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February 26, 2021

Via SEC Internet Comment Form

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-01-21
Release No. IC-34188
Potential Money Market Reform Measures in PWG Report of December 2020

To the Commission:

This letter is submitted by me personally in connection with the request for comments by the Securities Exchange Commission in response to its Request for Comments on Potential Money Market Fund Reform Measures in the President's Working Group Report of December 2010. I am the Richard Paul Richman Professor at Columbia Law School and co-director of the Millstein Center for Global Markets and Corporate Ownership. I participated extensively in two prior rounds of MMF reform proposals, including the rule-making that resulted in the present rules[1], commented on FSOC's proposed recommendations in 2102,[2] and published an article that addresses MMF reform generally, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?* (with Christopher M. Gandia).[3] The conclusion of the article was that "the best empirical evidence we have suggests that floating NAV *will not reduce MMF run-risk* during periods of financial distress."

[1] See comments posted at http://ssrn.com/abstract=1473275 ; and http://ssrn.com/abstract=2133588.
[2] See https://ssrn.com/abstract=2227169.
[3] Posted at http://ssrn.com/abstract=2134995. For the record, I am not retained by any party with a potential interest in any reform proposals nor have I received support for my research on money market funds from any such party.

My final submission was a November 17, 2013, comment letter (attached hereto), arguing that neither floating NAV nor gates and fees would provide stability to MMFs at a time of financial stress, indeed, could exacerbate run pressure. Some of my observations in that November 2013 comment letter are particularly pertinent to this round of reform deliberation and I would like to enter them into the record:

> "3. In candor I think the SEC has produced flawed proposals that simply fail to appreciate the nature of the MMF product and the sources of systemic risk. MMFs are a kind of nonbank bank; they take credit risk, provide liquidity transformation, and yet under current SEC rules, have no capacity to absorb losses. The floating NAV proposal makes this painfully clear. If *any* portfolio security were to default, *ever*, there is no virtually no way that the fund could report par, $1 per share, unless the sponsor agreed to swap out the defaulted security. This is because MMFs are flow-through vehicles. Dividends on portfolio securities may not be retained and thus are not available to apply against losses.
>
> An obvious point of stability of a bank or a bank substitute is capital, which provides the capacity to bear loss. Indeed, a major thrust of post-financial crisis reform has been to require financial institutions to hold more capital. In the case of MMFs, the SEC has proceeded as if unaware of this consensus. The SEC proposal is filled with new disclosure requirements for MMFs, because this is the SEC's hammer. Experts on financial institutions make the point, however, that the stability of an entity engaged in liquidity transformation depends upon its assets being informationally insensitive – that as soon as depositors need to begin evaluating the credit risk of the bank's portfolio, run risk escalates.[4] Detailed current disclosure, which will lead to competitive valuation estimates of portfolio assets and the search for arbitrage opportunities, may well be a source of instability in a financial crisis for MMFs with no capacity to absorb loss.
>
> What is the consequence? Ultimately the stability of MMFs depends upon implicit guarantees and other support by their sponsors, and, in extremis, the willingness of the Federal Reserve to take credit risk to avoid a massive run among MMFs. Nothing in the SEC rulebook tests sponsor capacity to provide support, nor links sponsor capacity to fund size, nor requires disclosure about sponsor capacity, much less

[4] Tri Vi Dang, Gary Gorton, and Bengt Holmström, Ignorance and the Optimality of Debt (2013), available at http://faculty.som.yale.edu/garygorton/documents/Paper_Ignorance_000.pdf.

requires any sponsor support. To be blunt, the SEC proposal relies on a future Federal Reserve bailout to protect the stability of the MMF sector.

4. The SEC has been sensitive to encroachments by the Federal Reserve Board on its securities markets domain. It seems to me that the best way for the SEC to proceed is to recognize that it needs to build in some mechanism for loss absorbency into its MMF regime. I think that both Proposals Two and Three of the FSOC's Proposed Recommendations on MMF Reform are useful starting points. I myself have previously offered a proposal for a "bundled" Class A/Class B share structure that would lead users, especially institutional users, to internalize the loss-absorbency and run-risk mitigation features that are necessary elements of reform. That proposal is more fully described in a comment letter of August 12, 2011, http://ssrn.com/abstract=2133588.

