BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

September 17, 2013

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

Re: Money Market Reform; Amendments to Form PF (Release No. 33-9408; IA-3616; IC-30551; File No. S7-03-13)

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the proposed regulations of the Securities and Exchange Commission ("SEC") regarding money market mutual fund reform ("Proposed Rules").[2]

For the first time in history, on September 19, 2008, the Treasury Department and the Federal Reserve implemented a series of emergency measures effectively guaranteeing the entire $3.7 trillion money market fund ("MMF") industry, after the Reserve Primary Fund broke the buck, sparked a panic, triggered a run on prime MMFs, caused asset fire sales, and caused a liquidity crisis in the short term wholesale funding market. This unprecedented and historic action from the first days of the 2008 financial crisis starkly illustrates the objective fact that MMFs are systemically significant and will spread destabilizing risk first and fast throughout our financial system. In truth, MMFs are an uninsured investment product masquerading as a guaranteed banking product, and they will trigger and intensify future financial crises unless they are properly regulated now.

In a purported effort to address this threat, the Proposed Rules set forth two important but exceedingly modest and disappointing MMF reforms. Even though the Release suggests that they may be applied in combination, they are proposed as **alternative** approaches, not as a consolidated framework. The first approach would require institutional MMFs (representing only one-third of the MMF market) to float

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 Money Market Fund Reform; Amendments to Form PF; Proposed Rule, 78 Fed. Reg. 36,834 (June 19, 2013) ("Release").

their net asset value per share ("NAV"). The second approach would, subject to board discretion, require the imposition of liquidity fees and redemption gates whenever weekly liquid assets dropped below 15 percent of total assets. The Proposed Rules also include new disclosure, diversification, and stress testing requirements that would apply under each of those two alternative frameworks.

The Proposed Rules are inadequate and simply will not fully address the systemic risks posed by money market funds to the U.S. financial system. Moreover, they threaten to engender the false and dangerous sense of comfort that these critical problems are being solved, when in fact, absent a much more robust approach to MMF reform, the MMF marketplace will continue to harbor risks that could once again erupt and cause terrible financial damage. Given what happened just five years ago—an all too familiar piece of our financial history—this half-hearted approach to MMF reform is a disservice to the American people.

Thus, the SEC must strengthen the Proposed Rules in numerous important respects. The final rule must include **both** of the reforms proposed in the Release—the floating NAV **and** the liquidity fees and gates—not simply one or the other. Furthermore, it must eliminate the exemptions for government and retail MMFs, which together would exclude two-thirds of all MMFs from the most important reforms under the Proposed Rules. In addition, although capital buffers have not been included in this rule proposal, they are an important adjunct to the other reforms set forth in the Release, and they must also be included in any final rule.

Finally, the SEC must seriously consider the need for a fundamentally different solution to the systemic risks posed by money market funds: a self-insurance plan like deposit insurance at banks. Money market funds want it both ways: to pretend they are as safe as insured bank accounts while not paying for that insurance. This is the classic Wall Street distortion. Rather than confronting, accepting, and paying for the risks they pose, the MMF industry would prefer to rely on the implicit government and taxpayer backing that will once again come to the rescue during the next crisis.

If the SEC cannot or will not do everything possible to limit the risks associated with MMFs, then it should acknowledge that it is powerless to regulate these financial products effectively under the securities laws, and it should advocate for the application of banking regulation to MMFs, including industry-funded insurance coverage analogous to FDIC deposit insurance.

INTRODUCTION

The financial crisis made it painfully clear that MMFs present a serious risk of systemically significant runs and that those runs can cripple the short-term credit markets, potentially tipping the entire financial system into chaos. In the most compelling example of MMF run risk, the Reserve Primary Fund broke the buck on September 19, 2008 due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. This nearly unprecedented event happened even though Lehman-related assets comprised only 1.2 percent of the fund's total assets. When the fund sponsors declined to provide support, a run immediately ensued. Within two days, investors sought to redeem $40 billion from the fund.

This required the fund to sell tens of billions of dollars in assets immediately so that it could pay for the flood of shareholder redemptions. This fire sale in turn depressed asset values, further weakening the fund.

The run quickly spread to the entire prime MMF industry, and during the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) of prime MMF assets. This caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, depressed prices, redemption requests, more asset fire sales, and rapidly evaporating liquidity. The run abated only after the Treasury, on September 19, 2008, established the Temporary Guarantee Program for Money Market Funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis.[3]

Notwithstanding this unprecedented and massive intervention in what was then a $3.7 trillion market, the September 2008 run resulted in large and rapid disinvestment by MMFs in short-term instruments, "which severely exacerbated stress in already strained financial markets."[4] The decline in outstanding commercial paper contributed to a sharp rise in borrowing costs for commercial paper issuers.[5] In addition, while the losses ultimately sustained by investors in the Reserve Primary Fund were modest, those investors suffered substantial liquidity damage, losing access to their money for an extended period pending the outcome of judicial proceedings.[6]

The current regulatory framework applicable to MMFs is not adequate to address this run risk and the resulting contagion affects that we know can threaten the entire financial system. In 2010, the SEC adopted amendments to Rule 2a-7 that strengthened the liquidity, credit quality, and maturity standards governing MMF portfolio investments.[7] However, those measures were a preliminary first step, not the end of the effort to fortify MMFs against the risk of destabilizing runs.[8] SEC staff continued to develop a proposal to further strengthen the standards applicable to MMFs.

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3 *See* SEC DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION, RESPONSE TO QUESTIONS POSED BY COMMISSIONERS AGUILAR, PAREDES, AND GALLAGHER, at 12 (Nov. 30, 2012), *available at* http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

4 FSOC Proposal, at 69,464.

5 *See generally* FSOC, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69,455, 69,458, 69,464 (Nov. 19, 2012) ("FSOC Proposal"); *Perspectives on Money Market Mutual Fund Reforms, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs,* 112th Cong. 6 (June 21, 2012) (Testimony of Mary Schapiro, Chairman, SEC) *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=66f4ddb5-4823-4341-bad9-8f99cdf5fe9a ("Schapiro Testimony").

6 Schapiro Testimony at 6-7.

7 Money Market Fund Reform, 75 Fed Reg. 10,060 (Mar. 4, 2010).

8 FSOC Proposal, at 69,459.

In August of 2012, SEC Chairman Mary Schapiro issued the disappointing announcement that the SEC would not propose additional MMF reforms due to lack of support from three of the SEC's five commissioners.[9] As a result, on September 27, 2012, the Chairman of the Financial Stability Oversight Council ("FSOC"), Treasury Secretary Geithner, sent a letter to the FSOC members calling upon them to take action because the SEC would not or could not do so.[10]

In November 2012, the FSOC published its Proposed Recommendations Regarding Money Market Mutual Fund Reform ("FSOC Proposal").[11] In its release, FSOC set forth a proposed "determination," in accordance with the Dodd-Frank Act, that the activities and practices of MMFs could create or increase the risk of significant liquidity, credit, and other problems spreading among bank holding companies, nonbank financial companies, and U.S. financial markets. It also set forth three proposed recommendations for structural reform of MMFs that would reduce the risk of destabilizing runs and other significant problems spreading throughout the financial system as a result of MMF activities:

(1) floating the NAV;

(2) maintaining the stable NAV but requiring a capital buffer and a minimum balance at risk ("MBR"); or

(3) maintaining the stable NAV but requiring a larger capital buffer, along with other measures such as stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure obligations.

The FSOC Proposal noted that these recommendations were not mutually exclusive but could be implemented in combination to address the structural vulnerabilities that make MMFs susceptible to runs.[12]

Better Markets submitted a comment letter[13] in strong support of the FSOC proposal, based on the reality that MMFs continue to create systemic risk as a result of their structure and their interconnectedness with the financial markets. Better Markets argued that all of the core Proposed Recommendations—the floating NAV, the capital buffer, and the minimum balance at risk—were meritorious and would help substantially reduce the ability of MMFs to trigger or propagate systemic risk in the financial markets. However, Better Markets also argued that none of them would be

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

10 FSOC Proposal, at 69,549.

11 FSOC Proposal, at 69,455.

12 FSOC Proposal, at 69,456.

13 *See* Better Markets letter "Proposed Recommendations Regarding Money Market Mutual Fund Reform" *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0121, incorporated by reference herein as if fully set forth.

sufficient, in and of itself, to address those problems, and they should therefore be applied in combination. Similarly, Better Markets argued that the collection of supplemental reforms, including enhanced diversification, additional liquidity requirements, and more robust disclosure, were all worthwhile and should also be implemented.

