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January 25, 2013

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

Re: President's Working Group Report on Money Market Fund Reform; Rel. No. IC-29497; File No. 4-619; Comment submitted on the Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket No. FSOC-2012-0003)

Dear Ms. Murphy:

Enclosed is a copy of the initial comments we submitted on behalf of our client, Federated Investors, Inc., on December 17, 2012 to the Financial Stability Oversight Council (the "Council") on the Council's *Proposed Recommendations Regarding Money Market Mutual Fund Reform* ("Proposed Recommendations"). The enclosed comment letter discusses, among other things, the Council's arbitrary use of its Section 120 authority and its failure to meet Dodd-Frank and Securities and Exchange Commission statutory and other criteria for economic analysis.

We ask that our comments be made a part of the Commission's record.

Sincerely,

John D. Hawke, Jr.

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December 17, 2012

The Honorable Timothy Geithner
Chairman, Financial Stability Oversight Council
c/o Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003).

Dear Secretary Geithner:

We are writing on behalf of our client, Federated Investors, Inc. and its subsidiaries ("Federated"), to provide initial comments in response to the Financial Stability Oversight Council's (the "Council's") recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform* ("Proposed Recommendations" or "Release").[1] The Release is issued pursuant to Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), which authorizes the Council, subject to specified criteria and conditions, to issue recommendations to a primary financial regulatory agency to apply new or heightened standards or safeguards.[2] Federated plans to submit detailed comments and data on the Proposed Recommendations in the coming weeks.

Federated has served since 1974 as an investment adviser to money market mutual funds ("MMFs").[3] We appreciate the opportunity to comment on whether the Council should recommend that the Securities and Exchange Commission ("SEC") adopt

[1] Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) ("Release").

[2] Pub. L. 111-203 § 120, 12 U.S.C. § 5330 (July 21, 2010) (Dodd-Frank).

[3] Federated has nearly thirty-nine years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

the potential changes to the regulatory framework for MMFs described in the Release. As discussed below, the Council should not issue the Proposed Recommendations, for the following reasons:

(1) Section 120 of Dodd-Frank should not be invoked arbitrarily where an agency is continuing to consider regulatory reforms, simply because the agency's chair is unable to prevail on a particular approach at a particular time. The legitimate concerns raised by a majority of members of the SEC – an agency bound by statute and its own administrative procedures to consider and assess the economic consequences of any regulatory action – should have been respected by the Council.

(2) In issuing the Release, the Council failed to consider overwhelming public comments that raised substantial concerns about the costs and effectiveness of the very proposals – a floating net asset value ("NAV"), minimum balance at risk, and capital requirement – that the Council is putting forward. At minimum, the Release should have addressed those comments, which it did not.

(3) The Release fails to meet Dodd-Frank and SEC statutory and other criteria for economic analysis. It omits any recognition or assessment of significant economic costs that were raised in surveys, analyses and reports in the SEC's public comment file. The benefits identified by the Release are purely speculative and contrary to the data, surveys and reports in the SEC's file, and the Release admits that the proposed reforms would not prevent runs during a financial crisis.

(4) The Release fails to consider the impact of the proposals in shrinking MMF assets and leading to further growth of the largest systemically important banks and expansion of the federal safety net.

(5) The proposed recommendations are based on a faulty premise concerning the role of MMFs in the financial crisis and on a perplexing view of the MMF redemption activity during 2011. We challenge whether deterring the type of redemption activity experienced by MMFs during 2011 should be a goal of MMF reform, as the Release suggests.

(6) MMFs are not subject to the Council's jurisdiction, as a matter of law, because their activities are not "financial in nature" under the language of Dodd-Frank, the Bank Holding Company Act, and applicable rules and agency orders.

(7) Bank regulators' inconsistent treatment of bank short term investment funds demonstrates a lack of understanding by the Council of the factors affecting MMF stability.

(8) The Release fails to recommend workable reforms that would enhance, rather than harm, MMFs and their investors and has failed to address the need for actions by regulators other than the SEC to address identified systemic risks. The Council should focus on reforms mandated by Congress that are directly relevant to mitigating or preventing future financial crises.

(1) *The Council Should Not Use the Dodd-Frank Section 120 Process at this Time for this Purpose.*

The Council issued the Release because the Chair of the SEC was unable to obtain support from three members of the SEC, a majority, for a draft rulemaking release proposing significant structural changes to MMFs, prepared by the SEC staff at the Chairman's direction.[4] The Commissioners had access to an extensive docket containing hundreds of individually distinct comment letters, reports, surveys, articles, and other materials filed by a range of MMF users, market participants, government officials and academics.[5] These comments were filed over a two-year period in response to the SEC's request for comment on the 2010 Report of the President's Working Group on MMF Reform Options ("PWG Report"),[6] and, during the past year, in response to public statements made by the SEC Chair in which she outlined what she believed a formal rule proposal would include.[7] Based upon their review of the docket and their analyses of the staff draft proposals, three Commissioners issued statements on August 23 (Commissioner Aguilar) and August 28 (Commissioners Gallagher and Paredes) stating their views that the staff draft proposals lacked sufficient foundation;[8] specifically, the draft proposals "were not supported by the requisite data and analysis, were unlikely to be effective in achieving their primary purpose, and would impose significant costs on issuers and investors while potentially introducing new risks into the nation's financial

[4] Release at 69456. *See* Press Release, Mary L. Schapiro, Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), http://www.sec.gov/news/press/2012/2012-166.htm.

[5] Request for Comment, President's Working Group Report on Money Market Fund Reform, File No. 4-619, http://www.sec.gov/comments/4-619/4-619.shtml. Unless otherwise stated, all letters to the SEC cited in this letter were filed in response to this Request for Comment.

[6] Report of the President's Working Group on Financial Markets Money Market Fund Reform Options (October 2010), http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf (PWG Report).

[7] Chairman Mary L. Schapiro, Remarks at Securities Industry and Financial Markets Association (SIFMA) 2011 Annual Meeting (Nov. 7, 2011), http://www.sec.gov/news/speech/2011/spch110711mls.htm.

[8] Commissioner Luis A. Aguilar, Statement Regarding Money Market Funds (Aug. 23, 2012), http://www.sec.gov/news/speech/2012/spch082312laa.htm; Commissioner Daniel M. Gallagher and Commissioner Troy A. Paredes, Statement on the Regulation of Money Market Funds (August 28, 2012), http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm.

system."[9] The Commissioners' statements called for additional study and analysis but in no way ruled out further MMF reforms.[10] In fact, the statements reflected an intention by the majority of the SEC to "do better" than the staff draft in addressing MMF regulation.[11]

The Council's Release acknowledges that "[t]he SEC by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risks that MMFs present to the economy."[12] The SEC also is subject to statutory requirements that it consider the effects of any regulations on efficiency, competition, and capital formation, and must comply with its own mandatory requirements to assess the economic consequences of any rule before even proposing it.[13] Yet, the Council invoked Section 120 in an attempt to pressure the SEC to move forward on the *very proposals* that a majority of the SEC found unsupported by data or sound economic analysis and potentially risky to the financial system. While the Chair of the SEC has the ability to set the agency's agenda, each member of the SEC (1) is appointed by the President, (2) is confirmed by the Senate, and (3) has an equal vote and an equal responsibility not to put forward regulatory proposals that he or she believes ineffective in achieving their purpose and costly and potentially risky to investors.

We do not believe Congress intended the Section 120 process to be used arbitrarily and in disregard for agency processes, in circumstances where an agency is continuing to grapple with a regulatory issue under its direct jurisdiction, simply because

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[9] Commissioner Daniel M. Gallagher and Commissioner Troy A. Paredes, Statement on the Regulation of Money Market Funds (August 28, 2012), http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm.

[10] In this connection, the SEC recently published a report by its Division of Risk, Strategy and Financial Innovation in response to questions posed by the three commissioners. Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (Nov. 30, 2012), http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf. We are reviewing the study and will address its findings in future submissions.

[11] Commissioner Daniel M. Gallagher and Commissioner Troy A. Paredes, Statement on the Regulation of Money Market Funds (August 28, 2012), http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm.

