Columbia University in the City of New York | *New York, N.Y. 10027*
SCHOOL OF LAW 435 West 116th Street

Jeffrey N. Gordon
Richard Paul Richman Professor of Law
Co-Director, Millstein Center for Global Markets and Corporate Ownership
Co-Director, Richman Center for Business, Law and Public Policy
Co-Director, Center for Law and Economic Studies

Voice: 212/854-2316
Fax: 212/854-7946
jgordon@law.columbia.edu

Feb. 28, 2013

The Financial Stability Oversight Council
Attn: Amias Geraty
1500 Pennsylvania Ave.
Washington, DC 20220

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform
Docket: FSOC-2012-003

Dear Financial Stability Oversight Council:

This letter is submitted by me personally in connection with the request for comments by the Financial Stability Oversight Council in response to its Proposed Recommendations Regarding Money Market Mutual Fund Reform, November 2012. I am the Richard Paul Richman Professor at Columbia Law School and co-director the Millstein Center on Global Markets and Corporate Ownership. I have submitted two comments in response to prior SEC releases[1] and an invited written submission in connection with the June 2012 hearings on money market fund reform held by the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate. I have recently written a paper on money market fund policy questions entitled *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?* (with Christopher M. Gandia).[2] I am not retained by any party with a potential interest in these reform proposals nor have I received support for my research on money market funds from any such party.

My summary responses to the proposed alternatives are as follows:

1. I would not favor floating NAV, because it would not address the systemic run-risk problem of money market funds ("MMFs") and worse, would give the appearance of addressing those problems. The chief driver of MMF run risk is the response of safety-seeking MMF users in circumstances that threaten full payment of principal, not the desire to capture the small permitted

[1] These comments are posted at http://ssrn.com/abstract=1473275 ; and http://ssrn.com/abstract=2133588.
[2] Posted at http://ssrn.com/abstract=2134995. At various points in this submission, I may quote from that paper without explicit attribution.

spread between $1 reported NAV and $0.995 actual NAV. The adoption of the floating NAV alternative would leave MMFs still highly exposed to run risk.

2. I would favor Proposal Two, the NAV Buffer and Minimum Balance at Risk ("MBR"). This proposal addresses the two characteristic sources of MMF fragility: (i) the inability to bear loss on the default or value depreciation of any portfolio security; and (ii) the incentive of MMF users to redeem shares – to run -- in a way that exacerbates financial distress. The control of potential runs by MMF users is critical to reducing the systemic risk posed by MMFs. This is because MMFs are themselves critical sources of finance for other financial institutions throughout the world, particularly systemically important banks. The present set-up, in which MMFs have no explicit loss-absorbing capacity, puts MMFs at high risk of a run in conditions of financial instability. As a result, MMFs will respond proactively, in effect "running" on the counterparties to MMF finance by simply not rolling-over existing short term debt instruments; this reduces MMF credit risk and builds liquidity. However, this MMF run will give rise to funding shortfalls in financial sector counterparties, which could be highly destabilizing in some circumstances and at a minimum is likely to lead to credit contraction to the real economy. As the FSOC has explained in its Proposed Recommendation, the Minimum Balance at Risk feature is a novel way to reduce MMF run risk by imposing some of the run costs on the users of MMFs.

3. If Proposal Two were not adopted, I would favor Proposal Three, the NAV Buffer and Other Measures. The main difference between the two proposals is that Proposal Three would require a higher up-front loss-absorbing layer – call it "capital" – instead of a lower capital charge but a MBR. My view is that ultimately the MMF users ultimately will bear the costs associated with these various ways to enhance MMF stability – as they should – but that Proposal Two is the least costly approach. In Proposal Three, since the capital will be provided by the sponsor or a third party, an MMF user will absorb none of the potential costs of a run. Thus the capital needs to do all the work of avoiding a run, that is, provide a sufficient buffer against both default on a portfolio security and depreciation in market value of portfolio securities because of fire sales associated with redemptions throughout the MMF industry. For a given level of protection against systemic distress, a higher level of capital will be required in a Proposal Three regime (capital) than in a Proposal Two regime (capital plus MBR). Given the challenges in raising capital, this could be an important reason to favor Proposal Two.[3]

