknowledged that there is no single "correct" fair value and, that "The same security held in the portfolios of different funds can be given different fair value prices at any one time, all of which can be reasonable estimates meeting the statutory standard."⁷¹

In practice, MMFs have elaborate and rigorous procedures to obtain valuations for their portfolio assets and to measure deviations between the MMF's amortized cost price per share

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Treasury, to Members of the Financial Stability Oversight Council (Sept. 27, 2012), <http://www.treasury.gov/connect/blog/Documents/SEC.Geithner.Letter.To.FSOC.pdf>.

⁶⁶ Of course, for government MMFs, there are ample market prices for Treasuries and agency securities.

⁶⁷ Accounting for Certain Investments in Debt and Equity Securities, Statement of Fin. Accounting Standards No. 115, § 7 (Fin. Accounting Standards Bd. 1993). See also the discussion of amortized cost as applied to MMFs in Professor Dennis R. Beresford, *Amortized Cost is "Fair" for Money Market Funds* (Fall 2012), http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Money-Market-Funds_FINAL.layout.pdf.

⁶⁸ Letter from Fisch & Roiter to SEC at 7 (Dec. 2, 2011).

⁶⁹ 17 C.F.R. § 270.2a-4.

⁷⁰ Letter from Fisch & Roiter to SEC at n.22-23 (Dec. 2, 2011).

⁷¹ *Id.* at 6.

and the “current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions).”⁷² SEC rules require that they do this. Virtually all MMFs engage independent pricing services to get to a high degree of comfort that the valuations identified by these services for each instrument held in portfolio appropriately “reflects current market conditions,” and MMF internal valuation experts closely monitor any deviations from the valuations obtained using amortized cost accounting. Where there are variations, depending upon internal thresholds that may be reached, MMF procedures generally require involvement of internal valuation committees and in some circumstances the board.

But, these pricing services normally do not identify “mark-to-market” prices, due to the fact that many of the instruments held in a prime MMF portfolio do not have reported trading prices on any given day. For those instruments that do not trade on a daily basis, these services generally use what is known as “matrix” pricing: the pricing service compares each individual instrument within the portfolio to a homogenous set of instruments in the market (*e.g.*, because they have similar ratings, interest rates, maturities) and derives a valuation that it believes reflects current market conditions based upon similar instruments that have traded that day.⁷³ While matrix pricing is mechanistic and may be an “appropriate substitute” where there is no mark-to-market price, different pricing services may arrive at very minute differences in prices for a portfolio asset, depending upon how they bucket it and the market prices used as reference points. Moreover, each MMF board has the ultimate responsibility to assure that valuation methods used (whether by a pricing service or otherwise) are appropriate. It is this valuation method that MMFs use to arrive at a “shadow price” to compare against the amortized cost valuations.⁷⁴ It is an important benchmark, but it is, like amortized cost valuation, a type of fair valuation and is not “mark-to-market.”⁷⁵ Indeed, as discussed further below, because the valuations derived under this method are often identical to, or very similar to, valuations derived using amortized cost, amortized cost is a more efficient and reliable means of pricing MMF portfolio assets.

⁷² 17 C.F.R. § 270.2a-7(c)(8)(ii)(A).

⁷³ Fair Value Measurement, Accounting Standards Update Topic 820-10-55-3C (Fin. Accounting Standards Bd. May 2011) (“Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities.”).

⁷⁴ These calculations and comparisons are done periodically as determined by the fund’s board of directors, generally weekly if required by rating agencies, or every two weeks. Calculations should be more frequent in volatile market conditions.

⁷⁵ The same general approach has been adopted by the Financial Industry Regulatory Authority (“FINRA”), and approved by the SEC, as the standard for broker-dealers to price debt securities when there is no active trading market.” FINRA Rule IM-2440-2; Securities Exchange Act Release No. 55638 (Apr. 16, 2007), 77 Fed. Reg. 20150 (April 23, 2007).

A Distinction Without a Difference. Day to day, the shadow price of an MMF – however it is determined – deviates from the \$1.00 per share arrived at through amortized cost accounting by only miniscule amounts, if at all. The Investment Company Institute (“ICI”), has produced several studies detailing this point. According to its analysis of MMF prices maintained even *prior* to the 2010 reforms, “Data from a sample of taxable money market funds covering one-quarter of U.S. taxable money market fund assets show that the average per-share market values for prime money market funds varied between \$1.002 and \$0.998 during the decade from 2000 to 2010.”⁷⁶

An analysis of more recent data submitted by the ICI to Congress demonstrates that the remarkable stability of MMF prices has continued under the 2010 reforms:

[U]sing publicly available data from Form N-MFP reports that require money market funds to disclose their underlying mark-to-market share price, without using amortized cost pricing, ICI calculated changes in prime fund share prices on a monthly basis for January 2011 to March 2012. Nearly all (96 percent) of the prime money market funds had an average absolute monthly change in their mark-to-market share prices of 1 basis point [(one hundredth of one penny per share)] or less and all had an average absolute monthly change of less than 2 basis points.⁷⁷

As these data demonstrate, the stable NAV using amortized cost closely tracks the shadow price (the “floating” value) using other methods of valuation. They are usually identical (even before rounding the NAV to the nearest cent) and only occasionally deviate from one another by plus or minus a few one-hundredths of a cent.⁷⁸ To put this in perspective, a deviation of a hundredth of one percent is equal to \$.10 on a thousand dollars worth of MMF shares. Unless the MMF is suddenly liquidated, even that small price deviation is not translated into actual losses, because the underlying portfolio investments mature in short order and are repaid at par, which returns the shadow price to \$1 per share. Due to the very high levels of liquid assets that MMFs are required to hold under amended Rule 2a-7, it is now even less likely that an MMF would need to sell portfolio assets before maturity to raise cash and recover less than par value. The enhanced liquidity requirements of amended Rule 2a-7 further support the

⁷⁶ Letter from ICI to SEC (Feb. 16, 2012).

⁷⁷ *Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 112th Cong. at 29-30 (Jun. 21, 2012) (testimony of Paul Schott Stevens, President, Investment Company Institute), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc73189c9c0 (citing the publicly available data from the Form N-MFPs MMFs are required to file each month with the SEC).

⁷⁸ ICI Research Report, *Pricing of U.S. Money Market Funds* (Jan. 2011).

economic validity of using amortized cost – they ensure that absent a credit event, no “first-mover advantage” will materialize.

At least two financial regulators represented on the Council recently have published statements acknowledging the effectiveness of amortized cost in tracking the shadow price using other methods of valuation. First, in the RiskFin Report the SEC staff analyzed the distribution of MMF shadow prices between 1994 and 2012 based on data from N-SAR filings. Except for two brief periods, Figure 16 of the Division’s report shows 95% of MMFs continuously maintained shadow NAVs of \$0.999 or greater. The two exceptions are the first half of 1994, when the Federal Reserve unexpectedly implemented a series of significant interest rate hikes, and the height of the financial crisis in September 2008. Neither of these events caused the shadow NAVs of these funds to fall below \$0.998.⁷⁹

Second, when permitting bank short-term investment funds to use amortized cost accounting and round share prices to nearest cent, the Comptroller of the Currency concluded, “[B]ecause . . . investments are limited to shorter-term assets and those assets generally are held to maturity, differences between the amortized cost and mark-to-market value of the assets will be rare, absent atypical market conditions or an impaired asset.”⁸⁰

(6) A floating NAV, with a mandated \$100.00 initial share price, would not be “consistent with the requirements that apply to all other mutual funds” but rather would be arbitrary and punitive, and would destroy MMFs as a product.

In its Release, the Council suggests that its proposal to require MMFs to float their NAVs and mark portfolio assets to market is “consistent with the requirements that apply to all other mutual funds.”⁸¹ But the Council also recommends that MMFs re-price their shares to an initial \$100.00 per share “to be more sensitive to fluctuations in the value of the portfolio’s underlying securities than under a \$1.00 per share price.”⁸² The latter is certainly *not* consistent with the requirements that apply to other mutual funds.⁸³ In fact, no current law or regulation requires an investment company under the Investment Company Act of 1940 to offer its shares at a

⁷⁹ Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* at 27-28 (Nov. 30, 2012), <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>.

⁸⁰ Short-Term Investment Funds, 77 Fed. Reg. 61230 (Oct. 9, 2012) (to be codified at 12 C.F.R. Part 9).

⁸¹ Release at 69466.

⁸² *Id.*

⁸³ This issue is discussed extensively in letter from Stephen Keen to the Council. Letter from Stephen A. Keen to the Financial Stability Oversight Council (Nov. 26, 2012), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0004>.

particular price. Other investment companies that value their shares their shares at \$10.00 do so by market custom, not as required by law or regulation. Rather, removing the pricing exemption provided by Rule 2a-7 would require MMFs to comply with Accounting Series Release No. 219, which states only that MMFs must calculate “current net asset value per share with an accuracy of one-tenth of one percent”⁸⁴

Although stating in its Release that its proposal would require MMFs to price shares in the same way other mutual funds do, the Council is in fact holding MMFs to an arbitrarily more stringent pricing standard than other types of funds. In fact, MMF shares fluctuate so little that the Council has had to concoct an abnormally high \$100.00 share price in order to show movement in the NAVs of the funds. To what end? What purpose is served, given that investors are already aware of the potential for fluctuations in MMF’s underlying NAVs? The only result of this arbitrary requirement would be to drive investors to alternative cash management products that are not burdened with an arbitrary pricing standard and do not impose on investors the tax, accounting, and operational burdens described below.

(7) A Floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate MMFs as a viable cash management tool by destroying their principal liquidity function.

Nearly every commenter who filed a letter with the SEC opposing the floating NAV wrote that forcing MMFs to abandon the stable NAV would eliminate the MMF as a viable cash management tool by destroying its principal liquidity function. These commenters include both users and issuers, state and local government officials, local and regional chambers of commerce, asset managers, and the industry groups that represent them. Many users, both institutional and individual, stated that MMFs, because of their stable NAV feature, are essential to their cash management strategies.⁸⁵

⁸⁴ Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Investment Company Act Release No. 9786, 42 Fed. Reg. 28999, 29001 (June 7, 1977).

⁸⁵ Letter from David Daniel to SEC (Aug. 21, 2012); Letter from Rick Fetterman to SEC (Aug. 15, 2012); Letter from Joe McNamara to SEC (Aug. 14, 2012); Letter from Rudy Mueller to SEC (Aug. 14, 2012); Letter from Hal Goldberg to SEC (Aug. 14, 2012); Letter from Denver Metro Chamber to SEC (July 20, 2012); Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Utah Association of Counties to SEC (Jun. 27, 2012); Letter from North Carolina Independent Colleges and Universities to SEC (Apr. 13, 2012); Letter from Association for Financial Professionals, Benefit Resource, Inc., Blue Cross Blue Shield of Massachusetts, CacheMatrix, Catholic Health Initiatives, California ISO, CareSource, Centerline Capital Group, Crawford & Company, Grass Valley USA LLC, Miami-Dade County Public Schools, Solix, Inc., University of Colorado – Treasurer’s Office, and WellCare Health Plans, Inc. to SEC (Apr. 4, 2012) (Letter from Association for Financial Professionals and 13 other organizations); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letters from American Public Power Association, Council of Development Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, International City/County Management Association, International Municipal Lawyers Association, National Association of Counties, National Association

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As a group of 14 local, state, and national public agency associations explained, MMFs “are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked.”⁸⁶ While similarly extolling the benefits of stable NAV funds, the New Hampshire College & University Council warned of the adverse consequences of requiring MMFs to shift to a floating NAV:

These funds have consistently proven to be a safe, efficient, and effective cash management tool. Requiring a floating NAV would have negative implications for the utilization of money market mutual funds, as investors would be forced to seek alternative products that are less regulated and provide less diversification. To that end, we are concerned a floating NAV would effectively eliminate money market mutual funds as a viable investment tool for public and private higher education institutions.⁸⁷

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of Health and Educational Facilities Finance Authorities, National Association of Local Housing Financing Agencies, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National League of Cities, U.S. Conference of Mayors to SEC (Mar. 8, 2012) (14 National, State and Local Entities); Letter from Greater Raleigh Chamber to SEC (Feb. 28, 2012 and Jan. 31, 2011); Letter from Bob Maddox to SEC (Feb. 7, 2012); Letter from New Hampshire College & University Council to SEC (Jan. 12, 2012); Letter from Washington State Treasurer to SEC (Nov. 15, 2011); Letter from New Jersey Association of Counties (Jul. 11, 2011); Letter from Greater Albuquerque Chamber of Commerce to SEC (Feb. 7, 2011); Letter from Florida Department of Financial Services to SEC (Feb. 3, 2011); Letter from Jacksonville Chamber to SEC (Jan. 31, 2011); Letter from Association of Commerce and Industry, New Mexico to SEC (Jan. 31, 2011); Letter from Providence Chamber of Commerce to SEC (Jan. 31, 2011); Letter from Greater Durham Chamber of Commerce to SEC (Jan. 31, 2011); Letter from New Mexico Association of Counties to SEC (Jan. 28, 2011); Letter from Florida Chamber of Commerce to SEC (Jan. 28, 2011); Letter from North Carolina Chamber of Commerce to SEC (Jan. 25, 2011); Letter from American Association of State Colleges and Universities to SEC (Jan. 21, 2011); Letter from Texas Municipal League to SEC (Jan. 21, 2011); Letter from Utah State Treasurer to SEC (Jan. 20, 2011); Letter from New Jersey Chamber of Commerce to SEC (Jan. 18, 2011); Letter from Northern Rhode Island Chamber of Commerce to SEC (Jan. 15, 2011); Letter from the Mayor of Salt Lake City, Utah to SEC (Jan. 13, 2011); Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010). *See also* Letter from Independent Directors Council & Mutual Fund Directors Forum to SEC (May 2, 2012); Letters from John D. Hawke, Jr. on behalf of Federated Investors (Mar. 19, 2012 and Dec. 15, 2011); Letter from SunGard Global Network to SEC (Mar. 16, 2012); Letter from DST Systems to SEC (Mar. 2, 2012); Letter from Cachematrix to SEC (Dec. 12, 2011); Letter from Fisch & Roiter to SEC (Dec. 2, 2011); Letter from Cachematrix to SEC (Apr. 29, 2011). *See also* Letter from 2254 individuals to SEC (Various dates).

⁸⁶ Letter from American Public Power Association, Council of Development Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, International City/County Management Association, International Municipal Lawyers Association, National Association of Counties, National Association of Health and Educational Facilities Finance Authorities, National Association of Local Housing Financing Agencies, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National League of Cities, U.S. Conference of Mayors to SEC (Mar. 8, 2012).

⁸⁷ Letter from New Hampshire College & University Council to SEC (Jan. 12, 2012).

The Council in its Release acknowledges that a wide range of entities use MMFs “for a variety of cash management and investment purposes,” and that certain types of users “may be unwilling or unable to conduct their cash management through an investment vehicle that does not offer a stable value.”⁸⁸ The Council states that removing the stable NAV of MMFs “would be a significant change for a multi-trillion dollar industry in which the stable \$1.00 share price has been a core feature” that “may reduce overall investor demand for MMFs, which would diminish the funds’ capacity to invest in the short-term securities of financial institutions, businesses, and governments, possibly impacting their costs of funding.” But, the Release simply claims “the ultimate long-term reaction to such a change is difficult to predict with any precision.”⁸⁹ It then declines to make any attempt to size the impact of eliminating MMFs as a cash management tool on the MMF users or long-term economic growth.

(8) A Floating NAV, for the sake of showing minute variations in value that cancel out over time, also would impose significant operational, accounting and tax burdens on users of MMFs and destroy their utility.

Although the Release acknowledges certain “operational costs,” “accounting impacts,” and “tax considerations” associated with requiring MMFs to adopt a floating NAV, the Council does so with little analysis and does not attempt to size their impact on users.⁹⁰ Further, the Council does not address the potential consequences of the migration of assets away from MMFs once they no longer exhibit the key features of operational, tax and accounting simplicity and efficiency. Given that these changes will make MMFs a substantially less attractive and more cumbersome product compared to other cash management alternatives, a shift of assets away from MMFs and into other cash management products is a likely outcome of the Council’s proposal.⁹¹ The Council’s failure to address these consequences in the Release is a significant oversight.

⁸⁸ Release at 69457, 69468.

⁸⁹ *Id.* at 69468.

⁹⁰ *Id.* at 69467-68.

⁹¹ Letter from Jonathan R. Macey to Financial Stability Oversight Council (Nov. 27, 2012), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0010> (“A stable \$1.00 NAV provides convenience and simplicity to investors and managers alike, boosting MMFs’ efficiency with regard to tax, accounting, and recordkeeping. Unlike other mutual funds, MMFs are used primarily as a cash management tool, which means that large transactions flow through them every day. Without a stable NAV, many investors will bolt for other cash management entities in order to minimize tax, accounting, and recordkeeping burdens.”) (Macey 2012).

Users would lose key operational features only available with a stable NAV fund. A number of features MMFs currently offer would not be possible with a floating NAV. As the investment advisor Invesco stated, “a stable share price simplifies cash management policies for investors and has made it possible for broker-dealers to make available to clients a wide range of features including ATM access, check writing, and ACH and Fedwire transfers. These features are generally provided only for accounts with a stable NAV.”⁹² For example, according to ICI, MMFs “typically offer retail investors same-day settlement on shares redeemed via ‘wire transfers’ (where redemption proceeds are wired to an investor’s bank account via fedwire), whereas bond funds typically offer only next day settlement for wire transfers.”⁹³

If MMFs are required to float their NAV, all of these systems would have to undergo significant retooling of accounting, trading, and settlement systems to accommodate the possibility of a minute change in a fund’s NAV. That cost, according to many commenters, would be substantial.⁹⁴ Cachematrix, a software provider of online institutional trading systems for banks and financial institutions, stated,

[A]n entire industry has programmed accounting, trading and settlement systems based on a stable share price. The cost for each bank to retool their sub-accounting systems to accommodate a fluctuating NAV could be in the millions of dollars. This does not take into account the costs that each bank would then pass on to the thousands of corporations that use money market trading systems.⁹⁵

As an example, the stable share price of MMFs currently simplifies corporate treasury operations. Treasurers know the \$1.00 NAV in advance, and, as Vanguard pointed out, that amount often is hard-coded into companies’ accounting and cash-tracking systems. Treasurers can then use an MMF to fund transactions over the course of the day.⁹⁶ Bank sweep account systems with an option to invest in MMFs often do the same.⁹⁷ As the American Bankers Association described the effect of the floating NAV on these operations,

⁹² Letter from Invesco to SEC (Sept. 4, 2009).

⁹³ Letter from ICI to SEC (May 25, 2012).

⁹⁴ Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letter from Association for Financial Professionals and 13 other organizations to SEC (Apr. 4, 2012); Letter from John D. Hawke, Jr. to SEC (Mar. 19, 2012); Letter from ICI to SEC (Feb. 16, 2012); Letter from Cachematrix to SEC (Dec. 12, 2011); Letter from Invesco to SEC (Sept. 4, 2009).

⁹⁵ Letter from Cachematrix to SEC (Dec. 12, 2011).

⁹⁶ Letter from Vanguard to SEC (Jan. 10, 2011). *See also* Money Market Working Group, Investment Company Institute, *Report of the Money Market Working Group* at 109-10 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmwg.pdf.

⁹⁷ *Id.*

If the NAV floats, service providers would need to request that shares be redeemed prior to the close of the market (when the fund is priced), but the number of shares needed to be redeemed to fund the transaction would be uncertain. Estimating the number of shares needed to be redeemed will result in an end-of-day excess or shortfall. This leads to a potentially significant difficulty in calculating the end-of-day values. By contrast, a stable NAV provides certainty for funding the day's transactions. Similarly, municipal bond issuers who, under their indentures, are required to maintain reserves at a specified level can be assured that they will not have to advance cash to satisfy that reserve level because funds invested in MMFs will not fluctuate.⁹⁸

In the case of same-day settlement by floating NAV MMFs, retooling would require major changes to the way pricing services and the Fedwire system operate, and ultimately may not be feasible. The Release points to a single floating NAV fund that offers same-day settlement of wire transfers, suggesting that MMFs need only "modify systems" to allow same-day settlement of redemption transactions. In fact, this change would require, among other things, a substantial overhaul of operations by third party pricing services. The earliest the pricing services will transmit valuations for money market instruments is after 4 p.m. EST. Currently, pricing services gather valuation information from market participants throughout the morning and early afternoon of each trading day to establish valuations as of 3 p.m. EST. The services then input this information into their valuation system and quality check the results, a process which itself takes over an hour. There is no guarantee that pricing services would be able to collapse this day-long process to a fraction of the time to accommodate the demand for intra-day pricing of money market instruments. Further, it should be noted that it took several years to convince pricing services to provide valuations as of the close of the New York Stock Exchange (in addition to 3 p.m. valuations), so pricing services may resist efforts to add more valuation times.

Additionally, in the absence of more frequent valuation to permit a fund to pay redemptions, a floating NAV MMF would be forced to send all wire transfer redemptions late in the afternoon, towards the close of the Fedwire, rather than throughout the day. This would impede the efforts of wire transfer recipients attempting to rewire redemption proceeds, and could greatly increase the volume of late day transfers over the Fedwire system, potentially beyond the system's capabilities. Having a single NAV calculation per day in a floating NAV fund would significantly inhibit investors' access to cash and would further decrease the utility of MMFs overall.

⁹⁸ Letter from American Bankers Association to SEC (Jan. 10, 2011). *See also* Letter from American Bankers Association to SEC (Sept. 8, 2009).

*A range of business functions would require costly overhaul.*⁹⁹ A floating NAV would disrupt numerous business applications that run on automated accounting and settlement systems designed for same-day settlement and rely upon a stable NAV. The effect on business and public accounting processes would be far-reaching and at a minimum would include: trust accounting systems at bank trust departments; corporate payroll processing, corporate and institutional operating cash balances; federal, state and local government cash balances; municipal bond trustee cash management systems; consumer receivable securitization cash processing; escrow processing; custody cash balances and investment manager cash balances; 401(k) and 403(b) employee benefit plan processing; broker-dealer and futures dealer customer cash balances; and cash management type accounts at banks and broker-dealers. These processes would all have to undergo significant and costly retooling in the absence of stable NAV MMFs. As discussed in Arnold & Porter's March 19, 2012 letter to the SEC, these specialized uses likely account for well over half of total MMF assets.¹⁰⁰

A floating NAV would create an additional accounting burden for users. With a stable \$1.00 NAV, MMFs currently qualify as "cash equivalents" under accounting standards.¹⁰¹ Because the NAV is fixed at \$1.00 per share (absent an event that drives the fund's shadow price below \$0.995 or above \$1.005), there is no need for investors to recognize gains or losses for financial accounting purposes. With a floating NAV, different accounting standards would apply. Users would be required to reclassify their holdings of MMFs, likely as Available-for-Sale securities, which must be held at fair value.¹⁰² The ICI explained the consequences of this accounting treatment of floating NAV MMFs:

⁹⁹ The impact on these specialized uses is discussed in detail in the Appendix.