[12] Release at 69460.

[13] *See* National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, § 106 (amending 15 U.S.C. § 80a–2). The National Securities Market Improvement Act of 1996 added amendments to each of the major Federal Securities Laws (including the Investment Company Act) requiring the SEC to consider efficiency, competition, and capital formation whenever it is engaged in rulemaking that requires the agency to consider or determine whether an action is necessary or appropriate in the public interest. *See also* Division of Risk, Strategy, and Financial Innovation and Office of General Counsel, Securities & Exchange Commission, *Current Guidance on Economic Analysis in SEC Rulemakings* (Mar. 16, 2012), http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

the agency's chair is unable to prevail on a particular approach at a particular time.[14] The Release threatens other actions by the Council – including actions that exceed the Council's authority under Dodd-Frank – in the event the SEC fails to move forward with reforms satisfactory to the Council.[15] For these reasons, the Release violates both the letter and intent of the relevant provisions of Dodd-Frank.

(2) *The Council Ignores Overwhelming Public Comments Raising Substantial Concerns About Floating NAV, Minimum Balance at Risk And Capital Requirements for MMFs.*

The Release also ignores the extensive record of public comments in the SEC's docket. While the Release contains several footnote references to isolated letters and surveys in the SEC's comment file, the vast majority of comments were not referenced in the Release and apparently not considered by the Council. The Council approved the Release in a perfunctory 20-minute meeting at which there was no discussion of the significant concerns raised in hundreds of comment letters concerning *these same proposals* for MMF reform – a floating NAV, minimum balance or "holdback" requirement, and a capital requirement.

The hundreds of individually distinct public comment letters in the SEC's docket contained substantial research, data, reports, surveys and other analyses developed over a period of almost two years. Commenters put forward data and research regarding the adverse impact of the proposals; they also argued strongly that, based on their analysis of the data, the proposals not only would fail to prevent or reduce the risk of runs in a crisis, they in fact could precipitate runs and increase systemic risks. Arnold & Porter filed a letter with the SEC on July 17, 2012, copying all members of the Council, in which we detailed the comments, surveys, reports and other data filed with the SEC as of that date.[16]

The Release fails to acknowledge, much less address, the concerns raised by commenters. This is an arbitrary and disappointing first use of the Council's Section 120

[14] The Council's disregard for agency processes is further reflected in its statement that, "[i]n accordance with Section 120 . . . the Council has consulted with the SEC *staff*." Release at 69457 (emphasis supplied). Section 120, in fact, requires consultation with "the primary financial regulatory agenc[y]" – in this case, the five-member Commission, rather than its staff or its chair alone. Dodd-Frank § 120(b)(1).

[15] The Release warns that the Council might act against MMFs under Title I of Dodd-Frank to designate a MMF as systemically important (and subject to Federal Reserve regulation) or under Title VIII of Dodd Frank (which authorizes the Council to designate certain payment, clearing or settlement activities as systemically important) – neither of which authorities do we believe may be used to designate the MMF industry as a whole, an individual MMF or its advisor. Release at 69460.

[16] Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (July 17, 2012).

authority. The Release should be withdrawn pending a thorough analysis by the Council of the comments already in the SEC's docket. We briefly summarize some of the major concerns raised by commenters, below.

The Floating NAV Proposal Would Not Enhance the Stability of MMFs, But Would Cause MMFs to Shrink. Hundreds of comment letters addressed the question of whether MMFs should be required to sell and redeem shares based on a floating NAV.[17] Surveys and other comments provided evidence that the vast majority of investors understand that MMFs may lose value, are not insured, and that the underlying assets may deviate from $1.00 per share. MMFs publish their "shadow" NAV as a regular benchmark, and it is not credible to suggest that investors are misinformed or that a floating NAV would better inform them of MMF risks. Comment letters explained that many instruments in a MMF portfolio cannot be "marked-to-market" in any event, and therefore to promote a floating NAV as a true mark-to-market price is misleading.

Most important, the evidence is clear that requiring MMFs to use a floating NAV would not advance the regulatory goal of reducing or eliminating "runs" in a crisis.[18] Data from floating NAV funds and ultra short bond funds during the recent financial crisis confirm this conclusion.[19] The Council in its Release, as well as the Federal Reserve Bank of New York in a recent staff report, acknowledge this.[20]

Letters from MMF users state overwhelmingly that requiring a floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate

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[17] These letters are compiled and summarized in Arnold & Porter's letter of November 2, 2012, filed with the SEC and the Council. Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Nov. 2, 2012).

[18] Hal Scott, *Interconnectedness and Contagion, Committee on Capital Markets Regulation* at 222-25 (Nov. 20, 2012), http://www.capmktsreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Letter from Fidelity Investments to IOSCO (May 30, 2012) (filed with the SEC); David W. Blackwell, Kenneth R. Troske & Drew B. Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk*, U.S. Chamber of Commerce Center for Capital Markets Competitiveness (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf; Statement of the Investment Company Institute, SEC Open Meeting of the Investor Advisory Committee at 4 (May 10, 2010), http://www.ici.org/pdf/24289.pdf (ICI); ICI, Report of the Money Market Working Group at 105 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[19] Jill Fisch & Eric Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?*, Institute for Law and Economics, Univ. of Pa. at n.186-88 (Aug. 2011), http://www.sec.gov/comments/4-619/4619-110.pdf (filed with SEC Dec. 2, 2011). *See also* Release at 69467.

[20] Release at 69467; Patrick E. McCabe, et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 5-6, 54 (July 2012), http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf.

MMFs as a viable cash management tool for many and would impose significant operational, accounting and tax burdens, as well as require a costly retooling of accounting, trading and settlement systems. Investors who are subject to statutory prohibitions and investment restrictions would be prohibited from using floating NAV funds. For these reasons, according to commenters, requiring a floating NAV would substantially shrink the assets of MMFs, raise borrowing costs, and create a migration of users to less regulated and less transparent products. It also would result in large users managing their own portfolios of money market instruments and/or would accelerate the flow of MMF assets to too-big-to-fail banks – in each case adding to systemic risk.[21]

The Minimum Balance at Risk Proposal Would Cause MMFs to Shrink and Would Increase Investor Incentive to Redeem Early in a Crisis. Numerous comment letters raised serious concerns about the type of minimum balance at risk ("MBR") or "holdback" requirement promoted by the SEC Chair and proposed in the Release. These include a detailed study published by the Investment Company Institute ("ICI"), the national association of U.S. investment companies;[22] a comment letter filed by DST Systems, Inc., an information processing service provider to the global asset management, insurance, retirement, brokerage and healthcare industries;[23] a report published by Blackrock, a leading asset management company;[24] a comment letter filed by the American Benefits Council, an association representing 350 organizations that either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans;[25] an analysis of operational impediments and state law impediments to minimum balance requirements filed by Federated Investors;[26] a report addressing various types of redemption restrictions, including minimum balance restrictions, filed by Treasury Strategies, Inc., a consulting firm advising corporate and institutional treasurers;[27] three letters Arnold & Porter filed on behalf of Federated

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[21] The surveys, data, analyses and other public comments on these various impacts are summarized in Arnold & Porter's letter of November 2, 2012 filed with the Commission. Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Nov. 2, 2012).

[22] Letter from ICI to SEC (June 20, 2012).

[23] Letter from DST Systems, Inc. to SEC (Mar. 2, 2012).

[24] Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate Continues* (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117.

[25] Letter from American Benefits Council to SEC (June 19, 2012).

[26] Letter from Federated Investors to SEC (Mar. 16, 2012).

[27] Treasury Strategies, *Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective & Crippling Regulation*, http://www.sec.gov/comments/4-619/4619-172.pdf (filed as a comment letter with the SEC Apr. 27, 2012).

Investors, which describe in detail the various uses of MMFs and the impact of redemption restrictions, including minimum balance restrictions, as well as the estimated size of the various MMF users that would be impacted by restrictions on investor redemptions;[28] and others.