In brief, the proposal calls for all prime money market funds to issue two classes of equity, Class A, designed to retain a fixed NAV, and Class B, whose value will float to cover outright defaults or depreciation in market value of portfolio securities. Class B issuances must equal (or exceed) the largest single portfolio position permitted by regulation or by the fund's fundamental policy (a self-imposed limitation) plus an additional amount to reflect the risk of a general decline in money market asset values outside of such a default. Because Class B is loss bearing, Class A shares will be able to retain a fixed NAV in virtually all circumstances. Institutional funds and retail funds could be treated differently as to the source of the Class B capital. For institutional funds, the investors in the fund *must* buy the class B shares; for retail funds, the sponsor *may* buy the Class B shares. That is, for institutional funds, the users must buy a Class A/Class B "unit" or "bundle."

How will the Class A/Class B work for institutional funds? An investor can immediately redeem 100 percent of its Class A shares, but can redeem its Class B shares only thirty days subsequent to a redemption request. In ordinary times, the Class B functions like a minimum balance in a bank transactional account; so long the necessary fraction of Class B is retained, Class A share "transactional" purchases and redemptions continue as previously. In almost all circumstances, the investor suffers only a liquidity loss, because in the absence of default on a portfolio instrument, the Class B shares will receive the same yield as the Class A shares. In the event of a portfolio instrument

default, the Class B shares are loss-bearing, but ordinarily the Class A shares retain fixed NAV.[5]

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

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

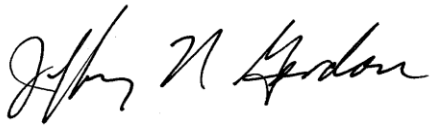
* * *

There is perhaps $6 *trillion* in short term funds in the global financial system looking for safety and liquidity outside of the banking system. It is important to devise financial institutions that can manage such cash flows in a systemically robust way and that does not depend on a taxpayer subsidy for its rescue. The prior design of MMF was an experiment that produced a bad outcome. So we must experiment again, learning from experience and being willing to revise our institutions in light of new economic challenges."

[5] A loss that breaks through the Class B is treated like a breaking of the buck under the current regime. It may trigger a liquidation of the fund, meaning losses imposed on the Class A shares.

I hope to comment more particularly on the PWG report before the comment deadline. One thing that I think the Commission should not ignore is the distortionary impact of its current MMF Rule on financing decisions of the Federal Home Loan Banks. As documented in the PWG report, Chart 1, p.9 the enacted Reforms resulted in a dramatic increase in the demand for Government funds (because they qualified for fixed NAV), and a decrease in the demand for Prime funds (floating NAV). The demand for short term USG issuances has been fulfilled by a significant increase in short term issuances by the Federal Home Loan Bank System.[6] In formulating a reform proposal to address the problems revealed by the Covid-crisis run in March 2020, the Commission should consider the financial stability and other effects associated with this shift in Federal Home Loan Bank finance.

Sincerely,



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Attachment

[6] See Kenechukwu Anadu and Viktoria Baklanova, The Intersection of U.S. Money Market Reforms, Bank Liquidity Requirements, and the Federal Home Loan Bank System, Oct. 31, 2017 (OFR Working Paper 17-05)

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November 17, 2013

Via SEC Internet Comment Form

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

Re: File No. S7-03-13
Release No. 33-9804; IA-3616; IC-30551
Money Market Reform

To the Commission:

This letter is submitted by me personally in connection with the request for comments by the Securities Exchange Commission in response to its Money Market Fund Reform Proposals of June 5, 2013. I am the Richard Paul Richman Professor at Columbia Law School and co-director of the Millstein Center for Global Markets and Corporate Ownership. I have submitted two comments in response to prior SEC releases[1], an invited written submission in connection with the June 2012 hearings on money market fund reform held by the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, and a comment on the Financial Stability Oversight Council Proposed Recommendations on November 2012, which is attached hereto and made part of this comment. I have recently written a paper on money market fund policy questions entitled *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?* (with Christopher M. Gandia),[2] which is attached hereto and made part of this comment. My comments on the particular SEC proposals draw on analysis and findings in that paper. I am not retained by any party with a potential interest in these reform proposals nor have I received support for my research on money market funds from any such party.