The SEC has now issued the Proposed Rules, which acknowledge the need for additional reforms in the regulation of MMFs, but which fall well short of what is necessary to adequately oversee these financial products. In the balance of this letter, we review the ways in which MMFs continue to pose significant risk to the financial system; we argue for more comprehensive reforms, with fewer exemptions; and we urge the SEC to clarify and streamline its economic analysis.

SUMMARY OF COMMENTS

It is clear and beyond legitimate dispute that MMFs continue to pose significant systemic risks to our financial markets and to investors. To adequately address these problems, the SEC must apply all of the reforms set forth in the Proposed Rules (as recommended below), and in addition, a strong capital buffer. Further, it must apply those reforms without exemptions for governmental or retail MMFs. Without at least this combination of reforms, the SEC's regulation of MMFs will be inadequate:

- a floating NAV that mitigates run risk and that is more accurate, more transparent, and more fair to investors;

- a capital buffer that can absorb a significant level of fund losses, thus promoting stability, instilling investor confidence, and reducing the likelihood of damaging runs;

- a mechanism for imposing liquidity fees when a fund is sufficiently stressed that its buffer is exhausted, to discourage further redemptions and to more fairly allocate the costs and risks associated with a loss of fund liquidity;

- a system of gates that can halt a vicious cycle of redemptions and asset fire sales when liquidity fees are inadequate; and

- a set of disclosure requirements, stress testing protocols, and other measures designed to maximize transparency, stability, and investor confidence in MMFs.

If the SEC cannot adopt these reforms, then it must reevaluate the wisdom of attempting to regulate MMFs as investment products under the securities laws and must, in concert with other regulators, work toward establishing a banking regulatory regime for MMFs, including the establishment of FDIC-like insurance.

Finally, the SEC fulfilled its limited duty under the applicable provisions of the securities laws to consider whether the Proposed Rules promote efficiency, competition, and capital formation. However, the SEC can and should do more in the final rule release to clarify the nature of its obligation to conduct economic analysis, to limit the consideration of costs and benefits, and to relate its MMF proposals to the overarching goals of protecting investors and preventing another financial crisis.

OVERVIEW OF PROPOSED RULES

The Proposed Rules set forth two alternatives, and the SEC notes that it could "adopt either alternative by itself or a combination of the two alternatives."[14] Under the first alternative, a non-government, non-retail MMF would be required to float its NAV by rounding its NAV to the nearest fourth decimal place (*i.e.*, $1.0000). In addition, all MMFs would generally be required to value their assets at market value, rather than at their amortized cost. Under the second alternative, a non-government MMF whose weekly liquid assets fell below 15 percent of its portfolio would, subject to the board's discretion, have to impose a two percent liquidity fee on all future redemptions, and the MMF's board could, in its discretion, temporarily suspend or "gate" redemptions.

According to the Proposed Rules, "[t]he two alternatives are designed to address money market funds' susceptibility to heavy redemptions, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, the benefits of money market funds."[15]

The Proposed Rules also include various amendments that will strengthen and improve the resiliency of MMFs. In particular, the SEC proposes stronger diversification requirements; disclosure of sponsor support; publication of an MMF's daily and weekly liquid assets and market-based NAV on the MMF's website; disclosure of material events; disclosure of more risk-related information on Revised Form-MFP; the immediate publication of that form; enhanced stress testing requirements; and disclosure of portfolio information by private fund advisers.

COMMENTS

I. Notwithstanding the SEC's 2010 reforms, MMFs continue to create systemic risk which must be addressed through the SEC's adoption of additional measures.

As the Release appropriately concludes, "while the 2010 reforms were an important step in making money market funds better able to withstand heavy redemptions when there are no portfolio losses . . . , they are not sufficient to address the incentive to redeem when credit losses are expected to cause fund's portfolios to lose

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[14] Release at 36,834.
[15] *Id.*

value or when the short-term financing markets more generally are expected to, or do, come under stress."[16] Indeed, based upon the nature, scope, interconnectedness, and recent history of MMF activities, it is clear that (1) MMFs remain subject to the risk of runs, and (2) those runs will have a seriously destabilizing impact on other financial entities, on the credit markets, and on the entire financial system. The events of September 2008 prove that MMFs are systemically significant.

There is ample support for this conclusion not only in the structure of MMFs and the way they operate, but also in lessons learned from past experience, including recent episodes of MMF instability. The most dramatic example is the collapse of the Reserve Primary Fund and the ensuing run on prime MMFs during the financial crisis, as described above. But there have been scores of other instances before and after the financial crisis when MMFs either broke the buck or clearly would have without capital support from sponsors or the backing of the federal government. These conclusions are buttressed by the findings of numerous domestic and international regulatory bodies and commentators. Finally, the arguments advanced in opposition to further MMF reform are illogical or unfounded claims about the supposed lack of need for regulation or alarmist predictions of upheaval in the financial sector if MMFs are subjected to further regulatory measures.

A. MMFs present run risk due to their basic features and their interconnectedness with other sectors of the financial markets.

Due to the nature of MMFs, the way they operate, and their role in the fabric of the financial markets, destabilizing runs on MMFs remain a very real threat. Moreover, those runs can create losses and liquidity problems spreading rapidly to other entities and throughout our credit markets.

Currently, MMFs are used by investors as a safe "cash equivalent," which provides the often-cited benefits of principal preservation, same-day liquidity, risk diversification, enhanced yields, and ease of administration. However, MMFs have two principal characteristics that create a significant risk of potentially destabilizing investor runs: (1) the artificially stable NAV, which suggests a guaranteed return; and (2) the absence of a loss absorption capacity, a buffer,[17] or insurance.

First, maintaining an artificially stable NAV creates a distinct first-mover advantage, especially among large institutional investors with the sophistication and capacity to monitor markets closely in real time and with huge amounts of money at stake. Moreover, those institutional investors know that the stable NAV is both artificial and misleading, and they know that MMF investors can and do lose money. Therefore, at the very earliest indication that an MMF with a stable NAV is under stress, such investors have an incentive to withdraw their funds immediately, since those who attempt to redeem early and before a fund breaks the buck are more likely to receive the full $1.00

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16 Release at 36,848.

17 FSOC Proposal, at 69,480; SEC Press Release, *supra* note 9.

per share value than those who wait.[18] That is why institutional investors were the first to abandon the Reserve Primary Fund.

Second, MMFs do not have any form of capital insurance or other formal mechanism to absorb losses.[19] Historically, MMFs have relied upon ad hoc discretionary support from sponsors to maintain their $1.00 per share price when asset values decline. But, as demonstrated by the Reserve Primary Fund, sponsors are not obligated to provide this support. The resulting uncertainty regarding both the ability and willingness of sponsors to serve as a backstop against losses makes MMFs even more susceptible to runs. Because investors cannot rely upon sponsors to protect the stable NAV with infusions of their own capital during periods of financial instability, they will rationally assume that prompt withdrawal of funds is the safest course of action.[20]

In addition to the structure of MMFs, the potentially widespread impact of the MMF run phenomenon is also a function of the sheer size of the MMF market, the concentration in the MMF industry, and its interconnectedness with the credit markets. In terms of size, MMFs have grown enormously since their inception, and they now hold **$2.9 trillion** in assets.[21] Moreover, the top 20 MMF sponsors operate funds representing 90 percent of the MMF assets under management, reflecting a high degree of concentration.[22]

MMFs are connected to the financial markets in many ways. They provide substantial short-term funding to a wide array of companies, financial firms, and governmental entities. For example, as of September 30, 2012, MMFs owned 44 percent of U.S. dollar-denominated financial commercial paper and 30 percent of all uninsured dollar-denominated time deposits.[23] They also held approximately one-third of the lending in the tri-party repo market, and held substantial amounts of short term securities issued by state and local governments and the Treasury.[24] Further evidence of the interconnectedness between MMFs and the financial system is reflected in these facts:

- Most short-term **financing**—86 percent—provided by MMFs to non-governmental entities is made **to financial firms** through certificates of deposit, financial commercial paper, asset-backed commercial paper, repurchase agreements, other MMF shares, and insurance company funding arrangements.[25]

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18 FSOC Proposal, at 69,461.
19 *Id.*
20 *Id.* at 69,462.
21 *Id.* at 69,461.
22 *Id.*
23 *Id.* at 69,462.
24 *Id.*
25 *Id.* at 69,463.

