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September 10, 2013

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

Re: File Number S7-03-13, Money Market Funds

Dear Commissioners:

The attached paper is submitted in response to the Commission's request for comment on its proposals relating to MMFs.

Sincerely,

Melanie L. Fein

Melanie L. Fein

Attachment

The SEC's Money Market Fund Proposal: An Inappropriate Use of the Investment Company Act to Address a Bank Regulatory Problem

by

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September 10, 2013

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Executive Summary

The SEC's Proposal seeks to address a problem originating in the banking industry, not the MMF industry, and whose solution lies in banking regulation, not MMF regulation. The problem is one of excessive reliance on short-term credit to fund long-term assets by banks operating with insufficient capital, liquidity, or risk controls. That problem, combined with flawed bank credit underwriting standards, was at the root of the financial crisis. The problem must be addressed by banking regulators under the banking laws, not the SEC under the Investment Company Act.

The Federal Reserve's insistence that the SEC impose drastic regulatory measures on MMFs is geared to shift the problem where it doesn't belong and subsidize the banking industry at the expense of MMFs and their investors. Statements by Fed officials indicate they want MMFs to serve as captive lenders to the commercial paper market in a crisis. The SEC's Proposal would do the Fed's bidding and place MMF shareholders at risk for the irresponsible behavior of large banking organizations. MMF shareholders would be held hostage to the emergency funding needs of institutions that banking supervisors have allowed to become too-big-to-fail and too-big-to-manage. The Proposal would force MMFs and their shareholders to prop up banks and the bank commercial paper market in a crisis—a function that Congress intended to be performed by the nation's central bank, not MMFs and their investors.

It is inappropriate for the SEC to pursue measures under the Investment Company Act that in reality are bank regulatory ambitions masquerading as MMF reforms. The Fed's proposals, embedded in the SEC's rulemaking, have serious implications for market efficiency and the future viability of MMFs, with uncertain long-term structural implications for the financial system as a whole.

Rather than attempt to solve bank regulatory problems by subjecting MMFs to inappropriate regulatory actions, the SEC should abandon the Proposal. Instead, the SEC should recommend that the Fed and other banking regulators pursue supervisory measures to address systemic risks that arise when too-big-to-fail banks rely excessively on short-term credit to fund long-term assets with insufficient capital, liquidity, or risk controls.

The Fed has said it currently is mulling over whether to seek public comment on possible approaches to address this problem, including by imposing an additional capital requirement on banks that rely excessively on the short-term markets. The SEC should encourage the Fed to pursue that process, which will address the problem directly, rather than adopt costly and unnecessary changes under the Investment Company Act that will harm MMF investors and have potentially disruptive and unpredictable consequences for the short-term credit markets.

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I. INTRODUCTION

The SEC in June of 2013 issued a 700-page proposal that could dramatically alter the way MMFs operate.[1] One element of the Proposal—elimination of the $1.00 stable NAV for institutional prime funds—would remove the key feature that has made MMFs so useful and valued by institutional investors.

The stated purpose of the Proposal is to address potential problems that might occur during a crisis such as in 2008 when MMF investors rapidly transferred assets from prime funds to government funds in response to unprecedented events that almost destroyed the financial system. The Proposal aims at forestalling heavy shareholder redemptions that would lead MMFs to withdraw from the short-term financial markets in a crisis, particularly the commercial paper market. The proposal thus is meant to protect those markets and the institutions that rely on those markets—mainly banking organizations. Notably, the Proposal does not identify any significant problems within the MMF industry itself that need correcting.

The Proposal discusses three approaches for achieving its stated goal:

Floating NAV. The first approach would prohibit institutional prime funds from offering their shares at a stable $1.00 NAV and instead require them to "float" their NAV.[2] Government and retail MMFs would be exempt.[3]

Redemption Fees. The second approach would impose a two percent redemption fee on shareholders of any prime fund whose weekly liquid assets fall below 15 percent of its total assets.[4] This "liquidity fee" would apply to all redemptions, by both institutional and retail shareholders, unless the fund's board of directors determines that the fee is not in the best interest of the fund or that a lesser fee is in the fund's best interest.

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[1] 78 Fed. Reg. 36834 (June 19, 2013) (the "Proposal").

[2] The Proposal would do this by requiring prime fund to value their portfolio securities using market valuations rather than amortized cost, thus causing their share prices to experience slight fractional fluctuations daily.

[3] A government MMF is defined in the Proposal as one that holds at least 80 percent of its assets in cash, government securities, or repurchase agreements collateralized with government securities. A retail MMF is defined as one that limits each shareholder's redemptions to no more than $1 million per business day.

[4] MMFs are required to maintain 30 percent of their total assets in cash, Treasury securities, or other instruments that can be converted to cash within one week.