[1] These comments are posted at http://ssrn.com/abstract=1473275 ; and http://ssrn.com/abstract=2133588.
[2] Posted at http://ssrn.com/abstract=2134995. At various points in this submission, I may quote from that paper and the prior comment letters without explicit attribution.

My summary responses to the proposed alternatives are as follows:

1. Floating NAV/ Proposal One. I do not favor the current floating NAV proposal, because it does not address the systemic run-risk problem of money market funds ("MMFs") and worse, will give the appearance of addressing those problems.

2. *Gates/Redemption Fees/ Proposal Two.* I do not favor Proposal Two, which will exacerbate the present run risks of MMFs by injecting a new source of uncertainty and instability without substantially changing the run risks of the present fixed NAV funds.

3. The SEC proposals fail to come to grips with the core problem of MMFs as presently constituted: they perform bank-like functions of liquidity and maturity transformation and they bear credit risk, all without *any* independent capacity to bear loss. Under either of the SEC proposals, the stability of the MMF sector will continue to depend upon implicit sponsor support, the same kind off-balance guarantees that proved to be insufficient in the 2007-09 financial crisis. Such conditional guarantees are an unacceptable safeguard for a multi-trillion dollar financial intermediary. Otherwise put, the SEC proposal relies on a future Federal Reserve bailout to protect the stability of the MMF sector.

4. The SEC should reconsider alternative proposals that provide for capital or other mechanisms of loss absorbency, such as Proposals Two and Three in the FSOC's Proposed Recommendations. Alternatively, in a prior submission, I have proposed a bundled Class A/Class B structure that provides a mechanism for loss absorbency and disincentives for runs.

* * *

1. Floating NAV/ Proposal One. I do not favor the current floating NAV proposal, because it does not address the systemic run-risk problem of MMFs and worse, will give the appearance of addressing those problems. The chief driver of MMF run risk is the response of safety-seeking MMF users in circumstances that threaten full payment of principal, not the desire to capture the small permitted spread between $1 reported NAV and $0.995 actual NAV. In a floating NAV structure, the incentive to run remains: In conditions of financial distress, today's exit price is almost certain to be higher than tomorrow's exit price. Money market instruments rarely trade and so today's apparent price does not reflect the likely future path of price changes in a distressed market. Sophisticated parties are well aware of this dynamic and will act accordingly. In short, the adoption of the floating NAV alternative would leave MMFs still highly exposed to run risk.

For example, assume that Reserve Primary Fund had been a floating NAV fund in 2008. The default of Lehman Brothers would certainly have reduced the NAV of Reserve Primary Fund and every other fund that held Lehman paper, perhaps by the full amount of the fund's

Lehman holdings. But the Lehman default also would have reduced the "true" NAV of virtually every MMF. This is because claims on financial institutions constituted the overwhelming share (> 85 percent) of the non-US government holdings of most MMFs, and the value of those claims were highly correlated because of the interlocks, contagion mechanisms, and parallel behavior in the financial sector.[3] But because money market instruments rarely trade, their carrying value on the books of a MMF would have been "stale." A sophisticated party would have known that as more trading occurred, values would fall, thus today's NAV would be higher than tomorrow's NAV. In short, floating NAV would not have eliminated the first mover advantage.

The argument that floating NAV makes MMFs just like other mutual funds ignores the particular function of MMFs on both the liability side and the asset side. For many investors, particularly institutional MMF users, MMFs are a non-bank substitute for a bank transaction account. MMF users are generally seeking safety and liquidity. MMFs may improve on the safety of a bank transaction account because they assemble diversified portfolios of short term claims. But when safety and liquidity are at risk, MMF users can be expected to exit *en masse*, not exhibiting the pattern of holding or "slow" exits in other mutual funds.