4. In a previous submission to the SEC I have offered a proposal that bears a family resemblance to Proposal Two, except that it puts the entire provision of capital on MMF users, at least in the case of institutional funds. The proposal calls for MMFs to issue two classes of equity, Class A, designed to retain a fixed NAV, and Class B, whose value will float to cover defaults or depreciation in market value of portfolio securities. Class B issuances must equal (or exceed) the largest single portfolio position permitted by regulation or by the fund's fundamental policy

[3] I have concerns about some of the add-ons to Proposal Three beyond the capital requirement. Liquidity requirements can reduce the usefulness of MMFs as financial intermediary, since they limit the pool of MMF credit users, and they add to the pressure on MMFs to run on their counterparties in periods of financial instability. Shortening maturities in the MMF portfolio enhances the speed of the MMFs' withdrawal of finance from their counterparties.

(a self-imposed limitation) plus an additional amount to reflect the risk of a general decline in money market asset values outside of such a default. Because Class B is loss bearing, Class A will be able to retain a fixed NAV in virtually all circumstances.[4] So, for example, institutional users would be required to purchase a Class A/Class B "bundle."[5] The percentage of Class B in the bundle reflects the loss-bearing capacity of the fund. Requiring institutional users, collectively, to provide "capital" – on which they receive a return equal to their other investment in the fund – will avoid the need for sponsors to raise very significant sums in the capital market. Assuming an institutional prime MMF market of $1 trillion, sponsors would need to raise or contribute $10 billion if the required capital is one percent; $30 billion if it is three percent. This proposal was explained in a comment letter submitted to the SEC on August 12, 2011, which is attached to this submission.

5. In addition to authority in Title I of Dodd-Frank, I think the FSOC also has authority with respect to MMFs in Title VIII, since MMFs are used in conducting "payment, clearing, or settlement activity that the Council has designated as systemically important under section 804," as further defined in section 803(7). This would then give FSOC authority to assure that appropriate risk management rules were adopted by the SEC. See Section 805(a)(2)(E). I think a strong case for the importance of MMFs to payment, clearing, and settlement activity is made in an Appendix to a submission to the SEC by Arnold & Porter, dated November 2, 2012. I have attached a copy of the Appendix, entitled "Impact on Specialized Systems that Use Money Market Funds to Hold Temporary Liquidity Balances," to this submission.

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To understand the issues that the FSOC now faces, I think it is necessary to appreciate the origin and consequences of MMF growth in the financial system. MMFs arose in the 1970s as regulatory arbitrage around the regulatory ceiling on interest rates that depository institutions, banks and thrifts, could offer to depositors, so-called "Reg Q." At a time of high short interest rates, MMFs provided retail savers access to money market rates and became a substitute for both savings and checking accounts. The industry and the SEC understood this substitution. As a marketing tool, as consumer protection, and presumably as systemic risk mitigation, the industry and the SEC collaborated on a series of portfolio constraints, principally to limit maturities and to assure credit quality, in order to lower the risk that MMF shares would fall below a fixed net asset value, typically $1 a share. The SEC also provided a form of regulatory forbearance that permitted MMFs to use amortized cost accounting rather than "mark to market" valuations to smooth over small deviations from par. The SEC also from time to time granted regulatory relief to permit MMF sponsors to support $1 net asset values through buying