- MMFs are extensively **sponsored by subsidiaries of bank and savings and loan holding companies**, and such bank-sponsored funds represent over 50 percent of industry assets.[26]

- **Banks provide liquidity enhancements** and guarantees for a significant portion of the securities held by MMFs.[27]

- MMFs are widely used as **cash management vehicles** by individuals, businesses, institutional investors, and governments. As a result, a widespread run on MMFs can create serious liquidity problems for these MMF clients, representing millions of individual investors and entities who depend upon immediate and unfettered access to their money.[28]

- MMFs tend to have **similar exposures** due to limits on the nature of permitted investments. As a result, losses creating instability and a crisis of confidence in one MMF are likely to affect other MMFs at the same time.[29]

- Finally, MMFs are **internationally connected** as well: 13 of the top 15 private-sector firms receiving funding from U.S. MMFs were domiciled outside the United States, thus making domestic MMFs sensitive to stress in global markets.[30]

These facts and statistics illustrate that based on structure, operation, and interconnectedness, MMFs present an ongoing risk of runs that are capable of spreading widely and rapidly throughout the financial system.

B. Lessons from the past prove the point.

Recent past experience has validated these concerns. As described in the Introduction, the most dramatic example of MMF run risk was the collapse of the Reserve Primary Fund in September of 2008. It triggered a run on the entire prime MMF sector, created massive disruption in the credit markets, and imposed significant hardships on investors in the fund.

The collapse of the Reserve Primary Fund was hardly the first time—or the last—when MMFs faced significant stresses and potential collapse. For example, one study found 144 cases from 1989 to 2003 in which MMFs would have broken the buck had it

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26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.*

not been for sponsor support.[31] Another survey reveals 78 instances between 2007 and 2011 in which sponsors provided support to their MMFs in the form of either cash contributions or purchases of securities from the fund at inflated prices.[32]

Recent history confirms that MMFs remain vulnerable to runs, notwithstanding the SEC enhancements to Rule 2a-7 in 2010. In the summer of 2011, institutional prime MMFs experienced a dramatic surge in withdrawals, amounting to a net $179 billion (or 16 percent).[33] Although this class of MMFs withstood the drain on their assets during the period of instability, due in part to the 2010 Rule 2a-7 enhancements, the episode illustrated the fragility of investor confidence and the potential for runs based purely on investor expectations: The run was triggered not by actual losses in funds, but by concern about exposure to "European holdings and the U.S. debt-ceiling impasse."[34]

These experiences illustrate two unique attributes of MMFs that make reform so important: their susceptibility to runs, and the widespread instability that such runs can cause. MMFs are in effect canaries in the financial coal mine, serving as an early warning sign that systemic problems are emerging—or are perceived to be emerging—in the financial system.[35] Thus, MMFs are not only a link in the chain of events leading to a financial crisis, they can play a significant role in igniting such a run, crisis, and collapse.

Further, the run on MMFs in 2008 contributed so significantly to overall financial instability because it was, in reality, a run on the very large banks. By disrupting a major channel for short term bank borrowing—which large banks and investment banks use to fund their broker dealers, among other things—the run on MMFs threatened the stability of the banks and, thereby, the entire financial system.

The immediacy, scale, and scope of the federal government efforts to stop the run are clear and irrefutable evidence of the seriousness of the threat. This

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31 MOODY'S INVESTORS SERVICE, SPECIAL COMMENT, SPONSOR SUPPORT KEY TO MONEY MARKET FUNDS (Aug. 9, 2010), *available at* http://www.alston.com/files/docs/Moody's_Report.pdf; *see also* Release at 69,462 n. 28.

32 *See* STEFFANIE A. BRADY, ET AL., FEDERAL RESERVE BANK OF BOSTON, RISK AND POLICY ANALYSIS UNIT, THE STABILITY OF PRIME MONEY MARKET MUTUAL FUNDS: SPONSOR SUPPORT FROM 2007 TO 2011, WORKING PAPER RPA 12-3, at 4 (Aug. 13, 2012), *available at* http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1203.pdf; *see also* SEC Press Release, *supra* note 10, at 4 (citing over 300 instances since the 1980s of sponsor support necessitated by the diminished value of holdings or extraordinary redemptions).

33 FSOC Proposal, at 69,465.

34 *Id.*; *see also Perspectives on Money Market Mutual Fund Reforms, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 5 (June 21, 2012) (Testimony of David S. Scharfstein, Professor of Finance, Harvard Business School), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ca1f8420-b2de-46dd-aee1-9a22d47b198c ("Scharfstein Testimony").

35 *See The Impact of Dodd-Frank on Customers, Credit, and Job Creators, Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 112th Cong. 35 (July 10, 2012) (statement of Thomas Lemke, General Counsel and Executive Vice President, Legg Mason & Co., on Behalf of Inv. Co. Inst.).

interconnectedness with the financial system, and the sensitivity of MMFs to incipient disruptions in the financial markets, together provide strong support for the SEC's adoption of much more comprehensive MMF reform.

C. The need for additional reforms is widely recognized among regulators.

Further regulation of MMFs finds support in the views of other regulatory bodies that have examined the role of MMFs and have concluded that without the imposition of additional reforms, MMFs will continue to present an unacceptable level of systemic risk. Among those regulatory bodies are the President's Working Group on Financial Markets, the Office of Financial Research, the International Organization of Securities Commissions, and the FSOC.[36]

In addition, the Presidents of all twelve Federal Reserve Banks submitted a joint comment letter on the FSOC's Proposal squarely agreeing with the FSOC's initial determination "that the structural vulnerabilities of MMFs could create or increase the risk of financial instability" within the meaning of Section 120 of the Dodd-Frank Act.[37]

Finally, it is noteworthy that the FSOC's decision to issue its Proposal was by a unanimous vote.[38] This in itself reflects broad-based support for additional reforms, insofar as the FSOC is comprised of representatives from agencies overseeing **every** federally-regulated financial sector, including banking, securities, commodities, insurance, and housing.

D. Opposing arguments are unpersuasive.

Arguments denying the existence of MMF run risk and insisting that no additional reforms are necessary are baseless.

For example, some argue that on a comparative basis, MMFs are less likely to experience runs and create systemic risk than other financial institutions such as banks.[39] Even if this were true, however, it would hardly mean that MMFs pose no significant threat to financial stability and warrant no further regulation. In fact, the evidence clearly shows that MMFs do present significant risks that can and must be

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36 FSOC Proposal, at 69,459.

37 Letter from the Presidents of the 12 Federal Reserve Banks to FSOC, Re: FSOC's Proposed Recommendations Regarding Money Market Mutual Fund Reform, at 7 (Feb. 12, 2013), *available at* http://www.bostonfed.org/news/press/2013/pr021213-letter.pdf., incorporated by reference herein as if fully set forth.

38 FSOC, Minutes of the FSOC Meeting Held Nov. 13, 2013, at 4-7, *available at* http://www.treasury.gov/initiatives/fsoc/Documents/November%2013,%202012.pdf, incorporated by reference herein as if fully set forth.

39 *See* Letter from Jonathan Macey, Professor, Yale Law School to FSOC, Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform, *available at* http://www.sec.gov/comments/4-619/4619-279.pdf, and enclosed paper at 24 ("Macey Letter").

addressed. To the extent other, and perhaps even greater, risks persist in our financial system, then the appropriate response is to address those risks effectively **in addition** to strengthening regulation of MMFs.

Others argue that the undeniably dramatic run on the Reserve Primary Fund in 2008 and its subsequent collapse cannot serve as proof that MMFs require further regulation, since the financial crisis was a rare and extraordinary event that is unlikely to recur.[40] This claim ignores the crucial importance of prophylactic regulation aimed at preventing financial crises and economic disasters that exact massive costs on society and cause widespread human suffering.[41] Had this thinking prevailed in the 1930s following the "extraordinary" stock market crash of 1929, the regulatory reforms embodied in the securities laws would never have been enacted—and the relative stability and prosperity in our financial markets that we witnessed until the financial crisis of 2008 would not have occurred.