Moreover, MMFs do not exhibit the same degree of diversification as the typical mutual fund. As noted previously, MMF assets overwhelmingly consist of short term credit issuances by financial firms, especially large global banks. Even though MMF portfolios are diversified *within the sector*, they are poorly diversified *across the economy*. In short, the correlations on the asset side make MMFs more susceptible to runs than the typical mutual fund; the correlation on the user side (in the sense of a common pursuit of safety and liquidity) make MMFs more susceptible to runs than other mutual funds. The interaction of these two correlations creates a strong and dangerous run risk. Thus the claim that with floating NAV, MMFs will be like just any other mutual fund ignores MMFs' particular role in the economy.

Similarly, floating NAV as means to desensitize investors to fluctuating MMF valuations seems to misperceive what drives a systemic MMF run: It is not the breaking of the buck at any particular fund, but a high-enough probability that the underlying portfolio event(s) that produced a break will correlate across MMFs generally. The prior instance of buck-breaking, the Community Bankers Fund in 1994, provides an instructive example. The fund broke the buck because of valuation changes in a portfolio "unsuitably" concentrated (27 percent) in interest-rate sensitive structured notes. The fund was small (only $150 million), its portfolio concentration violated the SEC rule, and the securities did not default. The fund's idiosyncratic investment strategy (and small size) meant that the industry did not suffer a run.[4] By contrast, the Reserve

[3] For extensive documentation of the financial sector focus of MMF assets, see Samuel E. Hanson, David S. Scharfstein & Adi Sunderam, An Evaluation of Money Market Fund Reform Proposals, Dec. 20, 2012, available at http://www.people.hbs.edu/shanson/MMF_Reform_20121220_FINAL.pdf.

[4] See Securities Exchange Commission, In the Matter of John E. Backlund et al., Rel. No. 33-7626 (Jan. 11, 1999, http://www.sec.gov/litigation/admin/33-7626.txt. A Federal Reserve policy change that abruptly raised short term interest rates reduced the valuation of money fund instruments generally. An additional factor in avoiding a run was that money market fund sponsors stepped up to provide support at

Primary Fund ($60 billion) held defaulted-upon securities of a large financial firm (Lehman) at a time of (i) high concentration of MMF assets in the financial sector and (ii) increasing and correlated instability among financial firms. In other words, it appears that the correlation of possible portfolio losses rather than the "focal point" effect of a buck-breaking was the main driver of the MMF run. A floating NAV fund is susceptible to these correlation concerns no less than a fixed NAV fund.

In a research paper that is included with this submission, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?,* a co-author and I take advantage of a natural experiment presented by European money market funds to provide empirical evidence on the run risk of floating NAV funds. Although all US MMFs are fixed NAV funds, money market funds offered in Europe come in both "stable NAV" and "accumulating NAV" varieties. A "stable NAV" fund is equivalent to the "fixed" US counterpart. An "accumulating" fund does not maintain fixed NAV, and while it does not fully "float," it does offer a useful proxy for the effects of a "floating NAV" fund. We examined the performance of these European MMFs during "Lehman Week" to test the factors that contributed to run propensity. Although virtually all funds experienced a significant run, the only internal factor that consistently predicted extra run propensity in our various models was ex ante risk, proxied by reported yield before Lehman Week. By contrast, the difference in run propensity between stable and accumulating NAV funds was not economically or statistically significant, indicating that NAV "fixedness" did not contribute to the run.

In short, the best empirical evidence we have suggests that floating NAV *will not reduce MMF run-risk* during periods of financial distress.

* * *

1.1. Floating NAV/Proposal One/Details. Assuming the SEC were to adopt its floating NAV proposal, (i) I do not think that the proposed distinction between retail prime funds (fixed NAV) and institutional prime funds (floating NAV) would achieve the desired stability, and (ii) I would strongly urge a recharacterization of "government" funds to require that at least 99 percent of assets be invested in cash, Treasury securities or other "government securities," or in repo collateralized by such securities (but only if such non-Treasury securities are supported by an explicit or implicit US government guarantee), not 80 percent as in the present proposal.