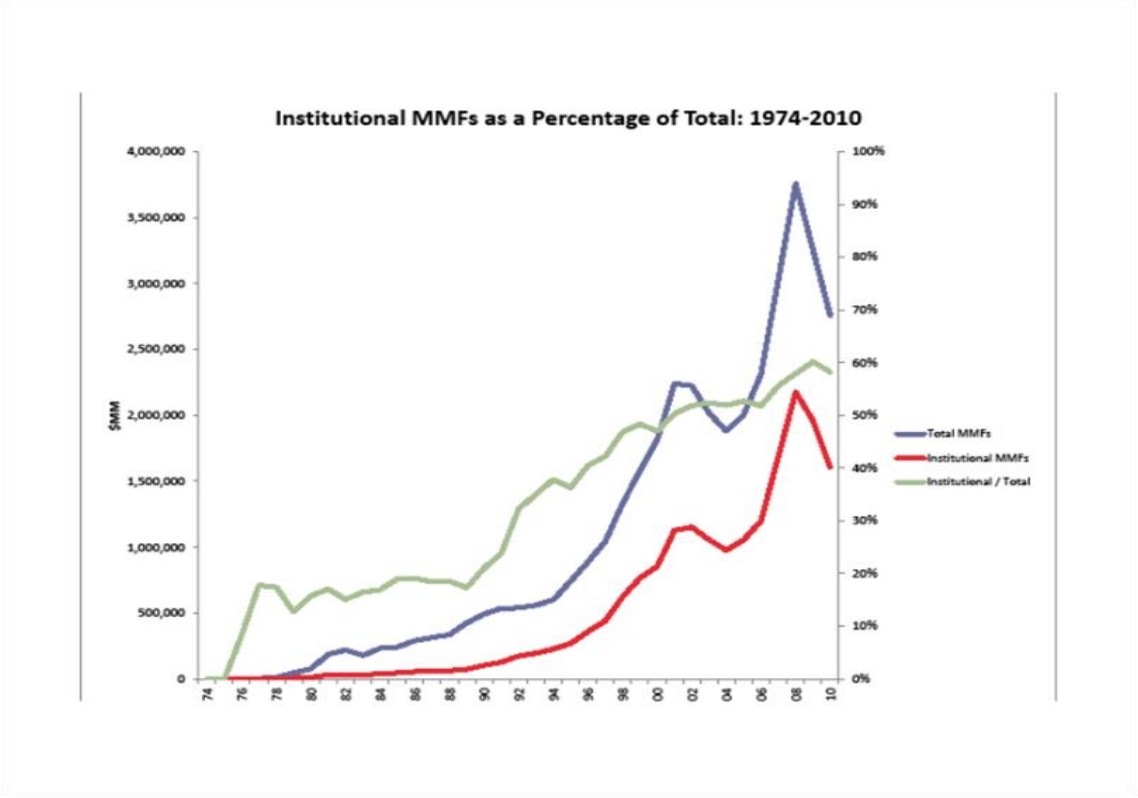
[4] In the event that the combination of default losses and market value losses exceed the Class B buffer, then the fund should suspend redemptions and liquidate.

[5] The proposal treats institutional funds and retail funds differently as to the source of the Class B capital. For institutional funds, the investors in the fund must buy the class B shares; for retail funds, the sponsor must buy the Class B shares. Government funds are treated separately.

distressed securities in MMF portfolios. The limitations of these SEC-crafted substitutes for the security of deposit insurance became apparent in the financial market distress of fall 2008.

The role of MMFs in the economy dramatically changed in the 1990s. Over time various institutional actors – non-financial corporations, pension funds, securities lenders, and asset managers, for example -- have become increasingly important MMF users. This is illustrated by Figure 1 below, which shows an institutional share of MMF assets of nearly 60 percent by 2008 and thereafter.

Figure 1



Source: Federal Reserve, Flow of Funds, Table L.206 (2011).

These institutional users look to MMFs for safety, liquidity, and convenience. Given the sums involved, far in excess of prevailing deposit insurance ceilings,[6] these users often prefer not to rely on banks exclusively. Yet the bulk of MMF prime assets, more than 80 percent, currently consist of short term issuances by banks and other financial intermediaries.[7] In effect MMFs have been providing institutional users with (1) bank-like cash management services, (2) diversified portfolios of credit-screened claims on other financial intermediaries, especially banks, and (3) substitute deposit insurance through the implicit promise of the MMF sponsor to swap out a "bad" portfolio security as necessary to avoid breaking the buck. The value proposition for any given institutional user is positive: A well-

[6] This excepts the now-expired temporary lifting of the deposit insurance ceiling in the Dodd-Frank Act.
[7] This is documented in Samuel G. Hanson et al, An Evaluation of Money Market Reform Proposals, Dec. 20, 2012.

chosen diversified portfolio of financial intermediary claims could well have less credit risk than any particular bank, the yield might be higher, and the implicit deposit insurance is an additional backstop.