¹⁰⁰ Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012).

¹⁰¹ Letter from American Benefits Council, American Society of Pension Professionals & Actuaries, The ERISA Industry Committee, Financial Services Institute, Investment Company Institute, National Association of Insurance and Financial Advisors, National Telecommunications Cooperative Association, Plan Sponsor Council of America, Securities Industry and Financial Markets Association, The Small Business Council of America, The Society for Human Resource Management, The Spark Institute, and the U.S. Chamber of Commerce to SEC (Aug. 21, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letter from AFP to SEC (Jan. 10, 2011); Letter from Invesco to SEC (Sept. 4, 2009); Money Market Working Group, Investment Company Institute, *Report of the Money Market Working Group* at 107-08 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmwg.pdf. See Statement of Cash Flows, Statement on Fin. Accounting Standards No. 95 (Fin. Accounting Standards Bd. 1987) ("[C]ash equivalents are short-term, highly liquid investments that are both: readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations).").

¹⁰² See Accounting for Certain Investments in Debt and Equity Securities, Statement on Fin. Accounting Standards No. 115 (Fin. Accounting Standards Bd. 1993).

Accounting standards setters aren't likely to grant cash-equivalent status to floating-value money market funds, which means institutions would have to track and reflect any fluctuations in shares' values on their books. Individuals and many institutional investors would have to regard every money market fund transaction as a potentially taxable event, and funds would have to build reporting systems to track gains and losses in the pennies. In short, the fact that money market funds could float means that investors, funds, and intermediaries have to be prepared that they *will* float. Changing the nature of these funds from stable to floating would force funds and investors to adapt, build new accounting systems, and overhaul their cash management—whether the funds' value actually fluctuates or not. The result would be heavy costs.¹⁰³

The ICI described the consequences specifically for corporate users as follows:

Corporate treasurers would also have to track the costs of their shares and determine how to match purchases and redemptions for purposes of calculating gains and losses for accounting and tax purposes. Moreover, under the new treatment, companies could not enter and reconcile cash transactions nor calculate the precise amount of operating cash on hand until the money market fund's NAV became known at the end of the day, creating additional disincentives for corporations to use money market funds for cash management purposes.¹⁰⁴

Over two thousand users have written to the SEC to warn that the floating NAV would create an “accounting nightmare” for them as well.¹⁰⁵

A floating NAV would create an additional tax burden for users. The stable NAV currently allows an MMF to distribute all returns to shareholders as income, which greatly reduces tax and accounting burdens for both retail and institutional investors. As several commenters have explained,¹⁰⁶ the stable NAV also relieves investors of having to consider the timing of purchases and sales of shares of MMFs, as they must with variable NAV funds, to

¹⁰³ Letter from ICI to SEC (Apr. 13, 2012).

¹⁰⁴ Money Market Working Group, Investment Company Institute, *Report of the Money Market Working Group* at 107-08 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmmwg.pdf.

¹⁰⁵ Letter from 2256 individuals to SEC (Various dates); Letter from David Daniel to SEC (Aug. 21, 2012); Letter from Rick Fetterman to SEC (Aug. 15, 2012); Letter from Joe McNamara to SEC (Aug. 14, 2012); Letter from Rudy Mueller to SEC (Aug. 14, 2012); Letter from Hal Goldberg to SEC (Aug. 14, 2012).

¹⁰⁶ Letter from Vanguard to SEC (June 4, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letter from ICI to SEC (Jan. 10, 2011); Letter from Voyageur Asset Management to SEC (Sept. 8, 2009). *See also* Money Market Working Group, Investment Company Institute, *Report of the Money Market Working Group* at 107-08 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmmwg.pdf.

ensure compliance with the so-called “wash sale rule.”¹⁰⁷ MMFs transactions currently do not implicate the rule due to the funds’ stable NAV.

As these commenters point out, if MMFs were forced to adopt a floating NAV, investors would need to track the amount and timing of all purchases and sales, capital gains and losses, and share cost basis to ensure compliance with the rule. Investors already face these burdens in connection with investments in long-term mutual funds, but most investors do not trade in and out of long-term mutual funds with the same frequency as many do with MMFs. Moreover, as the ICI explained, often the investments in long-term mutual funds are made within tax-advantaged accounts (*e.g.*, 401(k) plans), where such issues do not arise.¹⁰⁸ Thus, if MMFs had a floating NAV, and all share sales become tax-reportable events, the result would be to magnify greatly the tax and recordkeeping burdens of investors who use their MMFs for daily cash management purposes, all for the purpose of tracking fluctuations amounting to fractions of a cent.¹⁰⁹

To its credit, the Release does appear to acknowledge the tax burden a floating NAV MMF would place on all MMF users.¹¹⁰ The Release recognizes that

because each redemption could produce a gain or loss for the shareholder, it would be necessary to determine for every redemption—(i) which share was redeemed, (ii) the tax basis (generally, the acquisition cost) of that share, and (iii) whether the holding period of that share was long term or short term. In addition, if a shareholder purchases shares in an MMF within thirty days before or after a redemption, the Tax Code’s “wash sale” rules would limit the extent to which the shareholder could deduct any loss realized on the redemption.¹¹¹

¹⁰⁷ Under this IRS rule, investors are prohibited from recognizing a loss on the sale of a security if they purchase a replacement security within the next 30 days (or for that matter, if the investor has purchased a replacement security in the 30 days prior to the sale that triggers the loss). Instead, the loss is added to the basis of the replacement security. The holding period for the sold stock is also added to the holding period of the replacement stock. 26 C.F.R. § 1.1091-1.

¹⁰⁸ Letter from ICI to SEC (Jan. 10, 2011).

¹⁰⁹ Multiple commenters warned that a floating NAV would cause each MMF sale a tax-reportable event. Letter from Donald Brundrett to SEC (Mar. 24, 2012); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letter from SunGard Global Network to SEC (Mar. 16, 2012); Letter from Washington State Treasurer to SEC (Nov. 15, 2011); Letter from Financial Services Institute to SEC (Jan. 10, 2011); Letter from FSC Securities Corporation to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from Wells Fargo Funds Management to SEC (Jan. 10, 2011); Letter from Treasury Strategies to SEC (Jan. 10, 2011); Letter from Royal Alliance Associates to SEC (Jan. 7, 2011); Letter from Letter from SagePoint Financial to SEC (Jan. 7, 2011). *See also* PWG Report at 21 (noting the “loss of accounting convenience and tax efficiencies” resulting from the move to a floating NAV).

¹¹⁰ Release at 69467.

¹¹¹ *Id.*

The Council purports to dismiss the burden this altered tax treatment would place on users by suggesting that the Treasury Department and the IRS “will consider” various forms of administrative relief for MMF users and sponsors.¹¹² It does not include any proposals to recommend such relief to the Treasury Department, and certainly the Council makes no guarantee that any such relief will be forthcoming. Congress surely created a multi-agency council to coordinate such proposed reforms more efficiently than the Council has in the Release.

(9) A Floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

Many commenters warned that a floating NAV would preclude certain investors, who are permitted to invest only in stable NAV funds, from investing in MMFs.¹¹³ The Council in its Release succinctly states the problem:

Some MMF investors may be unwilling or unable to conduct their cash management through an investment vehicle that does not offer a stable value. Some institutional investors may be prohibited by board approved guidelines or firm policies from conducting cash management using MMFs that do not have a stable NAV and may be unwilling to change these policies. Other investors, such as some state and local governments, may be subject to statutory or regulatory requirements that permit them to invest certain assets only in funds that seek to maintain a stable net asset value.¹¹⁴

¹¹² *Id.*

¹¹³ Letter from Denver Metro Chamber to SEC (July 20, 2012); Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Indiana County Treasurers Association to SEC (Apr. 25, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letters from ICI to SEC (Apr. 19, 2012 and Jan. 10, 2011); Letter from Association for Financial Professionals and 13 other organizations; Letter from Metropolitan Mayors Caucus to SEC (Mar. 28, 2012); Letter from 14 National, State and Local Entities to SEC (Mar. 8, 2012); Letter from Texas Association of Business to SEC (Feb. 27, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with the SEC (Dec. 15, 2011); Letter from Fisch & Roiter to SEC (Dec. 2, 2011); Letter from the Financial Services Roundtable to SEC (Jun. 30, 2011); Letter from Colorado County Treasurers' Association to SEC (Jun. 21, 2011); Letter from Jacksonville Chamber to SEC (Jan. 31, 2011); Letter from Greater Boston Chamber of Commerce to SEC (Jan. 28, 2011); Letter from Texas Municipal League to SEC (Jan. 21, 2011); Letter from 12 National, State and Local Entities to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from FSC Securities Corporation to SEC (Jan. 10, 2011); Letter from Royal Alliance Associates to SEC (Jan. 7, 2011); Letter from SagePoint Financial to SEC (Jan. 7, 2011); Letter from Port of Houston Authority to SEC (Jan. 6, 2011); Letter from Tom Welch to SEC (Dec. 26, 2010).

¹¹⁴ Release at 69468. See also Letter from American Bankers Association to Financial Stability Oversight Council (Jan. 18, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0062> (“Although MMFs are now popular with both retail and institutional investors alike, trust departments in banks of all sizes still make large

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Undertaking to size the potential disruption to institutional investors (who include Fortune 500 corporations, states, localities, and major fund managers), Treasury Strategies, a treasury management consulting firm, found that 33% of corporate, government, and other institutional users surveyed currently are subject to investment policies, laws, or other restrictions prohibiting them from investing in floating NAV products.¹¹⁵

A joint letter from twelve national, state and local entities, including the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, and the U.S. Conference of Mayors, elaborated on the potential disruption:

[M]any governments have specific policies that mandate stable values, and money market funds are to be used for their short-term investments due to the fixed NAV. MMMFs are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked. If the SEC were to adopt a floating NAV for MMMFs, the organizations [co-signing this letter] expect that many, if not all, of their members would divest a significant percentage of their MMMFs¹¹⁶

(10) A Floating NAV, because of the operational burdens, costs, and other impediments, would substantially shrink the assets of MMFs.

The impact of the burdens, costs and other impediments of a floating NAV in shrinking the assets of MMFs is borne out in surveys of users:

- Fidelity Investments, the largest MMF manager in the United States, surveyed both its institutional and retail MMF investors. Of retail investors surveyed, 74% stated a preference to keep the stable NAV, and 47% said they would decrease or discontinue use

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investments in MMFs to meet their fiduciary obligation to make trust assets productive. . . . It is highly likely that bank trust departments will no longer invest in MMFs if they are not able to maintain a stable NAV.”); PWG Report at 21.

¹¹⁵ Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies).

¹¹⁶ Letter from American Public Power Association, Council of Development Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, International City/County Managers Association International Municipal Lawyers Association, National Association of Counties, National Association of Local Housing Financing Agencies, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National League of Cities and U.S. Conference of Mayors to SEC (Jan. 10, 2011) (12 National, State and Local Entities).

of MMFs if they adopted a floating NAV. Of institutional investors surveyed, 89% stated a preference to keep the stable NAV, while 57% said they would decrease or discontinue use of MMFs if they adopted a floating NAV.¹¹⁷

- In a wide ranging survey of institutional MMF users commissioned by the ICI, Treasury Strategies found that forcing MMFs to adopt floating NAVs would drive a large portion of current users out of the MMF market. Of the more than 200 corporate, government, and other institutional users of MMFs surveyed, 79% said they would decrease or stop using MMFs if the fund had a floating NAV. Of that number, 44% said they would stop using MMFs entirely, and a full 72% said they would decrease use by more than half.¹¹⁸

Alarmingly, Treasury Strategies estimated that as 61% of the MMF assets currently held by corporate, government and institutional investors would flow out of MMFs if the funds were required to adopt a floating NAV.¹¹⁹ Despite the potential for large scale redemptions upon the adoption of a floating NAV for MMFs, which in some cases will be a legal or prudential requirement, the Council notes only that it “may take time for investors and short-term funding markets to adjust to such a change, and the ultimate long-term reaction to such a change is difficult to predict with any precision.”¹²⁰

(11) A Floating NAV would therefore contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.

Dozens of commenters stated that forcing MMFs to adopt a floating NAV, thereby eliminating or reducing the utility of MMFs for many users, would contract the market for, and raise the costs of, short-term public and private debt financing.¹²¹ Some of these commenters

¹¹⁷ Letter from Fidelity Investments to SEC (Feb. 3, 2012).

¹¹⁸ Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies).

¹¹⁹ *Id.*

¹²⁰ Release at 69468.

¹²¹ Letter from 33 Members of Congress to SEC (May 1, 2012), http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658511.pdf (“Letter from 33 Members of Congress to SEC”). This letter, from 33 Members of the House of Representatives, is particularly significant in light of the experiences of its various signatories, all of whom served as officials of state or local governments and in the letter express their views of the importance of MMFs to such entities. The following Members of Congress signed the letter: Congressman Richard E. Neal (D-MA), Congressman Tom Reed (R-NY), Congressman James P. Moran (D-VA), Congressman Frank C. Guinta (R-NH), Congressman Gerald E. Connolly (D-VA), Congressman David Schweikert (R-AZ), Congressman Michael E. Capuano (D-MA), Congressman Steve Chabot (R-OH), Congressman Gary Peters (D-MI), Congressman Aaron Schock (R-IL), Congressman Jim Himes (D-CT), Congressman Phil Roe, MD (R-TN), Congressman David Cicilline (D-RI), Congressman Mike Coffman (R-CO), Congressman Henry

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Cuellar (D-TX), Congresswoman Lynn Jenkins (R-KS), Congressman John Carney (D-DE), Congresswoman Cynthia Lummis (R-WY), Congressman Brian Higgins (D-NY), Congressman James B. Renacci (R-OH), Congressman Martin Heinrich (D-NM), Congressman Adam Kinzinger (R-IL), Congressman Albio Sires (D-NJ), Congressman Kenny Marchant (R-TX), Congressman Bill Pascrell (D-NJ), Congressman Steve Stivers (R-OH), Congressman John Larson (D-CT), Congressman Bill Posey (R-FL), Congressman Sam Farr (D-CA), Congressman Jeff Fortenberry (R-NE), Congressman Todd Rokita (R-IN), Congressman Mike Fitzpatrick (D-PA), and Congressman Mike Kelly (R-PA). *See also* Letter from Michael B. Hancock, Mayor of Denver, to SEC (July 25, 2012); Letter from Stephanie Rawlings-Blake, Mayor of Baltimore, to SEC (July 20, 2012); Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Utah Association of Counties to SEC (Jun. 27, 2012); Letter from New York State Association of Counties to SEC (Jun. 20, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letter from Association for Financial Professionals and 13 other organizations to SEC (Apr. 4, 2012); Letter from Mutual Fund Directors Forum to SEC (Mar. 29, 2012); Letter from Metropolitan Mayors Caucus to SEC (Mar. 28, 2012); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letter from 14 National, State and Local Entities to SEC (Mar. 8, 2012); Letter from Texas Association of Business to SEC (Feb. 27, 2012); Letter from Northern Kentucky Chamber of Commerce to SEC (Jan. 20, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with SEC (Dec. 15, 2011); Letter from New Jersey Association of Counties (Jul. 11, 2011); Letter from the Financial Services Roundtable to SEC (Jun. 30, 2011); Letters from Utah League of Cities and Towns to SEC (May 10, 2012 and Jan. 11, 2011); Letter from Greater Albuquerque Chamber of Commerce to SEC (Feb. 7, 2011); Letter from New Jersey Business & Industry Association to SEC (Feb. 7, 2011); Letter from Florida Department of Financial Services to SEC (Feb. 3, 2011); Letter from Jacksonville Chamber to SEC (Jan. 31, 2011); Letter from Greater Raleigh Chamber to SEC (Jan. 31, 2011); Letter from Association of Commerce and Industry, New Mexico to SEC (Jan. 31, 2011); Letter from Providence Chamber of Commerce to SEC (Jan. 31, 2011); Letter from Greater Durham Chamber of Commerce to SEC (Jan. 31, 2011); Letter from New Mexico Association of Counties to SEC (Jan. 28, 2011); Letter from Greater Boston Chamber of Commerce to SEC (Jan. 28, 2011); Letter from Florida Chamber of Commerce to SEC (Jan. 28, 2011); Letter from Rhode Island Economic Development Corporation to SEC (Jan. 26, 2011); Letter from North Carolina Chamber of Commerce to SEC (Jan. 25, 2011); Letter from American Association of State Colleges and Universities to SEC (Jan. 21, 2011); Letter from Texas Municipal League to SEC (Jan. 21, 2011); Letter from New Jersey Chamber of Commerce (Jan. 18, 2011); Letter from Northern Rhode Island Chamber of Commerce to SEC (Jan. 15, 2011); Letter from New York Business Council to SEC (Jan. 14, 2011); Letter from the Mayor of Salt Lake City, Utah to SEC (Jan. 13, 2011); Letter from Cincinnati Chamber to SEC (Jan. 13, 2011); Letter from J.P. Morgan Asset Management to SEC (Jan. 10, 2011); Letter from Kentucky State Treasurer to SEC (Jan. 10, 2011); Letter from 12 National, State and Local Entities to SEC (Jan. 10, 2011); Letter from Agilent Technologies, Inc., Air Products & Chemicals, Inc., Association for Financial Professionals, The Boeing Company, Cadence Design Systems, CVS Caremark Corporation, Devon Energy, Dominion Resources, Inc., Eastman Chemical Company, Eli Lilly & Company, Financial Executives International's Committee on Corporate Treasury, FMC Corporation, Institutional Cash Distributors, Kentucky Chamber of Commerce, Kraft Foods Global, Inc., National Association of Corporate Treasurers, New Hampshire Business and Industry Association, Nissan North America Inc., Pacific Gas and Electric Company, Safeway Inc., Weatherford International, Ltd., U.S. Chamber of Commerce to SEC (Jan. 10, 2011) (Letter from 22 Issuers and Associations); Letter from FSC Securities Corporation to SEC (Jan. 10, 2011); Letter from SIFMA to SEC (Jan. 10, 2011); Letter from Associated Industries of Florida to SEC (Jan. 10, 2011); Letter from Invesco Advisors to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from Kentucky Chamber of Commerce to SEC (Jan. 10, 2011); Letter from Dallas Regional Chamber to SEC (Jan. 10, 2011); Letter from Professor Jonathan Macey to SEC (Jan. 8, 2011); Letter from Royal Alliance Associates to SEC (Jan. 7, 2011); Letter from SagePoint Financial to SEC (Jan. 7, 2011); Letter from Cincinnati/Northern Kentucky International Airport to SEC (Jan. 7, 2011); Letter from Port of Houston Authority to SEC (Jan. 6, 2011); Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010).

noted that MMFs hold almost 40% of outstanding commercial paper, roughly two-thirds of short-term state and local government debt, and significant portions of outstanding short-term Treasury and federal agency securities.¹²² In addition, corporate and other institutional investors may also decide to invest directly in money market instruments, thus concentrating their risk and necessitating an increase in in-house expertise.

A letter co-signed by 22 diverse companies and organizations, representing a broad range of industries and entities that rely on MMFs to support their capital raising and investment needs by purchasing their commercial paper, warned that:

American business will lose one of its most important sources of short-term funding if money market funds are forced to abandon their stable per-share value, whether directly or indirectly With such a change, the expected flight of investors from these funds will severely impair the ability of companies to raise capital in the U.S. and undermine efforts to strengthen the American economy.

. . .

There are no immediate substitutes for money market funds in this financing role. Bank lending cannot fill this funding gap unless banks raise substantial new capital. Unregulated private pools might see an opportunity to expand, but encouraging investors to migrate to these vehicles hardly seems consistent with efforts to reduce risk, increase transparency, and ensure greater market stability. Mandating a floating NAV would make short-term financing for American business less efficient and far more costly, ensuring a severe setback for an economy emerging from recession.¹²³

A letter signed by 33 Members of Congress who are all former state and local officials further stated, “Any reduction in demand for money market funds would reduce demand for the securities issued by state and local governments and purchased by Money Funds. As a result, states and municipalities would be deprived of a critical funding source and would be faced with increasing debt issuance costs.”¹²⁴ The PWG Report acknowledged that a floating NAV “might

¹²² This data originally appeared in the PWG Report at 7.

¹²³ Letter from Agilent Technologies, Inc., Air Products & Chemicals, Inc., Association for Financial Professionals, The Boeing Company, Cadence Design Systems, CVS Caremark Corporation, Devon Energy, Dominion Resources, Inc., Eastman Chemical Company, Eli Lilly & Company, Financial Executives International's Committee on Corporate Treasury, FMC Corporation, Institutional Cash Distributors, Kentucky Chamber of Commerce, Kraft Foods Global, Inc., National Association of Corporate Treasurers, New Hampshire Business and Industry Association, Nissan North America Inc., Pacific Gas and Electric Company, Safeway Inc., Weatherford International, Ltd., U.S. Chamber of Commerce (Jan. 10, 2011) (“Letter from 22 Issuers and Associations to SEC”).

¹²⁴ Letter from 33 Members of Congress to SEC (May 1, 2012).

reduce investor demand for MMFs and thus diminish their capacity to supply credit to businesses, financial institutions, state and local governments, and other borrowers who obtain financing in short-term debt markets.”¹²⁵ Fidelity Investments estimated that for municipal issuers, the amount of annual interest paid by these entities to fund their operations would increase by billions of dollars if MMFs ceased to be significant purchasers, and that the federal government similarly would have to pay billions more in annual interest to finance its short-term debt.¹²⁶

Further, a range of MMF users and industry participants have warned that the very process of switching to a floating NAV would destabilize the short-term credit markets¹²⁷ and create volatility.¹²⁸ The Council even acknowledges this point in the Release, stating that it “may take time for investors and short-term credit funding markets to adjust” to a floating NAV, and that “if the transition to the new regulatory regime prompted investors to redeem suddenly and substantially, the transition itself could create financial instability.” The Council then reasons that “[a] longer transition period and the grandfathering of existing fund shareholdings are designed to lessen this risk.”¹²⁹ But as discussed above, more than 50% of the assets held in MMFs are likely to turnover in as little as a month.¹³⁰ As a result, a transition period structured as the Council recommends will prove ineffectual in stopping the sudden and substantial redemption of MMF assets that may occur should MMFs be required to adopt a floating NAV.

Given the body of evidence submitted by commenters on this issue,¹³¹ and the fact that the Council cites the importance of MMFs to short-term credit markets no less than a dozen

¹²⁵ PWG Report at 21.

¹²⁶ Letter from Fidelity Investments to SEC (Jan. 10, 2011).

¹²⁷ Letter from Cachematrix to SEC (Dec. 12, 2011); Letter from ICI to SEC (Jan. 10, 2011); Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010); Letter from Invesco to SEC (Sept. 4, 2009).

¹²⁸ See, e.g., Letter from American Association of State Colleges and Universities to SEC (Jan. 21, 2011); Letter from ICI to SEC (Jan. 10, 2011).

¹²⁹ Release at 69468.