Temporary Suspensions. The third approach would give a prime MMF's board of directors flexibility to temporarily suspend redemptions if the fund's weekly liquid assets fall below 15 percent of total assets.[5]

The SEC requested comment on whether it should adopt either the floating NAV approach or the liquidity fees and temporary suspension authority, or all of these approaches together.[6]

The existing public record on MMFs indicates that the first two ideas—floating NAVs and liquidity fees—are unlikely to achieve the SEC's stated goal.[7] It is doubtful that either of these ideas would prevent institutional MMF investors from reallocating their assets in a crisis. The imposition of liquidity fees in particular could cause investors to withdraw preemptively from prime funds in anticipation of a crisis to avoid such fees and potentially exacerbate liquidity pressures and trigger the crisis sought to be avoided. Both the floating NAV and liquidity fees would alter the nature of MMFs and substantially diminish their utility to investors and their role as efficient suppliers of short-term credit.

The third idea—to authorize a MMF to temporarily suspend redemptions—is more likely accomplish the SEC's aims. This approach would be an improvement over existing SEC rules that allow a MMF's board to suspend redemptions if the fund is in danger of breaking a dollar.[8] Under the existing rules, a MMF may not reopen if it suspends redemptions but rather must liquidate. The Proposal would allow a MMF to reopen after temporarily suspending redemptions during a crisis, thereby making it less likely that investors would panic since they would know that they would have access to their assets once the fund reopens after a short interval. This approach also has the advantage of not penalizing MMFs and their shareholders.

The Proposal is an outgrowth of ongoing efforts to address the causes of instability that shook the financial system in 2008. The Proposal cannot meaningfully address those causes, however, without a clear understanding of

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[5] A MMF would be required to lift the suspension within 30 days and could not suspend redemptions for more than 30 days in any 90-day period. A MMF would be required to make prompt public disclosure whenever it crossed the 15 percent threshold and imposed a liquidity fee or temporary suspension of redemptions.

[6] These approaches would be combined with increased disclosure requirements and enhanced stress testing requirements. Government MMFs would be exempt from the liquidity fees and temporary suspensions but could voluntarily apply these restrictions.

[7] See public comment file on President's Working Group Report on MMF Reform (Request for Comment), Release No. IC-29497; File No. 4-619, available at http://www.sec.gov/comments/4-619/4-619.shtml.

[8] 17 C.F.R. § 270.22e-3.

what they are and how they arose. Any proposed solution not rationally related to the causes of the crisis will be ineffective and potentially counterproductive.

This paper argues that the problem the Proposal seeks to address is one not caused by either MMFs or deficient MMF regulation. Rather, the problem arises from a history of lax supervision of banking organizations by federal banking regulators who allowed banks to expand beyond traditional limits into complex financing activities without adequately understanding or supervising the risks they generated.

The problem has many manifestations but boils down to excessive reliance on short-term funding by banking organizations that operated with insufficient capital, liquidity, or supervisory oversight. These institutions used the short-term markets to sell high-risk loans made in violation of their own credit underwriting standards and disguised with credit ratings obtained by offering guarantees they could not realistically meet. The solution to the problem is not to emasculate the short-term credit markets by eviscerating MMFs but rather to impose appropriate limits on banks that access to those markets.

II. THE PROPOSAL AIMS AT THE WRONG PROBLEM

A. MMFs Are Not the Problem—Banks Are

The Proposal seeks to address a problem originating in the banking industry—not the MMF industry—and whose solution lies in banking regulation, not MMF regulation.

The problem is one of excessive borrowing by banks in the short-term credit markets, primarily the commercial paper market, to fund long-term assets. The problem stems from imprudent practices by banks as issuers, sponsors, and guarantors of commercial paper and other short-term instruments, not the prudent practices of MMFs adhering to regulatory limits on the credit quality of their portfolios.

The financial crisis was rooted in unsound practices of banks and other financial institutions that used the commercial paper market to generate large volumes of poor quality loans that failed to meet their own credit underwriting standards, but which they foisted on unsuspecting investors using asset-backed commercial paper conduits (ABCP) and related structured investment vehicles (SIVs). Banks were able to sell the commercial paper because banking regulators allowed them to guarantee it and thereby obtain the highest credit ratings, even though there was insufficient bank capital backing the guarantees.

The SEC and the United States Department of Justice recently brought a civil action against a large banking organization supervised by the Federal Reserve alleging that more than 40 percent of the mortgages it placed in its securitized collateral pools did not comply with the bank's own underwriting standards.[9] The SEC has brought similar actions against other banking organizations supervised by the Federal Reserve and other banking regulators.[10] These cases suggest that violations of bank credit underwriting standards, and misleading bank guarantees, may have been a significant factor in the proliferation of subprime mortgages through ABCP conduits prior to the crisis.

