MSCI

17 September 2013

Submitted by email to rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-8549

Re: MSCI comments on Money Market Fund Reform, File Number S7-03-13.

Dear Ms. Murphy,

We are pleased to have the opportunity to comment on the Securities and Exchange Commission's proposed rules on money market fund reform ("the Release").

MSCI Inc. is a leading provider of indices, portfolio construction and risk management tools and services to banks, institutional asset managers, hedge funds, and asset owners. Through our legacy companies—MSCI for indices and Barra and RiskMetrics for risk and portfolio analytics—we have a lengthy record of establishing standards and innovating in the areas of managing and communicating risk. At the same time, we have been active participants in the dialogue with regulators on topics such as bank capital standards under the Basel Accord, fund risk control under UCITS, and hedge fund risk disclosure under Dodd-Frank.

The Release puts forward two alternatives for the governance of money market mutual funds under the Investment Act of 1940, with the aim of addressing the risk of systemic heavy redemptions, or "run-like behavior," and the market disruptions that such events produce. The first alternative is the requirement that a money market fund operate according to a net asset value (NAV) reflecting the actual current value of its assets instead of the stable NAV that is in effect today. The second alternative is the requirement that a money market fund impose a liquidity fee should its liquidity levels fall below a specified threshold. In addition to these two headline proposals, the proposed rule seeks to strengthen the practice of stress testing at money market funds.

In the context of what we believe are the Commission's broad goals, our comments will focus on the stress testing proposals. The main points of our comments are:

- The two main proposals—the floating NAV and the liquidity gates—both aim to reduce the likelihood of herd-like redemption behavior by addressing different types of "tipping point" dynamics in money market mutual funds.

- There are two clear tipping point dynamics—valuation and liquidity. Stress tests should address both of these, regardless of which of the two main proposals are ultimately adopted.
- Stress testing can potentially act in concert with one or both of the two main proposals. However, for this to be true, stress testing needs to be more than a compliance exercise, and the industry needs to establish best practices for the implementation and communication of stress tests.

A natural consequence of the establishment of best practices in stress testing will be for investors to demand disclosure of stress test results.In our full comments, we first discuss the Release in general, and how stress testing fits in with our understanding of the Commission's overall aims. Then we address a number of the Commission's specific questions from the stress testing section of the proposed rule.

With the experiences of 2008 still fresh, the proposed reforms can be seen as an attempt to mitigate the "get out first" dynamic that can develop in the current money market fund framework. As the Commission discusses in the Background section of the Release, there are a number of structural incentives that all can lead to investors redeeming from funds because of the perception that early redeemers will fare better than late ones.

The practice of operating with a stable NAV produces one class of these incentives: when a fund's market-based NAV falls significantly below its stable NAV, an early redeemer not only benefits from this price discrepancy, but also puts downward pressure on the market-based NAV for the remaining investors (as the realized losses on the fund's assets must be shared among a smaller investor base). The need to provide liquidity provides another set of incentives, as early redeemers may exhaust the fund's internal sources of liquidity (cash on hand, cash from maturing securities, etc.), leaving possibly distressed security sales as the only source of liquidity for late redeemers. A lack of transparency can inadvertently serve as an incentive for investors to redeem early, as investors may simply assume the worst if they are unable to gain timely information about a fund's liquidity profile, market value, or exposure to problematic securities.

Common to all of these incentives is some sort of tipping point: a level of valuation, liquidity, or risk exposure that will trigger investor redemptions, which will in turn make matters worse. As a result of these incentives, the potential for contagion and heavy redemption poses a threat to both the orderliness and the fairness of money market funds. The two alternative reforms address this threat, but by operating on different elements of the incentive structure.

The floating NAV proposal clearly mitigates the mechanical incentives built into the stable NAV practice, and would ensure that any losses that a money market fund realizes on its underlying assets are shared equitably across the investor base, regardless of redemption order. The significant question that remains is how investors will respond to money market funds that no longer offer a stable NAV.