¹³⁰ 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). Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012) (describing the various specialized uses of MMFs that require daily liquidity); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012) (supplying estimates of the amount of assets held for those specialized purposes).

¹³¹ The Release briefly acknowledges but does not attempt to size these concerns. Release at 69468, n.81 (“Moving to a floating NAV may cause the MMF industry’s AUM to contract . . . which would diminish the funds’ capacity to invest in the short-term securities of financial institutions, businesses, and governments, possible impacting their costs of funding. . . . In addition, if the transition to the new regulatory regime prompted investors to redeem suddenly and substantially, the transition itself could create financial instability.”).

times throughout the Release, the Council's failure to credibly account for these impacts is astonishing. The Council, in addition to statutory requirements compelling it to consider the costs to long-term economic growth,¹³² is subject to executive orders by the current and former administrations to undertake rigorous cost-benefit analyses when engaging in major regulatory actions.¹³³ Any recommendations to the SEC also must account for the SEC's own statutory requirements to consider efficiency, competition, and capital formation.¹³⁴ The Council not only has failed to assess the costs, it has no compelling data suggesting any benefits from forcing MMFs to move to a floating NAV. In fact, it has no evidence at all other than speculation regarding the misperceptions of the nature of MMFs as an investment product, which has been refuted by survey information.¹³⁵

(12) A floating NAV would force current MMF users to less regulated and less transparent products.

Commenters, including current and former state and local government officials, warned that forcing MMFs to move to a floating NAV would leave resource-strapped public treasurers without the safely managed investment option of MMFs.¹³⁶ One group of fourteen national, state

¹³² Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 120(b)(2)(A); 12 U.S.C. § 5330(b)(2)(A) ("Dodd-Frank").

¹³³ See Exec. Order No. 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011) (reaffirming Exec. Order 12866, 58 Fed. Reg. 51735 (Oct. 4, 1993)) (EO 13563). EO 13563 does not apply to "independent regulatory agencies" as defined by 44 U.S.C. § 3502(5), which includes agencies such as the SEC, FRB, OCC, FDIC, and CFTC – although they are encouraged to follow it. The Council is not a listed agency under § 3502(5) and therefore is covered by EO 13563. Indeed, the Council has referenced EO 13563's standards in its rulemaking. See *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 76 Fed. Reg. 64264, 64272 (proposed Oct. 18, 2011) (referencing Executive Orders 12866 and 13563 in the Council's rule release). The SEC also is subject to mandatory internal guidance requiring it to consider the economic consequences of any rulemaking. Division of Risk, Strategy, and Financial Innovation and Office of General Counsel, Securities & Exchange Commission, *Current Guidance on Economic Analysis in SEC Rulemakings* (Mar. 16, 2012).

¹³⁴ See National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, § 106. The National Securities Market Improvement Act of 1996 added amendments to each of the major Federal Securities Laws (including the Investment Company Act) requiring the SEC to consider efficiency, competition, and capital formation whenever it is engaged in rulemaking that requires the agency to consider or determine whether an action is necessary or appropriate in the public interest. See Investment Company Act of 1940, § 2, 15 U.S.C. § 80a-2.

¹³⁵ See Letter from Fidelity Investments to SEC (Feb. 3, 2012) (citing survey data of retail and institutional investors).

¹³⁶ Letter from 33 Members of Congress to SEC (May 1, 2012); Letter from Indiana County Treasurers Association to SEC (Apr. 25, 2012); Letter from Metropolitan Mayors Caucus to SEC (Mar. 28, 2012); Letter from American Public Power Association, Council of Development Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, International City/County Management Association, International Municipal Lawyers Association, National Association of Counties, National Association of Health and Educational Facilities Finance Authorities, National Association of Local Housing Financing Agencies, National

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and local entities, representing thousands of municipalities, agencies, and officials throughout the U.S. warned that if the SEC required MMFs to float their NAVs, it would force many of their members to look at “competing products that could be more susceptible to market conditions, more difficult to account for and manage, and may pose market risk. That would contrast sharply with the SEC’s goals, particularly since many of those competing products don’t provide investors with the same transparency and comprehensive regulatory protections as MMMFs.”¹³⁷

Numerous additional commenters warned that a floating NAV for MMFs would motivate investors to shift assets to riskier or unregulated cash-management vehicles once MMFs no longer meet the liquidity requirements of institutional and retail investors using MMFs for their short-term cash management needs.¹³⁸ A survey of recent scholarship by three finance and economics professors found that many criticized the adoption of the floating NAV as likely to “push many—particularly institutional investors—to move their money into less regulated sectors of the market.”¹³⁹ The Kentucky Chamber of Commerce, representing over 2,000 businesses and 250,000 workers, noted that a regulatory change that would drive investors to less-regulated

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Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National League of Cities, U.S. Conference of Mayors to SEC (Mar. 8, 2012) (“Letter from 14 National, State and Local Entities to SEC”); Letter from Washington State Treasurer to SEC (Nov. 15, 2011).

¹³⁷ Letter from 14 National State and Local Entities to SEC (Mar. 8, 2012).

¹³⁸ Letter from Michael B. Hancock, Mayor of Denver, to SEC (July 25, 2012); Letter from Stephanie Rawlings-Blake, Mayor of Baltimore, to SEC (July 20, 2012); Letter from New York State Association of Counties to SEC (Jun. 20, 2012); Letters from Vanguard to SEC (Jun. 4, 2012 and Jan. 10, 2011); Letter from Charles Schwab to IOSCO, filed with SEC (May 31, 2012); Letter from Invesco to IOSCO, filed with SEC (May 25, 2012); Letter from Independent Directors Council & Mutual Fund Directors Forum to SEC (May 2, 2012); Letter from 33 Members of Congress to SEC (May 1, 2012); Letter from Association for Financial Professionals and 13 other organizations to SEC (Apr. 4, 2012); Letters from Mutual Fund Directors Forum to SEC (Mar. 29, 2012 and Jan. 10, 2011); Letter from Texas Association of Business to SEC (Feb. 27, 2012); Letter from State Street Corporation to SEC (Feb. 24, 2012); Letter from ICI to SEC (Feb. 16, 2012); Letter from Northern Kentucky Chamber of Commerce to SEC (Jan. 20, 2012); Letter from the Financial Services Roundtable to SEC (Jun. 30, 2011); Letter from New Jersey Business & Industry Association to SEC (Feb. 7, 2011); Letter from New Hampshire College and University Council to SEC (Jan. 21, 2011); Letter from American Association of State Colleges and Universities to SEC (Jan. 21, 2011); Letter from New York Business Council to SEC (Jan. 14, 2011); Letter from Financial Services Institute to SEC (Jan. 10, 2011); Letter from J.P. Morgan Asset Management to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from European Fund and Asset Management Association to SEC (Jan. 10, 2011); Letter from SIFMA to SEC (Jan. 10, 2011); Letter from SVB Financial Group to SEC (Jan. 10, 2011); Letter from Kentucky State Treasurer to SEC (Jan. 10, 2011); Letter from Independent Directors Council to SEC (Jan. 10, 2011); Letter from Invesco Advisors to SEC (Jan. 10, 2011); Letter from Wells Fargo Funds Management to SEC (Jan. 10, 2011); Letter from Goldman Sachs Asset Management (Jan. 10, 2011); Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010).

¹³⁹ 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 36 (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf.

funds “is hardly consistent with efforts to reduce risk, increase market transparency and ensure greater market stability.”¹⁴⁰ The PWG Report stated the problem as follows:

[E]limination of MMFs’ stable NAVs may cause investors to shift assets to stable NAV substitutes that are vulnerable to runs but subject to less regulation than MMFs. In particular, many institutional investors might move assets to less regulated or unregulated cash management vehicles, such as offshore MMFs, enhanced cash funds, and other stable value vehicles that hold portfolios similar to those of MMFs but are not subject to the [Investment Company Act’s] restrictions on MMFs.¹⁴¹

Despite the overwhelming number of MMF users who have expressed to the regulators, either through surveys, coalitions, or individual letters, that they would not, or could not, invest in a floating NAV product, the Council acknowledges this point in only the most cursory fashion, and fails entirely to assess the harmful impact of this flow of funds out of MMFs and into alternative investment products on the broader economy.¹⁴² Regulators need to weigh fully whether the speculative benefits of the floating NAV proposal, as well as the other MMF reform proposals under consideration, are worth the cost of dramatically shrinking the MMF industry and directing investor funds to institutions and products that are less transparent and generate potentially higher systemic risks.

(13) A floating NAV would accelerate the flow of assets to “Too Big to Fail” banks, further concentrating risk in that sector.

The stability, diversification, transparency, high credit quality, and mandatory liquidity levels of MMFs have established MMFs as a more conservative investment than other fixed income alternatives, and far more efficient for an investor than attempting to manage an individual portfolio of bonds. As Professor Jonathan Macey points out, these key features, coupled with a stable NAV achieved through the amortized cost method, have enabled MMFs to serve as a viable investment alternative to bank deposits.¹⁴³ Even bank regulators acknowledge that, for large balances in excess of FDIC deposit insurance limits, MMFs are safer than bank deposits, which represent undiversified and unsecured exposures to a bank.¹⁴⁴

¹⁴⁰ Letter from Northern Kentucky Chamber of Commerce to SEC (Jan. 20, 2012).

¹⁴¹ PWG Report at 21-22.

¹⁴² Release at 69468.

¹⁴³ Macey 2012 at 41.

¹⁴⁴ 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* at 52 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> (“Even bank deposits have safety

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The operational, accounting, tax, and legal implications associated with requiring the adoption of a floating NAV would mean that a substantial portion of current MMF users would not, or could not, continue to use the product. Those assets which do not flow to less-regulated, less-transparent cash management alternatives would likely flow to banks, exacerbating the banks' need for capital and concentrating risks in that sector.¹⁴⁵ The Mutual Fund Directors Forum warned, "[A] shift of significant amounts of cash to the banking system may have unintended and unpredictable consequences," and stated "[A]ny increase in the systemic risk resulting from the flow of money to other investment vehicles is important and should be considered by the Commission before proposing or adopting further significant changes to the manner in which money market funds are regulated."¹⁴⁶ Regulators have noted that a broad shift of institutional cash to the banking system could lead to a large increase in uninsured, "hot money" deposits.¹⁴⁷

Over 75% of deposit growth in 2011 that was caused by unlimited deposit insurance of demand deposit accounts flowed into the ten largest banks.¹⁴⁸ The ten largest U.S. banks represent 65% of banking assets and 75% of U.S. GDP.¹⁴⁹ Institutional investors hold approximately two-thirds of MMF shares. If two-thirds of MMF balances move into the banking system and 75% of that flows into the ten largest banks, that would increase the size of the ten largest banks by \$1.3 trillion to 74% of U.S. banking assets and 84% of U.S. GDP.

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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 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 [even if the regulatory structure of MMF were altered].") (FRBNY Staff Report).

¹⁴⁵ See Letter from Independent Directors Council and Mutual Fund Directors Forum to SEC (May 2, 2012); Letter from Fidelity Investments to IOSCO, filed with SEC (May 30, 2012); Letter from the Financial Services Roundtable to SEC (Jun. 30, 2011); Letter from New York Business Council to SEC (Jan. 14, 2011).

¹⁴⁶ Letter from Mutual Fund Directors Forum to SEC (Mar. 29, 2012). In their analysis of the performance of stable and floating NAV funds, Fisch and Roiter pointed out that "[e]liminating MMFs as an alternative to bank deposits means greater concentration of risk in the one sector of our financial system that history has indisputably shown to be most prone to systemic risk, the banks." Letter from Fisch & Roiter to SEC (Dec. 2, 2011).

¹⁴⁷ FRBNY Staff Report at 6.

¹⁴⁸ FDIC Press Release, Insured Institutions Earned \$35.3 Billion in The Third Quarter of 2011 (Nov. 22, 2011); FDIC Quarterly Banking Profile, Vol. 3, No. 1, at 4 (Dec. 31, 2008) (noting that total deposits increased by \$307.9 billion (3.5%) in the fourth quarter of 2008, the largest increase in ten years), <http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP>.

¹⁴⁹ Richard W. Fisher, President, Federal Reserve Bank of Dallas, Remarks before Columbia University's Politics and Business Club: Taming the Too-Big-to-Fails: Will Dodd-Frank Be the Ticket or Is Lap-Band Surgery Required? (Nov. 15, 2011), <http://dallasfed.org/news/speeches/fisher/2011/fs111115.cfm>.

Further, much of the financing currently provided by MMFs will be forced onto bank balance sheets or into entities that are structured and regulated like banks.¹⁵⁰ One large asset manager questioned whether banks could perform the funding role that MMFs currently do, stating, “It is our belief that banks have neither the infrastructure nor the profit incentive based on minimum leverage capital requirements to provide short-term funding to the economy in the way that money market funds do through the purchase of commercial paper and other short-term debt instruments.”¹⁵¹

The inevitable consequence of this approach is the further substantial growth of the largest systemically important financial institutions and the further expansion of the federal government safety net of deposit insurance, government lending, and periodic bail-outs by taxpayers that is required to maintain them.¹⁵² The failure of any of these banks would be catastrophic to the economy and our financial system. MMF shares, on the other hand, are not insured by the federal government. In the two instances (in forty years) where an MMF broke a buck, investors lost a small amount of money but taxpayers were not on the hook. Increasing the size of the federal safety net was not the purpose of Dodd-Frank, the express purpose of which was to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts,”¹⁵³ and yet that would be the most likely result of the use of Title I of Dodd-Frank to shrink or eliminate MMFs.

(14) The Council’s proposal to rescind Rules 22e-3 and 17a-9 would remove important 2010 reforms designed to protect investors.

As discussed in Section 2 of this paper, the Release recommends the rescission of SEC Rule 22e-3, which currently grants MMF boards the authority to suspend redemptions and begin an orderly liquidation of an MMF has broken or is about to break the buck.¹⁵⁴ This rule, adopted

¹⁵⁰ See Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking An Integrated Overview of Policy Recommendations* (Nov. 18, 2012), http://www.financialstabilityboard.org/publications/r_121118.pdf.

¹⁵¹ Letter from BlackRock to SEC (Jan. 10, 2011).

¹⁵² Accord Letters from Fidelity Investments to IOSCO, filed with SEC (May 30, 2012); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from Invesco to SEC (Jan. 10, 2011); Letter from Professor Jonathan Macey to SEC (Jan. 8, 2011). The SEC staff acknowledged this point. Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 45 (Nov. 30, 2012), <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf> (“The shift to bank deposits would increase reliance on FDIC deposit insurance and increase the size of the banking sector, which raises additional concerns about the concentration of risk in the economy.”).

¹⁵³ Preamble to Dodd-Frank.

¹⁵⁴ 17 C.F.R. § 270.22e-3.

as part of the SEC's 2010 amendments, gives boards an important tool to assure equitable treatment of investors, and enables MMF boards to avert a run that could potentially reward first movers.

The Council in its Release also proposes to eliminate Rule 17a-9, which currently permits MMF affiliates to purchase portfolio securities from an MMF. The SEC has strongly supported this rule in the past as an important investor protection. The Council recommends rescission of the rule based on its assumption that a floating NAV makes it unnecessary.¹⁵⁵

While the issue of past incidences of MMF sponsor support has recently emerged as a central argument for imposing new limitations on MMFs,¹⁵⁶ sponsor support is not a new issue. Indeed, not only has the SEC acknowledged the value of sponsor support to MMF shareholders in the past, the SEC has twice amended its MMF rules to *facilitate* sponsor support of MMFs. The first was in 1996, when the SEC adopted Rule 17a-9 to permit MMF sponsors to buy portfolio securities from their MMFs, subject to certain conditions.¹⁵⁷ In response to commenters who opposed the new rule based on concerns that investors might rely upon the sponsor support to buy out troubled securities, thus guaranteeing a stable NAV, the SEC responded that it “believes that existing rules applicable to money funds already address this concern by requiring money fund prospectuses and sales literature to disclose prominently that there is no assurance or guarantee that a fund will be able to maintain a stable net asset value of \$1.00 per share.”¹⁵⁸

In 2010, when the SEC was well aware of the incidences of sponsor support during the financial crisis, the SEC amended Rule 17a-9 to make it easier for MMF sponsors to buy securities out of an MMF, without seeking an order from the SEC.¹⁵⁹ Although the SEC acknowledged that one commenter, Federated, “opposed the proposed amendment out of concern that the expansion of the rule may exacerbate the unwarranted expectation of some shareholders that advisers will take whatever steps are necessary to financially support the \$1.00 share price”¹⁶⁰ of their MMF, the SEC stated, “[W]e do not believe [the amendment] will materially change shareholders’ perceptions about money market funds or the likelihood of

¹⁵⁵ Release at 69466.

¹⁵⁶ See *Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Comm. on Banking, Housing and Urban Affairs*, 112th Cong. (June 21, 2012) (statement of Mary L. Schapiro, Chairman, SEC), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=66f4ddb5-4823-4341-bad9-8f99cdf5fe9a.

¹⁵⁷ Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 7275, Investment Company Act Release No. 21837, 61 Fed. Reg. 13956 (Mar. 28, 1996).

¹⁵⁸ *Id.* at 13974.

¹⁵⁹ Money Market Fund Reform, Investment Company Act Release No. 29132, 75 Fed. Reg. 10060 (Mar. 4, 2010).

¹⁶⁰ *Id.* at 10087.

sponsor support during times of market turmoil” and that “[t]he amendment simply extends the existing rule to types of transactions that historically have been permitted through no-action assurances obtained from the [SEC]’s staff because the staff believed they were in the best interest of the fund’s shareholders.”¹⁶¹

The Release states that Council believes a floating NAV would not eliminate the risk of runs and would “reduce, though not eliminate” a so-called “first-mover advantage.”¹⁶² But, MMF board action to suspend redemptions under Rule 22e-3 *does* stop an MMF run and is specifically designed to benefit MMF shareholders by eliminating first-mover advantage. MMF sponsor actions, facilitated by Rule 17a-9, clearly benefit shareholders, particularly in those rare instances where sponsor support helps sustain a stable MMF NAV. The Council’s proposals to rescind these rules contain no elaboration or supporting data. The Council should not recommend rescinding these important reforms, less than three years after their adoption.

(15) Instead of focusing on the floating NAV, regulators should consider how MMF’s enhanced liquidity has proved to be effective in absorbing heavy redemption requests, and how it has improved the characteristics of the marketplace from 2008.

Any empirical analysis of the data and prior history shows that a variable NAV does not prevent or absorb runs. Imposing a variable NAV would not foster systemic stability, although it would produce the negative consequences that we have previously described. This is because a variable NAV (or a capital requirement or a minimum balance at risk standard) does not address the reasons that investors run in the first place. Investors run when they believe that it is likely that they must redeem their investments immediately in order to avoid losses, or to avoid having their investment trapped in illiquidity when they may need cash in the near term. If enough investors hold the same beliefs, their expectations can become self-fulfilling as selling drives down prices and buyers stay on the sidelines waiting for the market to bottom. This happened repeatedly during the subprime financial crisis (e.g., to SIVs, CDOs and auction rate securities).

Therefore, in order to promote systemic stability, regulators should focus on measures that would foster the rapid transformation of investments to cash holdings, and that would provide investors with confidence that MMFs will be able to meet redemption demands. Experience and economic analyses both confirm that what prevents a run – or resolves a run before it causes a panic – is liquidity.¹⁶³ A 2006 analysis by Federal Deposit Insurance

¹⁶¹ *Id.*

¹⁶² Release at 69466-67.

¹⁶³ The only other regulatory measure that has historically been shown to prevent runs, or to absorb runs that have started, is government deposit insurance. Although the Council’s release does not propose insurance for MMFs, we

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Corporation staff shows that it is insufficient liquidity, rather than capital, that is the best predictor of financial panics in the banking system.¹⁶⁴ Likewise, a more recent study of German MMFs concluded that “[i]nvesting in less liquid assets . . . widens the narrow structure of money market funds and makes them vulnerable to runs. During the shortening of liquidity caused by the subprime crisis illiquid funds experienced runs, while more liquid funds functioned as a safe haven.”¹⁶⁵

Consistent with these studies, the experience of the subprime financial crisis showed that liquidity was an Achilles’ heel for many financial institutions, including certain MMFs. Before and during the subprime crisis, Rule 2a-7 did not establish specific minimum liquidity standards for MMFs, and disclosure of fund holdings was not as detailed. Thus, investors could not be sure that a given MMF would meet their liquidity requirements, and many sought immediate redemption in order to avoid future losses or a delayed access to cash.

In 2010, however, the SEC revised Rule 2a-7 by, among other things, establishing stringent liquidity standards for MMFs. Thus, each MMF is now required to have a minimum percentage of its assets in highly liquid securities so that it can meet reasonably foreseeable shareholder redemptions.¹⁶⁶ Under new minimum daily liquidity requirements applicable to all taxable U.S. MMFs, at least 10 percent of the assets in the fund must be in cash, U.S. Treasury securities, or securities that convert into cash (e.g., mature) within one business day.¹⁶⁷ In addition, under a new weekly requirement applicable to all MMFs, at least 30 percent of their assets must be in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within five business days.¹⁶⁸ No more than 5 percent of a fund’s portfolio may be “illiquid” (i.e., cannot be sold or disposed of within seven days at carrying value).¹⁶⁹

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note that government should promote competition in the financial system, and not foreclose the ability of investors to choose different alternatives for their cash holdings.

¹⁶⁴ 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.

¹⁶⁵ 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 at Abstract, 2, 30 (2008).

¹⁶⁶ Rule 2a-7(c)(5); see Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

¹⁶⁷ Rule 2a-7(c)(5)(ii), (a)(8); 17 C.F.R. §§ 270.(c)(5)(ii), (a)(8).

¹⁶⁸ Rule 2a-7(c)(5)(iii), (a)(32); 17 C.F.R. §§ 270.(c)(5)(iii), (a)(32).

¹⁶⁹ Rule 2a-7(c)(5)(i); 17 C.F.R. § 270.(c)(5)(i). To offer some perspective, these liquidity standards are far more stringent than those that apply to banks. In brief, MMFs may invest in debt instruments in which a national bank may invest, including prime commercial paper, bank deposits, short-term U.S. government securities, and short-term municipal government securities. 12 U.S.C. 24 (Seventh), 12 C.F.R. Part 1. However, they may not invest in less

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Finally, depending upon the volatility of the fund's cash flows (in particular shareholder redemptions), a fund may be required to maintain greater liquidity than would be required by the specific daily and weekly minimum liquidity requirements of Rule 2a-7. Thus, the 2010 reforms also require MMFs to conduct assessments of their shareholders' anticipated redemptions, and to gauge the liquidity risks posed by individual shareholders or types of shareholders.¹⁷⁰ Thus, as a practical matter, MMFs hold even more liquidity than regulations specify.