Banking regulators tolerated and even encouraged unsound ABCP practices of banks leading up to the financial crisis. They allowed banks to issue and guarantee excessive amounts of ABCP as part of the process of securitization, which became a substitute for traditional deposit-based lending. Because ABCP conduits were off-balance sheet entities, banks were not required to maintain normal capital to support their liabilities. Even though banks backed the commercial paper issued by these entities with letters of credit and other guarantees, regulators required no more than a modicum of capital. The regulators even amended their capital rules in 2004 to create an exemption that allowed banks to *avoid* consolidated capital treatment for their ABCP obligations. From 2004 onward, ABCP ballooned, fueling the subprime mortgage bubble. When the day of reckoning came, banks could not meet their ABCP and SIV obligations. Toxic assets in ABCP conduits and SIVs that had been off-balance sheet were forced on-balance sheet. The largest banks faced insolvency for want of capital or liquidity to take back assets they had imprudently generated and guaranteed. The banking system would have imploded but for emergency assistance from the Federal Reserve.

What caused the crisis was the securitization model of finance that enabled long-term assets to be funded with short-term borrowing, encouraged by banking regulators to the point where it became unsustainable. Banking

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[9] See U.S. Department of Justice, Press Release dated Aug. 6, 2013, "Department of Justice Sues Bank of America for Defrauding Investors in Connection with Sale of Over $850 Million of Residential Mortgage-Backed Securities." See also SEC Press Release 2013-148, Aug. 6, 2013 ("The Securities and Exchange Commission today charged Bank of America and two subsidiaries with defrauding investors in an offering of residential mortgage-backed securities (RMBS) by failing to disclose key risks and misrepresenting facts about the underlying mortgages. ").

[10] See, e.g., SEC Press Release 2012-233, Nov. 16, 2012, ("SEC Charges J.P. Morgan and Credit Suisse With Misleading Investors in RMBS Offerings"). See also In Re Citigroup Inc. Securities Litigation, Master File No. 07 Civ. 990 1 (SHS), Consolidated Class Action Complaint, S.D.N.Y., $590 million settlement against Citigroup.

regulators incentivized banks to overextend their capital in furtherance of the model and allowed banks to create off-balance sheet funding vehicles dependent on short-term credit using guarantees they could not realistically meet. The financial crisis was almost an inevitable outcome. The bank commercial paper market was doomed to collapse, as it did in 2007 and then in 2008, as investors realized that bank-sponsored ABCP contained assets of questionable quality and no longer met investment grade standards.

ABCP was an eligible investment for MMFs under SEC rules because of its high credit ratings, which depended on the guarantees issued by bank sponsors. When the underlying assets became suspect and bank guarantees uncertain, the ABCP no longer met permissible investment standards for MMFs and they stopped buying it. Such was the case with commercial paper issued by Lehman Brothers, which operated according to the Basel bank capital rules, as well as commercial paper issued by large banking organizations operating under the supervision of banking regulators. The withdrawal of MMFs from the commercial paper market was a rational response by responsible investors and should not have come as a surprise to regulators.

What happened was not the fault of MMFs, which adhered to strict regulations under SEC Rule 2a-7 limiting their investments to the highest quality instruments. Nor was it the fault of institutional prime MMF investors who acted prudently to safeguard their assets. Of all the committees, commissions, and conferences that have studied the financial crisis, none have said that MMFs caused the crisis.[11]

MMFs operated during the crisis as they were designed to do and only one MMF "broke the buck," ultimately returning 99 cents on the dollar to its investors. No MMFs would have been threatened and the financial crisis would not have occurred had banking regulators more prudently supervised the securitization and commercial paper activities of banks. The appendix hereto

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[11] A report published by the European Commission concluded that MMFs were not a cause of the financial crisis: "The activities of money market funds were not the underlying causes of financial instability during the financial crisis *per se*. . . .[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). . . . Moreover, the impact on MMF investors in terms of realised losses were either zero or very small." European Commission, Nonbank Financial Institutions: Assessment of Their Impact on the Stability of the Financial System, Economic Paper 472, Nov. 2012, 64-66. The report found that MMFs were nevertheless affected by the crisis and became part of a "feedback loop."

describes in greater detail how the regulators' bank capital rules led to the financial crisis.

B. Banking Regulators Should Fix the Problem, Not the SEC

Large banking organizations continue to dominate the commercial paper market and are the biggest users of short-term credit supplied by that market.[12] These organizations operate under the supervision of the Federal Reserve and other banking supervisors who have it within their power to limit inappropriate use of short-term funding by banks. It is the responsibility of banking supervisors, not the SEC, to curb risky dependency of banking organizations on commercial paper and other short-term credit. To the extent that over-reliance on short-term funding is a systemic risk, it is one posed by banking organizations, not MMFs. The unsafe and unsound practices of banks, not the safe practices of MMFs, are what need to be addressed.

