

# The Systemic Risk Council

September 16, 2013

Elizabeth Murphy, Secretary  
Securities & Exchange Commission  
100 E Street, NW  
Washington, DC 20549

## File No. S7-03-13: Proposed Rule Regarding Money Market Funds

Dear Commission:

The Systemic Risk Council<sup>1</sup> is writing to recommend that the Commission strengthen its proposed money market fund reforms and put in place a final rule that will fully address the destabilizing risks created by the stable NAV accounting fiction and so-called “penny rounding”. As we have noted previously, the SRC believes prompt and decisive action is needed to curb systemic risks posed by money market funds. When the Reserve Primary Fund “broke the buck” in 2008, extraordinary actions were required to back-stop and calm investors in money market funds and protect the short-term lending markets. While we commend the Commission for overcoming significant industry pressure aimed at derailing this essential reform, the two primary options are not sufficient to address these risks. The first (limited floating NAV) option will create a host of gaming and arbitrage opportunities and the second (gates and fees option) could make matters worse. *A much better approach would be to require a floating NAV for all money market mutual funds. This is the same, simple, regulatory framework that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.*

### **The Stable NAV is the Cause of Money Market Funds’ Structural Weakness**

Money market funds are used as “cash management” products – often as bank deposit substitutes – that, like deposits, are redeemable on demand. Unlike deposits, however, they have no capital, no insurance, no access to Federal Reserve liquidity and no legal requirements that their parent companies operate as a “source of strength”. While the value of their underlying assets change with the market every day *like every other mutual fund; unlike every other mutual fund*, the SEC

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<sup>1</sup> Systemic Risk Council: The independent non-partisan Systemic Risk Council was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This letter fairly reflects the consensus views of the Council, but does not bind individual members. [www.systemicriskcouncil.org](http://www.systemicriskcouncil.org)

permits money market funds to price their shares at a \$1.00 even when the value of the assets underlying the fund are not worth \$1.00. As has been highlighted at length by the Financial Stability Oversight Council, President's Working Group on Financial Markets, SEC, and others, this special exemption creates significant structural instability that – given the enormous role played by money market funds in the global lending markets – exacerbates crises and can threaten the functioning of our financial markets. This structural weakness must be addressed head-on: either through strong capital requirements or a floating NAV. While we are pleased that the SEC took a step in this direction by proposing a floating NAV for “institutional” “prime” money funds, we are concerned that other money funds, including retail and government funds, would retain the stable NAV weakness.

### **Leaving Stable NAV in Place Will Leave Retail Investors and Markets Unprotected**

Retail investors in stable NAV funds will remain at risk for bearing the costs of first-movers who will continue to have an incentive to run at the first sign of trouble. While it is true that runs during the 2008 money market fund crisis were concentrated in the institutional prime space, this does not mean other (e.g., retail) investors or investment classes were not at real risk. Institutional investors often move more quickly than retail investors and, because of the instability generated by their run in 2008, the government took quick and unprecedented action to guarantee the funds before the instability caused by their structural weakness could spread further. In the meantime, Congress has expressly prohibited the government from repeating those steps. Accordingly, a decision by the SEC to leave retail investors unprotected in stable NAV funds with large first mover advantages would be a mistake. Not only do retail investors often lack the ability to monitor fund holdings in real time and react with the speed of institutional investors, they are often the most at risk should their fund “break the buck” and be forced to halt redemptions and liquidate holdings. As was highlighted with the Reserve Primary Fund<sup>2</sup>, investors may have to wait a very long time before being able to access all their funds.

### **Leaving the Stable NAV for “Agencies” Would Further *Subsidize* Debt Issued by Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the U.S. Treasury**

The stable NAV subsidizes 2a-7 eligible assets relative to similar assets that are not eligible. Under current law, part of that artificial subsidy is spread among all 2a-7 eligible issuers (which include corporations, municipalities, the federal government and government-sponsored entities). To try to address the risks posed by the stable NAV accounting fiction, over time the SEC has narrowed the 2a-7 eligible assets, concentrating this subsidy on fewer and fewer issuers (and shorter-term debt) – and the proposal would focus it even more.

