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Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-11-09 - Comments on Money Market Fund Reform

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My name is Jack Winters and I have been involved in the money fund industry since 1976 on the buy side (Federated, Lehman, Bear Stearns, Fidelity, Credit Suisse), the sell side (Lehman), as a consultant (iMoneyNet), and now as an unaffiliated observer. With my experience and the fact that I am not affiliated with any firm, I believe that I can offer informed and objective comments on the challenges facing the industry. I will first offer general comments about money fund risk and then address specific topics on which the SEC has sought comment.

My comments are based upon the following facts and assumptions:

1. **FACT:** A credit incident with one money fund led to a classic liquidity run on virtually every money fund which led to systemic failure as the funds were unable to sell securities in sufficient amounts to meet redemption orders.

2. **FACT:** The money fund industry was bailed out by the U.S. Treasury and the Federal Reserve.

3. **ASSUMPTION:** The U.S. Treasury desires to decommission its Temporary Guaranty Program for Money Market Funds and allow the industry to resume operations independent of government assistance.

4. **ASSUMPTION:** The SEC, U.S. Treasury, Federal Reserve, and Obama Administration do not want to be in a position to have to bail out this industry again.

Summary Comment: The SEC's recently proposed regulatory changes are a step in the right direction <u>but will not materially reduce the systemic risk that is embedded within money market funds.</u> More substantial changes will be necessary to avoid future runs and bailouts.

<u>I. General Comments - Money Fund Risk</u>

The SEC's proposal document released on June 30, 2009 (IC – 28807) is extremely thoughtful and well written. In comparison with the recommendations made by the money fund industry itself (ICI Money Market Working Group – March 17, 2009), it is a bit more restrictive. But let us not forget the near-death experience of September 2008 in which the industry suffered a classic "run on the bank" as a result of The Reserve Primary Fund's credit loss and subsequent liquidity squeeze that quickly infected virtually every money fund. Fund operators could not meet panicky redemption requests and securities could not be sold in the marketplace. **Industry assets might still be frozen today if the Treasury had not guaranteed all money funds and if the Fed had not provided a number of liquidity sources.**[1]

In all honesty, industry participants must acknowledge that every prime money fund **effectively broke the buck** during that period in September when there were no bids for AAA commercial paper. Within the context of this bailout, the SEC Commissioners and the industry should recognize that <u>substantial regulatory changes</u> need to be made before we can believe that systemic risk is materially reduced. Without those changes, it is likely that the Fed and U.S. Treasury will be called upon to bail out the industry again.

As I wrote in a special report, *"Money Fund Strategic Options: Growth, Risk Transfer, Merger, and Liquidation – May 2005* by John M. Winters, CFA", the **money fund is the riskiest asset class** that resides within an asset management firm. That risk is based upon the fact that each fund sponsor effectively has given its shareholders a "free put at $1.00 per share".[2] In spite of massive asset growth over the years, the <u>sponsors have willingly assumed all of the ever-increasing operating risk in return for a very low fee</u>.

Throughout the history of money funds, shareholders have enjoyed all the benefits of this sponsor risk assumption - excellent safety, a stable NAV, easy liquidity, and a competitive yield. But the events of September 2008 have demonstrated that when just one money fund sponsor makes a credit mistake, <u>then all sponsors have a liquidity problem</u>. Systemic consequences are even more widespread for issuers, banks, dealers, and commerce in general as we have seen.

Regulators should recognize that, in the future, some of the sponsors may not have the willingness or the capacity to support their funds.[3] Credit risk in money funds has not been the most serious threat to money funds. I believe that the latent liquidity risk from

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[1] Even before The Reserve Fund broke the buck, the money fund industry suffered serious redemption runs in 2007 based upon credit concerns with subprime and SIVs. The sponsors that responded most effectively were those that were affiliated with banks because they had indirect access to liquidity through the Fed.
[2] While this is not a legal obligation, money funds have created a public perception of a constant NAV through their willingness to support funds in any crisis. A money fund is the only stable NAV investment product that employs a maturity mismatch (1-day liability versus assets with maturities of up to 397 days) without an assigned capital reserve. It is also takes on credit risk without a capital reserve while investors expect no principal losses.
[3] This is similar to the situation in which auction rate securities dealers supported their auctions until their financial situation precluded it, thus leading to failed auctions which locked investors unexpectedly into long term illiquid investments.

institutional fund shareholders who take advantage of the stable NAV (amortized cost) is the most serious factor in systemic risk faced by money funds and their regulator. **The solution is to transfer some of that liquidity risk over to shareholders. (**See Options below.)