II. In developing the final rule, the SEC should reorder its priorities, and place risk mitigation, transparency, and investor protection above any preservation of the features that make MMFs popular among investors and issuers.

The history of MMF regulation has been marked by a piecemeal, incremental approach and a fundamental reluctance to fully and appropriately regulate these financial products. This reticence has grown largely from a desire to preserve the very popular features of MMFs, including principal preservation, liquidity, and enhanced yield. This perspective is clearly reflected in the Release:

> We recognize, and considered when developing the reform proposals we are putting forward today, that money market funds are a popular investment product and that they provide many benefits to investors and to the short-term financing markets. **Indeed, it is for these reasons that we are proposing reforms designed to make the funds more resilient, . . . while preserving to the extent possible, the benefits of money market funds.**[42]

However, this approach is misguided and inconsistent with the statutory mandate of the SEC: protecting investors and the public interest.

MMFs are hybrid instruments, embodying elements of both securities investments and banking products. This combination of features poses unique problems that must be addressed, regardless of whether some of the popular features

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40 *Id.* at 21.

41 *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

42 Release at 36,837.

of MMFs must be sacrificed. For example, the stable NAV is one of the core attributes of MMFs that have made them a convenient cash management vehicle for both retail and institutional investors. But the stable NAV also creates a host of potential problems for the financial system and for investors: (1) it incentivizes early redemptions in times of stress and therefore aggravates run risk; (2) it perpetuates a conceptual fiction that misleads investors, since the fixed NAV does not accurately reflect true asset values; and (3) it subjects many investors to unfair treatment, since it allows more sophisticated and diligent investors who redeem early in a stressed market to foist losses on the remaining shareholders in a fund.

The only way to effectively address these and other problems posed by MMFs is through a series of reforms applied in combination to eliminate or reduce to the greatest extent possible the systemic risk posed by MMFs. If as a consequence, some of the "popular" features of MMFs are lost, so be it. Ultimately, the economic and financial benefits to investors and the marketplace—stability, transparency, and fairness—will be far greater if MMF reforms are not diluted or compromised in the name of convenience and popularity, which are not statutory considerations properly before the SEC.

III. The floating NAV is an essential reform that must be applied under any regulatory scenario, and without exception for government and retail funds.

A. The floating NAV is essential to MMF reform, regardless of what other measures the SEC chooses to adopt.

A critically important reform is requiring MMFs to have a floating net asset value. Under this approach, amortized cost valuation and penny rounding would be rescinded and instead of being fixed artificially and misleadingly at $1.00, the price of shares would fluctuate and would reflect the actual market value of the assets in the fund portfolio. This reform would require MMFs to employ essentially the same asset valuation and variable pricing methods that all other mutual funds under the Investment Company Act have been using successfully for decades.

As acknowledged in the Release, floating the NAV offers many benefits. First and foremost, it would reduce the incentive of any investor to expedite withdrawals from a stressed MMF in hopes of redeeming at the $1.00 price as opposed to something precipitously lower.[43] Investors who withdrew first would no longer benefit from a "first mover advantage," since they would receive the actual market-based value of their shares. And, eliminating this first mover advantage would substantially reduce run risk.

Floating the NAV would also enhance transparency. A fluctuating NAV would help correct the basic misconception among many investors that their MMF investment

[43] Release at 36,850.

cannot lose value. Instead, investors would see plainly that they bear the risk of loss as to MMFs, just as they do with other investment vehicles. Greater transparency would also help reduce run risk. Acclimating MMF investors to share price fluctuations would further mitigate their tendency to retreat in panic at the prospect that their MMF will "break the buck."[44]

Moreover, investors would be able to see a MMF's past NAV fluctuations, compare them with other MMFs, and become better informed as to the risks of a particular fund. Thus, rather than blindly redeeming shares at the first sign of trouble, investors would be less uncertain of the true value of their shares and would be more tolerant of minor market fluctuations or disturbances.

The floating NAV also promotes greater fairness among investors.[45] As a result of the artificially stable NAV, an investor that succeeds in redeeming early in a downward spiral may receive more than they deserve by liquidating at $1.00 per share even though the underlying assets are actually worth less. Without a sponsor contribution or other rescue, that differential in share value is paid by the shareholders remaining in the fund, who receive less not only due to declining asset values but also because early redeemers received more than their fair share of asset value. In substance, early redeemers receive a windfall and later redeemers pay the cost. The floating NAV eliminates this disparity and unfairness, while also reducing the risk of runs by removing the enormous incentive to redeem as soon as possible.

B. Opposition to the floating NAV is unpersuasive.

As a threshold point, there is no legal justification for continued adherence to the artificially stable NAV. On the contrary, the **floating** NAV is what Congress originally envisioned for all investment companies under the Investment Company Act. The Investment Company Act expressly requires each registered investment company to calculate its current net asset value per share **not** under the amortized cost method, which allows for the artificially fixed NAV, but instead at either "current market value" for securities with readily available market quotations, or "fair value," as determined by the board of directors in good faith.[46]

The use of amortized cost valuation and hence the artificially stable NAV was the product of an SEC exemption established in response to persistent and widespread requests from money market funds themselves. Beginning in the late 1970s, they sought exemptive relief "to facilitate their ability to provide (1) a steady flow of investment income at an interest rate comparable to those available by direct investment in money

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44 *Id.* at 36,851.

45 *Id.*

46 Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), 47 Fed. Reg. 5,428 (Feb. 5, 1982); 15 U.S.C. § 80a-2(a)(41).

market instruments and (2) a stable share price."[47] Thus, the proposal that the SEC **remove** the exemption and require MMFs to float their NAV actually merely **restores** the original language and intent of the securities laws.

Other arguments against the floating NAV are unpersuasive. The principal criticism of the floating NAV is that it will trigger a huge migration of capital out of MMFs because investors will be either unwilling or unable to use MMFs as cash management vehicles without the stable NAV feature.[48] Under this scenario, say critics, MMFs will be effectively destroyed "as we know them."[49] In addition, the level of systemic risk in our financial markets will supposedly increase, as much of the flight by investors will be to darker, less regulated markets. Finally, the cost of credit for the companies and governmental agencies that borrow from MMFs may increase, as the pool of available funding contracts shrinks.

This line of reasoning is flawed on two basic levels. First, although there is industry survey data reflecting investor intolerance for the floating NAV,[50] it is difficult to predict the level of contraction that would actually result from instituting a floating NAV. Dire and self-serving predictions are not credible, particularly when ostensibly based on small surveys of questionable quality and methodology. The move to a floating NAV does not alter the fundamental attributes of MMFs with respect to the type, quality, and liquidity of the investments in the fund. Rather, the impediments to continued investment in MMFs arising from the floating NAV are ancillary, practical concerns that can be otherwise addressed. It is therefore unrealistic to think that MMFs—or otherwise-labeled funds offering essentially the same investment and cash management benefits—will become extinct solely as a result of a move to a more accurate and transparent valuation methodology.

For example, the floating NAV might impose additional tax and accounting burdens on investors as well as MMF sponsors. The Release indicates that those burdens would be minimal.[51] But in any event, those challenges could be addressed either by investors shouldering that compliance burden—as investors in other mutual funds already do—or by changes in tax policy. In fact, the Release indicates that the Treasury Department and the IRS intend to consider administrative relief from these burdens for the benefit of both investors and fund sponsors.[52] Even if that relief is not forthcoming, however, a systemic risk in the financial markets, such as the run risk associated with MMFs, cannot be ignored simply because of tax or accounting concerns.

In addition, the operational challenges that a floating NAV would impose on MMFs are undoubtedly manageable, as sponsors must already have the capacity to

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47 47 Fed. Reg. 5,428.
48 FSOC Proposal, at 69,468.
49 Macey Letter, *supra* note 39, at 40.
50 FSOC Proposal, at 69,468.
51 Release at 36,868.
52 Release at 36,869.

periodically calculate their market-based NAVs for MMFs. Compliance by many sponsors would be a relatively simple matter of adapting or expanding systems already in place for use in managing **all** of their other mutual funds, which are priced at market value each day.[53] Recent trends support this view. As the Release points out, "[m]any large fund complexes have begun (or plan) to disclose daily money market fund market valuations . . . for example, BlackRock, Fidelity Investments, and J.P. Morgan."[54] In light of these developments, it is clear that MMF providers have the technological capability to calculate and disseminate net asset values for their money market funds on a daily basis. This trend will undoubtedly spur other MMFs to adopt the same reporting practices to remain competitive. As more providers begin to disclose daily NAVs, investors will become increasingly more comfortable with the concept of a floating NAV.[55]

Finally, institutional investors can presumably amend their investment policies to permit the use of MMFs with floating NAVs if all of the other attributes of MMFs continue to make them desirable to those investors.