The Fed and other banking regulators already have implemented measures to reduce potential instability in the bank commercial paper market. In 2010, they admitted they had underestimated the amount of bank capital needed to support bank ABCP activity and amended their capital rules to require banking organizations that guarantee ABCP to consolidate their ABCP vehicles and effectively maintain a 100 percent capital risk weight against the underlying assets.[13] This requirement, which reversed the ill-considered exemption adopted by the agencies in 2004, will limit the ability of banks to generate excessive amounts of ABCP they cannot realistically support. Going forward, banks that sponsor and guarantee ABCP will be required to fully consolidate their ABCP conduits on their balance sheets for risk-based capital purposes.

In addition, the overall level of bank capital will increase when new capital rules take effect under the Dodd-Frank Act and the revised Basel capital framework is fully functional. The new rules will enhance the ability of banks to withstand any future contractions in the short-term funding markets.

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[12] Of the approximately $1.0 trillion in commercial paper outstanding as of August 14, 2013, $533 billion was financial commercial paper and $263 billion was asset-backed commercial paper, both of which are issued and/or guaranteed primarily by banking organizations. See Board of Governors of the Federal Reserve System, Commercial Paper Outstanding, http://www.federalreserve.gov/releases/cp/outstanding.htm.

[13] 75 Fed. Reg. 4636 (Jan. 28, 2010). The new rule aligns bank capital requirements with changes to generally accepted accounting standards in FAS 166 and 167 adopted by FASB in 2009. See 75 Fed. Reg. 4636 (Jan. 28, 2010).

Nevertheless, further improvements are needed.[14] Ironically, the Fed has not yet issued any proposals to directly address the risks of large bank reliance on short-term funding, even though they have identified it as a critical weakness in the banking system.[15] Fed officials have said they are in the process of mulling over whether to seek public comment on possible approaches to address the problem, including the imposition of an additional capital requirement on banks that excessively rely on the short-term markets.[16] Why Fed officials have not pursued this process more vigorously given their statements concerning the urgency of the problem is unclear.[17] In contrast, Fed officials somewhat disingenuously have told Congress that "immediate action" is needed to prevent MMFs from withdrawing short-term credit from too-big-to-fail banks, even if required by Rule 2a-7 for the protection of MMF investors.[18]

Additional reforms to improve bank securitization practices may address the underlying causes of instability in the short-term funding markets. The Dodd-

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[14] See Federal Reserve Board, Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice, Press Release dated Aug. 19, 2013 ("Large bank holding companies have considerably improved their capital planning processes in recent years, but have more work to do to enhance their practices for assessing the capital they need to withstand stressful economic and financial conditions.").

[15] See, e.g., Daniel K. Tarullo, Speech entitled "Evaluating Progress In Regulatory Reforms to Promote Financial Stability," May 3, 2012.

[16] Governor Tarullo recently stated, "staff is currently working on a recommendation for an advance notice of proposed rulemaking to seek comment on possible approaches to requiring additional measures that would directly address risks related to short-term wholesale funding, including a requirement that large firms substantially dependent on such funding hold additional capital." Statement by Daniel K. Tarullo, Federal Reserve Board, July 2, 2013, http://www.federalreserve.gov/newsevents/press/bcreg/tarullo20130702a.htm.

[17] Fed Governor Tarullo earlier this year told the Senate Banking Committee that the feature of the financial system "in most need" of regulatory action is non-deposit short-term financing, which is of "greatest concern" when the recipients are highly-leveraged or engaged in substantial maturity transformation or both, a definition describing banks and their affiliates. Daniel K. Tarullo, Governor, Federal Reserve Board, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013; archived webcast at 38:00-40:00, http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.LiveStream&Hearing_id=84abcfc3-9dd8-49ec-b5c0-2f75c618f075.

[18] Daniel K. Tarullo, Governor, Federal Reserve Board, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013; archived webcast at 38:00-40:00. In contrast, Tarullo said the Fed would be "slowing down" its efforts to implement a rule mandated by the Dodd-Frank Act to impose counterparty credit risk limits on banks and "needs more time" so it can conduct a quantitative impact analysis to better assess the optimal structure of this "ground-breaking" rule.

Frank Act required the banking agencies to adopt rules imposing a risk-retention requirement on securitizations, which the agencies have not yet adopted.[19]

The Federal Reserve has acknowledged that the reason why many banking organizations had funding problems during the financial crisis was flawed liquidity risk management.[20] The Fed has stated that many of the liquidity problems encountered by banking organizations were due to "lapses in basic principles of liquidity risk management."[21] The Fed has proposed but not yet adopted a new liquidity regime for large bank holding companies.[22] Early this year, the Fed extended the comment period on its proposal "due to the range and complexity of the issues."[23]

Better supervision of banks and their lending and borrowing practices will go far to ensuring that banks maintain a proper balance between their long-term lending commitments and short-term borrowing needs. Banking supervisors have more than adequate tools at their disposal to curb excessive reliance by banks on short-term commercial paper as a source of funding. They have not exhausted their capacity to devise supervisory solutions to the problem. As noted, the Fed is in the process of developing a proposal to directly curb over-reliance on short-term funding by banking organizations.