"Know Your Customer" - Another significant aspect of money fund liquidity risk resides with electronic trading portals which have become popular among institutional investors for their trading convenience but have introduced a higher level of shareholder volatility that is encouraged by the portal operators. The risk is further heightened by the fact that money fund portfolio managers typically do not have a relationship with investors who buy their funds through portals and, therefore, have difficulty predicting the cash flows. If one fund cannot maintain a competitive yield, portal investors quickly migrate to a fund with a better yield often without any prior communication to the lower yielding fund. These are essentially redemption runs on a smaller scale.

As long as amortized cost is used to maintain a constant $1.00/share NAV, the liquidity risk will remain heightened and the potential for institutional shareholders to stage another run at the slightest provocation will now be higher than ever. During the run in September, it would not have mattered if a fund had a WAM of 30 days and 50% liquidity. In the context of that panic, and without the U.S. Treasury support, those institutional funds would have needed nearly 100% liquidity to satisfy shareholder redemption requests.

The SEC proposed rule changes that deal with liquidity risk do not really represent a change because most of the institutional prime funds were already in compliance with the proposed regulations relative to WAM, daily and weekly liquidity, and credit quality before The Reserve Fund blew up. For an industry that was bailed out and is still the beneficiary of government support, it seems to me that more substantial change is necessary.

II. Specific Comments

Below are some regulatory options for consideration. They are arrayed in a spectrum of systemic risk from highest to lowest. Options #2 through #5 represent different approaches to shift liquidity risk from sponsors to shareholders. They include requiring contractually committed private liquidity lines, restrictions on types of investors, restrictions on redemption orders, and mark-to-market valuation (Floating NAV) for institutional money funds.

Options to Address Systemic Liquidity Risk in Money Funds

Ranked Highest Risk to Lowest Risk

Highest Risk

1. Continue to use amortized cost for all MMFs with the new rules as proposed.

2. Use Option #1, and require contractually committed private liquidity lines for institutional prime and tax exempt MMFs and have a minimum capital requirement for sponsors of such funds.

3. Use Option #1, and place restrictions on large purchases by institutional investors into prime funds, particularly "hot money" and third-party sourced assets where there is no direct customer-to-fund sponsor relationship (electronic trading portals).

4. Use Option #1, and grant money funds the routine ability to temporarily suspend redemptions and, if necessary in an emergency, use redemption-in-kind <u>without</u> requiring the funds to liquidate.

5. Use mark-to-market valuation (Floating NAV) for institutional prime and tax exempt MMFs; allow amortized cost valuation (Stable NAV) for all retail MMFs and institutional government MMFs.

Lowest Risk

<u>Comments – Floating NAV – pp. 101-107</u>

The discussion of Floating NAV in the SEC proposal document is well written as it highlights the fact that Rule 2a-7 was negotiated during an era characterized by retail investors, small asset size, and fluid short term fixed income securities markets where reliable bids were available if ever needed. The industry has evolved into one with massive asset size and is dominated by highly opportunistic institutional investors which make it very challenging for a portfolio manager to provide liquidity and a competitive yield. With the demise of numerous dealers, liquidity in the securities markets has also been reduced.[4] <u>So the original assumption that securities market values always track amortized cost has not held up.</u> This has been the case since around the late 1990s when

[4] When money funds are forced to sell high quality securities during a run of redemptions, there are frequently no bids which effectively freezes the market, or, if there are "low ball" bids, portfolio losses will result if forced to sell.

institutional/corporate investors became more active users of money funds. At the same time, there is the question of whether the standard of fairness is still being upheld when active institutional investors are allowed to dilute returns for existing investors when rates are falling by investing at $1.00/share and the fund's market value is higher. Conversely, they still receive $1.00/share for redeeming quickly when the portfolio value is declining due to rising rates or credit problems. Passive investors are disadvantaged in both directions.