There is a second, even more important flaw in the criticism of the floating NAV. Even if a large exodus from MMFs were to occur, investors as well as entities that rely on the credit markets would undoubtedly adapt. Wherever there is a demand for a financial product and money to be made in providing it, a market solution arises. To the extent alternative vehicles designed to provide both cash management services and investment returns offer lower yields for investors and higher credit costs for institutions or governments, those changes would appropriately reflect the cost of reducing risk in the financial markets by eliminating the artificially stable NAV. Such an outcome is ultimately desirable, as it more fairly and transparently allocates risk and cost among investors and market participants.

Raising speculative, self-serving alarms about the possible migration of capital to dark, unregulated, or less regulated markets—where risks would remain opaque—is no answer to this reasoning. If that threat is indeed real (and materializes), then the appropriate regulatory response must be to enhance the oversight and transparency of those dark markets, not to forego critical MMFs reforms that are needed to eliminate run risk and systemic instability.[56]

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53 FSOC Proposal, at 69,467-68.

54 Release at 36,853 n. 165.

55 It is important to note that, contrary to some industry arguments, mere publication of the shadow NAV without a floating NAV requirement is insufficient. Although publication of the shadow NAV addresses current transparency concerns, it fails to adequately address run risk since investors would still have the incentive to redeem ahead of others in order to receive 100 cents on the dollar.

56 The FSOC Proposal supports this perspective, at least in principle, by declaring that "the Council and its members intend to use their authorities . . . to reduce or eliminate regulatory gaps to address any risks to financial stability that may arise from **dissimilar** standards for other cash-management products with risks similar to MMFs." FSOC Proposal, at 69,483.

C. The exemptions for government and retail funds must be eliminated.

The Proposed Rules include unwarranted exemptions for government and retail funds that would severely limit the application of the floating NAV. Together, these exemptions would **carve-out 66 percent of all MMFs** from this critically important reform.[57]

Neither exemption is warranted. Government funds may be more stable than some other types of MMFs, but they are nevertheless susceptible to run risk. For example, the Release explains that during the summer of 2011, government MMFs experienced a surge in redemptions as concerns intensified over the U.S. debt ceiling impasse and the possibility of a downgrade in government securities.[58] And, the run risk on government MMFs is not confined to the ever-lurking threat of congressional paralysis over the debt ceiling. As noted in the Release, government funds can hold up to 20 percent of their portfolios in non-government securities.[59] A credit event as to those securities could "trigger a drop in the shadow price, thereby creating incentives for shareholders to redeem shares ahead of other investors."[60] Finally, of course, investors in government MMFs are entitled to the same degree of transparency that investors in other types of MMF investments would receive if the NAV were floated. They should be aware that even shares of government funds can and do fluctuate in value.

The exemption for retail funds is even more untenable. As observed in the Release, "a retail prime MMF generally is subject to the same credit and liquidity risk as an institutional prime MMF."[61] Thus, there is nothing inherently more stable about a retail MMF in comparison to an institutional MMF. Indeed, the Release makes clear that the threats are the same.

The Release advances the curious argument that run risk in retail funds is significantly lower because retail investors are less inclined to monitor funds closely and to act quickly in the face of potential downturns. In essence, the Release argues that because retail investors are less sophisticated and slower to act, they deserve fewer protections.

First, the premise is suspect, as suggested in the Release. It is at best unclear to what extent retail investors have the impulse to redeem in times of market stress. And regardless of past episodes,[62] the behavior of retail investors may evolve and may in fact

57 The Release notes that government MMFs account for 40 percent of the market, Release at 36,855, while retail funds account for 26 percent, *id.* at 36,856.

58 Release at 36,845.

59 *Id.* at 36,854.

60 *Id.*

61 Release at 36,891.

62 In truth, the most that can be said is that retail investors might be slightly slower to redeem than institutional investors. In 2008, institutional investors ran first and fast, but the behavior of retail investors was never really put to the test, because the Treasury acted so fast to nationalize the money

mirror the tendency of institutional investors to redeem MMF shares in the face of instability or crisis.[63]

In any case, even if it were true that retail investors are less sophisticated and slower to act, that would not be a sufficient reason to exempt retail MMFs from a floating NAV requirement. Doing so would allow more sophisticated retail investors to **gain even more advantage** in times of stress over their less sophisticated peers in the fund. Thus, from the standpoint of fairness, as well as run risk, the exemption for retail funds from the floating NAV is indefensible.

The exemption also poses exceptionally daunting implementation challenges. Defining retail MMFs is an arbitrary and unreliable exercise. The Release proposes to define exempted retail funds as those that restrict shareholders from redeeming more than $1 million in any one business day.[64] However, it is not at all clear that this level is the appropriate one, and it is even more unclear how such a test should be applied to omnibus accounts. The alternative tests for retail MMFs suggested in the Release, such as minimum account balance, shareholder concentration, and shareholder characteristics, are no easier to apply. And however retail MMF is defined, it is inevitable that MMFs will game these artificial tests or thresholds in an effort to mimic retail funds and thereby avoid the floating NAV.

Thus, there are no good arguments for limiting the floating NAV to certain types of MMFs, while there are many reasons to apply it across the board for the benefit of all investors.

IV. Liquidity fees and gates should also be applied, in addition to the floating NAV, without exceptions for government or retail funds.

A. Liquidity fees and gates are important additional reforms.

It is clear that a floating NAV will not by itself adequately address run risk in MMFs. As explained in the Release,[65] "many factors" contributed to heavy redemptions in MMFs during the crisis, and the floating NAV proposal is "a targeted reform that may not ameliorate all of those factors."

Accordingly, other measures are necessary, and liquidity fees and gates should be among them. Liquidity fees serve two closely related goals: they discourage early redemptions by imposing a two percent fee, and they more equitably distribute the costs

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market fund industry, putting the full faith and credit of the U.S. behind them and stopping the run entirely. Extrapolating from those historic and unprecedented actions is not just unwarranted; it would be foolhardy.

63 Release at 36,857.

64 Release at 36,859.

65 Release at 36,850.

of liquidity by imposing at least some of that cost on redeeming shareholders instead of shifting it entirely on those who choose to remain in the fund during times of stress.

Gates are a necessary adjunct, since liquidity fees may not be effective in limiting redemptions. Shareholders may be willing to absorb those defined losses to avoid potentially larger losses if they remain invested in the fund.[66] In those scenarios, where the fees do not adequately neutralize the rush to redeem, gates can function as useful "circuit breakers,"[67] allowing a fund the time it needs to rebuild liquidity and to calm the shareholder fears that drive early redemptions.[68]

B. The SEC should eliminate the government MMF exemption, and adhere to its initial inclination not to exempt retail MMFs.

As discussed above, government funds are undoubtedly capable of experiencing instability and episodes of heavy redemptions, and liquidity fees and gates are therefore appropriate safeguards for government MMFs. Moreover, two of the principal justifications for exempting government MMFs from the fees and gates reform are unpersuasive. The Release notes that some investors may be unwilling or unable to invest in an MMF that might impose liquidity fees or gates.[69] But this reflects the same skewed priorities highlighted in Section II above: it subordinates the imperative of systemic stability to the convenience or product preferences of market participants, without a persuasive justification.

Second, the Release observes that due to their portfolio composition, most government MMFs are unlikely to reach the low liquidity level of 15 percent that would trigger the application of fees and gates. But the Release also acknowledges that some government MMFs could reach that point.[70] The appropriate conclusion to draw is that, while fees and gates are generally less likely to be needed, the condition of some government funds may deteriorate to the point where they are clearly necessary and appropriate and they should be available. Moreover, it is unwise to base policy decisions on the hope that investors will be sufficiently informed and rational about the specific levels of risk associated with the specific types of MMFs, at a time of extreme market stress when they may be facing the potential of dramatic and irretrievably large losses.