1.1(i). The case for distinguishing between retail and institutional funds rests on shaky ground: the different run behaviors in institutional vs. retail MMFs in fall 2008. But all we know from that experience is that users of institutional funds were *quicker* to run than users of retail funds, not that retail funds were run-proof despite one large fund's breaking the buck. The institutional run was stopped by the Treasury guarantee and the Federal Reserve's Asset-Backed Commercial Paper MMMF Liquidity Facility ("AMLF") put in place by Friday of Lehman

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43 of the 963 then-registered MMFs. SEC 2013 Money Market Fund Reform Proposal, 78 Fed. Reg. at 36840, Table 1.

Week. It is quite plausible, even likely, that in the absence of such intervention, a retail fund run would have started soon thereafter.

The experience of Northern Rock in the UK is instructive. The run of institutional short term credit suppliers began first. When retail depositors became apprehensive of the possibility of a bank failure and the inadequacy of UK deposit insurance, the lines for withdrawal rapidly emerged.[5] Dodd-Frank stripped Treasury of authority to issue such a protective MMF guarantee in the future and tightened the Fed's capacity to establish emergency liquidity facilities. This sets up conditions in which retail MMF investors could quite reasonably fear a loss of principal and thus run.

1.1(ii). As a characterization/advertising matter, a "government" MMF must currently hold 80 percent of its assets in government securities; a "Treasury" MMF must current hold 80 percent of its assets in Treasury securities.[6] Industry experience is that such funds do not currently test the lower bounds of those required percentages; instead, "government" MMFs commonly hold over 99 percent of assets in government securities. The experience of fall 2008 bears out that perception. Although institutions ran from prime MMFs, they ran to government/Treasury MMFs, on the view that the portfolios of such funds consisted of "risk free" assets. In the world contemplated by the SEC floating NAV proposal, government/Treasury MMFs will have strong incentives to reduce the fraction of risk-free assets. This is because government/Treasury funds will be the only funds that can offer institutional users the current transactional benefits of fixed NAV funds. Sponsors will want to "conserve" on their use of risk-free assets to increase the total of assets under management and to increase yields both for competitive reasons and to enable higher fees. These incentives push towards an 80/20 ratio of government (or Treasury assets) and "prime" assets. In turn, this would create a class of fixed NAV funds that carried significant credit risk and thus significant run risk. Assuming the SEC proceeds with its floating NAV proposal, I think it should limit the percentage of non-cash, government/Treasury assets to at most 3 percent, though I can see an argument for one percent. This would close down a channel of regulatory arbitrage.

2. *Gates/Redemption Fees/ Proposal Two.* I would not favor Proposal Two, which would exacerbate the present run risk threat of MMFs by injecting a new source of uncertainty and instability. The Proposal calls for a 2 percent redemption fee if a fund's "weekly liquid assets" fall below 15 percent of total assets and permits a suspension of redemption, a "gate," for up to 30 days. The key elements of the Proposal are that it preserves the fixed NAV structure and makes the redemption fees/gates optional at the discretion of the fund's board.

The Gates/Fees proposal creates two sorts of uncertainty. (i) Assume that investors believe that the fund will in fact impose fees and gates rather than letting sponsors intervene to provide liquidity. This now means that investors who seek safety and liquidity will need to

[5] *See* Hyun Song Shin, *Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis*, 23 J. ECON. PER. 101, 102 (2009).
[6] See current Rule 35d-1 and the discussion in the proposing release at note 169 and the accompanying text.

monitor not only the fund's asset quality but also the behavior of other investors. As financial stress builds, investor behavior will now be shaped by the desired to avoid a liquidity loss as well as a principal loss. The threat of gates and fees will exacerbate the fall-off in liquidity that exacerbates financial distress. Imagine further that a large investor in a fund makes a significant redemption to cover a maturing obligation. At a time of financial distress, such a liquidity-driven withdrawal could easily set off a run to obtain the fund's immediately available liquidity.