The ICI report provided extensive analysis of the costs and effectiveness of such a requirement. Treasury Strategies and Blackrock each published analyses, based in part on survey information, reporting that a MBR or holdback requirement likely would make investors "run" at the first sign of trouble in a MMF in order to avoid the holdback requirement. Arnold & Porter also filed a letter on August 9, 2012, which addressed a proposal by the staff of the Federal Reserve Bank of New York for the very same type of MBR/capital requirement contained in the Proposed Release; that letter identified and reported on comments of numerous other users and market participants.[29]

The data, analyses, surveys and other commentary in the SEC's docket show convincingly that the MBR/capital proposal's impact in reducing runs is speculative and unproven and in fact could and likely would precipitate runs under certain circumstances; it would harm MMF investors by layering costs and operational impediments upon their access to funds; it would make MMFs unavailable to investors who are precluded by state law or fiduciary requirements from investing in funds with minimum balance or subordination features; it would, in light of these costs and inefficiencies, shrink the size of the MMF industry and reduce the participation of MMFs in the market for commercial paper and state and local government debt, thereby increasing the funding costs for corporations and public entities who must seek other lenders; and it would drive MMF investors to less regulated and less transparent cash management vehicles or to systemically important banks – in either case increasing systemic risk.[30]

The Capital Proposal Would Not Enhance Stability of MMFs, Would Increase Investor Incentives to Redeem Early in a Crisis, Would be Inordinately Expensive, and Would Shrink MMFs. MMFs are financed exclusively by common equity capital provided by MMF shareholders. MMFs do not use leverage or other forms of debt or borrowing. The Release suggests a requirement that MMFs maintain a capital buffer, which the Release says could be built from fund income, from fund sponsors, or

[28] Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012); Letter from John D. Hawke, Jr. on behalf of Federated Investors to FSOC (Dec. 15, 2011) (filed with SEC).

[29] Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Aug. 9, 2012). This letter also was sent to each member of the FSOC.

[30] Data and commentary on each of these impacts is discussed in Arnold & Porter's letter of August 9, 2012 filed with the Commission. Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Aug. 9, 2012).

from issuance of a new category of subordinated equity capital, to absorb the "first loss" on defaulted portfolio securities.[31]

With the exception of the Reserve Primary Fund itself, the main problem faced by MMFs during the financial crisis was not capital. It was liquidity – and yet, as discussed further below, the Federal Reserve has failed to move forward with rules mandated under Dodd-Frank regarding the provision of liquidity to the financial system in the event of another crisis.[32] But a small capital buffer does little or nothing to address liquidity problems if they arise in the future. Maintaining a short-term fixed income portfolio, which holds a large amount of ready cash and near-cash assets and essentially self-liquidates in its entirety in a relatively short period of time, provides a much better protection against a "run." This is the approach taken by the SEC in Rule 2a-7, and these liquidity requirements have been made even more stringent through the 2010 amendments to that rule.

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

The SEC's docket contains numerous letters, surveys, reports and other analyses raising concerns about the imposition of any capital requirements on MMFs. Many of these comments focused on the increased risk created by a capital requirement. For example, a report filed by Treasury Strategies described how adding a capital requirement to funds places increased pressure on fund managers to drive yield; the "guaranteed" return of principal implied by a capital requirement promotes the false

[31] Release at 60470.

[32] Dodd-Frank § 1101(a)(6), 12 U.S.C. § 343(B)(i) (requiring the Board to establish, in consultation with the Secretary of the Treasury, "policies and procedures governing emergency lending . . . for the purpose of providing liquidity to the financial system . . . .").

notion that MMFs are deposits, increasing moral hazard from the investor's perspective as well.[33] Commenters stated that a capital buffer would accelerate, rather than prevent, runs. A submission by Professors Fisch and Roiter explained that, once an MMF taps the capital buffer in an effort to avoid breaking the buck, "investors are put on notice that the fund might not be able to sustain its $1 NAV. Knowing that the capital buffer is limited (somewhere between, perhaps, 0.5% to 3% of NAV), investors might have an *extra* incentive to redeem before the cushion is exhausted, thereby aggravating rather than reducing problems of collective action."[34] Commenters expressed concern that a capital requirement could change both the expectations and nature of investors in MMFs – investors would be more likely to view an MMF as a deposit rather than an investment, which "would attract an investor class that is ***more*** likely to flee at the first sign of distress or rumor, thus ***increasing*** the likelihood of a run."[35]

Surveys filed with the SEC reported on how investors would respond to reduced yield and concluded that it would drive many investors from MMFs to search for higher yields elsewhere, including in unregulated and less transparent vehicles.[36] The comments on this issue included a joint letter from 33 Members of Congress who are all former state and local government officials,[37] as well as a joint letter from the Independent Directors Council and the Mutual Fund Directors Forum, who warned that reduced yields will make MMFs "substantially less attractive to investors" and result in a shift to alternative products.[38] Commenters also provided analyses of the impact of a capital requirement on causing fund sponsors to exit the business.[39]

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

34 Jill Fisch & Eric Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?*, Institute for Law and Economics, Univ. of Pa. at 2 (Aug. 2011), http://www.sec.gov/comments/4-619/4619-110.pdf (filed with SEC Dec. 2, 2011).

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

36 Letter from ICI to SEC (Apr. 19, 2012) (providing a survey of corporate institutional investors conducted by Treasury Strategies); Letter from State Street to SEC (Feb. 24, 2012); Letter from Northern Kentucky Chamber to SEC (Jan. 20, 2012). *See also* PWG Report at 35 (stating that "a substantial mandatory capital buffer for MMFs would reduce their net yields and possibly motivate institutional investors to move assets from MMFs to unregulated alternatives (particularly if regulatory reform does not include new constraints on such vehicles).").

37 Letter from 33 Members of Congress to SEC (May 1, 2012), http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658511.pdf.

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

39 Letter from Treasury Strategies to SEC (Mar. 19, 2012). BlackRock commented, "[A]bove approximately 70 basis points of capital, the money market industry will no longer return the industry cost of capital to fund sponsors. . . . [This] will cause the industry to contract . . . unless fees rise . . . ." Letter from BlackRock to SEC (Mar. 2, 2012), referencing Blackrock, *Money Market Funds: The Debate*

Footnote continued on next page

According to commenters, these adverse impacts would occur, regardless of the source or structure of capital. ICI provided a detailed review and data analysis of two possible sources of funding for a capital buffer – requiring fund sponsors to commit capital or having funds build a capital buffer from fund income[40] – and found that a buffer coming from either adviser's profits or investor yield would take years to build up.[41] We understand that a third alternative, raising subordinated/third party capital, was thoroughly analyzed and discussed with SEC and Federal Reserve staff and found to be unmarketable and not viable.[42]

Other comment letters emphasized the differences between MMFs, which do not use leverage or hold non-transparent assets, have operating assets, use off-balance sheet financing or have deposit insurance, and banks, which do have these attributes and are in the business of assuming credit risk on long-term loans and other assets.[43] Investors in MMFs are shareholders, not creditors, and are subject to potential loss, in return for a market return on their short-term investments.

(3) *The Council's Release Fails to Meet Dodd-Frank and SEC Statutory and Other Criteria for Economic Analysis.*

Section 120 of Dodd-Frank requires the Council, in making recommendations to a primary financial regulatory agency that the agency apply new or heightened standards and safeguards for a financial activity or practice, "take costs to long-term economic

Footnote continued from previous page
Continues (March 2012), https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111160117). *See also* Letter from SIFMA to SEC (Jan. 10, 2011) ("If the level of required capital cannot be sustained by the marketplace, the result of a capital requirement would be to severely curtail the availability of money market funds, eliminating an attractive cash management option for investors, likely prompting a shift to less heavily regulated investment vehicles which pose more systemic risk, and eliminating a source of financing for issuers.").

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

[41] *Id*.

[42] For example, Charles Schwab stated, "We do not believe there is a viable market for a subordinated share class that would take first loss position in exchange for a higher return." Letter from Charles Schwab to IOSCO (May 31, 2012) (filed with SEC). *See also* Letter from Fidelity Investments to IOSCO (May 30, 2012) ("It is highly speculative that any market will develop for such subordinated shares."), http://www.sec.gov/comments/4-619/4619-185.pdf.