With respect to retail MMFs, the Release indicates that the SEC is not inclined to exempt them from the liquidity fees and gates.[71] This is the correct approach. Retail funds are not distinguishable from institutional funds in terms of credit and liquidity risks, and they are certainly susceptible to runs. Retail investors should benefit from the same stability mechanisms that are applied to institutional MMFs.

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66 *Id.* at 36,880.
67 *Id.*
68 *Id.*
69 *Id.* at 36,891.
70 *Id.*
71 *Id.*

C. A capital buffer is another necessary reform.

The Release repeatedly observes that none of the measures discussed in the Proposed Rules will necessarily eliminate MMF run risk, even if applied in combination. For example, it acknowledges that "our floating NAV proposal, [even] in conjunction with our other proposals, may not be sufficient to eliminate the incentive for shareholders to redeem shares in times of fund and market stress." [72]

Accordingly, it is necessary to apply another measure, in the form of a buffer that can absorb day-to-day fluctuations in the value of a fund's portfolio securities. A capital buffer offers a number of benefits. Most important, it could help reduce the risk of runs on MMFs. As noted in the Release, the floating NAV would not entirely eliminate the tendency of investors to redeem their shares, depending upon their perception of how large a fund's losses will be. By enhancing the ability of an MMF to absorb losses, a mandatory buffer could increase investor confidence that an MMF could withstand adverse movements in the value of portfolio assets without causing a significant drop in per share NAV. This in turn could reduce investors' impulse to redeem shares quickly when portfolio assets begin to drop in value. Thus, with the buffer in place, it is much less likely that liquidity fees and gates will be triggered, thereby also adding to investor confidence and reducing run risk.

In addition, the buffer would provide more transparent, reliable, and ultimately fair support for MMFs. Unlike sponsor support, which is uncertain in both availability and amount, the buffer provides an explicit level of support that investors can rely upon. The explicit buffer is also far better than the implicit expectation that taxpayers will once again be forced to rescue MMFs on the verge of collapse.[73]

The buffer could also reduce moral hazard and increase discipline in the management of MMFs. Although the cost of capital to fund a buffer should not be high, given applicable restrictions on permitted MMF investments and their relative safety,[74] there would be costs nonetheless.[75] Sponsors would have an added incentive to manage

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72 Release at 36,867.

73 The specific rescue measures that were deployed during the financial crisis to help staunch the flow of funds out of MMFs and to support the credit markets are no longer available. Schapiro Testimony, *supra* note 5, at 7.

74 Scharfstein Testimony, *supra* note 34, at 8.

75 The FSOC explains that the buffer could be raised in any number of ways, including sponsor capital, subordinated buffer shares, or retained earnings. FSOC Proposal, at 69,470. Each method would entail costs that presumably would be passed through to investors, but the incentive among sponsors to manage the buffer prudently would arise nevertheless, as higher costs to investors would commensurately reduce the attractiveness of the fund.

the MMF prudently not only to preserve investor confidence, but also to protect the buffer against depletion and costly replacement.[76]

To work, a buffer must be set at a level that accounts for multiple factors. First and most fundamentally, it must be able to absorb anticipated losses under a range of scenarios, including historical experience. In addition, it must account for additional costs associated with periods of high MMF stress. Those additional costs could be quantified in terms of the substantial amount of government support that proved necessary to prevent the collapse of MMFs during the financial crisis.[77] Alternatively, those additional costs could be framed in terms of the liquidity losses that investors would suffer if an MMF closes.[78]

Finally, the buffer must also be sufficient to convince fearful investors that the buffer is capable of absorbing whatever losses are anticipated under the applicable circumstances. If investors believe or fear that the decline in value from a financial shock could exceed the buffer, then they are going to withdraw their funds as quickly as possible, accepting known losses to avoid unknown and potentially much greater losses if they remain in the fund. The 2011 institutional prime MMF run (discussed above) illustrates the power of investor psychology in shaping behavior: the exodus from those funds was not triggered by actual, cascading losses, but by the mere fear and anticipation of such losses.

Therefore, any buffer must be set at a level that is sufficient to cover all of these factors: projected and historical losses; additional costs in the form of liquidity damages or government backstops; and investor psychology in the face of possible financial shocks or crises. In light of these considerations, the level of one or three percent suggested in the FSOC Proposal Recommendations would appear to be insufficient. Historical examples alone, as reviewed in the Release, indicate that MMF losses have risen as high as 3.9 percent.[79] This serves only as a floor regarding actual potential losses, clearly indicating that the necessary buffer must actually be substantially higher than 3.9 percent. Without such a level, the buffer will do little to further mitigate run risk.[80]

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76 Letter from the Squam Lake Group to FSOC, Re: FSOC Proposed Recommendations Regarding Money Market Mutual Fund Reform, at 2 (Jan. 17, 2013), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0065.

77 Scharfstein Testimony, *supra* note 34, at 8.

78 Release at 69,471.

79 *Id.*

80 The FSOC Proposal recommended the application of a "minimum balance at risk requirement," either alone or in combination with other reforms. Because the liquidity fee serves essentially the same function, but more effectively, we advocate for the liquidity rather than the MBR.

V. The other measures in the Proposed Rules aimed at promoting stability and transparency are clearly valuable additions to the regulatory framework for MMFs.

The Proposed Rules also include a variety of other measures to mitigate run vulnerability. These other measures include—

- More stringent investment diversification requirements, including revising the definition of "issuer" so that an MMF may not invest more than 5 percent of its assets in one issuer **and** its affiliated group.[81] These reforms are intended to reduce the likelihood that losses from the failure of a single issuer would threaten an MMF's stable NAV.

- Enhanced stress testing requirements, which would require funds to stress test their ability to avoid its weekly liquid assets falling below a threshold of 15 percent of all fund assets. This requirement is consistent with the proposed liquidity fees and gates requirement, which would be triggered at the same 15 percent level. Because "[f]unds that go below the 15 percent weekly liquid asset threshold may face significant adverse consequences," the advisers, board, and sponsors of a fund "should understand and be aware of what could cause a fund to cross such a threshold."[82]

- More robust disclosure requirements, including disclosures regarding daily and weekly liquidity levels; daily current NAV per share, rounded to the fourth decimal place; and material events such as instances of sponsor support or portfolio security default.[83] These enhanced disclosure requirements would provide several benefits, such as providing investors with accurate and contemporaneous valuations, as well as better insight into the risks assumed and actually experienced by their funds. In addition, such disclosures might help prevent across-the-board runs on MMFs during times of stress, by enabling investors to differentiate among funds and their actual, as opposed to assumed, vulnerabilities.

All of these reforms have value in terms of increasing the ability of MMFs to absorb losses, reduce run risk, and increase transparency. They should be included in the final rule. Additionally, the SEC should consider adopting the related measures included in the FSOC's Proposal, such as decreasing the current 5 percent limit on the amount of securities of any one issuer that may be held by a fund.

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81 Release at 36,954.
82 *Id.* at 36,967.
83 *Id.* at 36,924.

VI. Successful MMF reform requires the adoption of multiple reforms in combination with one another; otherwise MMFs should be treated like bank deposits and be required to have FDIC-type insurance.

None of the reforms included in the Propose Rules or advocated in this letter can, applied individually, adequately address the risks to the financial markets that MMFs pose. Therefore, to accomplish effective MMF reform, all of those measures must be adopted in combination: a floating NAV, liquidity fees and gates, a substantial capital buffer, and the proposed amendments relating to disclosure and diversity requirements. If the SEC is unable to adopt this approach, the result will be a failed rule that instills false comfort. In that event, the SEC should change its entire approach and enlist other regulators and policy makers in a concerted effort to establish a regime of banking regulation for MMFs.

It is true that the proposed reforms will alter the nature of the MMF product and eliminate so-called "principal preservation." But this alteration is a necessary consequence of taking adequate steps to minimize run risk, contagion, and the future need for government bailouts. Furthermore, this approach conforms with reality: "Principal preservation," or the effectively guaranteed ability of investors to receive 100 cents on the dollar on demand, with the implicit backing of the federal government, is fundamentally inconsistent with an uninsured investment product.