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<sup>2</sup> While the SEC made changes in 2010 to help improve problems identified in the Reserve Fund's disorderly liquidation, those reforms remain untested.

By leaving the stable NAV for institutional money market funds that invest in “agencies” (“government funds”) while floating the NAV for institutional funds that invest in corporate debt (“prime funds”), institutional investors seeking the stable \$1.00 will simply move their assets from prime funds to government funds, affecting the pricing for the underlying assets.

The availability of this pool of subsidized cheap, short-term funding will also provide incentives for the Treasury and the GSEs (who issue this agency paper) to borrow short instead of long (just as many other large financial institutions did during the run-up to the financial crisis). This is a perverse incentive: one that creates a potential for significant maturity mismatch and interest rate risk in the Government and the GSEs. If these entities become dependent on cheap, short-term funding – rather than stable longer-term funding, the potential for sudden contagion from a stable NAV money fund crisis grows. While we grant the SEC is not responsible for regulating the risks of the Treasury or the GSEs, this phenomenon is a direct result of the subsidy created by the SEC through the stable NAV fiction and it risks being even more concentrated now in the agency space.

It is also important to note that the SEC’s proposed definition of government funds would not eliminate “break the buck” risk from these funds. Not only would the agency debt held in these funds continue to face meaningful interest rate risk (and even credit risk for some GSE issuers), the proposal would also permit these stable NAV funds to invest up to 20 percent of their portfolio in non-agency assets. Not only could this potentially mislead investors who expect government/agency funds to be *entirely* or *almost entirely* government paper – but whatever “de-risking” comes from moving the stable NAV to government/agency assets would be lost as money funds use this 20 percent “other” bucket to reach for yield. This would put that stable NAV – and the markets – at risk in a crisis (again).

### **This Disjointed Approach Could Also *Raise* Borrowing Costs for Traditional Commercial Paper Issuers Relative to Agencies**

By allowing stable NAV to remain for institutional government funds and floating NAV for institutional prime funds, the new rules will cause significant money to flow *from* commercial paper issuers *to* agency issuers. On a relative basis, this will artificially *raise* the cost of borrowing for corporations (whose debt is in the floating NAV “institutional prime” space), and artificially subsidize borrowing by the Treasury and these government-sponsored entities (Fannie Mae, Freddie Mac and the Federal Home Loan Banks) whose debt is in the stable NAV “institutional government” space. At a time when the government should be working to *reduce* government subsidies which distort capital allocation, this approach goes in the opposite direction.

### **The “Gates and Fees” Approach Could Make the Situation Worse by Moving Up the Run**

The liquidity “gates and fees” option is potentially worse than existing law as it retains the existing structural weakness of the stable NAV, but adds increased investor uncertainty about potential gating and fees. Because investors who run *first* can still get their \$1.00 – and investors

who stay could bear the losses of the first movers *and* the potential for delays accessing their funds and new fees – MMF investors will have an incentive to run from these products even earlier than they do now.

### **The Proposed Enhanced Disclosures Will Help *Illustrate* the Structural Weaknesses in Money Market Funds But Will *Not* Address the Systemic Risk**

While new disclosures will help better illustrate the structural weaknesses in money market funds – the run risks caused by the stable NAV will likely be compounded by several new disclosures which will alert investors to liquidity and NAV problems in their funds, giving large first movers the opportunity to redeem (at a \$1.00) and embedding larger liquidity or capital losses on remaining holders.

Even if an investor does not *want* to run, because they risk bearing the losses imposed by others who do – run risk remains and may be worsened. The structure of the product continues to incentivize runs – and the disclosures provide more impetus to run. Because of the stable NAV, money market fund runs are *rational* and *not* self-correcting through disclosure. Accordingly, these improved disclosures may help *more* investors understand how to game money funds *by running*, but they will not eliminate the structural weakness that causes runs, nor the systemic risks that can follow.