The 2010 amendments to Rule 2a-7 have had multiple stabilizing effects on individual MMFs and on the financial markets in general. First, the high level of liquidity in individual MMFs allows them to absorb and stop nascent runs. When investors who request a redemption are quickly paid in full, no redemption queue forms, and investors do not panic and suddenly demand to redeem shares at once. Second, when an MMF has liquidity available from normal portfolio maturities to meet redemptions, it does not need to sell portfolio assets prior to maturity to raise liquidity. This, in turn, protects the MMF from having to incur losses from sales of performing notes into an illiquid money market, and protects the money market from becoming locked up with large amounts of paper being sold.

An analysis prepared by Fidelity Investments demonstrates how the post-crisis amendments to Rule 2a-7 have made MMFs so resilient that they cannot be said to present systemic risk.¹⁷¹ Fidelity examined how various hypothetical scenarios in which interest rates rose suddenly and investors abruptly redeemed shares would affect the NAV of a typical institutional prime money market fund. The analysis showed that even "an instantaneous rise in interest rates of 200 basis points, as well as a simultaneous shareholder redemption of 50% of outstanding shares," would not cause the MMF to "break the buck."¹⁷² By comparison, "in 2008, it took four weeks for the three-month LIBOR rate to rise by 200 basis points. Moreover, shareholder redemptions in the week following the [Lehman] bankruptcy totaled approximately 30% of institutional prime MMF assets."¹⁷³

Also, as noted above, MMFs hold more liquidity than the amounts specifically prescribed by Rule 2a-7 because they must assess and respond to the liquidity needs of their investors. Thus, in the RiskFin Report the SEC staff stated, "Today, the typical prime fund holds over one quarter of its portfolio in DLA [daily liquid assets] and nearly one half of its portfolio in WLA

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liquid, longer-term and more risky investments that national banks may own, such as medium and long-term government or corporate debt and most types of loans (*e.g.*, mortgages and consumer loans).

¹⁷⁰ See Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

¹⁷¹ Letter from Fidelity Investments to SEC (Mar. 1, 2012).

¹⁷² *Id.*

¹⁷³ *Id.*

[weekly liquid assets].”¹⁷⁴ According to Fidelity, as of January 2012, MMFs held in excess of \$1 trillion in 7-day liquid assets out of \$2.6 trillion in total assets.¹⁷⁵ This is many times the amount required to satisfy shareholder redemptions during the September 2008 crisis (\$310 billion) and the June through August 2011 period of the European debt crisis and U.S. debt ceiling debate (\$172 billion).¹⁷⁶ Fidelity stated, “The large liquidity cushions now required by Rule 2a-7 have mitigated risk without imposing exceedingly costly unintended consequences.”¹⁷⁷ Because the 2010 reforms are working to lessen the incentive to run and now require funds to have sufficient levels of liquidity to meet shareholder redemptions during periods of market stress, Fidelity concluded that additional reforms are unnecessary.

Their enhanced liquidity also allowed MMFs to handle large amounts of redemption requests in a time of extreme volatility in world markets — caused by fear of major sovereign defaults and the potential for related contagion — during the 2011 European debt crisis and federal debt ceiling impasse without disruptions. As of June 22, 2011, “prime” MMFs held about \$1.6 trillion in assets, requiring daily liquid assets under Rule 2a-7 of at least \$160 billion and weekly liquid assets of at least \$480 billion. From June 22 to June 29, 2011, following reports of exposures to European banks and Greek debt, about \$48 billion was redeemed from prime MMFs.¹⁷⁸ Under Rule 2a-7’s minimum standards, prime MMFs had about ten times the weekly liquidity needed to cover actual withdrawals in this period.

As of late July 2011, taxable MMFs (MMFs other than municipal securities MMFs) held approximately \$2.3 trillion in assets.¹⁷⁹ In the last week of July 2011, when negotiations over the federal debt-ceiling reached an impasse, almost \$120 billion in share value was redeemed from taxable MMFs.¹⁸⁰ In the week ending August 3, net outflows from taxable MMFs totaled \$69 billion, apparently due to concerns about the U.S. debt ceiling negotiations and Eurozone debt.¹⁸¹ Thus, under Rule 2a-7’s minimum requirements, taxable MMFs held weekly liquid assets of at least 5.7 times the amounts redeemed in late July and 10 times the amounts redeemed in early August. In fact, the minimum daily liquid asset requirement would have been more than sufficient to cover the heaviest week of withdrawals.

¹⁷⁴ Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 20 (Nov. 30, 2012), <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>.

¹⁷⁵ Letter from Fidelity Investments to SEC (Mar. 1, 2012).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ Investment Company Institute, *Historical Weekly Money Market Data*, <http://www.ici.org/research/stats>.

¹⁷⁹ *Id.*

¹⁸⁰ Mark Jewell, *With Risk of Debt Default Allayed, Money Funds Remain Safe Bet*, Associated Press (Aug. 7, 2011), http://articles.boston.com/2011-08-07/business/29862085_1_money-funds-crane-data-money-market.

¹⁸¹ Investment Company Institute, *Historical Weekly Money Market Data*, <http://www.ici.org/research/stats/mmf>.

From the end of May until August 3, 2011, investors redeemed over 10% of their prime (taxable non-government) MMF investments, totaling over \$169 billion in redemptions.¹⁸² The RiskFin Report notes that “[s]ome prime funds had redemptions of almost 20 percent of their assets in each of June, July, and August 2011, and one fund lost 23 percent of its assets during that period”¹⁸³ Much of the redemption activity was in short bursts around the key events of each financial episode. Yet no MMF “broke the buck,” faltered or was unable to meet redemption requests. Finally, as of March 2012, MMFs held 7-day cash liquidity of approximately \$1.1 trillion, an amount *seven times* the largest outstanding borrowing by banks from the Federal Reserve under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility in 2008, and multiples of the amounts needed to meet redemptions in September 2008.¹⁸⁴

The enhanced liquidity of MMFs has had a clear and positive effect on financial stability. It is therefore disappointing that the Council has not analyzed the present liquidity of MMFs and the impact of that liquidity on the current financial market. In support of its Proposed Recommendations, the Council’s Release only notes that in 2008, some MMFs experienced levels of redemption requests in excess of the new daily or weekly minimum liquidity requirements.¹⁸⁵ Yet this misses the point that in 2012, regulatory reforms have fundamentally altered the marketplace. Along with liquidity standards, the SEC has imposed stricter credit quality, diversification, portfolio maturity and disclosure requirements on MMFs. As a result, investors are better able to monitor fund portfolios, MMFs are able to redeem more shares without resorting to forced asset sales, and the likelihood of an MMF breaking the buck has been reduced substantially.

Conclusion. Forcing MMFs to adopt a floating NAV would do substantial damage to an investment product that has proved useful for over 30 million shareholders. It would eliminate MMFs as a viable cash management tool for a substantial portion of MMF investors who rely on

¹⁸² *Id.*

¹⁸³ Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 32 (Nov. 30, 2012), <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>.

¹⁸⁴ See also Fidelity Investments, *A Look at Regulatory Reform for Money Market Mutual Funds: Studying the Impact of the 2010 Changes* (Mar. 1, 2012) (“The amount of liquidity currently held in MMFs is many times larger than the temporary government support provided during the 2008 financial crisis. Moreover, current liquidity far exceeds the amounts redeemed from MMFs during either of the two most recent identifiable episodes of market crisis: (1) \$172 billion within an eight week period from June 2011 to August 2011 in the wake of the European debt crisis and U.S. debt ceiling debate; and (2) \$310 billion in the week following the Lehman bankruptcy in September 2008”).

¹⁸⁵ Release at 69464-65.

MMFs for a variety of specialized uses. Many of these investors would be prohibited from using a floating NAV MMF, and would place substantial tax, accounting, and operational burdens on the investors who could continue to use the product. These burdens would result in a dramatic shrinkage in MMFs. The consequences to both short-term credit markets could be substantial and remain largely unanalyzed by the Council. Further, this would cause investors to move liquidity balances elsewhere: to “Too Big to Fail” banks that are more risky and less efficient *and* require massive federal government support to stay afloat; to individually-managed investment accounts for the largest investor entities to invest directly in commercial paper, bank notes and other money market instruments; or to bank-sponsored short-term investment funds, hedge funds and offshore investment vehicles that are less transparent, less regulated, less efficient and result in the same “roll-over risk” for issuers in the money markets that the Council apparently wants to ameliorate through its plan to change the structure of MMFs.¹⁸⁶

The justifications the Council provides for its proposed recommendation in the Release – stopping runs, reducing a “first-mover advantage,” and removing uncertainty or confusion regarding who bears the risk of loss in an MMF – are speculative and unsupported by data. Indeed, each is contradicted by substantial research, data, reports, surveys and other analyses submitted by commenters to the SEC. The Council’s recommendation to require MMFs to adopt a floating NAV should not be proposed or adopted.

¹⁸⁶ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 72 (Nov. 2012); Macey 2012 at 28, 35-41. The Council must note that U.S. bank STIF funds also “broke a buck” during the subprime crisis, with considerable financial loss to the banks and investors involved. See *Matter of State Street Bank and Trust Company*, SEC Rel. No. 33-9107 (Feb. 4, 2010), <http://www.sec.gov/news/press/2010/2010-21.htm>. To provide liquidity to bank STIFs, the Federal Reserve extended the same credit facilities to bank STIFs that were made available to provide liquidity indirectly to SEC-regulated MMFs.

Appendix

Impact on Specialized Systems That Use MMFs to Hold Temporary Liquidity Balances

The MMF business developed during a period in which a wide range of businesses moved from archaic manual systems to automated systems for processing the posting and settlement of various types of transactions. As a result, use of stable value MMFs to hold short-term liquidity was incorporated into many of the accounting systems and the automated interfaces used in these systems. Examples, which are discussed in more detail below, include trust accounting systems at bank trust departments, corporate payroll processing, corporate and institutional operating cash balances, federal, state and local government cash balances, municipal bond trustee cash management systems, consumer receivable securitization cash processing, escrow processing, custody cash balances and investment manager cash balances, 401(k) and 403(b) employee benefit plan processing, broker-dealer and futures dealer customer cash balances, and cash management type accounts at banks and broker-dealers.

The systems changes that have been implemented in many different businesses over the past four decades have greatly reduced (i) the time required to post and settle transactions, (ii) the personnel required to post and settle transactions (and thus the overhead costs associated with those functions), (iii) the errors associated with posting and settling those transactions, (iv) the “float,” “due to,” and “due from” balances tied up in processing of transactions, and (v) the counterparty default risk associated with transactions between and among companies. These changes have had the net result over the past four decades of reducing risk and increasing the efficiency of many business activities and greatly reducing the amount of funding required for businesses to conduct transaction processing.

Many of these systems have as a key element the use of MMFs to hold short-term liquidity in connection with settlement of the transactions. The features of MMFs that are ideal for holding temporary balances in these systems include (1) stable \$1 per-share value during the time the transaction is being processed to allow certainty of the day of the exact dollar amounts that are being processed between different counterparty accounting systems so that the amount due and the amount paid do not diverge even by a few cents during the time in which the transaction is being processed, (2) same-day settlement capability (T+0 processing) which is possible only because of the use of amortized cost by MMFs, (3) high credit quality and underlying portfolio issuer diversification which reduces risk of insolvency during the time the transaction is being processed, and (4) operation within a highly-automated secure computer environment that allows for 24/7 no downtime interfaces with accounting and data processing systems of all parties to the transactions.

The use of amortized cost and the resulting stable NAV are crucial features of MMFs that allow them to work with automated processing systems. Amortized cost allows the use of a stable \$1 per-share pricing by MMFs. The valuation method accretes one additional day's worth of imputed interest on each portfolio asset each day using factors and information known in advance. This means that, absent a material credit event during the day that drops NAV below 99.5 cents per share, at 6:00 a.m., the system operators know what a share will be worth at 6:00 p.m. It will be priced at exactly \$1.00 per share. If MMFs were required to use continuously floating NAV, the exact price of a share as of the close of the day would not be known until after the markets close that day. Floating NAV funds must determine the purchase or redemption price of a share using the market-closing prices of the portfolio securities that are not known until the next close of markets *after* that purchase or redemption order is placed.¹⁸⁷

In other words, if MMFs used a floating NAV, the system operator would not know until 4:00 p.m. whether a share would be worth \$1.00001 or \$0.99999 at the end of the day. When the automated system learned in the morning that it must purchase or liquidate MMF shares to process a payment of say, \$10,000,000 that afternoon, and placed that order, it would not be clear at the time the order was placed exactly how many MMF shares would have to be liquidated to reach that exact amount. It might be a few cents more or less at the end of the day than anticipated. This few extra or short pennies would be a discrepancy that would need to be manually reconciled and the difference trued up before the transaction could be finished. Manual processing would mean more staffing requirement, more costs associated with staffing the function, and errors and delays in completing the process.

Furthermore, because the purchase and redemption price would not be known earlier, and the market-closing prices from after the purchase or redemption order was placed must be used to set the price for the purchase or redemption order, the settlement payment could not occur the same day the order is placed (T+0), but instead is made the next business day (T+1). This means one party to the transaction owes the other money for one more day (three if it is a weekend, four if a holiday weekend). Both parties would carry the unsettled transaction as an open position for one extra day and each party would be exposed for that time to the risk that its counterparty would default during the extra day, or that the bank holding the cash overnight (or over the weekend) would fail. For a bank involved in making a payment in anticipation of an incoming funds transfer as part of these processing systems, this change from same-day to next-day processing of MMF redemptions would turn intra-day overdrafts into overnight overdrafts, resulting in much greater default and funding risks to the bank. This extra day's float would mean more risk in the system and a larger average float balance that each party must carry and finance.

The net result of a floating NAV would be to make MMFs not useful to hold the large, short-term cash balances used in these automated transaction processing systems across a wide

¹⁸⁷ 17 C.F.R. §§ 270.2a-4, 270.22c-1.

variety of businesses and applications. A generation's worth of work in automating settlement systems, shortening settlement times, and limiting counterparty risk would be undermined. At a minimum this would require systems to be re-programmed on a wide scale, involving substantial personnel, time and years to complete. This would be comparable in some ways to the Y-2K effort, although the effort would be concentrated at fewer firms, but more work required at each affected firm to redesign and reprogram their processing and accounting systems. Completion of the systems would take many years and hundreds of millions of dollars to complete across a wide range of businesses and applications for which stable value MMFs currently are used to hold short-term liquidity. Until these systems could be redesigned, reconfigured and rebuilt, processing of transactions would essentially be back to the manual processes that existed in the early 1970s.

If MMFs no longer provide a business solution for holding short-term cash balances for each of these various processing functions, something else would need to be used. The vehicles that formerly held these pending balances before MMFs filled this need included credit balances at the commercial counterparty (due to and due from amounts at a commercial company, or free credit balances at a broker), bank short-term investment funds, corporate variable amount notes, and bank deposits. These vehicles have fallen out of use for this purpose or might no longer be available, and each carries with it much greater and more concentrated default risks.

Examples of some of the transaction processing systems that use MMFs to hold short-term cash balances are set forth below, along with a description of how MMFs fill a business need of that particular system.

Bank Trust Accounting Systems. Bank trust departments are responsible for receiving, tracking, accounting for, holding in custody, investing, and paying out cash balances for large numbers of trust accounts. This cash includes balances from many different trust and fiduciary accounts. It represents cash received from the proceeds of sales of securities or other assets, dividends and interest on client investments, and new balances placed in trust. The cash is held briefly pending distribution to beneficial owners, payment of expenses and taxes on behalf of clients, and payments for purchases of securities and other assets for client fiduciary accounts. At any given time, the balance for any one client account may be very large or very small, but in the aggregate the trust department as a whole represents a very large, short-term cash balance. Trust departments have an obligation to keep trust assets productive, minimize the time cash balances remain uninvested, and seek a competitive return on cash balances consistent with prudent investment principles.¹⁸⁸

Tracking, investing and accounting for these cash balances is a complex effort, due to the large numbers of fiduciary accounts which must be tracked, the many and varied inbound and outbound streams of cash, the need to plan and manage payments and distributions for the

¹⁸⁸ 12 C.F.R. § 9.10.

various client accounts, tax considerations, the non-uniform provisions of the many different trust instruments that govern the requirements of each different account, and the complex and overlapping requirements of state and federal laws governing fiduciary accounts. Fiduciary laws in many jurisdictions designate certain types of assets as permitted investments for trusts and certain other fiduciary accounts. MMFs have been recognized as permitted fiduciary investments in many states. A change to the regulatory requirements for MMFs that precluded MMFs from using amortized cost or seeking to maintain a stable net asset value per share could lead state legislatures to amend fiduciary statutes to prohibit the continued use of MMFs to hold trust cash balances.

Among the many complexities of applicable fiduciary laws is a requirement in many jurisdictions to track and separately account for principal and income on each account, and requirements on diversification and in what assets a particular type of fiduciary account can be invested, as well as restrictions on conflicts of interest by the trustee bank.

Most bank trust departments operate on trust accounting systems provided by one of ten large national vendors. These automated, computer-based systems are designed to maintain records of client accounts, generate internal and external reports used by the trust department, as well as tax records and client statements, and interact with the investment and cash management programs of the bank on an automated basis.

In the past, trust departments generally held trust cash either on deposit with the commercial side of the bank, or in a "short term investment fund" maintained by the trust department. Both of these alternatives had significant operational problems. If placed on deposit with the commercial side of the bank, the fiduciary account deposit generally must be collateralized by high quality bonds,¹⁸⁹ and must bear a competitive rate of interest.¹⁹⁰ Depositing with the commercial side presents a conflict of interest that must be carefully managed and maintained only for a short period.¹⁹¹ This presents further complications under the reserve requirements of Regulation D, which require reserves to be placed by the bank with the Federal Reserve equal to 10% of a "demand deposit" portion of these cash balances.¹⁹² The combination of these factors makes it impractical in many cases for the commercial side of the bank to accept fiduciary deposits.

¹⁸⁹ See 12 U.S.C. § 92a(d); 12 C.F.R. § 9.10.

¹⁹⁰ 12 C.F.R. § 9.10; *Md. Nat'l Bank v. Cumins*, 322 Md. 570, 588 A.2d 1205 (Md. 1991); *Van de Kamp v. Bank of Am. Nat'l Trust & Savs. Ass'n*, 251 Cal. Rptr. 530, 538 (Cal. Ct. App. 1988); *In re Orrantia's Estate*, 285 P. 266 (Ariz. 1930); *New England Trust Co. v. Triggs*, 135 N.E.2d 541 (Mass. 1956); *In re Doyle's Will*, 79 N.Y.S.2d 695 (N.Y. Surr. Ct. 1948); *In re Haigh's Estate*, 133 Misc. 240, 232 N.Y.S. 322 (N.Y. Surr. Ct. 1928); *Reid v. Reid*, 85 A. 85 (Pa. 1912).

¹⁹¹ *Id.*

¹⁹² 12 C.F.R. § 204.

Short-term investment funds (or STIFs) present other challenges as a cash management vehicle for trust department cash. STIFs are a form of bank common trust fund invested in relatively short-term high quality debt instruments,¹⁹³ and only certain types of bona fide fiduciary account balances from the bank that maintains the STIF and its affiliated banks can be placed in them. Revocable grantor trusts, investment management and custody accounts, IRA and pension and employee benefit plan assets cannot be placed with the other trust assets in a STIF due to requirements of the Investment Company Act exemption within which STIFs operate.¹⁹⁴ Moreover, separate STIFs must be operated in order to segregate pension plan assets from assets in trust accounts. This results in a relatively small investable balance for each STIF (compared to MMFs) and therefore a substantial challenge in keeping the portfolio of the STIF fully invested in a diverse pool of high quality assets while matching the timing of cash flow requirements dictated by trust account investments in and redemptions from the STIF.¹⁹⁵

One of the first major uses of MMFs was to hold these trust department temporary cash balances. MMFs provided a useful solution to bank trust departments which allowed them to invest balances of fiduciary accounts for short periods of times in an asset permitted by state fiduciary laws and trust instruments, at a competitive yield in a liquid, diverse pool of high quality debt instruments. Because an MMF can accept investors from many different banks' trust departments as well as other types of retail or institutional investors, an MMF can be much larger than a STIF and can accordingly achieve more portfolio diversification, better management of liquidity needs, and lower operating costs per dollar of assets, as compared to a STIF, and pay higher returns with less concentration of risk to trust accounts than a bank deposit. Use of amortized cost permits an MMF to anticipate NAV and share prices at the beginning of the day for the entire day (subject to the remote possibility that there will be an unexpected substantial credit event during the day that drops NAV below 99.5 cents per share), rather than needing to wait until after the close of the trading markets at 4 pm to know end-of-day NAV. This means the price of an MMF share can be anticipated at 6 am when the processing day begins.

Trust accounting systems interface with many different external systems on a daily basis. These include interfaces with systems of broker-dealer firms through which the trust department executes purchases and sales of securities for fiduciary accounts, systems providing notification of dividend and interest payments received through securities clearinghouses and payment agent banks, and systems for receiving and sending incoming and outbound payments through the

¹⁹³ 12 C.F.R. § 9.18(b)(4)(ii)(B).

¹⁹⁴ Investment Company Act 3(c)(3) (exemption for bank common trust funds), 3(c)(11) (exemption for bank collective funds for pension and employee benefit plans); *In the Matter of Commercial Bank and Marvin C. Abeene*, SEC Rel. 33-7116 (Dec. 6, 1994).

¹⁹⁵ See Martin E. Lybecker, *Regulation of Bank Trust Department Investment Activities: Eight Gaps, Seven Remedies, Part II*, 91 Banking L.J. 6 12-14 (1974); Martin E. Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 Yale L.J. 977, 984-86 (1973).

banking system on behalf of fiduciary accounts. These electronic data communications generally involve a bilateral exchange of pending payment amounts stated in dollars and cents, which are followed subsequently by deliveries of those amounts.

In order to reduce errors and cash shortfalls, trust accounting systems typically post a debit to the cash position in the account immediately before or simultaneously with the placement of an order to purchase a security, which is transformed into a redemption order for shares of the MMF to generate cash to pay, the next day, for the security being purchased.¹⁹⁶ These accounting systems require a predictable MMF NAV share value at the time the redemption order is placed for (i) the cash position to match the cash needed to settle the purchase order and (ii) the ending balance reflected as available in the MMF to be accurate for processing any other transactions in the customer account that day.

Predictability in the per share price of MMFs is critical to the operation of trust accounting systems, allowing them to be more fully automated (rather than relying on manual processes and the staffing costs, delays and errors associated with manual posting and processing of transactions and cash balances), allowing an exact sweep of cash balances to the penny, and permitting same day processing of cash payments. This permits same day (T+0) or next day (T+1) settlement of portfolio securities transactions for fiduciary accounts, which in turn reduces the amount of settlement cash, “due to” and “due from” “float” in the trust department and overnight overdrafts and out-of-balance trust accounts. This, in turn, means less counterparty risk and shorter time for client fiduciary assets to be less than fully invested.

Federated has been informed by the vendors of each of the major trust accounting systems that their systems are not designed to process cash balances using MMFs with a continuously floating NAV. Forcing MMFs to move to a continuously floating NAV would make MMFs incompatible with the major trust accounting systems. Until these trust accounting systems could be redesigned and reprogrammed either to accept a continuously floating NAV (assuming it could be done at all and trust departments would accept it) or use some other vehicle to hold cash balances, trust departments would essentially be forced to use more manual processing, returning them essentially to the 1970s.