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

growth into account."[44] We discuss this provision below, but also note that the Council's recommendations must satisfy a number of additional requirements for cost-benefit analysis, which the Release either dismisses or ignores.

For example, the Council must satisfy Obama Executive Order 13563,[45] which is "supplemental to and reaffirms the principles, structures, and definitions" in Clinton Executive Order 12866,[46] and which, with respect to an economically "significant regulatory action" under that order (not confined to actual rulemaking), must fully and rigorously assess the benefits and costs of the proposed action and the costs and benefits of reasonably feasible alternatives – in all cases furnishing the underlying analysis.

In addition, the SEC is subject to statutory requirements that it consider the effects of any regulation on efficiency, competition, and capital formation,[47] and is subject to its own mandatory rulemaking requirements for rigorous analysis of the economic consequences of any rule – an analysis that must be substantially complete before the SEC may even propose a rule for comment.[48] The Council cannot reasonably invoke Section 120 to propose that the SEC adopt rules that do not satisfy the criteria for economic analysis under the SEC's own governing statutes and requirements. Thus, the Release should have discussed how the proposals would have impacted efficiency, competition, and capital formation and should have at least attempted to measure the impact of the proposals against other reasonable alternatives. Instead, the Council said, in effect, that will be the SEC's problem when we send the recommendations its way.[49]

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[44] Dodd-Frank § 120(b)(2)(A), 12 U.S.C. § 5330.

[45] *Improving Regulation and Regulatory Review*, Exec. Order No. 13563 (Jan. 18, 2011).

[46] *Regulatory Planning and Review*, Exec. Order No. 12866 (Sept. 30, 1993).

[47] *See* National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, § 106 (amending 15 U.S.C. § 80a–2).

[48] Division of Risk, Strategy, and Financial Innovation and Office of General Counsel, Securities & Exchange Commission, *Current Guidance on Economic Analysis in SEC Rulemakings* at 16 (Mar. 16, 2012), http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[49] Release at 69479 ("If the SEC accepts the Council's recommendation, it is expected that the SEC would implement the recommendation through a rulemaking, subject to public comment, that would consider the economic consequences of the implementing rule as informed by the SEC staff's own economic study and analysis."). The Release also dismisses the requirements of the Regulatory Flexibility Act, which requires that whenever an agency is required to publish general notice of proposed rulemaking for any proposed rule, the agency must either provide an initial regulatory flexibility analysis or certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. §§ 601-612. The Release states that the proposed recommendations are not a "rule" and then goes on to say that the recommendations would "directly impact only the SEC, and any rulemakings by the SEC" and that in any event any SEC rule would "apply only to MMFs, of which few, if any are believed to be small entities"– ignoring the enormous impact that any rulemaking in this area would have on millions of users of MMFs,

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Instead of measuring the economic impact of the proposals against these statutory and administrative criteria, which require rigorous, detailed, and credible analyses of costs, benefits, and consequences of proposed regulatory actions, the Release simply acknowledges the provisions of Section 120 that require the Council to consider the consequences of its recommendations on long-term economic growth,[50] and then describes the Council's own narrow interpretation of the criteria:

> In the consideration herein, long-term economic growth refers to the average rate of change of overall economic activity, as measured by the rate of change in real GDP . . . over an extended period. Specifically, we consider expected costs and benefits over a horizon sufficient to include a transition period and the potential costs and benefits with respect to long-term capital formation and a diminished probability and severity of future financial crises. As such, these costs and benefits are likely to accrue over a period of a decade or substantially longer. The potential benefits of the proposed recommendations, in terms of long-term economic growth, arise from the higher level of economic activity expected to prevail from a reduction in the likelihood or severity of a financial crisis and the consequent adverse effects on investment and overall spending; similarly, the potential costs in terms of long-term economic growth stem from the reduced level of spending that may accompany higher costs of financing investment and other outlays.[51]

As discussed below, the Council's analysis of the economic consequences of its proposals fails to meet even its own narrow criteria.

Evaluation of Costs of the Proposed Recommendations. No less than a dozen times, the Release refers to the significance of MMFs as a source of short-term funding. For example, the Release states "MMF's are a significant source of short-term funding for businesses, financial institutions, and governments"[52] and play a "significant role . . . in the short-term credit markets."[53] The MMF industry "provides a substantial portion of

Footnote continued from previous page
and ignoring the impact of the Council's section 120 recommendation in pressuring the SEC to undertake such a rulemaking. *See* Release at n.117.

[50] Release at 69479.

[51] *Id.* at n.118.

[52] *Id.* at 69455.

[53] *Id.* at 60480.

the short-term funding available to a range of borrowers in the capital markets."[54] They are "important providers of short-term funding to financial institutions, nonfinancial firms, and governments, and play a dominant role in some short-term funding markets."[55]

Yet, in evaluating the costs to long-term economic growth of the Council's proposed new regulations for MMFs, the Council seeks to minimize the role of MMFs in the overall credit markets (e.g., "the total credit that they supply is relatively small compared to aggregate nonfederal nonfinancial debt outstanding") and looks only at the projected increase in costs of borrowing based on MMF's increased lending rates necessary to cover the costs of proposed capital requirements.[56] It then concludes, "The small estimated increment to borrowing costs implies that the potential costs to long-term economic growth . . . would be small."[57] It states that, "for the purposes of this consideration, the Council has assumed that borrowers will not shift borrowing away from MMFs and as a result will be forced to fully absorb this higher cost."[58]

This limited analysis fails to identify and assess the numerous relevant costs described and predicted by comment letters in the SEC's docket. For example, the Council's analysis minimizes and fails completely to size or assess the impact of the proposals in significantly shrinking the MMF industry – a shrinkage predicted in numerous comment letters and surveys and reports filed with the SEC and available to the Council.[59]

A shrinkage of the MMF industry has significant consequences, both for raising borrowing costs and in increasing systemic risk. For example, while the Release attempts to project the higher costs of funding through MMFs, it fails to assess the increased costs

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[54] *Id.* at 69461.

[55] *Id.* at 69462.

[56] *Id.* at 69481.

[57] *Id.*

[58] *Id.* at 69480.

[59] *See* Letter from Tennessee Municipal League to SEC (May 10, 2012); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letter from Texas Association of Business to SEC (Feb. 27, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with SEC (Dec. 15, 2011). For example, statutory and other investment guidelines prevent certain investors from using a MMF with a floating NAV or minimum balance at risk requirement; these requirements also would make MMFs impractical operationally as a cash management tool for specialized functions required by numerous current users of MMFs. *See* Letter from ICI to SEC (June 20, 2012); Letter from Alleghany Conference on Community Development and Greater Pittsburg Chamber of Commerce to SEC (Apr. 24, 2012); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letter from Texas Association of Business to SEC (Feb. 27, 2012).

for borrowers who must turn to other lenders at higher, less competitive funding costs. Bank loans are consistently more expensive – often 200 points or more – than rates on commercial paper.[60] Such higher short-term borrowing costs will result in slower growth, reduced employment and a delayed economic recovery. A shift of balances from MMFs to banks will increase financing costs to state and local governments and corporate borrowers, resulting in further strains on state and local government budgets and lower economic growth and fewer jobs, while decreasing returns to savers and investors on their cash balances.

The Release also overlooks the potential impact of the proposals in removing market discipline and/or increasing systemic risk. For example, while the Release acknowledges that the proposals could cause a "migration to non-MMF cash management products,"[61] it fails to assess the economic consequences of this migration, both as to potential increases in the cost of financing and the increase in systemic risk from less regulated, less transparent vehicles.

The Release fails to even acknowledge, much less assess, the impact of a large portion of the current $2.6 trillion of MMF assets migrating to large, systemically important banks, expanding the federal government safety net of deposit insurance and government lending required to maintain these banks, as well as periodic bail-outs by taxpayers.

The Release overlooks as a cost the loss of benefits (and increase in risk) in removing the current market discipline of MMF managers managing to a stable NAV, and the discipline of both managers and investors operating without a net of capital. Indeed, it fails to assess the effects of capital in increasing moral hazard for both investors and managers. This assessment is absolutely critical in evaluating a dramatic structural change in MMFs as an investment product, with well-known risks where investors understand they bear the loss, to a product more resembling a guaranteed deposit, backed by capital.