### **The Best Solution is a Floating NAV for All Money Market Mutual Funds**

A floating NAV for all money market funds would not only address the core structural weakness and systemic risks posed by money funds – it would improve market functioning and fair competition by applying *equally to all issuers and all investors*. To the extent certain assets perform better than others, investors in those funds will profit. To the extent they perform worse, investors will take a loss. Functioning like other mutual funds, this approach does not *create* new run risks – nor does it result in the SEC picking winners and losers among issuers or asset classes – as the stable NAV approaches do. A floating NAV (for all funds) is the same, simple, regulatory framework that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.

### **Floating NAV and “Run Risk”**

A number of reform opponents have sought to undercut the floating NAV solution as insufficient to address all possible runs, noting that investors may still move to “safety” in a crisis. While these are often rational changes in investment decisions, in this context, opponents of a floating NAV appear to use the term “runs” when describing what, in other traditional mutual fund (floating NAV) contexts is just a routine move and re-pricing.

The key point though is that floating funds do not cause runs – stable NAV funds do. To its credit, the proposal notes:

The floating NAV alternative is not intended to deter redemptions that constitute rational risk management by shareholders or that reflect a general incentive to avoid loss. Instead, it is designed to increase transparency, and thus investor awareness, of money market fund risks and dis-incentivize redemption activity that can result from informed investors attempting to exploit the possibility of redeeming shares at their stable share price even if the portfolio has suffered a loss. (emphasis added).

It is true that a floating NAV would not “prohibit” investors (even en masse) from selling short-term 2(a)-7 eligible assets because of changes in the market place. Our markets are constantly re-pricing assets (often by the millisecond). If new information arises, or events occur – markets re-price and sometimes investors sell assets in bulk and at the same time. This can occur in any asset<sup>3</sup> – at any time. This re-pricing occurs all the time in many stocks and bonds: many of which are held by floating NAV mutual funds without destabilizing effects.

### **The Stable NAV Causes & Exacerbates Runs – While the Floating NAV Does Not**

As noted at length by the SEC, President’s Working Group on Financial Markets, FSOC and others, the Stable NAV provides *positive* incentives that encourage first movers to run – and because of the \$1.00, it provides little, if any, incentive not to run. If a fund’s assets are worth less than a \$1.00 – and you can redeem at \$1.00 – the remaining shareholders are *effectively paying* first movers to run. This embeds *permanent* losses in the fund for the remaining holders. Those shareholders can then be paid *back* eventually by sponsor support or suffer permanent losses when the fund breaks a buck. Over the short-term, and particularly in a crisis, the potential upside for NOT running remains ONLY a \$1.00. Accordingly, an investor gets a *certain* \$1.00 if they run, but only a *possible* 1.00 if they stay (and it could be less and delayed through fund liquidation, gates, etc). Accordingly, investors have every incentive to run on a money market fund at the first sign of trouble.

The floating NAV by contrast does not pay people to run. If a fund’s assets are worth less than \$1.00 (e.g., \$0.98), its price is less than \$1.00 (\$0.98). Accordingly, the investors’ choice is between 0.98 now or the potentially *upside* or *downside* tomorrow: just like other mutual funds. Moreover, because of forward pricing, the floating NAV – unlike the stable NAV -- requires that investors bear some of the liquidity and capital costs associated with their redemptions.<sup>4</sup> This is a

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<sup>3</sup> Including Treasuries, government-sponsored agency debt or repos collateralized by such debt.

<sup>4</sup> Some money market fund reform opponents have argued that asset managers will still sell liquid assets first – giving first movers an advantage – but this argument does not undermine the fact that the floating NAV is much better than stable NAV in this regard. That same liquidity dynamic occurs in a stable NAV product now AND the

dramatic change in run dynamics. Not only does floating NAV not actively pay first movers to run (the difference between the real NAV and the \$1.00), it helps limit their incentives to run (through forward pricing).

### **The SEC Floating NAV Rules Must Prohibit Gaming**

Given the size of the existing stable NAV market, fund companies may try to find new ways around the SEC's floating NAV rules. While we cannot guess all the possible ways, we urge the SEC to be vigilant against such efforts. Two tools used in the past have been (1) sponsor support and (2) amortized cost accounting.