Corporate Payroll Processing. Most companies pay their employees either twice per month or every two weeks. Generally, pay is disbursed to all employees on the same days. The pay is either distributed in a direct deposit to an account previously designated by the employee, or in a physical paycheck given to the employee. The aggregate amount of money involved in each payroll disbursement is very large. The bigger the company, and the larger its employee base, the larger is the aggregate amount of cash involved. The corporate treasury department manages its cash availability through a variety of short-term investments that are sufficiently

¹⁹⁶ See Letter from ASC to Eugene F. Maloney (Oct. 16, 2008) (on file with recipient).

liquid to address scheduled payments that must be made. Payroll is a very large and recurrent payment amount.

Pending distribution to employees, the cash must sit somewhere. Large companies commonly use third-party vendors to handle payroll processing, but employers are not eager to incur the credit risk of such vendors on payroll balances, even for a short period of time. For a given pay period, the aggregate payroll amount for a large company is many millions of dollars, well in excess of the standard \$250,000 FDIC deposit insurance limits (which limits are only temporarily suspended on noninterest bearing demand deposits until year-end 2012). If the entire balance is placed on deposit at a bank, and the bank fails, the company is at risk of losing a large portion of the payroll balance in excess of \$250,000. Companies with large payrolls are understandably anxious about limiting their loss exposure in the event of the insolvency of a bank. From the bank's perspective, many banks are not eager to take on multi-million dollar deposit balances for periods of a few days each month, because there are costs involved with having those balances on the bank's balance sheet and the bank is not able to profitably invest the cash for such a short period of time.

As an alternative, many large employers place cash pending distribution of payroll into MMFs, with an automated sweep into the payment system and vendor used by the employer. AN MMF knows in advance, through communications with the employer and experience, how much money is coming in and out and when it will arrive and depart, and is able to profitably invest the proceeds through the MMF's portfolio for a few days in short term instruments, carefully managing the cash position of the MMF with advance knowledge of the amounts and schedules of the payroll arrival and disbursement.

Key features that allow MMFs to work to hold short-term balances for corporate payrolls pending distribution include the use of amortized cost and a stable NAV of \$1 per share, which allows for a predictable value of share prices throughout the day (rather than needing to wait for end-of-day market close prices to know share prices and processing of purchases and redemptions after 4:00 p.m.) and same-day processing of investments and redemptions of shares. The bank that is processing the payroll distributions makes payments as checks and other items are presented through the banking system, and is able to redeem shares of the MMF and receive payment on a same day basis and avoid an overnight overdraft. If MMFs were required to use a continuously floating NAV, purchases and redemptions would need to be processed on a next-day basis. This would require either (i) that large balances be redeemed and held as cash overnight or over a period of days as items are presented to the bank, creating an exposure by the employer to the credit risk of the bank for large amounts of money, or (ii) leaving the bank exposed to the risks associated with overnight overdrafts pending receipt of cash from the MMF or directly from the employer.

Moreover, if a continuously floating NAV is required for MMFs, on a multi-million dollar balance, the value of the MMF shares would move around a small amount, such that the payment sent by the employer and held in the MMF for a few days would be a few dollars over

or a few dollars short of the gross payroll amount each payroll period. This, in turn, would require more manual processing, creating more delays and errors, and significantly undermining the usefulness of MMFs to employers, banks and payroll processors.

Corporate and Institutional Operating Cash Balances. In addition to payroll balances, companies have other payments received, as well as incoming cash from operations, and closely manage those cash balances in order to meet their payment obligations as they occur. Large companies typically have a corporate treasury management function to handle the liquidity needs and short-term investment of the company's assets.

The balances involved at a company at any given time can be very large. Due to low (or zero) interest rates on short-term corporate deposits and the risk of bank failure when balances are in excess of the \$250,000 FDIC deposit insurance limits, leaving large amounts of cash on deposit at a bank is not a good alternative. Although the FDIC deposit insurance coverage on non-interest bearing demand deposits has been temporarily increased to an unlimited amount until December 31, 2012, that remains a short-term and not a highly attractive solution for corporate treasurers for holding large cash balances.¹⁹⁷

Traditionally, larger corporate treasury departments managed cash balances by holding separately managed portfolios of direct investments in commercial paper, treasury bills, and other high quality short-term debt instruments. Many corporate treasurers have found it more efficient to invest a portion of those short-term balances in MMFs. This allows for professional management at a lower cost of a diverse portfolio with greater liquidity than the company's treasury desk could accomplish on its own. In this context, MMFs are an alternative to an individually-managed portfolio of securities.

Use of amortized cost accounting which has resulted in nearly all circumstances over the past 35 years in a stable NAV of \$1 per share provides a simple means for MMF balances to be integrated into the internal accounting and cash management systems used in corporate treasury departments. Same day processing of MMF share purchases and redemptions, which is not possible with a floating NAV MMF, allows MMFs to be used more efficiently by corporate treasurers and permits a more automated interface among the internal accounting systems used by the corporate treasury department, the banks through which the company sends and receives payments, and the MMF's transfer agent. This, in turn, reduces float in the system, overnight overdrafts by the corporation's banks and the balances of the corporation with its banks in excess of FDIC deposit insurance limits.

¹⁹⁷ The statutory deadline was imposed by Section 343 of the DFA and is codified in 12 U.S.C. § 1821(a). As discussed below in Section II-D, further extension of unlimited deposit insurance would be inconsistent with the goal of reducing the size of the Federal safety net and would also further fuel the growth of the largest banks.

Federal, State, Local Government Cash Balances. Like businesses, governments have cash management needs. Many state, local and federal government bodies use MMFs as an efficient means to invest short term liquidity balances. Governments have payrolls to pay and operating cash balances to invest for short and medium periods of time. Government cash balances often are tied to tax payment cycles and expenditures tied to fiscal year budgets. Investment of the balances is subject to a myriad of state and local government requirements on investment of government assets, and in some cases to Internal Revenue Service requirements. These state and local laws commonly include lists of permitted investments that specifically authorize investments in MMFs, defined in terms of a fund that seeks to maintain a stable net asset value per share.¹⁹⁸ A change to the regulatory requirements for MMFs that precluded MMFs from using amortized cost or seeking to maintain a stable net asset value per share would require many state and local government statutes to be amended by the state legislature to permit the continued use of MMFs by the state or local government.

Although placing the funds on deposit at a bank is an alternative, government deposits frequently are required to be collateralized with high quality bonds,¹⁹⁹ which make them expensive for the bank to hold. Another alternative is for the state or local government to attempt to manage a portfolio of direct investments in individual money market instruments, although this is a more expensive, higher risk and ultimately less liquid means of investing cash balances of state and local governments than investing in MMFs. An unintended consequence to a movement away from amortized cost and a stable value of \$1 per share would be to diminish the ability of state and local governments to use MMFs and to force them into less liquid, more expensive, higher risk alternatives for investment of cash portfolios.

Municipal Bond Trustee Cash Management Systems. State and local governments raise money for general operations and for specific projects through the issuance of municipal bonds. Each bond issuance has an indenture with a bank as bond indenture trustee and payment agent to handle various aspects of the bonds' issuance, payment of interest and ultimate retirement. Substantial cash balances flow through the bond trustee and paying agent bank, with which cash payment must be made on time every time pursuant to the contractual terms of the bonds to avoid default. In many cases, the credit quality and credit rating of the bond issuance is tied to a very carefully developed cash management program designed to assure that there will be cash available to make scheduled interest payments and sinking fund retirements of the bonds. The trust indenture of the bond, as well as state and local government laws and IRS requirements dictate certain aspects of how and into what types of assets the cash balances can be invested pending payment or distribution.

¹⁹⁸ See, e.g., N.J. STAT. ANN. § 18A:20-37; S.C. CODE ANN. §§ 6-5-10(6), 12-45-220; Tex. Gov't Code Ann. § 2256.014 (West); COLO. REV. STAT. § 24-75-601; CONN. GEN. STATS. § 7-400(1)(B); MICH. COMP. LAW. §§ 129.91, 129.93; Op. Ind. A.G. No. 96-3 (Sept. 5, 1996).

¹⁹⁹ 12 U.S.C. §§ 1821(a)(2), 1823(e)(2).

Leaving large amounts of cash on deposit at a bank results in a concentration of credit exposure that in some cases is not acceptable to bondholders. In addition, because the liquidity balances flow through the bond trustee and payment agent over relatively short periods of time, a bank may not be able to profitably invest the cash on a short term basis. As a result, MMFs are used in many cases to hold portions of the short term liquidity pending payment or distribution on scheduled dates.

Use of amortized cost accounting and a stable NAV of \$1 dollar per share allows MMF balances to be integrated into the accounting systems used in the corporate trust department of the bank that serves as bond trustee. Same day processing of MMF share purchases and redemptions, which is not possible with a floating NAV MMF, allows MMFs to be used more efficiently by the bond trustee and payment agent. This, in turn, reduces float in the system, overnight overdrafts by the payment agent bank and the balances of the issuer with its bank in excess of FDIC deposit insurance limits.

A trust company president described the importance of MMFs with a stable NAV of \$1 per share to the investment of cash amounts associated with municipal bonds as follows:

Until the advent of money market mutual funds, state and local government entities investing bond proceeds for infrastructure projects were extremely limited in scope to the manner in which bond proceeds could be invested. The work that we did collectively to have state statutes passed to allow a broader investment product array by utilizing money market funds as “permitted investments” has allowed for the minimization of market risk

If for some reason the maintenance of a stable \$1.00 value by money market mutual funds is at risk, we will see a mass exodus of investors from the institutional side of the business, such as Reliance Trust Company. This exodus will expose all investors to increased processing costs, substantially greater risk and liability, limited choices of investment vehicles primarily because of statutory restrictions and far greater exposure to credit risk.²⁰⁰

Consumer Receivable Securitization Cash Processing. The structures used for issuance of mortgage-backed bonds and other securitizations of consumer receivables share some of the attributes and cash management needs of municipal revenue bonds, but the cash flows are far more complicated and less predictable. Many of the structures require an initial cash balance and additional retention, build-up and hold back of significant amounts of cash

²⁰⁰ Letter from Anthony A. Guthrie, President, Reliance Trust Company to Eugene F. Maloney, Federated Investors, Inc. (Oct. 17, 2008) (on file with recipient).

from payments received on the underlying consumer receivables as a “prefunded account” in order to assure timely payment of the senior tranches of the securitization.²⁰¹ These cash hold-backs serve some of the same purposes as a back-stop letter of credit from a bank, which may also be in place in addition to the cash hold-back. The prefunded account reduces the likelihood of the need to draw on the letter of credit and the potential size of that draw. MMFs are used as a more efficient and lower risk alternative to direct investment by the indenture trustee of the prefunded balances in a portfolio of individual money market instruments.

MMFs are used in some cases to hold portions of these cash balances, for essentially the same reasons described above – MMFs limit counterparty risk exposure to any one bank, and the stable NAV permits same day processing of share redemptions and more convenient inclusion of balances in the complex accounting systems needed to track payments and disbursements in these securitization structures.

The permitted instruments into which cash balances can be invested generally are specified in the trust indenture and other governing documents of the structure and cannot readily be changed after the securitization structure is launched and its securities sold to investors. Changing the regulatory attributes of MMFs could compromise their role in holding short-term liquid assets in securitization structures.

Escrow Processing. Money is placed in escrow in connection with a variety of transactions ranging from the purchase of a home to corporate acquisitions. The basic purpose is similar -- to place a cash balance into the hands of an independent party to make a payment on a contractually specified amount when certain conditions are met. The amounts per customer may be a few thousand dollars for mortgage escrows to hold tax and insurance payments, or billions of dollars in a corporate M&A transaction. The funds may be held for a few hours, days or months. The amounts held by an escrow agent commonly exceed deposit insurance limits of \$250,000. If pass-through deposit insurance treatment is not available, or if the amounts per ultimate beneficial owner exceed \$250,000, allowing the escrow agent to place the escrow balance in a bank deposit may not be an acceptable risk to the parties. Escrow agreements commonly allow the parties to direct the escrow balances be held in shares of a designated MMF, as a way of limiting counterparty risk.

MMFs are useful for this purpose because they do not represent the credit risk of a single issuer, but instead represent a diversified pool of high-quality short term debt obligations of many underlying issuers. In addition, because the value of the shares do not fluctuate, the escrow agent can hold an amount representing exactly what must be paid if the conditions to completion are met and the escrow amounts paid out on settlement. For escrows on purchases of companies with many shareholders, the accounting systems needed to assure exactly the correct amounts are paid to the proper shareholders are complex. Similarly, escrow agents that process

²⁰¹ See *Federated Investors, Inc.*, SEC Staff Letter 1997 SEC No-Act LEXIS 716 (July 8, 1997).

mortgage-related tax and insurance escrows use complex automated accounting systems that must track and account for a large number of consumer escrow accounts each with different balances and payment amounts.

The use of amortized cost permits the share price of an MMF to be anticipated in the morning (because the daily amortization factors are known for each portfolio security) for the day, rather than known only after the closing of the markets at 4:00 p.m. This permits a share price to be used at a stable dollar amount throughout the day by the automated accounting and payment processing systems used by escrow agents. Moreover, the use of amortized cost also permits same-day settlement of purchases and redemptions of MMF shares. These two features – a stable share price throughout the day and same-day settlement – are key to the utility of MMFs to hold temporary cash balances for escrow agents. If MMFs were required to use a continuously floating NAV, they would not be as useful to escrow agents, the escrow agents' accounting systems would need to be redesigned and reprogrammed to accommodate a floating NAV, and payment cycles would be delayed by a day. If escrow agents continued to use MMFs at all, there would be one extra day to closing required, and that delay means one extra day of counterparty risk. In addition, the cash balance would likely need to sit in a bank account overnight, adding the risk of bank failure during that period.

Custody Cash Balances and Investment Manager Cash Balances. Banks serve as custodians for securities accounts of commercial and individual customers. Securities purchases and sales orders are placed by the customer (or its investment adviser)²⁰² with a securities broker and the custodian bank is notified of the transaction. The custodian bank communicates settlement instructions with the broker-dealer. Custodial cash is commonly invested in MMF shares, in part because the cash balances commonly exceed the \$250,000 FDIC deposit insurance limit. When it receives instructions to deliver cash to a broker-dealer to settle a transaction, the custodian bank redeems shares of the MMF. Same-day settlement of MMF shares (T+0) permits the cash to be available to settle the securities transactions the next day (T+1). With a continuously floating NAV, there would be an additional business day required to redeem MMF shares, which would move the settlement cycle for the securities transaction back one day (T+2).

401(k) and 403(b) Employee Benefit Plan Processing. Private employers over the past few decades have shifted from defined benefit retirement plans to defined contribution plans due to the high costs and potentially large unfunded liabilities associated with defined contribution plans. Two common and highly popular forms of participant-directed defined contribution plans are 401(k) and 403(b) plans, which draw their names from provisions of the Internal Revenue Code. Among the requirements applicable to these plans under the Department of Labor rules implementing the Employee Retirement Income Security Act (ERISA) are that, in order to limit the liability of plan trustees, a stable value option be included as part of the plan to hold cash

²⁰² See 17 C.F.R. § 275.206(4)-2 (customer accounts of registered investment advisers required to be held in custody of bank or broker-dealer).

contributions for which a participant has not yet provided investment instructions.²⁰³ MMFs are an investment option eligible to meet this requirement for up to 120 days.

In addition, cash balances in participant accounts must be segregated from the assets of the plan trustee and held during brief periods of time when a plan participant is changing the investment allocation of the participant's account. MMFs serve this purpose within 401(k) and 403(b) plans.

The use of amortized cost and \$1 per-share pricing at MMFs allows for same-day settlement, and allows the value of shares to be known throughout the day. If MMFs were required to use a continuously floating NAV, it might further delay the settlement of transactions and share prices could fluctuate very slightly and would not be known with certainty until after 4:00 p.m. each business day. This would limit the utility of MMFs for use with the automated accounting and processing systems used by vendors that provide 401(k) and 403(b) plans, and if MMFs continued to be used at all, would increase settlement times by at least one day, increase float in the system, require a process for reconciling and truing up order amounts to reflect small variations in the value of MMF balances and require a significant redesign and reprogramming of the accounting and processing systems used by 401(k) and 403(b) plans to accept a floating NAV MMF to hold temporary cash balances.

Broker-Dealer and Futures Dealer Customer Cash Balances. Customer accounts at securities broker-dealers carry cash balances that are used to make payments on amounts owed by the customer on purchases of securities. This cash belongs to the brokerage customer. Cash flows into the brokerage account through cash amounts added to the account by the customer, dividends and interest on investments held in the account, and from the proceeds of sales of securities.

If the brokerage customer's cash balance is not invested in something, it sits as a "free credit balance" which is simply a "due to" amount owed to the customer by the brokerage firm. To protect customers against the risk of a failure of the broker-dealer firm (and ultimately the SIPC which guarantees customer cash balances up to \$250,000 per account), the broker-dealer is required to hold bank deposits or certain types of securities in a segregated account for the exclusive benefit of its customers, in an amount at least equal to the net unencumbered amounts of customer "free credit balances."²⁰⁴

As an alternative to holding customer cash as free credit balance liabilities of the broker-dealer, brokerage firms normally provide a cash sweep program by which customer cash balances are "swept" into investments in shares of MMFs which are then owned by the customer but held in custody through the broker-dealer. Investment of the cash balances into MMF shares

²⁰³ See 29 C.F.R. § 2550.404c-5 (Department of Labor Qualified Default Investment Alternative Regulations).

²⁰⁴ 17 C.F.R. § 240.15c3-3.

segregates these customer assets from the assets of the broker-dealer and removes them from the balance sheet liabilities of the broker-dealer.

Because MMF redemptions settle same day (T+0), cash is available very quickly to pay for customer purchases of securities, or to receive incoming cash from the sale by the customer of a security. This same day cash availability is important to avoid customer “fails,” and to assure compliance with the margin rule requirements applicable to brokerage accounts which require cash availability in the account when a customer places an order in a customer cash account and margin collateral coverage in a customer margin account.²⁰⁵ In addition, the use of amortized cost and a stable NAV of \$1 per share allows efficient processing of cash balances by the accounting system of the broker-dealer throughout the transaction processing cycle at a known and predictable amount, and communication with the accounting systems of the transfer agent of the MMF. This allows the use of MMFs as a means to hold cash balances within the automated accounting and transaction processing systems used by the broker-dealers, which in turn reduces settlement times, pending transaction float balances and fails, and the counterparty risk in the system.

Similarly, rules of the Commodity Futures Trading Commission (“CFTC”) require the segregation of customer cash balances at a futures firm used to pay for (and provide margin collateral for) futures transactions place by a customer.²⁰⁶ MMFs serve the same function at futures firms as they serve at securities broker-dealers -- hold customer cash balances, and to collateralize amounts due or potentially due on futures positions of the customer held through the futures firm. The CFTC reaffirmed the continued appropriateness of MMFs to hold customer liquidity balances in December 2011 after careful review and a lengthy rulemaking proceeding.²⁰⁷ The CFTC determined through this process that MMFs satisfy the statutory objective that “customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers . . . and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk”²⁰⁸ as well as the Regulation 1.25 prudential standard that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”²⁰⁹

Broker-dealers and futures dealers are subject to regulatory requirements specifying the types of assets that the entity can own and the types of assets that can serve as collateral or be

²⁰⁵ See Regulation T, 12 C.F.R. Part 220. The margin rule treats MMFs shares essentially as the equivalent of cash for this purpose.

²⁰⁶ 17 C.F.R. § 1.20.

²⁰⁷ CFTC, *Investment of Customer Funds and Funds Held in an Account for Foreign Futures*, 76 Fed. Reg. 78776 (Dec. 5, 2011).

²⁰⁸ *Id.* at 78776.

²⁰⁹ *Id.* (citing 17 C.F.R. § 1.25(b)).

used to invest client cash balances. Many of these regulatory provisions specifically include as a permitted investment MMF shares that seek to maintain a stable net asset value per share.²¹⁰

The ability of securities broker-dealers and futures commission merchants to shorten settlement times and reduce the systemic risks associated with unsettled transactions has been facilitated by the ability of MMFs to process purchases and redemptions of shares on a same day (T+0) basis, which in turn is only possible as a result of using the amortized cost method of accounting. Requiring MMFs to use a continuously floating NAV would require them to move to next-day settlement and lengthen settlement times of securities transactions by at least one day. The securities industry has spent the past 35 years shortening settlement times to in order to reduce systemic risk. Using MMFs to hold short-term cash balances in connection with the transaction settlement process has been an integral part of how that was accomplished. An unintended consequence of the movement of MMFs to a continuously floating NAV (or the elimination altogether of MMFs) would be longer securities transaction settlement cycles and an increase in systemic risk.

Cash-Management Type Accounts at Banks and Broker-Dealers. Brokerage firms and banks offer “cash management” type accounts that permit customers to access cash balances in their brokerage accounts by check or debit card. Millions of retail customers find these accounts to be convenient. Cash balances in these accounts are held either in MMFs or in brokered deposits at banks. Checks and debit cards are processed by a bank for the brokerage firm. The payments of these items are funded by cash received from redemptions of MMF shares held in the customer’s brokerage account. The bank runs nightly files of items presented for payment, which triggers a redemption of MMF shares. The bank advances payment on the items after confirming electronically MMF shares are being redeemed to repay the bank on the advance of Funds. The cash from the redemptions is then sent to the bank.

Processing the transactions is done on an automated basis, requiring a series of electronic data exchanges among the bank that issues the debit card and processes the checks, the brokerage firm that carries the customer’s brokerage account, and the transfer agent of the MMF which processes the redemption requests and forwards payment to the bank.

Use of amortized cost and stable value of \$1 per share is crucial to processing these accounts because it permits same-day processing of MMF share redemptions. This allows the bank to limit its credit exposure and avoid overdrafts and “NSF” or “bounced” checks. Use of a predictable \$1 per share value is also critical to the interface among the accounting systems. The systems are programmed to work on a stable value of \$1 per share. A continuously floating NAV would result in transactions being a few pennies over or short each day, which would require manual processing of the transactions. In the alternative, if the accounting systems were

²¹⁰ N.Y. Mercantile Exchange Letter to Mr. Richard Recker, Federated Securities Corp. (May 18, 2001); Options Clearing Corp. Memorandum to all Clearing Members (Feb. 18, 2005).

reprogrammed to address a continuously floating NAV by submitting the redemption request as a dollar amount rather than a number of MMF shares, the account balance remaining after an MMF share redemption is processed would be off by a few pennies per day, requiring inclusion of a larger buffer balance in the customer's account to ensure a sufficient available cash balance to avoid fails and overdrafts in subsequent transactions by the customer in the account, and additional work by the customer to keep track of available balances in the account.