In focusing only on borrowing costs, the Release completely fails to assess the cost of the loss of efficiencies for millions of businesses and others who use MMFs for

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[60] *See* Board of Governors of the Federal Reserve System, *Selected Interest Rates (Weekly) – H.15* (updated Dec. 10, 2012), http://www.federalreserve.gov/releases/h15/current/ (showing the weekly average prime rate charged by banks on short-term loans to business); Board of Governors of the Federal Reserve System, *Commercial Paper Rates and Outstanding Summary* (updated Dec. 13, 2012), http://www.federalreserve.gov/releases/cp/ (showing daily interest rates for 90-Day AA Nonfinancial Commercial Paper).

[61] Release at 69457.

cash management. It ignores the substantial costs to change business systems that have been tailored to the stable NAV and same-day liquidity.

Each of these and other significant cost factors were described in the hundreds of comment letters filed with the SEC.[62] The SEC's statutory and administrative requirements mandate that each of these impacts be assessed and sized by the SEC when and if it proposes rules. The President's Executive Order clearly requires the FSOC, in undertaking a major regulatory action of such impact, to assess the costs and provide the underlying analysis. But, the Release provides a narrow and self-serving analysis of the costs of these proposals. This cannot be what Congress intended in prescribing a statutory requirement that the Council consider the costs of any proposal under Section 120 to long-term economic growth.

Evaluation of Benefits. The Release states that the Council "expects that the proposed recommendations would significantly reduce the risk of runs on MMFs and, accordingly, lower the risk of a significant long-term cost to economic growth. Specifically, the proposed recommendations could bolster the resilience and stability of MMFs during periods of financial stress, and reduce the severity of financial crises."[63] It also says that there may be a "tradeoff between accepting higher costs in normal times in order to significantly reduce the costs of financial crises."[64]

Thus, in determining benefits, the Release rests entirely on its "expectation" – which turns out to be sheer speculation – that the proposals will lead to a "diminished probability and severity of future financial crises."[65] These benefits accrue only if the proposals, in fact, would accomplish the goal of preventing or reducing runs during a period of financial stress. However, the Release offers no data that the proposals would do so. In fact, the Release concedes that each of the proposed reforms would likely be ineffective in preventing a run during a period of stress. This admission by the Council is consistent with numerous letters, reports, articles and surveys filed with the SEC.

The Release states, for example, "while a floating NAV would remove the ability of a shareholder to redeem shares at $1.00 when the market value is less than $1.00, it would not remove a shareholder's incentive to redeem whenever the shareholder believes

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[62] As noted earlier, Arnold & Porter has filed several letters that are compendia of the comment letters filed with the SEC. *See, e.g.*, Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (July 17, 2012); John D. Hawke, Jr. on behalf of Federated Investors to SEC (Aug. 9, 2012); John D. Hawke, Jr. on behalf of Federated Investors to SEC (Nov. 2, 2012).

[63] Release at 69480 (internal citations omitted).

[64] *Id.* at n.119.

[65] *See* Release at n.118.

that the NAV will decline significantly in the future . . . ."[66] This is borne out in the experience of floating NAV funds during the crisis, which was documented in a number of comments and analyses filed with the SEC.[67] If this is the case, what then is the point of requiring a floating NAV in the first instance? Why is it the role of the Council, which is charged with addressing systemic risks, to change the fundamental characteristics of a cash management product used by investors more than 40 years, when there is no evidence that such a change would diminish systemic risk? The Release suggests that the goal may be to remove uncertainty as to who bears the risk of loss in a MMF. But, institutional investors already are clearly aware of these risks, and, according to surveys of retail investors, the vast majority of them also are well aware of these risks.[68] If investor confusion is a concern and investor protection is a goal, to promote the idea to investors that a floating NAV MMF is more safe and less run-prone is itself misleading.

The Release states, "While the combination of the NAV buffer and the 3-percent MBR likely would not be sufficient to stop a run on an MMF if investors anticipate very large losses in that fund, such a combination may be large enough to stem runs on most other funds *unless investors expect that very large losses would be incurred across MMFs*.[69] What, then, is the point of imposing an MBR requirement on MMF investors and removing an essential characteristic of MMFs – 100% liquidity – that is critical to many investors? The panic of 2008 was triggered by widespread concerns about the stability of major financial institutions and, importantly, concerns about whether the government had the ability to manage the crisis, after its flip-flop between a policy of rescuing systemically important financial institutions (Bear Stearns), then letting others go bankrupt (Lehman), then rushing to bail out others (AIG), with no consistency of policy response. There is no evidence that during normal periods, MMFs are susceptible to runs. The "benefits" claimed by the Release all depend upon the proposed reforms preventing or diminishing the severity of a future financial crisis, which the MBR proposal will not do.

With respect to capital, the Release states that while its 3% risk-based capital requirement "may reduce the probability that an MMF investor suffers losses, it is unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer."[70] The proposed capital requirement seeks to instill confidence in MMF investors

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[66] *Id.* at 69467.

[67] The Release acknowledges this data. *See* Release at n.72.

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

[69] Release at 69471 (emphasis supplied).

[70] Release at 69475.

that their investments are safe from loss by absorbing small losses without impacting the MMF's NAV. But, if the incentive still remains for investors to redeem when there is substantial uncertainty about the return of their investment in a financial crisis, as occurred during 2008, then the benefits claimed by the Release regarding a capital requirement are as speculative and misleading as those claimed for the floating NAV and MBR proposals.

(4) *The Release Fails to Consider the Impact of the Proposals in Contracting the Assets of MMFs and Leading to Further Growth of the Largest SIFI Banks and Federal Safety Net.*

The Council's proposed recommendations regarding the structure and regulation of MMFs would cause MMFs to shrink, and force much of the financing currently provided by MMF onto bank balance sheets or into entities that are structured and regulated like banks.[71] The inevitable consequence of this approach is the further substantial growth of the largest systemically important financial institutions (SIFIs) and the further expansion of the federal government safety net of deposit insurance, government lending, and periodic bail-outs by taxpayers that is required to maintain them.

This approach is directly contrary to the instructions provided by Congress to the Council in Dodd-Frank, the express purpose of which as stated in the preamble is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail" [and] to protect the American taxpayer by ending bailouts . . . ."[72] A likely consequence of shrinking MMFs would be additional growth of the largest U.S. banks fueled by deposits of cash redeemed from MMFs. Over 75% of deposit growth in 2011 that was caused by unlimited deposit insurance of demand deposit accounts flowed into the ten largest banks.[73] The ten largest US banks represent 65% of banking assets and 75% of U.S. GDP.[74] Institutional investors hold approximately two-thirds of MMF shares. If two-thirds of MMF balances

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

[72] Dodd-Frank pmbl.

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

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

move into the banking system and 75% of that flows into the ten largest banks, that would increase the size of the ten largest SIFI banks by $1.3 trillion to 74% of US banking assets and 84% of US GDP. The failure of any of these banks would be catastrophic to the economy and our financial system. We do not have available financial resources to bail them out if they fail.

Substitution of bank deposits for MMF shares would also increase the overall size of the federal safety net. Bank deposits are FDIC-insured (up to $250,000 per depositor), so when a bank fails, the Deposit Insurance Fund pays, and the U.S. government stands behind it. MMF shares are not insured by the federal government; in the two instances (in forty years) where a MMF broke a buck, investors lost a small amount of money but taxpayers were not on the hook. Increasing the size of the federal safety net was not the purpose of Dodd-Frank, yet that would be the most likely result of the use of Title I of the Act to shrink or eliminate MMFs.