(ii) An alternative is that investors will expect sponsors to act as lenders of last resort to support the implicit liquidity promises as well as safety promises of their funds. Precisely because MMF users, especially institutional MMF users, value safety and liquidity, sponsors can be predicted to intervene to protect their sponsored funds from the circumstances in which fees/gates might be imposed. This seems the most likely outcome for most funds, but no one will know until the next crisis, and responses may different across sponsors.

Proposal Two only underlines the extent to which the stability of the MMF sector relies upon implicit sponsor guarantees. The financial crisis showed the extent to which MMF users benefited from sponsor backstop on the credit risks of a MMF portfolio.[7] The optional fees/gates will lead MMF users to look sponsors as providing liquidity support, private lenders of last resort. A future sequence could look like the following: Large Fund A incurs a default on portfolio security, which produces a run on (fixed NAV) Fund A. A relatively small sponsor does not intervene to protect Fund A by swapping out the defaulted security or by swapping out less liquid securities for cash. The run continues past the redemption fees/gates threshold, which are imposed by Fund A. These events have knock-on effects for many other funds, precisely because many institutional users depend on MMFs as transaction accounts and would suffer hardship if accounts were frozen or if what is regarded as a "cash" account suffered a sudden two percent haircut for immediate access. Since some but not all sponsors would be reliable sources of liquidity and solvency in these circumstances, there will be first mover advantage in redeeming. The first 14.9% of the redemptions will be without penalty and immediate. Afterwards, the redemptions are at risk. Thus Proposal Two may well exacerbate MMF run risk.

Moreover, the application of redemption gates is equivalent to the "suspension of convertibility," as when a bank suspends depositor withdrawals. Such actions have negative spillover to the real economy: depositors may be unable to pay their bills or meet their payrolls.

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[7] A careful study by the Boston Fed documented 31 instances between 2007 and 2011 in which prime MMFs would have broken the buck without sponsor support consisting of cash subvention. See Seffanie A. Brady, Ken E. Anadu & Nathanial Cooper, The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011, Fed. Res. Bank of Boston (Aug. 13, 2012), http://www.bos frb.org/bankinfo/qau/wp/2012/qau1203.pdf. Another careful study by Federal Reserve Board staff using a different methodology that broadens the definition of sponsor support to include guarantees shows that 29 funds would have broken the buck in the month following the Lehman failure without sponsor support. See Patrick E. McCabe, Marco Cipriani, Mochael Holscher & Antoine Martin, The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds, Fed. Res. Bd. D.P. 2012, at 31 (using reports required under the Treasury's Temporary Guarantee Program for Money Market Funds), http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf.

Suppliers are reluctant to extent trade credit because of increased credit risk, yet cash may be in short supply.

In important respects Proposal Two replicates the support arrangements that banks and other sponsors provided to Special Investment Vehicles and other off-balance sheet entities in the run up to the crisis. The banks provided "liquidity puts" that would protect holders of short-term SIV debt holders against market freezes. These arrangements were perceived and quickly became general bank guarantees of the debt-holders positions.

* * *

3. In candor I think the SEC has produced flawed proposals that simply fail to appreciate the nature of the MMF product and the sources of systemic risk. MMFs are a kind nonbank bank; they take credit risk, provide liquidity transformation, and yet under current SEC rules, have no capacity to absorb losses. The floating NAV proposal makes this painfully clear. If *any* portfolio security were to default, *ever*, there is no virtually no way that the fund could report par, $1 per share, unless the sponsor agreed to swap out the defaulted security. This is because MMFs are flow-through vehicles. Dividends on portfolio securities may not be retained and thus are not available to apply against losses.

An obvious point of stability of a bank or a bank substitute is capital, which provides the capacity to bear loss. Indeed, a major thrust of post-financial crisis reform has been to require financial institutions to hold more capital. In the case of MMFs, the SEC has proceeded as if unaware of this consensus. The SEC proposal is filled with new disclosure requirements for MMFs, because this is the SEC's hammer. Experts on financial institutions make the point, however, that the stability of an entity engaged in liquidity transformation depends upon its assets being informationally insensitive – that as soon as depositors need to begin evaluating the credit risk of the bank's portfolio, run risk escalates.[8] Detailed current disclosure, which will lead to competitive valuation estimates of portfolio assets and the search for arbitrage opportunities, may well be a source of instability in a financial crisis for MMFs with no capacity to absorb loss.