For debit cards, there is a two step-process notification and payment of items is separated by a few days. First, at point of sale, the merchant sends an electronic signal through the banking system that the customer is buying something at a certain price, and the available balance is confirmed and a hold placed on that balance at the MMF. A few hours or days later, the merchant submits the debits for payment through the banking system, which submits the items for payment to the bank that issued the debit card and, which makes the payments. The bank then sends a signal to redeem the MMF shares that are on hold, to repay the bank for the advance. If the MMF shares continuously floated up and down in price between the time between when the hold was placed and the shares redeemed, the payments would be off a little bit each time, requiring manual processing. If same day settlement of MMF redemptions were not available, the bank would not be reimbursed on the same day that it advanced payment on the debit card items. Same-day cash would not be available to the entity "sourcing" the transaction. This would require cash funding flow changes throughout the funding chain and could require some participants in the process to carry an overnight overdraft until the cash arrives the next business day. Additionally, as entities authorizing debit/POS/ATM transactions based on an "Available Balance" data delivered to them by the transfer agent or brokerage platform, that balance could be slightly off as the shares representing that balance change based on end-of-day floating NAV pricing. Currently, these workflows and systems all assume a stable NAV of \$1 per share throughout the chain of processing and same day processing of MMF share redemptions. Any change to that assumption will require a retooling of the workflow and cashflow timing to accommodate cash availability and delivery.

Banks offer a substantially similar product without the brokerage account. In the bank version, the bank offers a checking account with a debit card and ATM access, with balances above a set dollar minimum (which often is \$0) swept into shares of an MMF.²¹¹ The bank pays items after they are presented and after verifying there are enough MMF shares owned by the Customer. The bank places an order to redeem MMF shares to repay the advance.

²¹¹ See 1934 Act § 3(a)(4)(B)(v) (MMF sweep account exemption for banks in definition of securities "broker"), Regulation R, 12 C.F.R. § 218.741, 17 C.F.R. § 247.741 (same).

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 Three: NAV Buffer with Other Measures

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 Three: NAV Buffer with Other Measures*.”¹ The proposal in Alternative Three would require money market mutual funds (“MMFs”) to have a risk-based NAV “buffer” of 3 percent, which, according to the Council, would provide explicit loss-absorption capacity and could be combined with other measures. A separate alternative proposed by the Council, Alternative Two, also contains a 1 percent capital element as an adjunct to a minimum balance at risk (“MBR”) requirement for shareholder redemptions.

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

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

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 compiled in the SEC's docket and available to the Council before it issued its Release.

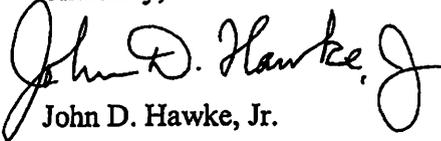
As discussed in the enclosed paper, the Council should not recommend that the SEC adopt the proposal described in Alternative Three, for the following reasons:

- (1) A capital buffer would not achieve the intended purpose of preventing large sustained redemptions from MMFs, but would instead make large sustained redemptions more likely.
- (2) A capital buffer would be prohibitively expensive to both investors and MMF sponsors, if it could be implemented at all.
- (3) A capital buffer would create moral hazard and would be confusing to investors, suggesting that what investors now understand to be an investment product carrying a risk of loss would, instead, have the guarantee features of a bank deposit.
- (4) The requirement for a capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.
- (5) A capital buffer would change the fundamental nature of MMFs, making them less attractive to investors, which would result in a substantial shrinkage or elimination of MMFs.
- (6) Shrinkage or elimination of MMFs would harm the economy, investors, municipal governments and businesses and cost jobs by increasing the cost and decreasing the availability of credit, and increasing systemic risk.
- (7) The current capital structure of MMFs – 100% equity capital and no debt – together with very high portfolio liquidity, transparency, credit quality and maturity requirements put in place by SEC in 2010, address redemptions concerns.

ARNOLD & PORTER LLP

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.

Enclosure

ARNOLD & PORTER LLP

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

**Proposal for a Capital Requirement 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

**Proposal for a Capital Requirement for Money Market Mutual Funds:
Ineffective in Protecting Against Runs in a Crisis;
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 comments on *Proposed Recommendations Regarding Money Market Mutual Fund Reform* (“Release”).² Specifically, this paper responds to “*Alternative Three: NAV Buffer with Other Measures*.”³ Alternative Three would require MMFs to have a risk-based net asset value (“NAV”) “buffer” of 3 percent “to provide explicit loss-absorption capacity,” which the Release says could be combined with other measures to enhance the effectiveness of the buffer and potentially increase the resiliency of MMFs.⁴ The Release lists other potential measures, such as more stringent diversification requirements, increased liquidity levels, and more robust disclosure.⁵ The Release also states that these other measures could reduce the size of the required buffer.⁶ Note that a separate alternative proposed in the Release, Alternative Two, also contains a 1 percent capital element as an adjunct to a minimum balance at risk (“MBR”) requirement for shareholder redemptions.⁷ Alternative Two is discussed in a separate paper filed with the Council on this date entitled, “Proposal for a Minimum Balance at Risk and NAV Buffer for Money Market Mutual Funds.” However, comments in this paper relating to the costs and other adverse consequences of a capital requirement also apply to the capital element of Alternative Two.

The Release states that the buffer could be funded by any funding method or combination of methods found optimal, such as: (1) an MMF sponsor could establish an escrow account and

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 Release at 69474.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 69469-74.

contribute assets pledged to support the fund's NAV; (2) an MMF could issue a class of subordinated non-redeemable equity securities that would absorb first losses in the funds' portfolios and that could be sold to third parties or purchased by a fund's sponsor or affiliates; or (3) an MMF could retain some earnings it would otherwise distribute to shareholders.⁸ No capital would be held against cash, Treasury securities, and Treasury repos; 2.25 percent capital would be held against other daily liquid assets (or weekly liquid assets in the case of tax-exempt funds); and 3.00 percent capital would be held against all other assets.⁹ The Release suggests transition times of up to six years to establish the full buffer.¹⁰ Treasury funds would not be subject to the capital requirement.¹¹

The Release states that, while the 3 percent risk-based capital requirement "may reduce the probability that an MMF investor suffers losses, it is unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer."¹²

Currently, MMFs are financed entirely by a single class of equity capital of investing shareholders. There are no junior or senior classes of equity, no priority or subordination of rights of one shareholder over another – indeed, these structures are prohibited by Sections 1(b) and 18 of the Investment Company Act. MMFs do not use debt, borrowing or other forms of leverage. If the portfolio of an MMF increases or decreases in value, the shareholders own those gains and losses equally as a percentage of the amount each has invested in the MMF. The purpose of this structure – which is a fundamental purpose in the recitals to the Investment Company Act – is to assure fairness among the investors, prevent conflicts of interest between share classes, and discourage inappropriate incentives and risk-taking.

The Release assumes that there is a "first-mover advantage" for shareholders to redeem shares before a portfolio loss is recognized, and posits that a small capital buffer will eliminate this supposed "first-mover advantage" and the incentive to "run" that it creates. The creation of a class of subordinated capital under the Council's capital proposals is intended to reduce the risk of senior share class investor redemption "runs" and reduce the risk that investors in the senior share class would suffer a loss of principal. But the Release acknowledges that the capital requirement could not eliminate either risk.¹³ The innuendo of the Council's Release is that, due

⁸ *Id.* at 69474.

⁹ Under Alternative Two, 0.75 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. *Id.* at 69469.

¹⁰ *Id.* at 69475. For Alternative Two, the transition time suggested is two years. *Id.* at 69470.

¹¹ Treasury MMFs invest at least 80% of their assets in cash, Treasury securities and Treasury repos. Release at 69469.

¹² Release at 69475.

¹³ *Id.*

to imperfections in their capital structure – the absence of any “loss absorption capacity” – MMFs caused the 2007-2009 financial crisis.¹⁴ This is simply a canard, easily disproved by a glance at a timeline of the financial crisis and the order in which markets and financial institutions came unglued.

As discussed in more detail below, a capital requirement should not be imposed on MMFs for the following reasons:

- (1) A capital buffer would not achieve the intended purpose of preventing large sustained redemptions from MMFs, but would instead make large sustained redemptions more likely.
- (2) A capital buffer would be prohibitively expensive to both investors and MMF sponsors, if it could be implemented at all.
- (3) A capital buffer would create moral hazard and would be confusing to investors, suggesting that what investors now understand to be an investment product carrying a risk of loss would, instead, have the guarantee features of a bank deposit.
- (4) The requirement for a capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.
- (5) A capital buffer would change the fundamental nature of MMFs, making them less attractive to investors, which would result in a substantial shrinkage or elimination of MMFs.
- (6) Shrinkage or elimination of MMFs would harm the economy, investors, municipal governments and businesses and cost jobs by increasing the cost and decreasing the availability of credit, and increasing systemic risk.
- (7) The current capital structure of MMFs – 100% equity capital and no debt – together with very high portfolio liquidity, transparency, credit quality and maturity requirements put in place by SEC in 2010, address redemptions concerns.

¹⁴ Release at 69455-56, 69460.

(1) A capital buffer would not achieve the intended purpose of preventing large sustained redemptions from MMFs, but would instead make large sustained redemptions more likely.

What prevents runs? After much study, the FDIC staff concluded in 2006 that what stops a run on a bank is liquidity, rather than capital.¹⁵ That FDIC staff conclusion is consistent with studies concluding that what prevents runs or mass shareholder redemptions from MMFs is a high level of liquidity and stringent portfolio credit quality standards.¹⁶ Holding liquid assets in portfolio (altering the left hand side of the balance sheet where reside the cash and other assets that can be used to redeem investors) increases liquidity. Creating a subordinated class of capital (altering the right hand side of the balance sheet which reflects no assets that can be used to redeem investors), particularly of a few percent or less, does not increase liquidity. If anything, creating a junior class of equity puts earnings pressure on an MMF to alter its balance sheet to decrease near-term liquid assets to generate investment returns available from longer-term, higher risk investments in order to either build capital through retained earnings or to compensate investors who have invested in the new class of subordinated equity capital of the MMF.

The Council's capital proposals would introduce, for the first time, a form of leverage into the capital structure of MMFs. The proposal would transform MMF shareholders into creditors protected against loss by a small, more junior class of shareholder.¹⁷ Under the Council's capital proposals, a small sliver of subordinated junior capital would be required to absorb portfolio losses in order to protect the much larger class of senior shareholders of MMFs. This would transform the senior shareholders from owners of all gains and losses on the portfolio into more passive investors who do not suffer the first losses, but are subject to losses if the small sliver of capital is exhausted. Under the proposed structure, when there is a portfolio loss,

¹⁵ 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.

¹⁶ Hal Scott, *Interconnectedness and Contagion*, Committee on Capital Markets Regulation at 222-24 (Nov. 20, 2012), http://www.capmksreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Letter from Treasury Strategies to SEC (Mar. 19, 2010); 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>.

¹⁷ See Letter from John D. Hawke, Jr. to SEC (Feb. 24, 2011); Letter from Federated Investors to SEC (May 6, 2011). 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> (letters dated 2010 or later) or the SEC's Request for Comment on a Proposed Rule: Money Market Fund Reform, File No. S7-11-09, <http://www.sec.gov/comments/s7-11-09/s71109.shtml> (letters dated 2009).

because the junior shares absorb all of that loss until the junior capital is exhausted before any portion of the loss is allocated to senior shareholders, a senior shareholder under this structure has an incentive to redeem its shares in order to exit the fund at full value ahead of other senior shareholders in the event that the MMF portfolio incurs further losses. The small sliver of capital provides the senior shareholders a few days of extra time to redeem shares before the sliver is exhausted. In contrast, with a single class of common shareholders, if portfolio assets lose value such that the fund is in danger of breaking the buck and the fund board responds appropriately, the board will cause the fund to price and redeem shares at a fluctuating NAV before any shareholder has an opportunity to gain an advantage through redemption.

The two-tier capital structure gives holders of the senior class less of an incentive to consider portfolio risks in an MMF before investing, and a greater opportunity to redeem shares when those risks manifest themselves in portfolio losses. In addition, the introduction of the new form of leverage creates an incentive for the manager of the MMF to increase portfolio risk in order to generate higher portfolio returns to reward holders of the junior class of shares or to raise capital by generating retained earnings. As with any form of leverage, the Council's capital proposals would create a classic "moral hazard" within MMFs.

With respect to similar proposals floated earlier for MMFs to create a new class of subordinated capital, a July 2012 report from the Staff of the Federal Reserve Bank of New York ("FRBNY Staff Report") acknowledged 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."¹⁸

Treasury Strategies, in a report filed with the Securities and Exchange Commission ("SEC") last year, stated that a capital requirement could change both the expectations and nature of investors in MMFs: "If a capital buffer existed, investors would be more likely to view an MMF as a deposit rather than an investment. This would attract an investor class that is *more* likely to flee at the first sign of distress or rumor, thus *increasing* the likelihood of a run."¹⁹

Once a capital buffer is instituted, speculative runs by investors will begin when the buffer is first drawn upon, rather than when a fund breaks the buck.²⁰ A comment letter filed by Professors Jill Fisch, of the University of Pennsylvania Law School, and Eric Roiter, of the

¹⁸ McCabe, Ciprini, Holscher & Martin, *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 6 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> ("FRBNY Staff Report").

¹⁹ Letter from Treasury Strategies to SEC (Mar. 19, 2012) (emphasis original).

²⁰ Letter from Treasury Strategies to SEC (Mar. 19, 2012); Letter from Fidelity Investments to SEC (May 5, 2011); Letter from Jill Fisch and Eric Roiter to SEC (Dec. 2, 2011).

Boston University School of Law, explained, the likely outcome this way: once an MMF taps the capital buffer in an effort to avoid breaking the buck, “investors are put on notice that the fund might not be able to sustain its \$1 NAV. Knowing that the capital buffer is limited (somewhere between, perhaps, 0.5% to 3% of NAV), investors might have an *extra* incentive to redeem before the cushion is exhausted, thereby aggravating rather than reducing problems of collective action.”²¹

Much of the Council’s efforts to date have been to attempt to conform the structure of various types of intermediaries to that of a bank.²² Thus, rather than accepting that MMFs are financed 100% by a single class of shareholder equity and not by debt or other forms of leverage, the Council re-imagines the existing shareholders of MMFs as creditors, and thus sees a need for a new form of junior capital, in order to conform MMFs to a bank model where the bank balance sheet is financed by depositors and other creditors, who are “protected” against portfolio losses by a small layer of capital.

One might ask whether this capital structure has worked at banks (or the similar structure at structured investment vehicles (“SIVs”) used by banks to securitize assets) to prevent runs. The answer clearly is “no.” A highly leveraged capital structure creates a moral hazard that amplifies both risk-taking in portfolio investments and the risk of runs by providers of senior funding. During the 2007-2009 financial crisis, many banks, including Wachovia, Washington Mutual and IndyMac Bank, suffered from devastating runs by creditors, which brought them to and beyond the brink of insolvency. All told during the financial crisis, one MMF broke a buck, but over 300 federally-insured U.S. banks became insolvent and were closed.²³ Similarly, the small sliver of equity capital in SIVs, broker-dealers, mortgage finance companies, and government-sponsored enterprises did nothing to prevent credit from drying up for those entities during the crisis. Each suffered from runs during the financial crisis.

Is the capital model employed by banks superior in promoting stability to that currently used by MMFs? Over the past 40 years, two MMFs have broken the buck, one costing investors roughly 4 cents on the dollar, and the other less than one cent, and neither costing taxpayers a nickel. In contrast, over the same period, more than 2900 banks have failed, costing the federal government over \$164 billion.²⁴ The capital structure used by banks has not been very

²¹ Letter from Fisch & Roiter to SEC (Dec. 2, 2011).

²² Jonathan R. Macey, *Money Market Funds: A Vital Source of Systemic Stability* (Fall 2012) at 31-35, 35-37 (“Macey 2012”).

²³ FDIC Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html> (listing bank closures from 2007-2010).

²⁴ *Id.*; FDIC, *Failures and Assistance Transactions*, <http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30> (listing bank failures from 1973 to 2013).

successful in preserving bank solvency or preventing runs on banks. There is no reason to believe that it will be successful at MMFs.

(2) A capital buffer would be prohibitively expensive to both investors and MMF sponsors, if it could be implemented at all.

In discussing earlier proposals for MMFs to create a new class of subordinated capital, the FRBNY Staff Report warned 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).²⁵

The scalability problem. One of the problems created by the introduction of a two-tier capital structure to MMFs is in how the capital buffer will interact with the typical growth and shrinkage of MMFs arising from normal investor demands. Under the current capital structure – 100% equity capital financing of a single class of common equity – there is no need to synch up the size of the capital base with the size of the fund. They are one and the same. As investors choose to invest additional assets in the MMF, they provide all of its capitalization. When investors redeem assets, they simultaneously redeem an equal amount of capital. The MMF’s capital base expands and contracts as needed to fund dollar-for-dollar the asset base. In this way, MMFs operate very much like separately-managed accounts of institutional investors that invest their liquidity balances directly into money market instruments. They can expand or shrink the balances invested in money market assets, or particular categories of money market assets, as needed to address their investment needs.

If, however, a second class of subordinated capital is introduced, the size of that new additional capital layer must be coordinated with the size of the senior capital that it is designed to “protect” against first loss. If investors purchase senior shares of an MMF, its assets under management (“AUM”) increases. If capital ratios are to be met, the size of the subordinated equity must also expand by an equal percentage in order for the MMF to continue to meet its capital coverage ratios. The subordinated capital does not automatically appear from the sky to meet this need.

If the source of junior capital is retained earnings, there is no natural connection between the timing or amount of retained earnings to build the junior capital buffer and the investor demand for senior shares that expands the MMF size and creates the need for the additional

²⁵ FRBNY Staff Report at 6-7.

junior shares. The upper bound for MMF growth becomes retained earnings. Moreover, the means of enforcing the proposed capital requirement – restricting new investments to cash, Treasury securities and Treasury repurchase agreements – will reduce the MMF’s earnings, making it more difficult to rebuild the capital buffer with retained earnings. Given the short-term nature of an MMF’s portfolio, a prime MMF that falls below the capital requirement could easily find itself forced to convert to a Treasury MMF.

If the source of the junior capital is the fund manager or third-party investors, there remains no automatic connection between the availability, amount and timing of new investment in the MMF to support demand among investors for senior shares of the MMF. If markets experience turbulence, investors willing to buy the riskier subordinated shares may dry up. MMFs may be required to turn away investors in the senior common shares due to problems in obtaining investors for the junior subordinated shares.

Similarly, if investors redeem senior shares and the MMF’s AUM shrinks, there will be more junior subordinated equity than needed, which will be a drag on net returns to the senior class, depressing its returns, which may lead to further redemptions, further contractions, etc.

The result of introduction of a two-tier equity capital structure with tranches of capital that do not automatically match up with one another is to make MMFs unable to respond by growing and shrinking to meet the demands of investors for MMFs (or for particular types of MMFs).

The capital availability problem. A second problem with the Council’s capital proposals is that the amount of capital required to fund it may not be available when needed. If up to 3% of capital is required for all prime MMFs as well as all tax-exempt MMFs, at their current AUMs – which currently aggregate to approximately \$1.7 trillion – between \$45 and \$50 billion in subordinated equity would be required to be raised.²⁶ This would be a completely new form of highly-leverage capital instrument whose closest market analogy would be the equity tranches of SIVs. Even for SIVs, the equity tranche consisted of capital notes that had a stated term or allowed the equity holders to vote to wind-up the SIV, rather than being subject to the perpetual subordination envisioned in Alternative Three, which truly would be unprecedented.

²⁶ Broadly speaking, prime MMFs would need to raise approximately 2.25% capital on 10% Daily Liquid Assets and 3.00% capital on the remaining 90% of assets, although prime MMFs would exclude cash, Treasuries, and Treasury repurchase agreements from the capital calculation. According to the ICI Fact Book, as of December 31, 2011, industry-wide about 7% of prime MMF assets were Treasuries and about 13.1% were repurchase agreements (although it is not clear what amount of prime MMF repurchase agreement assets were Treasury repurchase agreements, nor is the value of other cash assets clear). Investment Company Institute, *2012 Investment Company Fact Book* (2012), http://www.icifactbook.org/2012_factbook.pdf. Thus, the capital requirement would vary based on the future asset composition of prime MMFs, but with today’s asset composition could total \$45 to \$50 billion.

Approximately \$5.1 billion was raised in initial public equity offerings in the United States during 2012.²⁷ Total U.S. public equity offerings during 2012 raised approximately \$253 billion across all industry sectors.²⁸ It is not realistic to assume that an entirely new category of highly leveraged junior equity issued by one industry segment could garner between \$45 and \$50 billion of this total from the U.S. public equity markets. Alternative Three would require MMFs to raise during a transition period of maybe six years the same amount of a capital that SIVs were estimated to have accumulated over a period of over 20 years.²⁹

MMFs would have to offer an exceptional rate of return to attract investment in non-redeemable shares, the sole purpose of which is to absorb portfolio losses. Without any other potential for profit, junior shareholders would have to earn all of their return through dividends. Without a fixed term for the investment, these dividends would have to compensate junior shareholders for the indefinite use of their capital, as well as for the portfolio risks they would bear.

Subordinated equity also would create a different form of maturity mismatch between the extremely short term of the fund's portfolio and the indefinite term of the junior capital. When short-term interest rates fall, or if the junior capital earns interest at a floating rate and spreads tighten, the fund will have less income from its portfolio from which to pay interest on the junior capital. Both of these effects (higher rates and mismatched maturities) would increase the cost of junior capital and decrease the returns to the common shareholders, deterring investment in the fund. This could spiral out of control if the fund suffers substantial redemptions but cannot retire the excess junior capital, insofar as the redemptions will reduce the fund's income with no corresponding reduction in the expense of the junior capital, further reducing returns to the common shareholders. A fund would have to pay a substantial premium for the right to redeem the junior capital in this circumstance, which would also increase the cost of the junior capital. If the goal is to maintain MMFs as a stable funding source to borrowers in the money markets during a future financial crisis, issuing non-redeemable subordinated shares that drive ordinary shareholders from MMFs by depressing their yields would not be a successful approach.

The Release asks if other types of subordinated capital might be appropriate. Issuing junior capital that has a fixed term like preferred stock or bonds would introduce equally hazardous risks. In order to reduce the cost and maturity mismatch created by the junior capital, the fixed term would need to be relatively short, so MMFs would face rollover risk as the

²⁷ Committee on Capital Markets Regulation: Global IPOs by Foreign Countries (Broadly Defined) (2013), <http://capmksreg.org/education-research/competitiveness-measures/equity-raised-in-public-markets/>.

²⁸ Committee on Capital Markets Regulation: U.S. Share of Equity Raised in Public Markets (2013), <http://capmksreg.org/education-research/competitiveness-measures/equity-raised-in-public-markets/>.