The problem, of course, is that this set-up catastrophically failed in a moment of high systemic stress. I have heard it argued that the "only" money market fund that failed was the Reserve Primary Fund. That of course ignores the massive runs, the unprecedented Treasury guarantee of $3.5 trillion in MMF assets, and the backstopping of the sketchiest MMF assets through the Federal Reserve's Asset-Backed Commercial Paper MMMF Liquidity Facility ("AMLF"). Dodd-Frank stripped Treasury of authority to issue such a guarantee in the future and tightened the Fed's capacity to establish emergency liquidity facilities.

As noted above, until the financial crisis the ultimate stabilizer for the MMF industry was the practice of sponsor support, an implicit sponsor guarantee. There is an admirable history of sponsors coming to the rescue of their sponsored funds, particularly in 2007 and 2008. Yet the failure of the Reserve Primary Fund shows the limit of that strategy. Nothing in the SEC's MMF rulebook matches fund size to sponsor financial capacity, yet at moments of systemic distress, sponsor capacity is an important factor in outcomes. Indeed, for funds that needed sponsor support 2008, Moody's reported that at least 20 sponsors of fixed NAV funds in the US and Europe supplied $12.1 billion, ranging from $27 million to $2.9 billion, an average of $607 million per firm.[8] A careful study by the Boston Fed documented 31 instances between 2007 and 2011 in which prime MMFs would have broken the buck without direct sponsor support.[9] Another careful study by Federal Reserve Board staff using a different methodology that broadens the definition of sponsor support to include guarantees shows that 29 funds would have broken the buck in the month following the Lehman failure without sponsor support.[10] These needs arose even after announcement of the Treasury guarantee and the Fed's liquidity facility. Yet because we do not and realistically could not require a sponsor to guarantee its funds, the current practice of sponsor support (unless and until it is not feasible), is a treacherous ice floe on which to rest a multi-trillion dollar financial intermediary.[11]

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[8] Moody's Investor Service, Sponsor Support Key to Money Market Funds (Aug. 9, 2010).

[9] Seffanie A. Brady, Ken E. Anadu & Nathanial Cooper, The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011, Fed. Res. Bank of Boston (Aug. 13, 2012), http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1203.pdf.

[10] See Patrick E. McCabe, Marco Cipriani, Mochael Holscher & Antoine Martin, The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds, Fed. Res. Bd. D.P. 2012, at 31 (using reports required under the Treasury's Temporary Guarantee Program for Money Market Funds), http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf.

[11] For example, one of the largest US MMF sponsors, Federated Investors, Inc., managed, as of year end 2011, approximately $370 billion in assets, including $242 million in MMF assets, of which $110 billion were prime MMF assets, representing nearly 8 percent of all prime MMF assets. Federated Investors, Inc 2011 Annual Report, at 5, 8, 14; Inv. Co. Institute 2011 Factbook, at 164,Table 37. As of yearend 2011, Federated reported $50 million in cash and cash equivalents, "available for sale" equity securities of $160 million, and receivables, which together totaled approximately $345 million. These liquid holdings included investments in Federated money market funds, $118 million. On most favorable assumptions, then, its liquid assets were 0.31% of prime MMF assets. Federated also had a $200 million credit revolver. Assuming immediate and complete availability, this brings Federated's liquid resources up to 0.5% of prime MMF assets. Federated 2011 Annual Report at 19, 52, 37. See also Federated Investors Inc., Form 10-Q, June 30, 2012 (Management Discussion and Analysis of Liquidity). How much support could such a sponsor provide to its funds at crunch time, not just to cover losses but to supply liquidity to avoid a loss-making sale? This is not to pick on

It is against this backdrop that the various FSOC proposals must be evaluated.