What is the consequence? Ultimately the stability of MMFs depends upon implicit guarantees and other support by their sponsors, and, in extremis, the willingness of the Federal Reserve to take credit risk to avoid a massive run among MMFs. Nothing in the SEC rulebook tests sponsor capacity to provide support, nor links sponsor capacity to fund size, nor requires disclosure about sponsor capacity, much less requires any sponsor support. To be blunt, the SEC proposal relies on a future Federal Reserve bailout to protect the stability of the MMF sector.

[8] Tri Vi Dang, Gary Gorton, and Bengt Holmström, Ignorance and the Optimality of Debt (2013), available at http://faculty.som.yale.edu/garygorton/documents/Paper_Ignorance_000.pdf.

4. The SEC has been sensitive to encroachments by the Federal Reserve Board on its securities markets domain. It seems to me that the best way for the SEC to proceed is to recognize that it needs to build in some mechanism for loss absorbency into its MMF regime. I think that both Proposals Two and Three of the FSOC's Proposed Recommendations on MMF Reform are useful starting points. I myself have previously offered a proposal for a "bundled" Class A/Class B share structure that would lead users, especially institutional users, to internalize the loss-absorbency and run-risk mitigation features that are necessary elements of reform. That proposal is more fully described in a comment letter of August 12, 2011, http://ssrn.com/abstract=2133588.

In brief, the proposal calls for all prime money market funds to issue two classes of equity, Class A, designed to retain a fixed NAV, and Class B, whose value will float to cover outright defaults or depreciation in market value of portfolio securities. Class B issuances must equal (or exceed) the largest single portfolio position permitted by regulation or by the fund's fundamental policy (a self-imposed limitation) plus an additional amount to reflect the risk of a general decline in money market asset values outside of such a default. Because Class B is loss bearing, Class A shares will be able to retain a fixed NAV in virtually all circumstances. Institutional funds and retail funds could be treated differently as to the source of the Class B capital. For institutional funds, the investors in the fund *must* buy the class B shares; for retail funds, the sponsor *may* buy the Class B shares. That is, for institutional funds, the users must buy a Class A/Class B "unit" or "bundle."

How will the Class A/Class B work for institutional funds? An investor can immediately redeem 100 percent of its Class A shares, but can redeem its Class B shares only thirty days subsequent to a redemption request. In ordinary times, the Class B functions like a minimum balance in a bank transactional account; so long the necessary fraction of Class B is retained, Class A share "transactional" purchases and redemptions continue as previously. In almost circumstances, the investor suffers only a liquidity loss, because in the absence of default on a portfolio instrument, the Class B shares will receive the same yield as the Class A shares. In the event of a portfolio instrument default, the Class B shares are loss-bearing, but ordinarily the Class A shares retain fixed NAV.[9]

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

[9] A loss that breaks through the Class B is treated like a breaking of the buck under the current regime. It may trigger a liquidation of the fund, meaning losses imposed on the Class A shares.

Class B shares, including shares held by the "running" investor, which cannot be disposed of except after a month's lag.

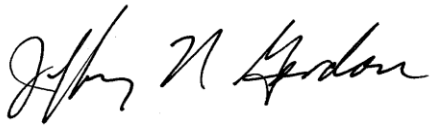
The unit concept therefore provides an additional element of systemic stability beyond proposals that call for a capital cushion only. A capital cushion cannot, by itself, fully protect against runs. Even if the capital could absorb the loss of the largest portfolio position, another default could break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

* * *

There is perhaps $6 *trillion* in short term funds in the global financial system looking for safety and liquidity outside of the banking system. It is important to devise financial institutions that can manage such cash flows in a systemically robust way and that does not depend on a taxpayer subsidy for its rescue. The prior design of MMF was an experiment that produced a bad outcome. So we must experiment again, learning from experience and being willing to revise our institutions in light of new economic challenges.

My apologies for the late submission of this comment. I respectfully ask that it be added to the record of these proceedings.

Sincerely,



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Attachment