My recommendation to <u>change from amortized cost to marked-to-market valuation for institutional prime and tax exempt money funds</u> is indeed a major one and is not taken lightly. It is, unfortunately, necessary because it has become obvious that the institutional money fund is not functioning in the manner the SEC contemplated when Rule 2a-7 was first conceived.

In my view, institutional shareholder volatility can be substantially reduced by using a floating NAV. It may not totally eliminate redemption runs, but investors will be less opportunistic if there is a cost to liquidity. This will remove a portion of the systemic risk and be more equitable for passive investors. The money fund industry seems reluctant to embrace this solution because it fears that large numbers of investors prefer a stable NAV and will pull out their money.

The first part of a response to that concern is that the industry needed a bailout precisely because active institutional investors took advantage of the sponsors and the inequity of the amortized cost value arbitrage. The second part is that, under most circumstances, **portfolio managers ought to be able to manage their money funds in such a way as to maintain a NAV that is very close to $10.00** and that the product would still offer the benefits of relative safety (not absolute safety as it is presently), convenience, and a competitive yield that is higher than deposit instruments most of the time.[5] The third part of a response is that, if an investor truly needed <u>absolute principal stability</u> and <u>absolute liquidity</u>, then he or she should use a government money fund which would still use amortized cost valuation. An additional observation is that, if the Floating NAV is used for institutional money funds, then the proposed changes for daily and weekly liquidity, WAM, average life, and final maturity might be relaxed somewhat because the liquidity risk should be muted by the potential for change in the NAV.

There are also some people who are concerned that issuers of short term obligations might face lower demand and higher financing costs if the floating NAV is used. The first part of a response to that concern is that investors might not move out of money funds as feared. The second part is that, even if some did move out, those investors would still need securities for investment regardless of whether they represented separate accounts or 3(c)7 managed funds. The third part is that the SEC's top priority is <u>not</u> to ensure easy, low cost financing for issuers but rather to protect investors from abuses and maintain orderly financial markets.

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[5] As a practical matter, if a large number of institutional shareholders migrated directly to bank instruments, banks would not have the capacity to accept $2 trillion dollars in new deposits. Accepting even a small fraction of that would drive rates on bank instruments to a very unattractive low level.

Finally, very little has been publicly said about what logistically might happen among money funds when the U.S. Treasury's Temporary Guaranty Program for Money Market Funds expires in September. In the institutional market, all the insured money funds currently have essentially the same aspect of safety in the eyes of investors. But when insurance coverage disappears, investors will undoubtedly conduct more rigid due diligence of their "approved funds". Their criteria will likely favor sponsors who are very large, have substantial capital, access to additional immediate liquidity, and the ability to access additional capital if necessary. If this indeed happens, then there could be significant movement of assets among funds resulting in greater concentration of industry assets. Those funds which lose assets may contemplate withdrawing from the industry which would actually strengthen the industry from the perspective of investors. The same due diligence process and possible migration is likely to happen with a change from Stable NAV to Floating NAV. In both cases, the Fed's liquidity support program should be extended during the transition period.

III. Other Comments

A. Eligible Securities – Use of NRSROs – p. 31

The current money fund security selection process that begins with credit ratings from NRSROs would be acceptable **if only** a money fund could rely on a rating from an agency. Unfortunately, NRSROs have failed to do the job that MMF investors need them for, i.e. provide objective assessment of credit strength and give advance notice of significant deterioration. Over the years, there have been numerous situations where the rating agencies failed to alert investors in a timely manner – Orange County, WorldCom, Lehman, etc. NRSROs do not seem to anticipate credit problems – they tend to document the problems and downgrade the rating after the fact. This should not be acceptable to money funds which cannot tolerate credit analysis mistakes. Rating mistakes may be acceptable for bonds, but not for money funds.