Prohibit Sponsor Support. The Proposal notes that:

...money market funds' stable share price, combined with the practice of fund management companies providing financial support to money market funds when necessary may have implicitly encouraged investors to view these funds as 'risk-free' cash. However, the stability...has been due, in part, to the willingness of fund sponsors to support the stable value of the fund.

While this is true, unfortunately, it has also been due to the SEC's willingness to *allow* such support. While the proposal includes more disclosure of support – the final rule should expressly prohibit sponsor support. The proposal seems to view the disclosure of sponsor support as being a negative for a fund company (as if investors will penalize a fund company for supporting them). Investors, particularly in a crisis, however, view the possibility of sponsor support *as a positive*. Accordingly, permitting continued sponsor support – even with greater disclosure – will give investors *more* reason to move assets to particular funds – not less.

Allowing sponsor support to continue incentivizes investment based on a fund sponsor's likelihood of support, rather than based on asset allocation decisions. This moral hazard results in an unfair advantage for funds with large sponsors (often large, complex financial institutions and bank holding companies) at the expense of funds with smaller independent sponsors. This leads to distorted markets when those expectations are met – and potentially catastrophic consequences if the expectations cannot be (as with the Reserve Fund).

The SEC should prohibit sponsor support so money market funds actually float, so investors get the real benefit – or loss – from asset allocation choices – and so investment companies compete

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stable NAV product effectively pays investors to run. The floating NAV product does not pay investors to run – and it prices in (albeit imperfectly) the liquidity and capitals cost of the redemptions.

fairly and equally with each other based on those investment choices – NOT based on the possibility that a parent company may provide support.

Investment companies are legally separate from their sponsors and should compete with each other equally. If the SEC continues to permit sponsor support it must require that sponsors put money market funds on their balance sheet.

As we learned with SIVs during the financial crisis, off-balance sheet vehicles should only be off-balance sheet if their risks cannot come back even during a crisis. Investors (and regulators) need full information about these public companies, their balance sheets and their potential future exposure – including whether they might be called upon to support a multi-billion dollar money market fund.

Amortized Cost Accounting. The proposal would also continue to allow money funds to use amortized cost for debt instruments that have 60 days or less to maturity. While we understand this exemption is limited, the SEC should make sure that this exception is not abused or gamed by clarifying that this approach only works if it accurately reflects the value of the portfolio overall – not just asset by asset.

Unlike traditional mutual funds, 60-day paper could represent a relatively large percentage of a money fund's assets (and theoretically a fund company could game the entire rule by only investing in 60 day paper) – and even “small” differences in asset by asset pricing (on an amortized cost basis vs. a mark-to-market basis) could result in a meaningful difference in a fund's value overall – particularly in a more normalized interest rate environment. Investor behavior is based on fund valuation *overall* not the price of individual fund assets. If investors can run at the amortized cost \$1.00 – rather than the lower real mark-to-market value – they can still game the fund, embed losses on others and risk sudden drops in price and rising redemptions.

## **Conclusion**

We strongly urge the SEC to require a floating NAV for all money market mutual funds. As seen during the 2008 crisis, the rigidity and destabilizing effects of a stable NAV can shut down capital formation for issuers who rely on money market funds for short-term funding. A floating NAV would make markets much more flexible and allow funds, and markets, to remain open and functioning in a crisis. Moreover, while other crises are sure to occur, they would no longer be *caused* or exacerbated by the stable NAV. Finally, a strong floating NAV approach, as outlined here, would help level the playing field for investment companies and investors by helping ensure that investment decisions and competitive outcomes are based on the quality of asset allocation decisions not the moral hazard of potential sponsor support. This is the same,

simple, regulatory framework that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read "Sheila Bair", enclosed within a thin blue rectangular border.

The Systemic Risk Council  
[www.systemicriskcouncil.org](http://www.systemicriskcouncil.org)

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