The Fed's insistence on immediate and drastic regulatory changes to MMFs under the Investment Company Act appears overreaching and designed to shift the burden of bank regulatory problems to the SEC. It would have the effect of subsidizing the banking industry at the expense of MMFs and their shareholders, who would be held hostage to the emergency funding needs of too-big-too-fail banks. MMFs and their shareholders would become lenders of last resort to the banking industry, a role Congress intended for the Federal Reserve.

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[19] See Credit Risk Retention, Proposed Rule, 76 Fed. Reg. 24090 (April 29, 2011). The agencies issued revisions to the proposal in August 2013. See Joint Press Release, Aug. 28, 2013.

[20] See 74 Fed. Reg. 32035, 32038 (July 6, 2009) (Proposed Interagency Guidance on Funding and Liquidity Risk Management) ("Recent events illustrate that liquidity risk management at many financial institutions is in need of improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.").

[21] 77 Fed. Reg. 594, 604 (Jan. 5, 2012) (Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; proposed rule).

[22] Id.

[23] 78 Fed. Reg. 13294 (Feb. 27, 2013).

C. Restructuring MMFs to Shield Banks from Mismanagement Is Not a Proper Use of the Investment Company Act

The Investment Company Act of 1940 was enacted by Congress to protect the investing public through the regulation and oversight of mutual funds by the SEC. Among other things, the Act requires mutual funds to make detailed disclosures, prohibits conflicts of interest by fund managers, guards against discriminatory treatment of fund shareholders, and ensures the safe and sound operation of mutual funds, including MMFs. The SEC has adopted a special rule for MMFs—Rule 2a-7—which imposes strict credit standards and requirements for liquidity, transparency, diversification, stress testing, and other matters designed to ensure the safe operation of MMFs in accordance with the Investment Company Act.

It is not a proper use of the Investment Company Act to regulate MMFs for the purpose of protecting banks from their own mismanagement, especially banks that operate in the commercial paper market with insufficient capital, liquidity, or supervisory oversight. The SEC should not become a party to a scheme devised by the Federal Reserve to use the Act to achieve bank regulatory policies that should be pursued under the banking laws. The Fed's scheme is flawed and dangerous because it ignores the true sources of systemic risk and may weaken the short-term markets by diminishing the role of MMFs as prudent investors.

The Proposal seeks to minimize the potential for disruption to the short-term funding markets in the event MMFs withdraw from the markets during a major financial crisis such as occurred in 2008. That problem is not one for MMFs and their shareholders, who invest only in highly rated commercial paper and other short-term instruments backed by lines of credit or other guarantees. Rather, it is a problem for *issuers* of commercial paper that rely excessively on short-term paper to fund their long-term assets and which may face reduced demand for their paper in a crisis. Large banks and other financial institutions are the principal issuers of commercial paper and borrowers in the short-term funding markets. It is their vulnerability to mismanagement of their own funding needs that must be addressed, not MMFs.

Statements by Federal Reserve officials indicate they want MMFs to serve as captive lenders to the commercial paper market in a crisis. The SEC's Proposal would do the Fed's bidding and place MMF shareholders at risk for the risky behavior of large banking organizations. MMF shareholders would be held hostage to the emergency funding needs of institutions that banking regulators have allowed to become too-big-to-fail and too-big-to-manage. The Proposal would force MMFs and their shareholders to prop up the bank commercial paper market in a crisis—a function that Congress intended to be performed by the nation's central bank, not MMFs or their investors.

Banks are the principal source of systemic risk in the financial system, directly and through their so-called "shadow banking" affiliates—not MMFs. Fed officials have disingenuously portrayed "shadow banking" as a phenomenon existing outside the regulated banking system and mislabeled MMFs as "shadow banks." As I have written at length elsewhere, the Fed's construct is mythical, founded on a flawed narrative of the financial crisis, and blind to the fact that the biggest "shadow banks" are the banking organizations they regulate.[24]

MMFs are merely pools of securities that have as their objective the preservation of principal and provision of liquidity for their investors. MMFs are subject to strict regulation under the Investment Company Act which, among other things, limits their investments to short-term instruments of only the highest quality. The Investment Company Act was not intended to be used as a back-door device for curing problems created by unsound lending practices of institutions subject to supervision and regulation by banking regulators under the banking laws.