There is an inherent conflict of interest when the issuers pay for the rating fee. Agencies say that their ratings are only "opinions" – they do not want to be responsible or accountable to investors. Why should they be if their "client" is actually the issuer?
In my view, money fund sponsors should pay for a credit rating service that they can rely upon, one with which their interests are aligned. There are a few firms that conduct investor-paid independent credit research that is probably objective and more reliable – e.g. **CreditSights** and **GimmeCredit**. Perhaps other firms will spring up to fill this need or perhaps Moody's, Standard & Poor's, et al will convert their business models to remove the conflict. As it currently stands, however, there is no point in continuing to use these ratings as a basis for the definition of an "eligible security" in a MMF.[6]

[6] A related potential conflict is with Money Fund Ratings where investors (instead of sponsors) should pay for the fund rating.

But investor-paid issuer ratings should only be the starting point as they are in the current eligible security process. My sense is that many money fund sponsors do not commit sufficient resources to the credit analysis of short term investments. Presently, only the very largest sponsors appear to have adequate resources. The focus should be on the ratio of fully dedicated analysts to the number of issuers/issues and not the size of assets under management. If a sponsor holds the securities of hundreds of corporate, ABCP, and municipal issuers and has only 3-4 analysts, then there is a natural tendency to rely more heavily on the NRSROs which, as I have discussed above, does not provide the investor protection that is expected. The SEC should consider placing more emphasis on its review of the in-house research process to ensure that each MMF advisor has an ample dedicated staff of credit analysts (who do not report to a portfolio manager) and review the credit approval process, periodic review process, and documentation of all.

To underscore the potential risks in the money fund credit review process, I provide an excerpt from my report, *"Money Fund Business Strategy: Growth, Risk Transfer, Merger, and Liquidation – May 2005"* by John M. Winters, CFA:

> The following discussion provides some insight into one organization's concern over the risk-exposure inherent in operating a money fund:
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> > A senior level official of a bank holding company pointed out to his colleagues that the lead bank's corporate lending process required three separate credit committee approvals to renew a $400 million line of credit whereas its affiliated investment adviser to the money fund could simply invest the same amount in a matter of seconds in the commercial paper of the same credit on the basis of a quick approval and the required ratings. The senior official questioned the quality of the organization's risk control that allowed such disparate procedures, especially in light of the fact that the line of credit carried an obligation by the bank to maintain loan loss reserves while the money fund did not. Should the money fund also have a capital reserve, and would money funds have acceptable profit margins if there were a cost of capital for the reserve?

B. **First Tier Only - p. 26**

I support removing Tier II as an eligible security because current rules severely limit usage, the impact on yield is small, credit quality is significantly lower than Tier I issuers, and, most importantly, Tier II usage diminishes the perception of money fund quality. Existing holdings should be allowed to mature.

C. Portfolio Maturity – p. 41

Reducing the WAM from 90 days to 60 days does reduce a money fund's potential market risk in the event that interest rates spike upward. But, in September of 2008, most portfolio managers maintained the WAM below the proposed 60-day limit. So I am not sure how effective this change will be for systemic liquidity risk. There have been individual situations over the years in which a fund was caught too long and the sponsor did have to take special measures to preserve assets and/or the NAV. I support the introduction of the Weighted Average Life measurement.

D. Portfolio Liquidity - p. 52

I support the proposal to eliminate the 10% illiquid bucket.

The proposed daily/weekly liquidity requirements for retail and institutional funds, although introduced as new rules, do not really present much of a change from the levels actually maintained by portfolio managers before the redemption run. So I am not sure how effective they might be in dealing with the next run on the funds. In the absence of a change to a Floating NAV or any other restriction on institutional investors, the liquidity levels should probably be increased to 25% daily and 40% weekly. This may seem high but we must keep in mind that institutional investors are now more inclined than ever to redeem at the first hint of trouble because the Stable NAV poses no penalty. The proposed retail levels will probably be sufficient.

E. Stress Testing - p. 68

As a device that should enhance investor protection, the concept of formalized stress testing is welcome because not all funds undertake that practice on a regular basis. When you look at the specifics, however, the proposed rule contemplates significant engagement by the Board of Trustees as relates to the type of test, the assumptions, who will conduct it, who will receive the results, and the remedies that may be needed.

Since many current Board members lack the expertise to devise such an effective test, I would favor a process in which the Board works with the advisor on developing the parameters, the test should be conducted on a periodic basis by the advisor, the results would be presented to the Board with recommended actions if necessary. Records of tests should be available to the SEC if requested.

Respectfully submitted,

John M. Winters

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