If the SEC cannot or will not adopt the entire collection of measures that reflect the true investment nature of MMFs and that are necessary to address the systemic risks they present, then MMFs should be treated like banks, subject to FDIC-like insurance and minimum capital requirements.[84] Some prominent MMF reform advocates have suggested this very approach, recognizing that MMFs "closely mimic[ ] the services provided by regulated banks,"[85] and therefore should be treated as such. Former Federal Reserve Chairman, Paul Volcker, for example, has stated:

> [MMFs] that desire to offer their clients bank-like transaction services, including withdrawal of funds from accounts at par, and promises of maintaining a constant or stable [NAV], should either be required to organize themselves as special purpose banks or submit themselves to capital and supervisory requirements and FDIC-type insurance on the funds under deposit. These "Stable NAV" [MMFs] would then be allowed to market themselves as offering redemption at par.[86]

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84 Admittedly, even this alternative has its drawbacks, including, as identified in the Release, "creating moral hazard and encouraging excessive risk-taking by money market funds." 78 Fed. Reg. 36,912. However, if the SEC fails to properly regulate MMFs and eliminate their known systemic risk, then the banking regulators should regulate them, and while doing so, address the potential drawbacks—including moral hazard—of that approach.

85 Letter from Paul A. Volcker to SEC, Re: President's Working Group Report on Money Market Fund Reform, at 1 (Feb. 11, 2011), *available at* http://www.sec.gov/comments/4-619/4619-79.pdf.

86 *Id.* at 2.

In short, unless the SEC implements the full array of reforms that are necessary to regulate MMFs effectively under the securities laws, their regulation should be shifted from the SEC to banking regulators.

DISCUSSION OF ECONOMIC ANALYSIS

I. The financial industry has made persistent and unfounded criticisms regarding the SEC's economic analysis.

Even when the SEC has clearly fulfilled its statutory duty to consider the economic impact of its rules, representatives from industry have challenged those rules claiming—without merit—that the SEC failed to appropriately conduct what the industry calls "cost-benefit analysis."

These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the SEC, the industry has:

(1) greatly exaggerated the actual duty imposed on the SEC by its governing statutes, Section 2(c) of the Investment Company Act, Section 202(c) of the Advisers Act, and Section 2(b) of the Securities Act, in effect seeking to transform that limited duty into what they call "cost-benefit analysis, but which is in fact really an "industry cost-only analysis;"

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process; and

(3) indefensibly ignored the enormous cost of the financial crisis and the larger collective benefit of all rules designed to help prevent a recurrence of that crisis or something far worse.[87]

Accordingly, it is important that the SEC adhere to a series of core principles governing the actual contours of its duty to consider the economic impact of its rule.

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[87] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf; *see also* TYLER ATKINSON ET. AL, DALLAS FED, HOW BAD WAS IT? THE COSTS AND CONSEQUENCES OF THE 2007-09 FINANCIAL CRISIS, STAFF PAPERS NO. 20 (Jul. 2013), *available at* http://dallasfed.org/assets/documents/research/staff/staff1301.pdf; U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013), *available at* http://gao.gov/assets/660/651322.pdf.

II. The SEC must apply the following core principles as it considers the protection of investors, the public interest, and the effect of its rules on efficiency, competition, and capital formation.

A. Under the securities laws, the SEC has no statutory duty to conduct cost-benefit analysis; in fact, its far more narrow obligation is simply to consider certain enumerated factors.

Section 2(c) of the Investment Company Act,[88] Section 202(c) of the Advisers Act,[89] and Section 2(b) of the Securities Act,[90] (collectively "Applicable Statutes"), set forth the SEC's statutory requirement to "consider" a rule's impact on several specifically listed economic factors. In particular, those sections require the SEC, "[w]henever . . . the Commission is engaged in rulemaking, . . . **and** is required to consider or determine whether an action is necessary or appropriate in the public interest" . . . , "to **consider** . . . whether the action will promote efficiency, competition, and capital formation."[91]

The securities laws contain no language requiring a cost-benefit analysis and there is no basis for imposing any such requirement (and certainly none for an industry cost-only analysis, which is what the industry is really seeking).[92]

When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis.[93] And, when Congress wants agencies to be free from those constraints, it imposes a less burdensome requirement, thus giving overriding importance to particular statutory objectives.[94] Indeed, the Court of Appeals for the District of Columbia has recently assessed the CFTC's economic

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88 15 U.S.C. § 80a-2(c).

89 15 U.S.C. § 80b-2(c).

90 15 U.S.C. § 77b(b).

91 15 U.S.C. § 77b(b); 15 U.S.C. § 80a-2(c); 15 U.S.C. § 80b-2(c) (emphasis added). Sections 3(f) and 23(a)(2) of the Exchange Act similarly set forth the Commission's statutory requirement to "consider" a rule's impact on the same specifically listed economic factors. 15 U.S.C. §§ 78c(f), 78w(a)(2). However, because the Proposed Rules are being implemented under the Investment Company Act, the Advisers Act, and the Securities Act, those provisions are inapplicable.

92 Better Markets has set forth a comprehensive analysis regarding the scope of the SEC's duties under the securities laws in BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf. In addition, Better Markets has recently filed an *amicus curiae* brief in support of the SEC on the agency's statutory duties in *American Petroleum Inst. v. SEC*, No. 12-1398 (D.C. Cir. Oct. 10, 2012). Both the report and *amicus* brief are incorporated by reference as if fully set forth herein.

93 *See American Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 510-512 & n. 30 (1981) (stating that "Congress uses specific language when intending that an agency engage in cost-benefit analysis" and citing numerous statutory examples).

94 *See Whitman v. American Trucking Ass'ns., Inc.*, 531 U.S. 457, 471 (2001) (holding that a statute "unambiguously bars cost considerations"); *see also Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes in which agencies must "consider" the "economic" impact or "costs" do not require cost-benefit analysis); *Cent. Ariz. Water Conservation Dist. v. EPA*, 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (language in 42 U.S.C. § 7491(g)(1) requiring "consideration" does not require a cost-benefit analysis).

analysis duty under Section 15(a) of the Commodity Exchange Act, which actually refers to "costs" and "benefits," and confirmed that "[w]here Congress has required 'rigorous, quantitative economic analysis,' it has made that requirement clear in the agency's statute, but it imposed no such requirement here." *Inv. Co. Inst. v. CFTC*, No. 1:12-cv-00612, at 15 (D.C. Cir. June 25, 2013) (citing *American Financial Services Ass'n v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985)); *cf., e.g.*, 2 U.S.C. § 1532(a).

The SEC's statutory duty stands in sharp contrast to the statutory provisions in which Congress explicitly mandates a netting or specific balancing of costs and benefits, let alone mentions "costs" and "benefits."

Moreover, Congress's careful choice of words in the Applicable Statutes and the case law construing similar provisions, make clear that the SEC has broad discretion in discharging its duty. The Supreme Court has long recognized that when statutorily mandated **considerations** are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[95]

The plain fact is that the SEC has no statutory or other obligation[96] to quantify costs or benefits,[97] weigh them against each other,[98] or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: requiring the SEC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives. The industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") does not change the law, the reasoned basis for the law, or the underlying policy.

95 *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611 (1950).

96 Indeed, there is no other law which would subject the SEC to a cost-benefit duty. The APA does not require such an analysis, *Vill. of Barrington v. Surface Transp. Bd.*, 636 F.3d 650, 670-671 (D.C. Cir. 2011), and the Executive Orders on cost-benefit analysis exclude the SEC and other independent agencies. Executive Order 13,579, 76 Fed. Reg. 41,587 (July 14, 2011); Executive Order No. 13,563, 76 Fed. Reg. 3,821, § 7 (Jan. 21, 2011); Executive Order 12,866, 58 Fed. Reg. 51,735, § 3(b) (Oct. 4, 1993).

97 *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that even in a cost-benefit analysis an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous, quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC*, 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

98 Even when a statute refers to "costs" and "benefits," Courts refuse to impose a duty to conduct cost-benefit analysis absent language of comparison in the statute. *See Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1045 (D.C. Cir. 1978); *see also Am. Petroleum Inst. v. EPA*, 858 F.2d 261, 265 & n.5 (5th Cir. 1988); *Reynolds Metal Co. v. EPA*, 760 F.2d 549, 565 (4th Cir. 1985).