The Federal Reserve has been the loudest critic of MMFs and the most ardent proponent of proposals to debilitate them. The SEC's Proposal unquestionably is the result of prodding by Fed officials who have heckled the SEC to "do something about MMFs" ever since 2008 when the Fed was caught off guard by the reaction of MMF investors to its chaotic handling of events culminating in the bankruptcy of Lehman Brothers and an $85 billion bailout of AIG. It is doubtful the SEC would have issued the Proposal absent pressure from Fed officials and Fed-inspired threats by the Financial Stability Oversight Council.[25]

The Fed's indictment of MMFs is remarkable in view of its failure to restrain the risky behavior of banks that occurred when it disarmed the Glass-Steagall Act's restraints in the years preceding the financial crisis. As I have described elsewhere in detail, it was not any act of Congress that opened the door to bank commercial paper and securitization activities. Rather, it was the Fed and banking regulators who approved and defended these activities as consistent with the Glass-Steagall Act in numerous court challenges brought by the securities

[24] M. Fein, The Shadow Banking Charade, http://ssrn.com/abstract=2218812. See also M. Fein, Shooting the Messenger: The Fed and Money Market Funds, available at http://ssrn.com/abstract=2021652.

[25] See Financial Stability Oversight Council, 77 Fed. Reg. 69455 (Nov. 19, 2012).

industry in the 1980s and 1990s.[26] Once they authorized these activities, banking regulators had a duty to ensure that they did not give rise to the "subtle hazards" the Glass-Steagall Act was intended to prevent. The regulators failed miserably in that task. The Fed's attack on MMFs is a poor excuse for its own supervisory failures and contradictory policies it pursued after the market for bank commercial paper market imploded in 2007 and 2008.

The Fed claims it was alarmed by the "unexpected" reaction of institutional investors in prime MMFs who shifted assets from prime MMFs to government MMFs during the financial crisis and "disrupted" the commercial paper market. What should have been alarming was not that MMFs stopped purchasing bank commercial paper, but that banks had contaminated the commercial paper with such poorly underwritten loans and so badly overextended their capital that they could not meet their commercial paper guarantees. Banking regulators should have monitored the impact of their 2004 amendment to the capital rules and seen that banks were bloating the short-term markets with commercial paper and other asset-backed securities backed by toxic assets. Not until the damage was done did the regulators realize how badly they had underestimated the risks of letting banks sponsor and guarantee asset-backed commercial paper with so little capital and liquidity.

MMFs are not guarantors of bank-issued commercial paper or insurers of the commercial paper market. To the extent potential instability in the commercial paper market is a cause for concern to the central bank, the Federal Reserve has ample authority under the Federal Reserve Act, the Bank Holding Company Act, and the Dodd-Frank Act to devise regulatory, supervisory, and emergency liquidity solutions to address such concerns directly. The Fed's demand that the SEC impose punitive measures on MMFs and their shareholders is misguided and fails to recognize the true source of the systemic problems that should concern the Fed. What will address the Fed's concern about the commercial paper market are reforms aimed at banks, not MMFs.

D. The Proposal Would Exacerbate the Problem

The floating NAV and redemption penalties in the SEC's Proposal are unlikely to prevent heavy redemption activity by institutional prime MMF shareholders during a crisis. Indeed, they could have the opposite effect by encouraging investors to withdraw from MMFs precipitously to avoid the redemption penalties or a decline in portfolio value, thereby exacerbating the very problem sought to be averted.

[26] See appendix to Fein, The Shadow Banking Charade, available at http://ssrn.com/abstract=2218812. See also appendix to Fein, Shooting the Messenger: The Fed and Money Market Funds, available at http://ssrn.com/abstract=2021652.

Moreover, none of the Proposal's alternatives would prevent MMFs from refusing to purchase commercial paper that fails to meet the strict credit standards under Rule 2a-7 or from abstaining from commercial paper purchases in a crisis. The problem of a contracting commercial paper market during a crisis is a problem that cannot be solved by changing the regulation of MMFs, unless perhaps the credit standards in Rule 2a-7 are substantially relaxed. But that would defeat the nature and purpose of MMFs, which are valued by investors for their safety and liquidity, especially during a crisis. A lowering of standards in the MMF industry to solve a problem of unsafe and unsound practices in the banking industry would be an absurd result.

Moreover, the floating NAV and redemption penalty proposals would impose unwarranted costs on MMFs that will diminish their utility to investors and the financial system as a whole. The floating NAV requirement in particular would necessitate costly operational changes for MMFs and their institutional shareholders, many of whom have indicated they would discontinue using MMFs. MMFs thus could not maintain their current level of efficient short-term funding and banks as well as other users of short-term credit would experience increased borrowing costs. With fewer MMFs to purchase municipal debt, state and local governments and their instrumentalities would find it more difficult to obtain efficient financing for a plethora of municipal programs, projects and services. Commercial paper issuers—including both bank and nonbank issuers—would have fewer ready purchasers for their paper.