(5) *The Proposed Recommendations Are Based on a Faulty Premise Concerning the Role of MMFs in the Financial Crisis.*

Evidence from the 2007-2008 Financial Crisis. The Release proposes to make a determination under Section 120, based on the proposition that "the conduct and nature of the activities and practices of MMFs . . . leave them susceptible to destabilizing runs . . . ."[75] The Release points to evidence from the 2007-2008 financial crisis and then states, "[T]he most serious phase of the run on MMFs occurred not in the two business days immediately after the Lehman bankruptcy, but in the two days following the Reserve Primary Fund's announcement that it had broken the buck."[76] It goes on to describe MMFs' "rapid disinvestment . . . of short term instruments[,] which severely exacerbated stress in already strained financial markets."[77]

This narrative seeks to attribute the panic and liquidity collapse that gripped the financial markets during the week of September 15, 2008 and the redemptions from MMFs that ensued largely to one event – the announcement by the Reserve Primary Fund on September 16 that it had "broken the buck." MMFs did not cause or exacerbate the financial crisis, which had been building for more than a year prior to that time. The Release fails to acknowledge the cumulative effects of a serious of shocks (failures, bailouts, seizures, and assisted acquisitions of numerous large financial institutions), which intensified during a turbulent 10-day period in September 2008. It also fails to mention that there was a large intervening shock between the Reserve's announcement,

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[75] Release at 69456.

[76] *Id.* at 69464.

[77] *Id.*

and the two days of peak "runs." In fact, several hours after the Reserve's announcement, and before the "most serious phase of the run on MMFs,"[78] investors were hit with the news that AIG required $85 billion in government funds to avoid collapse – news that a later analysis of the crisis identified as the tipping point, when the financial markets "skidded into a total liquidity collapse."[79] The Release's narrative also wholly fails to acknowledge what the Financial Crisis Inquiry Commission (FCIC) concluded: "The inconsistency of federal government decisions in not rescuing Lehman after having rescued Bear Stearns and the GSEs, and immediately before rescuing AIG added to the uncertainty and panic in the financial markets."[80] Investors had no confidence in the ability of the government to manage the crisis, and no way of predicting how it would respond to support other large financial institutions that clearly were under stress.

That there was a flight to safety from virtually all asset classes is not surprising. What is remarkable is how soon assets began flowing back to MMFs, as evidenced by the fact that after September 19, 2008 when the MMF temporary guarantee program was capped, MMF investors poured a net $170 billion in *uninsured* investments back into prime MMFs by year end 2008.[81] Those investors who returned to MMFs during the depth of the financial crisis were not seeking insurance or a guarantee; they were well aware that MMFs did not hold capital. They also were well aware that their post-September 19 investments were not insured. They were seeking the diversification, credit quality, expert management and liquidity provided by MMFs, at a time when investors remained reluctant to place funds at banks beyond the limits of federal guarantees.

The depth and severity of the financial crisis required that the government pump massive liquidity into virtually every corner of the financial markets,[82] but the government's program to fund banks' purchases of commercial paper from MMFs (the Asset-Backed Commercial Paper MMF Liquidity Facility, or AMLF) and guarantee MMF balances as of September 19, 2008 were small in size and duration compared to the massive government liquidity programs addressing the broader market problems.[83] The

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[78] *Id.*

[79] Treasury Strategies, *Dissecting the Financial Collapse of 2007-2009* at 8, http://www.sec.gov/comments/4-619/4619-188.pdf (filed as a comment letter with the SEC June 1, 2012).

[80] FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES at 343 (Jan. 2011).

[81] *See* Treasury Strategies, *Dissecting the Financial Collapse of 2007-2009* at 3, http://www.sec.gov/comments/4-619/4619-188.pdf (filed as a comment letter with the SEC June 1, 2012).

[82] Federated Investors, *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, American Banker, Jan. 19, 2012 at 8.

[83] *See* Federal Reserve, *Credit and Liquidity Programs and the Balance Sheet* (Nov. 2011), http://www.federalreserve.gov/monetarypolicy/bst.htm.

amount loaned under the AMLF constituted less than 2% of the government's total emergency funds outstanding on a weighted average monthly basis.[84] In fact, the AMLF was one of the smaller and shorter-lived liquidity programs of the Federal Reserve and Treasury during the financial crisis.[85] The Treasury's temporary guarantee program for MMFs also was limited in size and duration, was never called upon, and earned the Treasury $1.2 billion in premiums.[86] This is in sharp contrast to the Transaction Account Guarantee program, which provides unlimited amounts of deposit insurance for banks, and which has continued for four years. As of a report issued in June of this year, estimated losses under the program totaled approximately $2.5 billion.[87]

Indeed, since 1971, during the period MMFs have been in existence, over 2,900 banks have failed, and an additional 592 were kept afloat through federal bailouts, at a total cost to the federal government of over $164 billion.[88] During the financial crisis, from January 2008 through February 18, 2011, 344 banks failed in the United States.[89] All the evidence from the 2007-2008 financial crisis shows is that, during the worst financial crisis since the 1930s and during a period of investor panic when there was a total lack of confidence in the government's response, MMFs were not immune. Yet, they were the last asset class to be hit by the financial crisis and the first to recover. Of 807 MMFs in operation at the start of 2008, 806 did not "break a buck," and the lone exception, Reserve Primary Fund, returned over 99 cents on the dollar to its investors at no cost to taxpayers.

MMFs also were the first institutions to be subject to comprehensive reforms. After careful consideration of alternatives and considering the events of 2008, the SEC in 2010 adopted substantial enhancements to its regulations governing MMFs. These

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[84] Federated Investors, *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, American Banker, Jan. 19, 2012 at 8. *See* Office of the Inspector General, Board of Governors of the Federal Reserve System, *The Federal Reserve's Section 13(3) Lending Facilities to Support Overall Market Liquidity: Function, Status, and Risk Management* at 5 (Nov. 2010), http://www.federalreserve.gov/oig/files/FRS_Lending_Facilities_Report_final-11-23-10_web.pdf (AMLF utilization peaked at $152.1 billion.).

[85] It had no losses, and the Federal Reserve earned $543 million from its advances. *Id.*

[86] Press Release, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 19, 2009), http://www.treasury.gov/press-centeripress-releases/Pages/tg293.aspv.

[87] Letter from Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation to Hon. Shelley Moore Capito (June 29, 2012), http://www.aba.com/Issues/Index/Documents/FDICResponsetoCapitoonTAG.pdf.

[88] Federal Deposit Insurance Corporation, *Failures and Assistance Transactions*, http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

[89] Federal Deposit Insurance Corporation , *FDIC Failed Bank List*, http://www.fdic.gov/bank/individual/failed/banklist.html.

include enhanced reporting requirements and use of "shadow pricing" to benchmark share values, stricter portfolio credit quality requirements, shorter portfolio maturities and – directly addressing the risk posed by widespread redemptions of the magnitude experienced in September 2008 – portfolio liquidity requirements of not less than 10% overnight liquidity, 30% 7-day liquidity and a requirement to assess anticipated future investor redemptions and maintain additional liquidity sufficient to address those redemptions. In practice, MMFs hold well over 40% short-term liquid assets totaling over $1 trillion. The SEC has also implemented enhanced surveillance of patterns and risks in MMF portfolios using the additional portfolio information now reported by MMFs. These 2010 regulatory reforms are working well and clearly have made MMFs more resilient.

Evidence from 2011. Comments by Federal Reserve Chairman Bernanke at the Council's meeting approving the Release, in which he referred to the period of heavy redemptions experienced by MMFs in 2011 as evidence that the "basic run issue has not been solved," are perplexing.[90] Similar statements in the Release suggest that the Council itself, to the extent it voted to issue the Release, may hold this view.

The Release states, "Heavy outflows from institutional prime MMFs in the summer of 2011 further highlighted MMFs continued vulnerability to runs, even after the 2010 reforms."[91] It reports that, in the eight weeks ending on August 3, 2011, institutional prime funds experienced net outflows of $170 billion – 16 percent of assets – but "because the pace of outflows in 2011 was well below that experienced during the run in September 2008 . . . MMFs were able to withstand redemption pressures without further repercussions."[92] The Release states that these redemptions were apparently in response to concerns about the funds' European holdings and the U.S. debt ceiling impasse. It further states, "Importantly, these outflows occurred despite the fact that the MMFs suffered no material losses during this episode."[93]

We strongly challenge whether an outflow of 16% of MMF assets over a period of eight weeks – in response to investor perceptions of risk in MMFs' European holdings and the U.S. debt-ceiling impasse – is something to be concerned about. Isn't this activity reflective of rational investor behavior? Isn't the fact that there were "no material losses" evidence of good management on the part of MMFs? In our view, this

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[90] Financial Stability Oversight Council, Open Session Meeting of the Financial Stability Oversight Council (Nov. 13, 2012) (archive of meeting webcast), http://www.yorkcast.com/treasury/ondemand/asx/2012/11/13/FSOC.asx.