Floating NAV. Floating NAV has appeal because it eliminates the regulatory artifact (to adopt a more neutral term than "distortion") that distinguishes money market mutual funds from other mutual funds. Rule 2a-7 permits MMFs to report a fixed $1 NAV as long as the difference between the market value of the fund's portfolio and its aggregate amortized cost does not exceed a $0.005 band. That is, if a fund's NAV is greater than or equal to $0.995 it can report a $1.00 NAV. Proponents claim that floating NAV will reduce run risk because (i) it would eliminate the fund users' incentive in distressed markets to arbitrage between the $1.00 and the actual market value, (ii) it will condition investors to understand that "markets fluctuate" so that a decline in market prices does not necessarily signal an imminent default on portfolio securities, and (iii) it will relieve sponsors of the implicit guarantee of zero investor losses that can lead to unrealistic expectations of safety. Opponents, especially institutional users, say that floating NAV will destroy the utility of MMF's, because it would create significant tax, accounting, and disclosure problems.[12]

Skeptics wonder whether floating NAV has much effect on run risk. The purported arbitrage operates over a very limited range, one-half of a penny. That's a maximum of $50,000 on a $10 million portfolio, not taking into account transaction costs. Not trivial but not compelling. Moreover, investors are unlikely to have the real-time pricing information that would encourage such arbitrage. Large MMF portfolios typically contain dozens of securities and many money market instruments do not trade. Instead, the strongest reasons for a run on an MMF are the same as for an uninsured bank account: uncertainty about the full payment of principal and a prisoner's dilemma dynamic in which the first party to withdraw stands the greatest chance of a full recovery. The circumstances that provide the greatest arbitrage possibilities (that increase the gap between $1.00 reported NAV and the $0.995 shadow NAV floor) will also be those that reflect heightened risk of the fund's "breaking the buck," in which direct losses on portfolio defaults and indirect losses on redemption-driven fire sales can significantly exceed the $0.005 range. In large part this is because money market assets are likely to present a highly correlated risk of default or loss of liquidity because they mainly consist of short term credit issuances of financial firms and their affiliates.

Similarly, floating NAV as a means to desensitize investors to fluctuating MMF valuations seems to misperceive what drives an MMF run: It is not the breaking of the buck per se, but a high-enough probability that the underlying portfolio event will correlate across MMFs generally. The prior instance of buck-breaking, the Community Bankers Fund in 1994, provides an instructive example. The fund broke the buck because of valuation changes in a portfolio "unsuitably" concentrated (27 percent) in interest-rate sensitive structured notes. The fund was small (only $150 million), its portfolio concentration violated the SEC rule, and the securities did not default. The fund's idiosyncratic investment strategy (and small size) meant that the industry did not suffer a run.[13] By contrast, the

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Federated. Other asset managers with large MMFs like Vanguard and Fidelity are not public firms and do not disclose such information.

[12] Opponents may also believe that this is the point of various reform proposals, including floating NAV, the goal of which is to make banks the exclusive provider of transaction accounts. That is, even if floating NAV does not in fact reduce run risk, it will lead many MMF users to turn to banks instead because of the transactional conveniences of a fixed dollar account. So MMFs will be less a systemic threat because they will be smaller.

[13] See Securities Exchange Commission, In the Matter of John E. Backlund et al., Rel. No. 33-7626 (Jan. 11, 1999, http://www.sec.gov/litigation/admin/33-7626.txt.

Reserve Primary Fund ($60 billion) held defaulted-upon securities of a large financial firm (Lehman) at a time of (i) high concentration of MMF assets in the financial sector and (ii) increasing and correlated instability among financial firms. In other words, it appears that the correlation of possible portfolio losses rather than the "focal point" effect of a buck-breaking was the main driver of the post-Lehman MMF runs. These portfolio losses can arise not only through defaults but also through fire sale prices on non-defaulted assets as funds scramble to meet redemption requests.

Unless floating NAV significantly reduces run risk relative to fixed NAV, it will not produce systemic stability. Instead, one of the other proposals on offer becomes necessary.