The SEC's Proposal thus seems counter-productive with a real potential for affirmative harm not only to MMF shareholders but to the short-term financial markets and borrowers who use those markets. The Proposal may advance the Fed's goal of curbing undue reliance on short-term funding by banks by reducing the supply of such credit.[27] But that is not a proper purpose of regulation under the Investment Company Act, nor a proper goal of the SEC.

The SEC should not pursue measures that are poor substitutes for sound bank regulatory policies at the expense of MMFs and their shareholders. The Fed's proposals have serious implications for market efficiency and the future viability of MMFs, with uncertain long-term structural implications for the financial system as a whole.

[27] It might even succeed in the objective of some Federal Reserve officials to eliminate MMFs as competitors of banks.

III. CONCLUSION

Rather than attempt to solve what in reality is a bank regulatory problem, the SEC should abandon the Proposal and recommend that the Fed and other banking regulators pursue supervisory measures that directly address the systemic risks that arise when too-big-to-fail banks rely excessively on short-term credit to fund long-term assets with insufficient capital, liquidity, or risk controls.

Federal Reserve officials have said they are contemplating ways to deal with the problem directly, including by requiring banks that over-rely on short-term funding to maintain additional capital. The SEC should encourage the Federal Reserve to pursue that process rather than heed the central bank's unwarranted demands for drastic and costly regulatory changes to MMFs under the Investment Company Act. The Fed-inspired Proposal threatens to destroy an investment product valued by millions of investors and could have potentially disruptive and unpredictable consequences for the short-term credit markets.

IV. APPENDIX—HOW BANK CAPITAL RULES CAUSED THE CRISIS

A critical weakness during the financial crisis in 2007 and 2008 was the insufficiency of bank capital to withstand liquidity claims on bank backup letters of credit and other guarantees supporting bank-sponsored ABCP conduits. This deficit resulted from bank capital rules that created incentives for banks to structure their activities with reduced capital in a way that ultimately was a source of systemic risk. With less capital, banks were unable to withstand the bursting of the housing bubble and related runs on their ABCP, requiring massive support from the Federal Reserve, FDIC, and Congress.[28]

Bank capital rules created systemic risk that contributed to the financial crisis in three ways:

First, the capital rules required banks to hold less capital against residential mortgages than commercial loans. The risk weight for residential mortgage loans was 50 percent, compared to 100 percent for commercial business loans. Thus, 50 percent less capital was required for residential mortgage loans—including subprime loans—than commercial loans.[29] The rules thereby incentivized banks to generate residential mortgage loans.

Second, the capital rules allowed banks to hold less capital against residential mortgage loans that were securitized. The risk weight for triple-AAA rated residential mortgage-backed securities ("RMBS") was 20 percent.[30] Thus, banks had capital incentives to sell off residential whole mortgage loans to securitization vehicles and buy them back in the form of RMBS. Often, the RMBS was packaged with other assets in ABCP conduits and sold to third parties. Going into the financial crisis, banks held substantial amounts of their own RMBS and ABCP as investments for their own accounts.[31]

Third, banking regulators did not require banking organizations to consolidate their ABCP conduits on their balance sheets for regulatory capital

[28] Among other things, the FDIC provided unlimited deposit insurance for noninterest bearing checking accounts and an unlimited guarantee of bank debt during the crisis. See FDIC Press Release 100-2008 (Oct. 14, 2008). Congress appropriated $750 billion in the TARP program which the Fed used to recapitalize banks.

[29] See 12 C.F.R. part 225, Appendix A.

[30] *Id.*

[31] See Viral V. Acharya and Matthew Richardson, "Causes of the Financial Crisis," Critical Review Vol. 21, Nos. 2–3, 2009, at 200 ("[I]n fact, investors were not the chief purchasers of these securities: banks themselves were….[T]he banks became primary investors….The goal…was…to avoid minimum capital requirements.").

purposes, notwithstanding an interpretive standard adopted by the Financial Accounting Standards Board in 2004 that otherwise required consolidation.[32] Moreover, regulators imposed no capital charge on bank letters of credit or other support for ABCP prior to 2004, and in 2004 imposed only a 10 percent conversion factor, requiring minimal capital. The availability of bank guarantees for ABCP conduits encouraged the growth of ABCP and created demand for more and more mortgage loan assets, including subprime loans. Banks could provide more guarantees to their ABCP conduits because the capital rules did not require such guarantees to be fully capitalized.[33]

The capital rules thereby contributed to the buildup of RMBS and ABCP by requiring banks to hold less capital for residential mortgage loans, even less capital for securities backed by such loans, and virtually no capital for bank letters of credit and other guarantees of ABCP conduits.[34] Moral hazard resulted as banks relaxed or ignored their own credit underwriting standards, thinking they would not bear the ultimate risk.