[91] Release at 69465.

[92] *Id.*

[93] *Id.*

reflects: (1) that the funds were well-managed and had sufficient liquidity (a result of the 2010 amendments and the funds' own prudent management); (2) that the funds were transparent; (3) that investors acted on their assessments of risk in MMF portfolio holdings; and (4) that managers acted appropriately in response to this market discipline by subsequently reducing the size of their European holdings.

Is it the Council's goal in proposing the reforms to halt or impede the type of redemption activity that occurred during this period in 2011? Would a capital buffer have prevented institutional outflows under such conditions? If so, would that have been good? Or would it have muted the discipline of investors voting with their feet in response to their risk tolerance?

Would a 3% MBR have prevented institutional outflows from MMFs during the summer of 2011? As the Release acknowledges, the outflows occurred over an 8-week period, and there were no losses in any event. But had there been a loss at the end of the period, redemptions during the first 4 weeks by "first movers," (presumably the most sophisticated or luckiest) would have escaped the MBR, while a homebuyer seeking to redeem cash for a down payment from his or her MMF during the second 4 weeks would have been subject to a holdback of 3% of his MMF shares and any first loss exceeding the fund's capital. Of more concern, however, is the potential for the MBR, under the circumstances of 2011, to precipitate a run. As described by Treasury Strategies –

> A thirty day holdback provision essentially requires investors to look ahead thirty days and ask whether it is possible for certain conditions to deteriorate to the point at which an institution might be in distress. If the answer is "yes" or "maybe", then the threat of a holdback encourages the investors to sell. This definitely creates a first mover advantage. It also precipitates a prolonged run in which assets leave the fund, at first slowly, accelerating into a full-fledged run.
>
> Had this provision been in place during any number of recent events, investors would have invoked the thirty day look-ahead and exited perfectly healthy and well functioning MMFs. For example, during the summer of 2011, at the height of the European debt crisis and the U.S. budget impasse, investors could have preemptively sold their MMF investments in order to assure themselves of liquidity. August of 2011 would have seen the worst of both worlds: all of the first movers rewarded and their actions possibly triggering a firestorm run on the day of the U.S. sovereign downgrade.[94]

[94] Treasury Strategies, *Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective & Crippling Regulation* at 5-6, http://www.sec.gov/comments/4-619/4619-172.pdf (filed as a comment letter with the SEC Apr. 27, 2012).

The success of MMF's handling of high levels of redemptions in the summer of 2011 affirmed that the SEC's liquidity requirements for MMFs are working as intended. MMFs fully met redemptions. The SEC's enhanced MMF disclosure requirements gave investors greater insight into MMF portfolio holdings; investors took appropriate action consistent with their risk tolerance. The redemptions experienced by MMFs in the summer of 2011 were not a run; they reflected the discipline of investors assessing their MMFs' portfolios. To suggest that MMF regulation should be changed to halt or impede such activity is ludicrous. And, as the analysis by Treasury Strategies points out, had the MBR requirement been in place at that time, it could have triggered a wave of preemptory redemptions and a wholly unnecessary firestorm run.

(6) ***Money Market Funds Are Not Subject to the Council's Jurisdiction, as a Matter of Law, Because their Activities Are Not "Financial in Nature" Under the Language of Dodd-Frank, the Bank Holding Company Act, and Applicable Rules and Agency Orders.***

The Release states, "The Council believes that MMFs are 'predominantly engaged in financial activities' as defined in section 4(k) of the Bank Holding Company Act of 1956 and thus are 'nonbank financial companies' for purpose of Title I of the Dodd-Frank Act."[95] Stating the Council's belief will not make it so when the law, including the plain language of Dodd-Frank, says otherwise.

Section 120(a) of Dodd-Frank provides the Council authority to make recommendations for regulation only as to the activities or practices of bank holding companies and nonbank financial companies.

MMFs are not bank holding companies. MMF are not permitted to be bank holding companies or subsidiaries of bank holding companies under Section 4(c)(8) and 4(k) of the Bank Holding Company Act ("BHC Act").[96] Nor are MMFs "nonbank financial companies" within the meaning of Dodd-Frank. Under Dodd-Frank, a "nonbank financial company" is defined as a company that is engaged primarily in "activities that are financial in nature"[97] as defined by Section 4(k) of the BHC Act.[98] Section 4(k) includes activities specifically listed in the statute, and activities that were determined by the Board of Governors of the Federal Reserve System under Section 4(c)(8) of the BHC Act by rule or order prior to November 12, 1999 as being so closely

[95] Release at 69460 (internal citation omitted).

[96] 12 U.S.C. § 1843(c)(8), 1843(k).

[97] Dodd-Frank § 102(a)(6).

[98] 12 U.S.C. § 1843(k).

related to banking as to be a proper incident thereto, or permitted to be conducted outside the United States by a bank holding company under Section 4(c)(13) of the BHC Act. In brief, although the Board of Governors has implemented Sections 4(c)(8) and 4(c)(13) through rulemakings and individual orders which establish the activities permitted for banks, it has specifically *not* permitted a bank holding company or its nonbank subsidiaries to be or control an open end investment company such as an MMF under those Sections.[99]

Precisely because MMFs have never been permitted by the Federal Reserve to be bank holding companies or nonbank subsidiaries of a bank holding company under Sections 4(c)(8) and 4(k) of the BHC Act, the activities of MMFs by definition are not "financial in nature" under Section 4(k) of the BHC Act,[100] and they may not be deemed "nonbank financial companies" within the meaning of Section 120(a) of Dodd-Frank.

(7) *October 2012 Amendments to Bank Short Term Investment Fund Rules Demonstrate FSOC Members' Lack of Understanding of What Causes MMFs to be Stable or Unstable.*

The Council's Release acknowledges that the SEC adopted important reforms to Rule 2a-7 in 2010. However, the Release glosses over the impact of those enhancements by referring to the circumstances of 2008 to conclude that only "structural" changes (such as creation of a new class of subordinated capital to protect MMF shareholders) to MMF regulation will prevent similar runs from occurring in the future. It is *liquidity*, however, and not a given type of capital structure, that prevents runs.[101] The SEC acted to significantly enhance the liquidity of MMFs in 2010, so that MMFs are now more able to

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[99] *See* 12 C.F.R. § 225.28(b)(6), § 225.125; *Travelers Group Inc.*, 84 Fed. Res. Bull. 985 (1998); *Lloyds TSB Group plc*, 85 Fed. Res. Bull 116 (1998); *Societe Generale*, 84 Fed. Res. Bull. 680 (1998); *Cooperative Centrale Raiffeisen-Boerenleenbank B.A. Rabobank Nederland Utrecht, The Netherlands*, 84 Fed. Res. Bull. 852 (1998); *Commerzbank AG*, 83 Fed. Res. Bull. 679 (1997); *Bankers Trust New York Corp.*, 83 Fed. Res. Bull. 780 (1987); *BankAmerica Corp.*, 83 Fed. Res. Bull. 913 (1997); *Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993); 12 C.F.R. §§ 211.10(a)(11), 225.86(b)(3).

[100] *See* 12 U.S.C. § 1843(k)(4).