In a research paper that is included with this submission, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?*, a co-author and I take advantage of a natural experiment presented by European money market funds to provide empirical evidence on that run-risk question. Although all US MMFs are fixed NAV funds, money market funds offered in Europe come in both "stable NAV" and "accumulating NAV" varieties. A "stable NAV" fund is equivalent to the "fixed" US counterpart. An "accumulating" fund does not maintain fixed NAV, and while it does not fully "float," it does offer a useful proxy for the effects of a "floating NAV" fund. We examined the performance of these European MMFs during "Lehman Week" to test the factors that contributed to run propensity. Although virtually all funds experienced a significant run, the only internal factor that consistently predicted extra run propensity in our various models was ex ante risk, proxied by reported yield before Lehman Week. By contrast, the difference in run propensity between stable and accumulating NAV funds was not economically or statistically significant. Focusing in particular on US dollar funds that provide the best institutional comparison, our point estimate is that a 1 percent increase in yield (e.g., from 2.00 percent to 2.02 percent) was associated with approximately a 0.6 percent decrease in fund assets (e.g., from $100 million to $99.4 million). Over the approximately 1.8 percent yield range of the USD European MMFs, this suggests that the highest yielding funds on average should have experienced asset contractions of approximately 24% greater than the lowest yielding funds. To repeat, none of the contraction was explained by the difference between stable and accumulating NAV, indicating that NAV "fixedness" did not contribute to the run.

The two FSOC alternative proposals each entails loss-absorbing capital, in different configurations. Before distinguishing between the proposals, I first want to address two arguments against such proposals generally. First is the "mutual funds are not banks" argument. This is a syllogism to the effect that: banks require capital, money market funds are not banks, money market funds have no depositors or other debt claimants, so therefore money market funds should not be required to raise capital. This is an argument that would put form over function. Whether or not MMFs are classified as "banks" in our regulatory structure, they perform bank-like functions and, more importantly, are subject to bank-like fragility and destabilizing bank-like runs. Banks engage in three sorts of "transformation": credit transformation, maturity transformation, and liquidity transformation. Roughly, this means that banks convert short-term funds supplied by parties wanting safety and immediate 100 percent availability into credit assets that individually may carry significant default risk, that may remain outstanding for a significant time period, and that whose immediate sale price could well be substantially below the "hold to maturity" value. This description of a bank's function applies in all respects to a prime money market fund. MMF users expect safety and complete daily liquidity. Yet MMF prime assets carry meaningful default risk, have average maturities of two or three months, and would not necessarily be salable at amortized cost, especially in a stressed environment.

From the perspective of a fund's stability, it is of no moment that MMF claims are styled as "shares," rather than "deposits." The owner of MMF shares looks to "redeem" shares – receive funds from the MMF – not to sell them on the secondary market, and to redeem the shares at par. Precisely because MMFs are sold as a high liquidity-high safety vehicle, parties who perceive the risk of loss will run, for the same reason that bank depositors run. From the perspective of an MMF user, the MMF functions like a bank in providing liquidity and safety. The fact that in some formal way it can be described as similar to a bond mutual fund is irrelevant to appreciating the distinct systemic threat that MMF present in their current form. From a regulatory perspective, we ought not be so concerned about the losses absorbed by MMF users but very concerned about the destabilizing withdrawal of credit that MMFs otherwise supply to financial firms and nonfinancial firms that follows upon an MMF user run.

The second argument is that the 2010 amendments to Rule 2a-7 were sufficient to address the MMF stability problems revealed in fall 2008. The main thrust of the 2010 amendments was to enhance MMF liquidity, through (i) a daily liquidity requirement that 10 percent of the MMF portfolio consist of cash, Treasuries or one-day maturing assets; (ii) a weekly liquidity requirement that an additional 20 percent consist of cash, Treasuries, or other government securities maturing in 60 days or less, or assets that mature in one week or less; and (iii) a shortening of portfolio maturities ("weighted average maturity") from 90 to 60 days and adding a "weighted average life" limit of 120 days duration. [14]

These liquidity requirements could well contribute to MMF stability in certain circumstances, but they are not a substitute for capital because they do not provide loss absorbency. MMF users will run if they perceive a significant risk of loss. As shown by the most recent annual report of Treasury's Office of Financial Research, most MMFs have been at risk of breaking the buck upon the failure of a single significant issuer.[15] Because of the concentration of MMF assets in financial sector instruments, the possible correlation of defaults could produce a run in times of financial distress. Liquidity and capital work together. Capital makes it less likely that a default would produce a loss for MMF users. Without that assurance, liquidity may be rapidly absorbed.