The second alternative—liquidity fees—addresses a different set of incentives, with the expectation that fees or gates will slow redemptions so as not to exhaust the ready sources of liquidity, and to make it less likely that a fund would be forced to sell otherwise desirable assets in order to meet redemption demands.

The stress testing requirements, while not sharing the visibility of the two first proposals, also operate on the redemption incentives, though less directly. The stress testing proposals should heighten the awareness of a fund's board of directors to the risk of either valuation or liquidity tipping points, which should foster investment decisions that maintain a buffer against a valuation- or liquidity-induced redemption event. In such an environment of rigorous risk governance, there should be fewer surprises, and investors should reward funds by adopting a less skittish posture toward questions of transparency. Stress testing practices, then, should act in concert with the other reforms to preserve the orderliness of the market and to reduce the systemic risk of contagious redemptions.

The underlying argument here relies, however, on the presumption that investors will simply trust the new standards to protect them, and therefore not engage in the herd-like redemption behavior that has characterized periods of money market fund stress. But as is clear from the Commission's review of the 2008 crisis, the risks in money market funds derive from the interaction of market events and investor behavior. This argues for more than better internal risk practices, rather for better practices accompanied by better manager-to-investor communication.

Better practices themselves are unlikely to result from a regulatory mandate alone. Practices under a mandate, as the Commission has observed with the 2010 stress test guidelines, will likely be uneven, reflecting different views of how to comply. For best practices to truly develop, there should be transparency within the industry about how the stress test guidelines are interpreted and implemented, and about how stress test results are communicated to fund boards. The Commission should encourage this collective industry effort, as well as the fund-level implementation of the guidelines.

Ultimately we feel that the focus on stress testing for internal risk governance will lead to investor demand for disclosure. We have seen similar developments elsewhere. When hedge fund managers first started preparing to comply with the Form PF disclosure requirements, many anticipated demand from their investors for the same information, and prepared simultaneously to provide it to their clients. After a number of experiences with hedge fund managers imposing gates on redemptions during the financial crisis, investors have begun to demand a level of risk transparency that enables them to monitor managers for their likelihood of imposing gates again. We feel that with money market funds, risk disclosure to investors is a natural consequence of tighter standards on internal risk governance.

Greater transparency to investors, especially if it arises out of natural market discipline, fits nicely into the aim of mitigating the dynamics leading to excessive redemptions. Greater certainty about the risk profile of their funds should have a more significant calming effect on investors than internal risk standards alone.

We move now to some of the specific questions that the Commission has posed in the Release.

Should we continue to require funds with a floating NAV to stress test their portfolio?

Yes. Under the floating NAV regime, it would stand to reason that there is no need for a "break the buck" stress test. But while there would not be a notion of breaking the buck under a floating NAV, it is fair to assume that there still would be some form of a valuation tipping point.

We raised the question before of how investors would react to money market funds without the stable NAV feature. Certainly, for some investors, a stable NAV is a requirement, and the move to floating NAV for some classes of money market funds will push those investors to (presumably) safer but lower yielding investments in government money market funds. If the newly floating NAV funds do indeed survive this investor departure, their place in investor portfolios, as low-risk, modest return investments, will likely still be as a form of cash management. Some investors may accept a floating NAV for prime money market funds, but in return for the modest yields, it is unlikely they will accept NAV fluctuations outside of a very small band.

In this hypothetical new regime, we would expect that investors would still be very sensitive to price fluctuations, and their desire to avoid loss would still lead to a form of tipping point behavior, albeit milder than under a stable NAV. To address the redemption contagion that could result from an undesirable valuation change, floating NAV money market funds should still be required to stress test for valuation changes.

*Are the proposed clarifications (*to the stress testing procedures*) appropriate? Are there other clarifying changes that we should consider?*

Yes. We feel that the clarifications address the two most important categories of effects: market valuation changes and investor behavior.