[101] Hal Scott, *Interconnectedness and Contagion, Committee on Capital Markets Regulation* at 222-24 (Nov. 20, 2012), http://www.capmktsreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Letter from Treasury Strategies to SEC (Mar. 19, 2012); Stephan Jank & Michael Weddow, *Sturm und Drang in Money Market Funds: When Money Market Funds Cease to be Narrow*, Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No. 20/2008 (2008); Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp. This conclusion is consistent with the analysis in an FDIC Staff paper that insufficient liquidity, rather than capital, is the best predictor of financial panics in the banking system. *See* Kathleen McDill and Kevin Sheehan, *Sources of Historical Banking Panics: A Markov Switching Approach*, FDIC Working Paper 2006-01 (Nov. 2006), http://www.fdic.gov/bank/analytical/working/wp2006_01/wp2006_01.pdf.

withstand heavy redemptions. Analysis submitted to the SEC in response to the PWG Report demonstrates how the 2010 amendments to Rule 2a-7 have made MMFs far more resilient than was the case in 2008.[102] The Release fails to comprehend the importance of the 2010 amendments to assuring the stability of MMFs.

One measure of whether bank regulators understand what makes MMFs stable or unstable is how bank regulators regulate a similar stable value fund product that is operated by banks and exempt from SEC regulation. Failure of bank regulators to impose robust liquidity and credit quality requirements on their own cash funds documents bank regulators' failure to grasp the significance of those two requirements. Bank trust departments operate lightly-regulated "short term investment funds" ("STIFs") that are exempt from SEC regulation but that are offered by banks to pension investors and trust accounts, and to custodial accounts to hold securities lending collateral. STIFs are held out by banks as alternatives to MMFs. Like SEC-regulated MMFs, bank STIFs use the amortized cost method of accounting, seek to maintain a stable unit price, and are used to hold short-term liquidity balances and provide daily redemptions.

Although small in aggregate size relative to SEC-regulated MMFs, U.S. bank STIFs in the aggregate are larger than the aggregate assets of MMFs in any other country in the Western Hemisphere and in most other nations in Europe or Asia. Three of these U.S. bank STIF funds "broke a buck" during the financial crisis, with considerable financial loss to the banks and investors involved. To provide liquidity to bank STIFs during the financial crisis, the Federal Reserve extended the same credit facilities to bank STIFs that were made available to provide liquidity indirectly to SEC-regulated MMFs.

In response, the Office of the Comptroller of the Currency (an office of the Treasury Department and a member of FSOC) ("OCC") in October 2012 amended its rules at 12 C.F.R. § 9.18 that govern bank STIF funds to something akin to a watered-down version of the SEC's MMF Rule 2a-7.[103] Missing from the OCC's rule amendments were the two most important requirements imposed by the SEC on MMFs that are needed to maintain the STIF funds' solvency and stability: rigorous liquidity requirements and detailed credit quality requirements.

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[102] Letter from Fidelity Investments to SEC (Mar. 1, 2012); Letter from ICI to SEC (Feb. 16, 2012). *See also* Robert Comment, *Do Money Market Funds Require Further Reform?* (Nov. 23, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2174125; David W. Blackwell, Kenneth R. Troske & Drew B. Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk*, U.S. Chamber of Commerce Center for Capital Markets Competitiveness (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf; Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp.

[103] Short-Term Investment Funds, 77 Fed. Reg. 61229 (proposed Oct. 9, 2012).

The failure of the OCC to include detailed liquidity and credit quality standards in bank STIF rules indicates that at least four members of FSOC – the OCC, the Treasury Department of which it is a part, and the FDIC and Federal Reserve whose member banks must follow the OCC's STIF rules – fundamentally do not understand what causes a MMF to be stable or unstable. This surprising lack of understanding helps explain why the FSOC gives short shrift to the beneficial impact of the SEC's 2010 amendments to Rule 2a-7.

Equally surprising, the OCC's October 2012 amendments failed to include in the bank STIF rules (or even consider) *any* of the structural changes here recommended by FSOC to the SEC for imposition on MMFs. Apparently, what is considered to be good for the goose is not considered by FSOC's members to be good for the gander.

The Release recognizes the risk that might arise from a migration from MMFs to non-MMF cash management products, and it states that the Council and its members "intend to use their authorities, where appropriate and within their jurisdictions, to address any risks to financial stability that may arise from various products within the cash management industry in a consistent manner."[104] It states, "Such consistency would be designed to reduce or eliminate any regulatory gaps that could result in risks to financial stability if cash management products with similar risks are subject to dissimilar standards."[105] The OCC failed to impose such consistency (either to the reforms already imposed by the SEC on MMFs in 2010, or those now under consideration for proposal by FSOC) in its October 2012 amendments to the STIF rules.

(8) *The Release Fails to Recommend Workable Reforms that Would Enhance Rather than Harm MMFs and their Investors and Has Failed to Address the Need for Actions by Regulators Other Than the SEC to Address Identified Systemic Risks.*

The role of the SEC and the purpose underlying the Investment Company Act are to protect investors. The Proposed Recommendations would not benefit or protect investors. Instead, the Proposed Recommendations would reduce the utility of MMFs to many of the approximately 30 million shareholders who have chosen to invest in MMFs. As a former SEC economist has concluded "[i]t would be a mistake for the SEC to adopt the contemplated further reform of money market funds . . . . The further reform . . . is

[104] Release at 69457.

[105] *Id.*

only tenuously related to investor protection, if related at all, but poses a tangible threat to a product attribute (stable NAV) that is prized by consumers."[106]

The Release fails to discuss a number of simple reforms that have been suggested over the past several years. These reforms include enhanced disclosures to MMF investors, easier investor access to more recent shadow NAV information, discretionary gating by MMF boards of directors as is permitted for MMFs in Europe and used successfully in past occasions, and methods of providing further enhancements to liquidity in a future crisis.[107] Unlike the three proposals put forward by the Council, which the Release admits cannot be relied upon to prevent a run during a financial crisis, these types of potential reforms may provide significant benefits without imposing significant costs or disruptions on MMFs, those who rely on MMFs, or the broader economy. We suggest that consideration of further enhancements to MMF regulation focus on workable solutions that will not undermine the basic features of MMFs that millions of Americans, state and local governments, and employers, find useful.

The Release also fails to specify what steps (if any) the Council has taken to coordinate adoption of regulations by multiple agencies to address the Council's identified systemic risk or to address numerous state and trust law impediments to investors in MMFs operating under the proposed reforms. For example, the Release acknowledges that tax relief would be required for a floating NAV, but does not include any proposals to recommend such relief to the Treasury Department.[108] Similarly, the Release mentions that cash management products should be regulated in a consistent manner and that members of the Council intend to use their authorities to do so, but does not propose to recommend the same reforms to bank regulators it recommends to the SEC.[109] Congress surely created a multi-agency council to coordinate such proposed reforms, not to focus arbitrarily on one agency, mid-stream in the agency's own review of matters under its jurisdiction, or to dictate the outcome to that agency without regard to the extensive public comment record and statutory requirements the agency is bound to consider.

Congress in Dodd-Frank did not direct regulators to take action regarding MMFs, but it did direct the Federal Reserve "[a]s soon as practicable" after the date of enactment, to establish, by regulation and in consultation with the Secretary of the Treasury, policies

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[106] Robert Comment, *Do Money Market Funds Require Further Reform?* (Nov. 23, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2174125.

[107] The Release mentions some of these potential reforms in a cursory fashion only (in some cases as potential reforms to support an NAV buffer). *See* Release at 69477-78.

[108] Release at 69467.

[109] Release at 69457.

and procedures governing emergency lending for the purpose of providing liquidity to the financial system.[110] Two-and-one-half years after Congress gave the Federal Reserve and the Secretary of the Treasury this mandate, no rules have been proposed. Instead, the Federal Reserve and the Secretary of the Treasury are advocating the imposition of capital and other requirements on MMFs that the Council, in its Release, admits would not staunch a run in a crisis. Instead of using its Section 120 authority arbitrarily to pressure the SEC to adopt these unsupported and ineffective proposals, the Council should address authorities of other financial regulators who have failed to take steps mandated by Congress that are directly relevant to mitigating or preventing future financial crises.

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We urge all members of the Council to give serious thought to these matters and to incorporate appropriate data and rigorous economic analysis before proceeding with the Proposed Recommendations.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

[110] Dodd-Frank § 1101(a)(6), 12 U.S.C. § 343(B)(i).

cc: Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
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