The capital rules allowed banking organizations to engage in "regulatory arbitrage" that led to an unsustainable expansion of mortgage lending, unsound loans, a housing bubble, and proliferating risks to investors who purchased RMBS and ABCP containing RMBS.

Bank ABCP activities were not constrained by the limits on bank transactions with affiliates under section 23A of the Federal Reserve Act since the Federal Reserve Board did not regard ABCP conduits to be "affiliates" of banks.

Professor Acharya has explained how the capital rules incentivized banks to accumulate systemic risk using ABCP conduits:

> Why did the popping of the housing bubble bring the financial system—rather than just the housing sector of the economy—to its knees? The answer lies in **two methods**

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[32] See 69 Fed. Reg. 44908 (July 28, 2004).

[33] Acharya and Richardson at 201 ("Designing the guarantees as 'liquidity enhancements' of less than one year maturity (to be rolled over each year) allowed banks to exploit a loophole in Basel capital requirements. The design effectively eliminated the 'capital charge' and thus banks achieved a tenfold increase in leverage for a given pool of loans.").

[34] See Viral Acharya and Philipp Schnabl, "Do Global Banks Spread Global Imbalances? The Case of Asset-Backed Commercial Paper During the Financial Crisis of 2007–09," Paper presented at the 10th Jacques Polak Annual Research Conference Hosted by the International Monetary Fund, Nov. 5–6, 2009 at 21. See also Peter J. Wallison, "How Regulators Herded Banks Into Trouble," Wall Street Journal, Dec. 3, 2011.

> **by which banks had evaded regulatory capital requirements**.
>
> First, they had temporarily placed assets—such as securitized mortgages—in off-balance-sheet entities, so that they did not have to hold significant capital buffers against them. Second, the capital regulations also allowed banks to reduce the amount of capital they held against assets that remained on their balance sheets—if those assets took the form of AAA-rated tranches of securitized mortgages. Thus, by repackaging mortgages into mortgage-backed securities, whether held on or off their balance sheets, banks reduced the amount of capital required against their loans, increasing their ability to make loans many-fold. The principal effect of this regulatory arbitrage, however, was to concentrate the risk of mortgage defaults in the banks and render them insolvent when the housing bubble popped.[35]
>
> . . . . [E]specially from 2003 to 2007**, the main purpose of securitization was** not to share risks with investors, but **to make an end run around capital-adequacy regulations. The net result was** to keep the risk concentrated in the financial institutions—and, indeed, **to keep the risk at a greatly magnified level, because of the overleveraging that it allowed**.[36]
>
> . . . .[T]he financial firms that used off-balance-sheet entities had, through the guarantees they issued on the ABCP, written huge quantities of insurance against a systemic decline in the overall economy.[37]

Professor Acharya and co-authors have further described how banks used ABCP for regulatory arbitrage to reduce their capital without transferring the risks of ABCP:

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[35] Acharya and Richardson at 195. See also Viral V. Acharya and Thomas Cooley, Matthew Richardson and Ingo Walter, "Manufacturing Tail Risk: A Perspective on the Financial Crisis of 2007–2009," Foundations and Trends in Finance, Vol. 4, No. 4 (2009) 247–325, 2010.

[36] Acharya and Richardson at 195.

[37] *Id.* at 206. See also Acharya, Cooley, Richardson and Walter at 295 ("the guarantees were in fact 100% and were un-priced. . . .guarantees were structured in a way that reduced and effectively eliminated regulatory capital requirements.").

> Our main conclusion in this paper is that, somewhat surprisingly, this crisis in the ABCP market did not result (for the most part) in losses being transferred to outside investors in ABCP. Instead, **the crisis had a profoundly negative effect on commercial banks because banks had—in large part—insured outside investors in ABCP by providing explicit guarantees to conduits**, which required banks to pay off maturing ABCP at par. Effectively, banks had used conduits to *securitize assets without transferring the risks* to outside investors, contrary to the common understanding of securitization as a method for risk transfer. We argue that **banks instead used conduits for regulatory arbitrage**.
>
> . . . .We find that the majority of guarantees were structured as capital-reducing liquidity guarantees and that the majority of conduits were sponsored by commercial banks. . . . Also, we note [ ] that the growth of ABCP stalled in 2001 after regulators discussed an increase in capital requirements for conduit guarantees (following the failure of Enron which had employed conduit-style structures to create off-balance sheet leverage) and picked up again, especially the issuance of liquidity-guaranteed paper by commercial banks, after a decision against a significant increase was made in 2004.
>
> . . . . [W]e find that liquidity-guaranteed ABCP was issued more frequently by commercial banks with low *economic* capital, measured by their book value of equity relative to assets.[38]

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[38] Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez (senior economist, Federal Reserve Board), "Securitization Without Risk Transfer," Aug. 8, 2011 at 3-4, available at SSRN.com.