B. The SEC must be guided by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.

The SEC's preeminent duty when promulgating rules is to protect investors and the public interest. The agency was established for the purpose of implementing the securities laws, and therefore its primary duty is to achieve the legislative objectives of those laws, which are first and foremost to protect investors and the public interest from fraud, abuse, and manipulation in the securities markets. As is evident from the securities laws themselves, their legislative history, and the specific delegations of rulemaking authority, the public interest and protection of investors is a key consideration in the SEC's rulemaking process. Indeed, the Applicable Statutes explicitly refer to "the protection of investors" and "the public interest," but do not mention any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[99]

Moreover, the SEC's duty to protect investors and the public interest has renewed importance in light of the 2008 financial crisis. The financial crisis is a powerful reminder of the need to remain focused on the core purposes of securities regulation and the SEC's overriding duty to protect the public, investors, and the integrity of the markets. The Supreme Court's admonition about the importance of raising standards of conduct to the highest possible level following the Great Depression applies with equal force today:

> "It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail" in every facet of the securities industry.[100]

If these goals are subordinated to industry concerns over the costs of regulation in the rulemaking process, then any financial reform will have little chance of protecting our markets and our economy from the ravages of another financial crisis. Thus, in promulgating rules, the SEC must be guided by the preeminent concerns of the public interest and the protection of investors, not the burdens of regulation on industry.

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[99] *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

[100] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963) (quoted authorities omitted).

C. For any rule promulgated in accordance with, or in furtherance of, the Dodd-Frank Act, the ultimate public interest and investor protection consideration is implementing the reforms that Congress passed to provide for a safer and sounder financial system and to prevent another financial crisis.

The SEC must always consider and give proper weight to the overriding goal that Congress intended to achieve when it passed the comprehensive, interrelated law, and the enormous benefit that the rules collectively will provide to the public. That goal is to prevent another financial collapse and economic crisis, and that benefit is to avoid the economic costs, hardships, and human suffering that would inevitably accompany such disastrous events.

The dollar cost alone of the financial collapse and still-unfolding economic crisis is conservatively estimated to be in the trillions. A study by Better Markets estimates that those costs will exceed $12.8 trillion.[101] In addition, the Government Accountability Office issued the results of a study on the costs of the crisis earlier this year, observing that "the present value of cumulative output losses [from the crisis] **could exceed $13 trillion.**"[102] Therefore, as the SEC considers the public interest and the protection of investors under the securities laws, it must continue to consider, above all, the benefits of the entire collection of reforms embodied in the Dodd-Frank Act, of which any specific rule is but a single, integral part.

III. <u>The Release shows that the SEC complied with its duty under the Applicable Statutes but could do more to clarify its economic analysis.</u>

The Release shows that the SEC has considered the economic impact of the Proposed Rules under Section 2(c) of the Investment Company Act, Section 202(c) of the Advisers Act, and Section 2(b) of the Securities Act. This is all the law requires and it satisfies the SEC's duty. However, the SEC can still enhance its discussion of economic analysis in several respects. First, it should be more limited in its approach, adhering more closely to the statutory requirement and expressly disavowing any obligation to conduct cost-benefit analysis. To the extent the SEC feels compelled to consider specific costs and benefits, it should clearly tie those costs and benefits to the three statutory factors: efficiency, competition, and capital formation. Finally, the SEC should more clearly highlight the turmoil and costs of the past crisis—including the near collapse of

[101] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_0.pdf, incorporated by reference as if fully set forth herein.

[102] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013) (released Feb. 14, 2013), *available at* http://gao.gov/assets/660/651322.pdf (emphasis added); *see also* TYLER ATKINSON ET. AL, DALLAS FED, HOW BAD WAS IT? THE COSTS AND CONSEQUENCES OF THE 2007-09 FINANCIAL CRISIS, STAFF PAPERS NO. 20 (Jul. 2013), *available at* http://dallasfed.org/assets/documents/research/staff/staff1301.pdf.

the MMF markets—and the enormous value of the Proposed Rules in helping to avoid another crisis.

A. The SEC complied with the Applicable Statutes.

The SEC appropriately considered and explained how various aspects of the rule would affect efficiency, competition, and capital formation.[103] This is what the securities laws require, and by considering the specified factors, the SEC has fulfilled its duty with respect to economic analysis.

B. The SEC must ensure that its economic consideration is limited to its narrow duty under the Applicable Statutes.

The SEC should carefully avoid undertaking a general cost-benefit analysis, or any similar approach in which agencies determine and quantify costs and benefits, net them against one another, and adopt the least costly rule. This type of analysis is not required by the Applicable Statutes, it poses a threat to the implementation of Congress's policy goals, and it wastes agencies' resources without producing accurate or useful results. In fact, consideration of costs and benefits beyond those specifically tied to the relevant securities laws provisions tends to mislead the public and the Commission by overemphasizing easily quantifiable costs to the detriment of important, albeit unquantifiable, benefits.

At a minimum, the SEC should clearly set forth its statutory duty under the Applicable Statutes, and state if and when they apply. If, for example, the rule is not being implemented under a statute which "require[s] [the SEC] to consider or determine whether an action is necessary or appropriate in the public interest," it should explicitly state that the economic considerations are inapplicable and refrain from such a consideration, as contemplated by Congress. In addition, it should explicitly assert that it is not required to perform a cost-benefit analysis, quantify or compare costs and benefits, or perform any analysis that exceeds the requirements in the Applicable Statutes. Moreover, as mentioned above, there is no need for the agency to quantify or "determine" the Proposed Rules' costs and benefits.

Throughout the Release, the SEC discusses specific costs and benefits associated with the Proposed Rules. Assuming that particular costs and benefits are at all relevant to the SEC's required economic consideration, the agency should more clearly set forth how those costs and benefits are directly related to protecting investors or the public or to efficiency, competition, or capital formation.

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[103] *See, e.g.,* Release at 36,915 ("[O]ur proposal would require that money market fund sponsors disclose their support of funds, which also would advance investor understanding of the risk of loss in money market funds and thus may advance allocative efficiency if investors make better investment decisions as a result.").

C. The SEC should more fully set forth the connection between the Proposed Rules; the comprehensive, integrated framework of which it is a part; and the benefits of avoiding another crisis.

The context in which the Proposed Rules are being promulgated, concurrently with a comprehensive overhaul of the entire financial marketplace under the Dodd-Frank Act, is extremely important and should have been more fully set forth in connection with the consideration of the application of the Applicable Statutes. The agency appropriately acknowledges the financial crisis as an impetus for the Proposed Rules in the beginning of the Release.[104] However, it should more explicitly and completely set forth the extraordinary collapse of the MMF market during the crisis, the unprecedented rescue of MMFs by the federal government, and the fact that the Rules are being proposed and promulgated as part of an entire framework envisioned by the Dodd-Frank Act, with the goal of protecting investors and promoting the public interest by preventing another crisis.

This level of explanation is appropriate to illustrate the larger interests at stake: not only protecting investors by increasing the transparency of their risks, but also reducing the potential contagion from heavy MMF redemptions and ultimately reducing the likelihood of a future financial collapse and economic crisis.

While some may argue that the near collapse of the money market fund system was a minor aspect of the crisis, this claim ignores the plain fact that the federal government's backstop of money market funds was the largest U.S. government guarantee of a private activity in the country's history. As the FSOC explained in its MMF proposal, reducing the risk of runs on MMFs will decrease both the likelihood and severity of future financial crises.[105] Moreover, because financial crises have such a profoundly damaging impact on economic activity and economic growth over an extended period,[106] "reforms that even modestly reduce the probability or severity of a financial crisis would have considerable benefits in terms of greater expected economic activity and, therefore, higher expected economic growth."[107]

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104 *See, e.g.*, Release at 36,843.

105 FSOC Proposal, at 69,481.

106 *Id.; see also* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

107 Release at 69,482. FSOC acknowledges "the inherent difficulty in assigning a probability to runs on MMFs and how such runs could contribute to a financial crisis." *Id.* at 69,481. But it also highlights the very high degree of interconnectedness between MMFs and other parts of the financial system, and it correctly draws on lessons learned during the financial crisis, when the MMF run of September 2008 "clearly exacerbated already severe strains in financial markets and contributed to a broader curtailment in the availability of credit." *Id.*

CONCLUSION

We hope that our comments are helpful as the SEC finalizes its Proposed Rules on MMF reform.

Sincerely,

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