²⁹ J.P. Morgan, U.S. Fixed Income Markets Weekly at Table 2 (showing an estimated \$50 billion in equity funding for SIVs) (Aug. 24, 2007).

maturity dates for junior securities approach. If there were not sufficient investor interest at an affordable price to replace the junior securities, the MMFs would need to shrink or wind down their operations. In times of financial uncertainty, investor demand for a highly leveraged, deeply subordinated interest in a pool of money market assets would likely be far less than in more stable financial times. This would mean far less of this capital would be available when needed, and would cost significantly more than in more stable economic times. At best, this junior capital cushion would provide a period of wind-down for MMFs as it matured and is redeemed. Therefore, this type of capital would also fail to serve the goal of reducing rollover risk to borrowers, because MMFs issuing subordinated instruments with near term maturities would experience their own rollover risk.

Regardless of its term, reliance on junior capital would impair a prime MMF's ability to attract new assets. Under the proposal, if an MMF grew faster than its ability to maintain the required capital cushion, it would have to invest exclusively in cash, Treasury securities and Treasury repo. This would lower the yield from the MMF's portfolio and, consequently, make its yield less competitive with other MMFs. Issuing additional junior capital will increase the MMF's expense (both the issuance cost and the interest paid on the junior capital), which make the MMF's yield even less competitive. The MMF may have to wait for any Treasury securities and Treasury repo it purchased to mature before investing in higher yielding prime securities and restore its yield to a competitive level. In the interim, the reduction in yield will have made the MMF less attractive to new investors and may even prompt current shareholders to redeem.

In a detailed report analyzing the feasibility of a capital requirement for MMFs, the Investment Company Institute ("ICI") concluded that "small funds and small fund complexes would likely find it difficult and costly to issue and roll over subordinated securities, resulting in industry consolidation and raising a barrier to entrants."³⁰

Several fund managers also have expressed doubts about the feasibility of the capital proposal. Charles Schwab stated, "We do not believe there is a viable market for a subordinated share class that would take first loss position in exchange for a higher return."³¹ The ICI provided a detailed review and data analysis of two possible sources of funding for a capital buffer – requiring fund sponsors to commit capital or having funds build a capital buffer from fund income³² – and found that a buffer coming from either adviser's profits or investor yield

³⁰ Letter from ICI to SEC (May 16, 2012).

³¹ Letter from Charles Schwab to IOSCO, filed with SEC (May 31, 2012). *See also* Letter from Fidelity Investments to IOSCO (May 30, 2012) ("It is highly speculative that any market will develop for such subordinated shares.").

³² Letter from ICI to SEC (May 16, 2012). ICI considered funding the capital buffer from the market as a third possibility, and noted "significant legal, business, accounting, and economic hurdles to raising capital in the market."

would take many years to build up.³³ The third alternative, raising subordinated/third party capital, was thoroughly analyzed and discussed with SEC and Federal Reserve staff in Fall 2011 and determined to be unmarketable and not viable.

A capital requirement borne by MMF managers or MMF common shareholders would drive many sponsors of MMFs out of the business.³⁴ According to an analysis prepared by Treasury Strategies, “A capital requirement of 50 basis points (0.50%), if applied against all MMFs, would total \$12.5 billion. Given today’s ultra-low interest environment, it would not be feasible to build the buffer by retaining a portion of the customer yield. As a result, the requirement would fall to the fund sponsors. They would also be responsible for replenishing the capital, should any losses be incurred within the portfolio. From the sponsors’ perspective, that is tantamount to providing a blanket guarantee on the entire fund. Their only logical alternative is to exit the business.”³⁵

The Securities Industry and Financial Markets Association (“SIFMA”) further explained, “If the level of required capital cannot be sustained by the marketplace, the result of a capital requirement would be to severely curtail the availability of money market funds, eliminating an attractive cash management option for investors, likely prompting a shift to less heavily regulated investment vehicles which pose more systemic risk, and eliminating a source of financing for issuers.”³⁶

³³ *Id.*

³⁴ Letter from Invesco to IOSCO, filed with SEC (May 25, 2012); Letter from Treasury Strategies to SEC (Mar. 19, 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.

³⁵ Letter from Treasury Strategies to SEC (Mar. 19, 2012). BlackRock commented, “[A]bove approximately 70 basis points of capital, the money market industry will no longer return the industry cost of capital to fund sponsors [This] will cause the industry to contract . . . unless fees rise” 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.

³⁶ Letter from SIFMA to SEC (Jan. 10, 2011). *See also* Letter from ICI to SEC (May 16, 2012); Letter from SunGard Global Network to SEC (Mar. 16, 2012); Letter from Federated Investors to SEC (May 6, 2011); Letter from Senator Patrick J. Toomey (R-PA), Michael F. Bennet (D-CO), Mike Crapo (R-ID), Jon Tester (D-MT), Mark Kirk (R-IL), and Robert Menendez (D-NJ) to SEC (Nov. 4, 2011), <http://www.preservemoneymarketfunds.org/senate-letter-to-sec-chairperson-mary-schapiro/>.

The economic cost of capital problem.³⁷ The Release posits that the economic cost of the new class of junior subordinated capital will be *de minimis* at 0.0075%.³⁸ This assumption is plainly wrong, unsupported by data or meaningful Council analysis in the Release, and flatly at odds with information that has been submitted in response to the President's Working Group on Financial Markets report on Money Market Mutual Fund Reform Options. MMFs have pushed down short-term borrowing costs for prime corporate and municipal borrowers well below the rates charged by banks. If MMFs shrink or disappear those rates will go back up.

The Release estimates a cost of capital of 5% above the returns on common shares of MMFs, based on returns on BBB-rated corporate bonds. If the junior subordinated capital had no fixed maturity or a very long-dated maturity, it would need to bear equity-like returns and would face a limited market. A better estimate of equity returns would imply a significantly higher cost of capital, nearly double that rate.³⁹

The Release then assumes the 5% cost of capital is spread out over the portfolio of the MMF at a leverage ratio of 100-1 and passed through entirely to issuers whose instruments are held in the MMF's portfolio. Dividing 5% by 100 and then dividing that further by the percentage of financing provided by MMFs, the Release reaches its 0.0075% estimate of the economic cost of the Council's equity capital proposal.

The Release notes that the economic cost of its proposal would be lower still if issuers into the money markets shifted to obtaining funding from other sources.⁴⁰ That assumption ignores the fact that the cost of obtaining financing from a bank is approximately 200 to 300 basis points higher than the cost of obtaining financing from an MMF.⁴¹ Accordingly, if money

³⁷ While the economic costs of the Council's capital proposals are briefly discussed herein, a more detailed analysis of these issues may be found in a forthcoming letter by Stephen A. Keen, to be filed on behalf of Federated Investors.

³⁸ Release at 69480-81.

³⁹ See NYU Stern Business School, *Cost of Capital by Sector* (Jan. 2012), http://w4.stern.nyu.edu/~adamodar/New_Home_Page/datafile/wacc.htm (estimate of 7.6% (Midwestern banks) 9.76% (diversified financial services) 11.43% (life insurance); Roger J. Grabowski, Duff & Phelps, VALCON 2012 *Developing the Cost of Equity Capital: Risk-free rate and ERP during periods of "Flight to Quality"* (Feb. 24, 2012), avail. online at <http://materials.abi.org/sites/default/files/2012/Feb/DevelopingCostEquityCapital.pdf> (concluding a 2012 equity risk premium of 5.5% above a long-term risk free rate of 4.0% for a total cost of capital of 9.5% during normal economic times, but significantly higher costs of capital during periods involving "flights to capital").

⁴⁰ Release at 69480-81.

⁴¹ See Board of Governors of the Federal Reserve System, *Selected Interest Rates (Weekly) – H.15* (updated Jan. 14, 2013), <http://www.federalreserve.gov/releases/h15/current/> (showing the weekly average prime rate charged by banks on short-term loans to business); Board of Governors of the Federal Reserve System, *Commercial Paper Rates and Outstanding Summary* (updated Jan. 16, 2013), <http://www.federalreserve.gov/releases/cp/> (showing daily interest rates for 90-Day AA Nonfinancial Commercial Paper).

market issuers are forced to obtain their financing from banks, their costs will increase dramatically. Conversely, if MMFs are disintermediated by a shift by money market issuers to obtaining their financing directly from separately managed accounts or from less regulated bank short-term investment funds (“STIFs”), hedge funds and offshore funds, a primary goal of the Council proposal – stabilizing the funding sources for money market issuers and limiting their rollover risks in a future financial crisis – is gutted, as those alternate funding sources will pull funding from money markets when their principals flee to quality in the face of market uncertainty.

Analyzing the costs of two possible sources of funding for a capital buffer, the ICI found the following in a report filed with the SEC last year:

- Assuming the buffer would come from fund sponsors, “all advisers would expect to earn the market rate of return on such capital. If they cannot earn that rate of return, they would seek better business alternatives, such as moving investors to less-regulated cash management products where investors still must bear the risks of investing.”⁴² The ICI further observed that the rate of return on capital contributed would have to be quite large, because although the likelihood of potential losses in a money market fund is very low, the *percentage* losses on its small capital investment could be large in the event the buffer must be tapped. Assuming a 1.5 to 3 percent buffer, the funds’ current fee structure and current market conditions, ICI calculated that recouping the buffer would take every dollar of at least 8 to 20 years of advisers’ profits from the fund. In the alternative, advisers would be forced to raise fund fees between 16 and 40 basis points to achieve a market rate of return on pledged capital.
- If a buffer were to come from withheld shareholder yield, ICI calculated it would take a prime MMF 10 to 15 years to raise a 0.5 percent buffer given plausible assumptions about future interest rates, the reaction of investors to the buildup of the buffer, and the willingness of fund advisers to continue to absorb fee waivers. Under the “best of circumstances,” ICI calculated the 0.5 percent buffer would take at least 5 years to buildup.⁴³

A capital buffer funded by withholding a portion of income and gains from MMF shareholders would reduce yields and would motivate investors to abandon MMFs in search of higher yields elsewhere, including in unregulated and less transparent vehicles.⁴⁴ A joint letter

⁴² Letter from ICI to SEC (May 16, 2012). ICI considered funding the capital buffer from the market as a third possibility, and noted “significant legal, business, accounting, and economic hurdles to raising capital in the market.”

⁴³ *Id.*

⁴⁴ Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies); Letter from State Street to SEC (Feb. 24, 2012); Letter from Northern Kentucky Chamber to

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from the Independent Directors Council and the Mutual Fund Directors Forum stated that reduced yields will make MMFs “substantially less attractive to investors” and result in a shift to alternative products.⁴⁵

In a survey of institutional MMF users commissioned by the ICI, Treasury Strategies found that the institution of a capital buffer will drive a large portion of current users out of the MMF market.⁴⁶ Of the more than 200 institutional users of MMFs surveyed, 36% said they would decrease or stop using MMFs if the fund contained a capital buffer. Of those, 35% said they would stop using MMFs entirely. Even the survey respondents who said they would continue using MMFs upon the institution of a capital buffer showed little tolerance for loss of yield. More than half of those users would divest given a 2 basis point loss, and 92% would divest at 5 basis points.

Commenters also provided analyses of the costs of a capital requirement borne by fund sponsors, which would cause fund sponsors to exit the business.⁴⁷

The junior subordinated class is designed to take the first loss on portfolio assets. As proposed, the new structure is highly leveraged – somewhere between 99-1 and 97-3 depending on the asset mix and which proposal is involved. This greatly magnifies the portfolio risk to investors in the junior class for which they will require some form of compensation. Assuming a separate class of junior shareholders is created, because the junior subordinated shares would bear much greater risk than the senior common shares of the MMF, the MMF would need to pay junior shareholders a higher return. To pay the cost of capital of the junior subordinated shares, a portion of portfolio asset returns would need to be shifted from senior common shareholders to junior subordinated shareholders of the MMF.

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SEC (Jan. 20, 2012). See also PWG Report at 34 (stating that “a substantial mandatory capital buffer for MMFs would reduce their net yields and possibly motivate institutional investors to move assets from MMFs to unregulated alternatives (particularly if regulatory reform does not include new constraints on such vehicles).”).

⁴⁵ Letter from Independent Directors Council and Mutual Fund Directors Forum to SEC (May 2, 2012).

⁴⁶ Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies).

⁴⁷ Letter from Treasury Strategies to SEC (Mar. 19, 2012). BlackRock commented, “[A]bove approximately 70 basis points of capital, the money market industry will no longer return the industry cost of capital to fund sponsors [This] will cause the industry to contract . . . unless fees rise” 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. See also Letter from SIFMA to SEC (Jan. 10, 2011) (“If the level of required capital cannot be sustained by the marketplace, the result of a capital requirement would be to severely curtail the availability of money market funds, eliminating an attractive cash management option for investors, likely prompting a shift to less heavily regulated investment vehicles which pose more systemic risk, and eliminating a source of financing for issuers.”).

If instead, the junior class is an accumulated stash of retained earnings built up over time and held in a suspense account rather than a separate shareholder class, the retention could only be built up by withholding earnings from shareholders, and thereby reducing their returns. Either way, the already low returns to prime MMF shareholders would be further reduced.

Because the Council is proposing that no capital requirements be imposed on Treasury MMFs, the return on Treasury MMFs sets a lower bound on a minimum return that would need to be paid to shareholders. According to BlackRock, “assuming a 6-basis point charge to the fund, prime funds’ yields would have been lower than government funds’ more than 1/3 of the time. Looking forward, this relationship is sensitive and could result in substantial flows of capital among funds, thereby destabilizing the industry.”⁴⁸ MMF investors would have no reason to accept lower returns on prime MMF common shares than they could earn on Treasury MMF shares. There simply is not enough yield in prime MMF portfolios under current market conditions to pay for any of the new forms of capital suggested in the Release.

Other Technical Problems with Capital Proposals. In a paper on the feasibility of various types of capital requirements, ICI noted that there are “significant legal, business, accounting, and economic hurdles to raising capital in the market.”⁴⁹ Among these technical issues are the tax treatment of MMFs. MMFs, like all U.S. mutual funds, are permitted to deduct dividends paid to shareholders during each tax year. Any earnings a fund retains, however, are taxed at corporate tax rates. Retained earnings are subject to an additional excise tax if the MMF fails to distributed at least 98% of its taxable income and net gains each calendar year. If the MMF fails to distributed at least 90% of its income and net gains each taxable year, it also loses the right to deduct its dividends, so that all of its income becomes subject to double taxation, first to corporate taxes and then as taxable dividends to its shareholders. These tax requirements would make it extremely difficult and inefficient to build a capital buffer by retaining earnings, and could cut an MMF’s yield to such as extent as to drive away shareholders. Depending upon how these tax provisions are amended to permit the retention of earnings, shareholders may be taxed on “phantom” earnings that are withheld as part of the buffer and not available to them. Assuming *that* tax issue is resolved through further amendments to the tax code, the process for accounting for and recapturing the deferred taxes on the withheld earnings that form the buffer would be a very complicated process.

In addition, a capital buffer would present fairness issues if it is built up through retained income and gains, as current shareholders would be forced to pay to protect future

⁴⁸ 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.

⁴⁹ Letter from ICI to SEC (May 16, 2012).

shareholders.⁵⁰ Such a program would shift wealth from current investors to future investors in MMFs.

The deferral of income and gains to set aside a hidden capital buffer to calm investors by offsetting future portfolio losses also has the awkward attribute of being a form of income “smoothing” that long has been a target of SEC enforcement actions as a specie of securities fraud.⁵¹ It is not too surprising that the banking regulators developed this capital proposal to calm MMF shareholders and reduce their propensity to “run” in a crisis, as the bank regulators (until the SEC put a stop to the practice at banks in 1998) had long encouraged or permitted banks to engage in similar practices to reserve income in good years as a buffer to offset loan losses in bad years and create an appearance of stability; they continue to voice support for a return to the practice.⁵²

In addition, creating a two-class structure for an MMF (or any registered investment company) is prohibited by Sections 1(b) and 18 of the Investment Company Act, and is contrary to the legislative findings and legislative purposes behind that Act to prevent the conflicts of interest among different stakeholders that necessarily follow from leveraged or multi-class capital structures. The SEC would need to waive this fundamental prohibition in order to permit the two-class capital structure. To the extent that retained earnings are used to create the capital buffer, this method conflicts with several valuation and accounting requirements codified in the Investment Company Act, which also would need to be waived by the SEC.⁵³

Moreover, existing MMFs would have to amend their charters and other organizational documents in order to issue a subordinated class of equity. 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

⁵⁰ Letter from Federated Investors to SEC (May 6, 2011).

⁵¹ See, e.g., Complaint, *SEC v. Federal Home Loan Mortgage Corporation et al.*, Case No. 07-CV-1728 (D.D.C. filed Sept. 27, 2007); Complaint, *SEC v. James N. Standard et al.*, No. 06-CV-7736 (S.D.N.Y. filed Sept. 27, 2006); *In the Matter of American International Group, Inc.*, SEC Rel. No. 34-48477 (Sept. 11, 2003).

⁵² Bernanke, *Financial Reforms to Address Systemic Risk*, Remarks at Council on Foreign Relations, (Mar. 10, 2009), <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>; Balla & Rose, *Loan Loss Reserves, Accounting Constraints, and Bank Ownership Structure*, Federal Reserve Bank of Richmond Working Paper No. WP-09 (Nov. 17, 2011), http://www.richmondfed.org/publications/research/working_papers/2011/pdf/wp11-09.pdf; Balla, Rose & Romero, *Loan Loss Reserve Accounting and Bank Behavior*, Federal Reserve Bank of Richmond Economic Brief EB12-03 (Mar. 2012), http://www.richmondfed.org/publications/research/economic_brief/2012/pdf/eb_12-03.pdf; Rivard, Bland & Hatfield Morris, *Income Smoothing Behavior of U.S. Banks Under Revised International Capital Standards*, 9 IAER 288 (Nov. 2003).

⁵³ Investment Company Act § 22. 17 CFR §§ 270.2a-4, 270.22c-1.

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.

(3) A capital buffer would create moral hazard and would be confusing to investors, suggesting that what investors now understand to be an investment product carrying a risk of loss would, instead, have the guarantee features of a bank deposit.

The three alternative Council proposals are internally inconsistent in their aims. On the one hand, the Council proposes a movement to a continually floating NAV so that investors will better understand that their investments may lose value, which the Council believes will desensitize investors to future events that cause an MMF to break the buck and thus investors will be less likely to redeem their shares to avoid a loss in a future financial crisis.⁵⁴ On the other hand, with its capital proposal, the Council proposes to create a capital buffer to insulate MMF common shareholders from portfolio losses, so that they will not redeem their shares in a financial crisis.⁵⁵ The two approaches cannot be reconciled.

The capital buffer also creates concerns about transparency and investor confusion.⁵⁶ The Treasury Strategies report stated that the “guaranteed” return of principal implied by a capital requirement promotes the false notion that MMFs are deposits, increasing moral hazard from the investor’s perspective.⁵⁷ MMF disclosures currently advise shareholders that their investments are not guaranteed, which creates an incentive for investors not to chase yield, but instead to consider the quality of the manager and of the investment portfolio of the MMF.⁵⁸ With a capital buffer in place, investors lose that incentive and instead benefit most from investing in the riskiest fund with the greatest yield.⁵⁹ This feedback loop of risky incentives will significantly undercut the gains made through the 2010 amendments by increasing systemic risk.⁶⁰ Treasury Strategies has noted that “adding a capital requirement to funds places increased

⁵⁴ Release at 69466.

⁵⁵ *Id.* at 69469, 69475.

⁵⁶ Letter from Keystone ELF to SEC (Nov. 18, 2011) (“How does [the floating NAV] address the transparency issues addressed by the required ‘shadow NAV?’ Will there now be three NAV’s to track? By artificially skewing the NAV in a more positive light, are we giving more comfort for investors?”).

⁵⁷ Letter from Treasury Strategies to SEC (Mar. 19, 2012).

⁵⁸ Letter from John D. Hawke, Jr. to SEC (Feb. 24, 2011). *See also* Macey 2012 at 25-27.

⁵⁹ *Id.*

⁶⁰ Letter from Treasury Strategies to SEC (Mar. 19, 2012); Letter from John D. Hawke, Jr. to SEC (Feb. 24, 2011).

pressure on fund managers to drive yield. In order to meet this pressure, managers will have to either extend maturities or add credit risk.”⁶¹

In its report, Treasury Strategies cited two empirical studies demonstrating moral hazard in the deposit insurance context: a 2000 study that found “explicit deposit insurance tends to be detrimental to bank stability;”⁶² and a more recent study finding that “banks take on higher risk in the presence of explicit insurance and hence that explicit deposit insurance has generated moral hazard incentive for banks.”⁶³ Treasury Strategies stated that there is an “obvious parallel” between an MMF capital requirement and FDIC deposit insurance: “Just as insurance can change the behavior of the insured, a capital requirement will encourage fund advisers to buy riskier investments, as they seek higher yields to increase assets under management.”⁶⁴

Professor Macey of Yale Law School has noted this issue as well:

The government intervention may be having the opposite effect by providing artificial support and perhaps an unrealistic sense of security. Imposing a like regime upon MMFs would squash alternatives and bring more assets under this problematic umbrella.

...

If regulators’ goal is to end the need for government bailouts for financial institutions that are “too big to fail,” cash investors must bear some risk and responsibility. Making the government’s role in regulating MMFs substantially more oppressive, or killing them off entirely and re-routing the money to FDIC-insured banks (most likely Systemically Important Financial Institution (SIFI) banks) will not help to achieve this objective. Regulation that nudges investors towards banks will only compound these many destabilizing forces inherent within banks. Instead of attempting to treat MMFs more like banks, regulators should instead seek to keep assets in the more-stable MMFs.⁶⁵

⁶¹ Letter from Treasury Strategies to SEC (Mar. 19, 2012). *See also* Letter from Federated Investors to SEC (May 6, 2011).

⁶² Letter from Treasury Strategies to SEC (Mar. 19, 2012) (citing Asli Demirgüç-Kunt and Enrica Detragiache, *Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation*, April 2000).

⁶³ Letter from Treasury Strategies to SEC (Mar. 19, 2012) (citing Isabelle Distigui, Tchudjane Kouassi, Amine Tarazi, *Bank Deposit Insurance, Moral Hazard and Market Discipline: Evidence from Central and Eastern Europe*, June 2011).

⁶⁴ Letter from Treasury Strategies to SEC (Mar. 19, 2012).

⁶⁵ Macey 2012 at 17-19.

(4) The requirement for a capital buffer, if it acts as its proponents suggest, would undermine, not promote, market discipline.

The Council's proposal for a capital buffer, discussed in this paper, and its MBR/NAV buffer proposal, discussed in a separate paper submitted by Arnold & Porter this same date titled "Proposal for a Minimum Balance at Risk and NAV Buffer for Money Market Mutual Funds," 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."⁶⁶ 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.

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.⁶⁷ 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.

⁶⁶ Release at 69472.

⁶⁷ *Id.*

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.”⁶⁸ 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.”⁶⁹ 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.

(5) A capital buffer would change the fundamental nature of MMFs, making them less attractive to investors, which would result in a substantial shrinkage or elimination of MMFs.