For market effects, we would recommend a focus on the level of general interest rates, the spreads on securities in different asset classes, and the spreads on individual issuers that represent significant concentrations. The stresses on asset class spreads can probe a fund's exposure to the sort of broad investor flight that has been experienced in the past, for example, in asset-backed commercial paper or European financials. The issuer spreads can probe for exposure to a Lehman-like event. In both cases, it is important to examine the correlations between the spreads being stressed and the value of other securities which may not be impacted directly.

We also agree that the stress tests should incorporate scenarios on investor redemptions, including assumptions about how the fund would meet those redemptions. To the extent that a redemption scenario would require the fund to sell securities, then the fund should make some assumption as to the liquidity haircut it would take under such a sale. We acknowledge that liquidity data is scarce on transactions such as these, and emphasize that simple assumptions are all that can reasonably be expected on this point.

Should we make any other changes to the stress testing requirements, such as requiring a minimum frequency that funds should conduct their stress tests?

We feel that the potential benefits of the stress testing requirements go beyond the improvement of funds' internal risk governance. If funds can establish a set of industry best practices for stress test implementation and reporting, this will heighten investors' confidence in funds, and make them less likely to react in a way that leads to contagious heavy redemptions. Taking this a step further, we expect that investors will begin to insist on risk disclosure from the stress testing exercises, and encourage the Commission and the fund industry to anticipate this demand.

How should we define what set of events qualify as baseline, adverse, or severely adverse? Should we require funds to use or look to the scenarios published annually by the Federal Reserve?

We do not feel that the scenarios published annually by the Federal Reserve are appropriate for stress testing of money market mutual funds. The Federal Reserve establishes these scenarios to stress the capital adequacy of banks over the course of a protracted economic downturn. The horizon for these stress scenarios is between one and two years. By contrast, the scenarios that are of concern with money market funds are short term—valuation shocks and investor redemptions over a matter of days or weeks.

*Should we include this additional metric (*the stress test on weekly liquid assets*)? Why or why not? Would the proposed requirement help fund managers better manage the risks of a stable price fund with standby liquidity fees and gates?*

Regardless of whether a fund operates with a stable or floating NAV, or whether a fund implements liquidity gates or fees, we feel that it is important to examine the impact of a stress scenario on both valuation and liquidity. We anticipate that investors will monitor both the market-based NAV and the liquid assets ratio, and that a deterioration of either of these metrics could spark redemption behavior. The scenarios driving these two tests could be the same, but the two outputs serve different purposes. By applying both of these stress metrics, funds can address two of the structural incentives that can lead to heavy redemptions.

Is the threshold of 15% weekly liquid assets the right level to stress test on for a fund?

If the 15% threshold is established as the trigger for liquidity fees or gates, then we feel that a fund should stress test against a lower threshold. Since the primary aim of the proposed rule, as we see it, is to short-circuit some of the mechanisms that can lead to heavy redemptions of money market funds, we believe that fund managers should manage with an eye toward a significant buffer, whether against the 15% liquid assets threshold or against a "break the buck" valuation level. In order to maintain the confidence of their investors, fund managers should establish a stress test practice that helps them to understand which market events might significantly erode such a buffer.

Stress testing against a lower threshold would have the added benefit of promoting better risk management practices generally. Based on our experience, if a fund tests against only the highest of thresholds, then most stress tests will show that hitting the threshold is highly improbable. Over time, a long stream of such results will produce complacency, and a lack of engagement of the board with the stress test exercise. On the other hand, if a fund stresses against a lower level, the result will more likely change frequently, and at times indicate that hitting the threshold is plausible. This leads to greater engagement from the board, to explain the result, possibly to challenge it, and then to discuss mitigating actions.

Once again, we appreciate the opportunity to contribute our thoughts on this important set of reforms. We are happy to provide further information or clarification if the Commission so desires.

Sincerely,

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