The ICI has stated that “[a]dding subordinated debt or equity would turn a rather simple product—the money market fund—into a considerably more complex offering. . . . [T]he approach potentially would create competing interests between the subordinated and senior investors, such as the subordinated investors’ desire to avoid losses and senior investors’ desire for the fund to take greater risks to boost fund yields. A market-raised capital buffer would reduce the yield available to senior shareholders, and subordinated investors would have a highly levered investment.”⁷⁰

By statute, and by their very nature, all mutual funds, including MMFs, have a single class of equity and do not use leverage. All investors share equally in incomes, gains and losses according to their percentage ownerships. This is why they are called *mutual* funds. This structure was put in place by Congress to do away with the conflicts of interest and skewed incentives that will always exist with multiple classes of shares with different priorities and economic rights.⁷¹ For many investors, this equal treatment of all shareholders is the most attractive aspect of mutual funds, including MMFs. By creating a multi-class equity structure and introducing financial leverage in the form of a subordinated class, the product is fundamentally changed into something like a bank or an SIV of the sort used in the toxic asset securitizations that were the actual proximate cause of the 2007-2009 financial crisis.

⁶⁸ *Id.* at 69471.

⁶⁹ *Id.*

⁷⁰ Letter from ICI to SEC (May 16, 2012).

⁷¹ Investment Company Act 1(b). Macey 2012 at 25-29.

A group of 33 Members of Congress who are all former state and local government officials expressed concern that the imposition of additional changes to MMF regulation that have been discussed by policymakers, including the capital requirement, “would alter the fundamental structure of MMFs and would, in turn, lead investors to other less-regulated products.”⁷²

The Council’s capital proposals, if implemented, would harm MMF investors and the money markets by creating conflicts of interests with the new subordinated shareholders and/or with managers, create moral hazards, reduce returns to investors and increase short-term borrowing costs. The proposed capital standards would not meet the requirement under Section 2(c) of the Investment Company Act that rulemakings must further the protection of investors, and promote efficiency, competition, and capital formation.

(6) Shrinkage or elimination of MMFs would harm the economy, investors, municipal governments and businesses and cost jobs by increasing the cost and decreasing the availability of credit, and increasing systemic risk.

The Release acknowledges the importance of MMFs to the economy.⁷³ A capital requirement that results in a shrinkage of MMF assets would contract the market for and raise the costs of, short-term public and private debt financing.⁷⁴ MMFs provide critical financing to every sector of the short-term credit market. If MMFs were taken out of the financial system, and the role currently performed by MMFs in providing short-term financing was performed solely by commercial banks, the economy would be harmed through increased financing costs to business and governments.

Banks are far less efficient than are MMFs in providing funding to corporate and government borrowers in the money markets. Banks have overhead costs that are far higher per dollar of assets than the operations costs of MMFs. A comparison of expense data shows that cost differential is between 200 and 300 basis points per year per dollar of assets. This large cost differential between the expense ratios of MMFs as compared to banks means there are lower returns to savers and higher costs to borrowers when balances are intermediated through the banking system. If MMFs disappeared and were replaced by banks, the higher cost of borrowing

⁷² Letter from 33 Members of Congress to SEC (May 1, 2012), http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658551.pdf.

⁷³ Release at 69455.

⁷⁴ Letter from 33 Members of Congress to SEC (May 1, 2012); Letter Greater Raleigh Chamber of Commerce to SEC (Feb. 28, 2012); Letter from the Northern Kentucky Chamber of Commerce to SEC (Jan. 20, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with SEC (Dec. 15, 2011). *See also* Letter from Melanie Fein to SEC (May 11, 2012).

would translate directly into less economic growth, fewer jobs, and even further cuts to government programs, payrolls, pensions and benefits.

Shrinking MMFs will directly reduce the amount of credit financing they are able to provide through the short-term money markets. MMFs are significant purchasers of commercial paper, short-term state and local government debt, and short-term Treasury and federal agency securities.⁷⁵ MMFs will purchase significantly less public and private debt once the funds' holdings are reduced. A letter from 33 Members of Congress who are all former state and local officials warned that “[a]ny reduction in demand for money market funds would reduce demand for the securities issued by state and local governments and purchased by MMFs. As a result, states and municipalities would be deprived of a critical funding source and would be faced with increasing debt issuance costs.”⁷⁶

Shrinking MMFs would increase systemic risk by causing further growth of the largest SIFI banks. Over 75% of recent deposit growth that was caused by unlimited deposit insurance of demand deposit accounts flowed into the ten largest banks. The ten largest U.S. banks represent 65% of banking assets and 75% of U.S. GDP. Institutional investors hold approximately two-thirds of MMF shares. If two-thirds of MMF balances move into the banking system and 75% of that flows into the ten largest banks, that would increase the size of the ten largest SIFI banks by \$1.3 trillion to 74% of U.S. banking assets and 84% of U.S. GDP. Increasing the concentration of the banking industry and the size and systemic importance of the largest banks is directly contrary to the purposes stated in the preamble to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 “to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts.”⁷⁷

This movement of balances from MMFs to bank deposits would also result in a much larger federal safety net with fewer assets to backstop FDIC insurance. Each trillion dollars of balances shifted from MMFs to bank deposits results in the FDIC’s Bank Insurance Fund falling an additional \$20 billion below its 2% target ratio of BIF assets to covered deposits. Even without this increase, the FDIC projects that it will not reach its target ratio until at least 2020.

The existence of MMFs to hold these large, short-term corporate balances reduces the risk to the U.S. banking system by keeping them from moving across the balance sheets of U.S. banks, reducing the size of the federal safety net, and reducing the interest rate risk and funding

⁷⁵ PWG Report at 7.

⁷⁶ Letter from 33 Members of Congress to SEC (May 1, 2012). *See also* Letter from ICI to SEC (May 25, 2012); PWG Report at 34 (“If asset managers or other firms were unwilling or unable to raise the capital needed to operate the new SPBs, a sharp reduction in assets in stable NAV MMFs might diminish their capacity to supply short-term credit....”).

⁷⁷ Preamble to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

risk that these balances would otherwise present to banks. MMFs benefit the financial system by providing a relatively safe means for commercial users to store short-term liquidity away from the banking system and its explicit federal guarantee.⁷⁸

Nor do banks want a large new inflow of short-term deposits. Because of their cost structures, including the cost of capital, FDIC insurance premiums, and personnel and occupancy expense, banks cannot profitably invest deposit inflows into short-term money market assets. In order to avoid losing money on every new dollar, banks must invest the deposit inflows into loans and other long term, higher risk assets, which creates interest rate risk, funding risk and credit risk for the bank on these balances. These balances, coming in from corporate treasurers or through omnibus accounts, are often in very large dollar amounts and placed for short periods of time. The balances often exceed the FDIC deposit insurance limit of \$250,000 many times over. Relying upon this type of balance to finance a part of a bank's balance sheet creates funding risk. In a crunch, the bank may need suddenly to replace this funding source just as cash availability is becoming much more expensive and much less available. This is why some banks at times have turned away new large deposit balances or charged depositors a fee to hold the balance.

If investor balances are instead shifted to separately managed institutional investor accounts that invest directly in commercial paper, bank deposits and other money market instruments, or to STIFs, hedge funds or offshore funds, the financing remains subject to roll-over risk. Investors will choose not to renew this financing in a crisis as they shift liquidity balances to lower risk assets such as government securities and government securities MMFs. In times of uncertainty, an investor "flight to quality" will occur regardless of the structure imposed on MMFs.⁷⁹ As the European Commission recently concluded, "withdrawal [by MMFs] of deposits from banks perceived as weak only mirrors what [MMFs'] underlying shareholders would do anyway at times of stress. So [MMFs] should be seen more as a messenger of stress in the system rather than the underlying cause."⁸⁰

⁷⁸ Macey 2012 at 17-19, 29-30.

⁷⁹ See Letter from Federal Reserve Bank of Dallas to Financial Stability Oversight Council (Jan. 7, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0030> (observing that an even sharper contraction of the commercial paper market occurred during the Great Depression than during the recent financial crisis). Notably, there were no MMFs in existence during the Depression (nor had the Investment Company Act of 1940 been enacted). A similar observation could be made regarding the Panics of 1857 and 1873, the Hard Times of 1893, the Panic of 1907, and the Penn Central commercial paper panic of 1970.

⁸⁰ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 72 (Nov. 2012), http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp472_en.pdf.

(7) The current capital structure of MMFs – 100% equity capital and no debt – together with very high portfolio liquidity, credit quality and maturity requirements put in place by SEC in 2010, address redemptions concerns.

MMFs are financed exclusively by common equity capital provided by MMF shareholders. MMFs do not use leverage or other forms of debt or borrowing. The Release suggests a requirement that MMFs issue a new category of subordinated equity capital to absorb the “first loss” on defaulted portfolio securities.

With the exception of the Reserve Primary Fund itself, the main problem faced by MMFs during the financial crisis was not capital. It was liquidity. A few percentage points of junior capital does little or nothing to address liquidity problems. Instead, maintaining a short-term fixed income portfolio, which holds a large amount of ready cash and near-cash assets and essentially self-liquidates in its entirety in a relatively short period of time, provides a much better protection against a “run.”⁸¹ This is the approach taken by the SEC in Rule 2a-7, and these liquidity requirements have been made even more stringent through the 2010 amendments to that rule.

According to an analysis provided by Fidelity Investments in March of last year, MMFs held more than \$1 trillion in 7-day liquidity, many times the amount required to satisfy shareholder redemptions during the September 2008 crisis (\$310 billion) and the June through August 2011 period of the European debt crisis and U.S. debt ceiling debate (\$172 billion).⁸² Fidelity stated, “[t]he large liquidity cushions now required by Rule 2a-7 have mitigated risk without imposing exceedingly costly unintended consequences.”⁸³ Because the 2010 reforms are working to lessen the incentive to run and now require funds to have sufficient levels of liquidity to meet shareholder redemptions during periods of market stress, Fidelity said additional reforms, including a capital requirement, are unnecessary. The recent SEC staff study also reported high levels of MMF liquidity, stating, “Today, the typical prime money fund holds over one quarter of its portfolio in DLA [daily liquid assets] and nearly one half of its portfolio in

⁸¹ Hal Scott, *Interconnectedness and Contagion*, Committee on Capital Markets Regulation at 222-24 (Nov. 20, 2012), http://www.capmksreg.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>.

⁸² Letter from Fidelity Investments to SEC (Mar. 1, 2012).

⁸³ *Id.*

WLA [weekly liquid assets]. Some prime money market funds choose to hold considerably more DLA and WLA than required.”⁸⁴

The capital structure in the Proposed Recommendations would transform shareholders of MMFs essentially into depositors or creditors, who are protected against loss by a small, more junior class of shareholder, and who would not share in any upside yield. This would introduce a form of leverage to MMFs for the first time. Currently, MMFs have 100% equity capitalization. Shareholders are not guaranteed against losses. Instead, they are very clearly told that, although the fund will attempt to maintain a stable net asset value per share (generally \$1 per share) there is no guarantee that it will be able to do so, and are told very clearly that there is no federal guarantee of the value of their shares. This creates an incentive for investors not to chase yield, but instead to consider the quality of the investment portfolio of the MMF. The absence of a junior class of securities also reduces the incentive for the sponsor as the likely holder of that junior class to pursue a higher risk portfolio investment strategy in order to increase the residual return to the junior class of equity after paying the senior investor class its yield, the way, for example, that bankers and hedge fund sponsors do.

A capital buffer would be inappropriate in the MMF context.⁸⁵ As SIFMA has pointed out previously in a comment filed with the SEC, “[u]nlike banks, money market funds do not use leverage or hold non-transparent assets, and they do not have operating assets, use off-balance sheet financing or have deposit insurance. It is for these reasons that banks have capital buffers that are structured to shield the Federal Deposit Insurance Corporation, depositors and other creditors. Investors in money market funds are shareholders, not creditors. They are subject to potential loss, in return for a market return on their short-term investments.”⁸⁶ A former Federal Reserve lawyer further noted that “[c]apital may be appropriate as a loss-absorbing mechanism for banks, which are in the business of assuming credit risk on long-term loans and other assets. Unlike banks, MMFs operate subject to the strict limitations of Rule 2a-7 and are permitted to incur only minimal credit risk.”⁸⁷ Other comment letters filed with the SEC emphasized the differences between MMFs, which do not use leverage or hold non-transparent assets, have operating assets, use off-balance sheet financing or have deposit insurance, and banks, which do have these attributes and are in the business of assuming credit risk on long-term loans and other

⁸⁴ SEC Division of Risk, Strategy, and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, at 20-22 (Nov. 30, 2012), <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>.

⁸⁵ Letter from SIFMA to SEC (Jan. 10, 2011); Letter from ICI to SEC (Jan. 10, 2011).

⁸⁶ Letter from SIFMA to SEC (Jan. 10, 2011).

⁸⁷ Letter from Melanie Fein to SEC (Apr. 18, 2012).

assets.⁸⁸ Investors in MMFs are shareholders, not creditors, and subject to potential loss, in return for a market return on their short-term investments.

As Professor Macey has observed, banks are inherently unstable because “(1) their assets and liabilities are mismatched with respect to maturity and (2) their assets and liabilities are mismatched with respect to liquidity; (3) their assets are opaque and thus hard to monitor; and (4) banks are very thinly capitalized.”⁸⁹ In contrast, Professor Macey concluded that “the assets held by MMFs are more liquid, more transparent, easier to value, and better match the liabilities in terms of maturity and liquidity than assets held by banks and other financial institutions.”⁹⁰

To put it another way, it is very hard to know what a bank's assets (the left-hand side of its balance sheet) are worth or how much money a bank would get if it had to sell them. Banks finance their portfolios primarily with deposits and other promises to repay creditors a fixed principal amount plus interest (together with equity capital, the right-hand side of the balance sheet). Most of these bank debt obligations are medium and near term deposits and borrowings. Bank assets are medium and long-term, most not publicly offered or traded, with most loans originated by the bank in privately negotiated loan transactions. These assets are carried at historical cost on the bank's balance sheet which may or may not reflect their current value. The Federal Reserve and other banking agencies have fought a long public relations and legislative battle to prevent the SEC and the accounting profession from requiring banks to calculate and publicly disclose the current value of their assets.⁹¹ Capital provides a cushion or fudge factor between the unknown current value of a bank's assets and the fixed and certain amount the bank must repay its creditors.

⁸⁸ Letter from SIFMA to SEC (Jan. 10, 2011). *See also* Letter from Melanie Fein to SEC (Apr. 18, 2012).

⁸⁹ Macey 2012 at 17-18.

⁹⁰ *Id.* at 28.

⁹¹ *See* SEC Office of the Chief Accountant, Division of Corporation Finance, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* (2009), <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>; Elizabeth Blankespoor, Thomas J. Linsmeier, & Catherine Shakespeare, *Fair value accounting for financial instruments: Does it improve the association between bank leverage and credit risk?* (Stanford Graduate Business School Research Paper No. 2107 (June 2012)), <https://gsbapps.stanford.edu/researchpapers/library/RP2107.pdf>; Christian Laux and Christian Leuz, *Did Fair-Value Accounting Contribute to the Financial Crisis?* 24 *Journal of Economic Perspectives* 93 (Winter 2010), <http://nd.edu/~carecob/April2011Conference/LeuzPaper.pdf>; William R. Emmons, *Fair Value Accounting: Don't Shoot The Messenger*, Federal Reserve Bank of St. Louis, Central Banker (Summer 2009), <http://www.stlouisfed.org/publications/cb/articles/?id=1332>; Joyce Joseph-Bell, Ron Joas, and Neri Bukspan, *Banks: The Fight over Fair Value*, Bloomberg/Businessweek, Markets & Finance (Oct. 15, 2008), <http://www.businessweek.com/stories/2008-10-15/banks-the-fight-over-fair-valuebusinessweek-business-news-stock-market-and-financial-advice>; Sanders Shaffer, *Evaluating the Impact of Fair Value Accounting on Financial Institutions: Implications for Accounting Standards Setting and Bank Supervision*, Federal Reserve Bank of Boston, Working Paper No. QAU 12-01 (Dec. 31, 2011), <http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1201.pdf>.

In contrast, the assets of an MMF have a known current value and it is easy to determine what the MMF will get for them if sold. MMF assets are purchased in transactions from public reporting issuers and have very short maturities. On average, MMF portfolio assets have been purchased within the past thirty days and will be repaid within the next sixty days. The portfolio of an MMF is almost entirely replaced every few months. Although they are carried at historical/amortized cost, MMFs also calculate and disclose the current value of their portfolio assets, and MMF boards under SEC rules are permitted to use amortized cost only so long as the board believes it fairly reflects the market-based net asset value per share. In contrast to bank assets, because of the very short maturity and high credit quality of MMF assets, the difference between the amortized cost and current value of MMF assets is negligible.⁹² MMF assets are financed entirely by equity, not debt, and there is no obligation to pay equity holders a set amount on redemption. MMF shareholders have a right only to a pro rata piece of the current value of the MMF's portfolio as of the end of the day on which the redemption request is processed. Unlike at banks, there is no need at an MMF for a separate subordinated capital layer to serve as a buffer or fudge factor between the value of the portfolio assets shown on the left-hand side of the balance sheet and the amount due to stakeholders on the right hand side of the balance sheet.

The Council's capital proposal in Alternative Three would also impose on MMFs, in addition to a new form of subordinated capital, other heightened standards such as additional liquidity requirements, additional diversification/counterparty credit limit standards, additional disclosure requirements, or other as-yet unspecified requirements. MMFs have long been subject to requirements of these sorts, and the SEC's 2010 Amendments to Rule 2a-7 provided enhancements to these requirements. We believe it is appropriate for the SEC to periodically consider changes to these requirements as they have from time to time in the past. There may be incremental changes to Rule 2a-7 that could further enhance the stability of MMFs and investor understanding of MMFs.

Without a specific proposal on these additional standards, however, it is difficult in the abstract to provide specific comments. Care should be taken not to make MMFs less stable and more subject to risk by imposing tighter standards without consideration of all of the potential consequences and costs. For example, by setting lower limits on the exposure of an MMF to a particular issuer, the MMF would be required to move the overage currently invested in those issuers into other issuers in which it otherwise would not have invested (or invest a larger

⁹² SEC Division of Risk, Strategy, and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* at pp 26-30 (Nov. 30, 2012), <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>; Robert Comment, *Do Money Market Funds Require Further Reform?* (Nov. 23, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2174125; Blackwell, Troske & 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.

amount than it otherwise might have invested). This could result in a systematic shift of a portion of portfolio assets from the soundest credits (as viewed by the MMF's investment adviser) to weaker credits. While this may reduce the exposure of the MMF to any one issuer as a percentage basis, it would increase the overall exposure of the portfolio to weaker credits or to credits about which the investment adviser has less information. Diversification is good, but at some point becomes counterproductive. Similarly, a shift towards greater liquidity would further reduce portfolio returns, which would have the triple effect of making MMFs less attractive to investors, further reduce the ability of the MMF to generate or pay for a new layer of junior capital, and further push the financing available to issuers in the money markets towards shorter maturities, something that the Council understands is not optimal. Given the extraordinary liquidity currently required under Rule 2a-7 and the even larger amounts of liquidity actually held by MMFs (well over 40% of AUM, totaling over \$1 trillion, in seven-day liquid assets) of roughly triple the amount redeemed from MMFs during the week of September 15, 2008, adding further to liquidity requirements may be counterproductive.

As noted at the beginning of this paper, the innuendo of the Council's Release is that, due to imperfections in their capital structure, MMFs caused the 2007-2009 financial crisis.⁹³ This is easily disproved by a glance at a timeline of the financial crisis and the order in which markets and financial institutions came unglued. MMFs did not cause the 2007-2009 financial crisis. Even the European Commission has concluded,

[I]n the context of the financial crisis, it must be noted that the underlying cause of risks to financial stability operating through money market funds did not originate in money markets. In particular, risks arose within the banking sector (due to securitised loan assets) that fed through to prime MMFs and due to the behaviour of investors in response to falling NAVs. Moreover, the impact on MMF investors in terms of realised losses were either zero or very small (Macey, 2011).⁹⁴

In other words, banks and the banking system are the primary risk to financial stability. MMFs are not the problem. The capital structure of MMFs is not the problem. Turning MMFs into banks or bank-like entities with bank-like capital structures, or eliminating or shrinking MMFs, will not reduce systemic risks, it will increase systemic risks by concentrating an even larger percentage of financial intermediation into the banking system and a handful of the largest banks.

⁹³ Release at 69455-56, 69460.

⁹⁴ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 66 (Nov. 2012).

Conclusion. MMFs are financed 100% by common equity. MMFs do not use debt or other forms of leverage. The Council's capital proposals would, for the first time, introduce financial leverage to MMFs. The change in capital structure proposed by the Council are not needed and would make MMFs less stable rather than more stable in the event of a financial crisis.

The stated purpose of the change is to reduce the risk of "runs" on MMFs (sustained investor redemptions) created by a hypothetical "first-mover advantage" that the Council believes incents investors to redeem at the first sign of trouble in MMFs. What prevents and stops runs is not capital, however, but large amounts of available liquidity and high credit quality. The SEC has already acted to bolster MMF liquidity and credit quality through the 2010 amendments to Rule 2a-7. Capital does not prevent runs at banks, and there is no reason to believe it will prevent investor redemptions at MMFs.

As for the "first-mover advantage", in the current structure it can occur only if the MMF's board fails in its duty to immediately recognize a decrease in value of shares when there is a portfolio event that would cause the MMF to break the buck, as happened at the Reserve Primary Fund in September 2008. The introduction of a subordinated capital tranche as proposed by the Council would provide a lag time between the first sign of trouble in an MMF's portfolio and a hit to the value of the senior shares that would *create* an incentive and an opportunity for an MMF's senior shareholders to redeem early in hopes of getting paid in full before the capital buffer is exhausted.

To the extent that the Council capital proposals could be implemented at all, they would be sufficiently expensive to investors, issuers that obtain financing from MMFs, and MMF sponsors, to result in a dramatic shrinkage in MMFs. This would cause investors to move liquidity balances elsewhere: to "Too Big to Fail" SIFI banks that are more risky and less efficient *and* require massive federal government support to stay afloat; to individually-managed investment accounts for the largest investor entities to invest directly in commercial paper, bank notes and other money market instruments; or to STIFs, hedge funds and offshore investment vehicles that are less transparent, less regulated, less efficient and result in the same "roll-over risk" for issuers in the money markets that the Council apparently wants to ameliorate through its plan to change the structure of MMFs.⁹⁵

The Council's suggested changes to the capital structure of MMFs should not be proposed or adopted. If implemented, they will shrink MMFs, raise the cost and limit the availability of short-term credit, and harm borrowers, investors and the economy.

⁹⁵ European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 72 (Nov. 2012); Macey 2012 at 28, 35-41.

**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

**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

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.

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

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),

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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.

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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 preemptively 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

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

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 it 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.

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.

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 filed 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

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

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.

...

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

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 Act⁷⁰ 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.

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

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.