The liquidity requirements themselves are costly. For example, the shortening of portfolio maturity may enhance liquidity, but it also increases the speed with which MMFs can withdraw credit from the firms that rely on MMF finance, which adds to systemic fragility. The shortened maturities will also change the composition of MMF portfolios. Non-financial firms are not well-equipped to use short term liabilities to finance long term assets. Thus financial firms, which specialize in such maturity transformation, will increase their share of MMF financing. Indeed, this has already occurred.[16] As the financial crisis demonstrated, financial firm solvency is likely to be highly correlated. Thus the effect to address stability by enhancing liquidity may well undermine stability by creating correlated solvency risk. One thing we are learning in the Basel III process is that capital and liquidity are complements not substitutes for financial intermediaries.

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[14] The 2010 Amendments also tighten quality requirements for MMF assets, enhance disclosure, and augment the Board's power to suspend redemptions and liquidate the Fund if it is about the break the buck.

[15] US Treasury, Office of Financial Research, 2012 Annual Report, 71-72, including Chart 3.3.11. OFR was established and tasked by Sections 153, 154 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a concrete example, a recent Moody's analysis showed that 15 MMFs held positions in Lehman Brother securities, ranging from 0.25% of assets to 5.6% of assets, that could have resulted in such funds' breaking the buck in fall 2008. See McCabe et al., supra note 9, at 29.

[16] See Samuel G. Hanson et al, An Evaluation of Money Market Reform Proposals, note 6 supra.

The conclusion that MMFs need loss absorbency – capital – seems to me an inescapable element of the series of financial system reforms undertaken after the financial crisis. In a sense Congress has mandated that MMF take on capital in light of the reform to the emergency lending authority of the Federal Reserve. The Dodd Frank Act, section 1101, amends section 13(3) of the Federal Reserve Act to require that emergency lending programs "shall be designed to ensure … that the security for emergency loans is sufficient to protect taxpayers from losses." Collateral is to be assigned a "lendable value … in determining whether the loan is secured satisfactorily for purposes of this paragraph." In a financial crisis MMFs are highly likely to require liquidity support from the Federal Reserve, as events of fall 2008 demonstrated. The amendment of section 13(3) probably means that a liquidity facility like the AMLF, in which the Fed lent against sketchy asset-backed commercial paper at par, would not be possible. Instead, the Federal Reserve would need to apply a haircut in accepting such assets as collateral to avoid credit risk. But here's the problem: without capital the MMF cannot offer the collateral at anything less than par, unless it is prepared to register an immediate loss for MMF users.[17] The haircut is based on an assessment of "lendable value"; as such, the haircut forces the realization of a potential credit loss; and without capital the MMF has no capacity to absorb such a loss. In a fixed NAV regime, use of a Fed facility would therefore mean breaking the buck.[18] Moreover, "lendable value" of less than par presumably affects NAV calculation for similar assets – and not just at the borrowing MMF but other MMFs that may hold such assets. Thus without capital the use of the Fed facility will exacerbate industry-wide MMF run risks even in a floating NAV regime.

So how is the MMF to raise capital? The most straightforward way to achieve this would be through Proposal Three, the NAV buffer and other measures. I am concerned that particularly in the present interest rate environment requiring capital of three percent might well present a difficult hurdle for sponsors or third party capital providers. Moreover, as I have previously noted, addressing the run risk problem through run cost internalization by institutional MMF users would be more efficient.

Proposal Two, a lower NAV buffer and a Minimum Balance at Risk, is designed to minimize run risk while providing some direct loss absorbing capacity. The Lehman week run illustrated the problem. At a time of valuation uncertainty, MMF investors faced a classic prisoner's dilemma game in which the rational individual strategy was to "redeem," rather than "not redeem" despite the collective irrationality of such a strategy. "Redeeming" meant a higher chance of receiving par than "not redeeming" and never would make the redeeming investor worse off. From the MMF side, the need to generate cash to meet actual and anticipated redemption requests meant that MMFs could receive depressed "fire sale" prices on sound assets, which itself can lead to wide-spread MMF losses and thus bad investor outcomes.

This "run" dynamic can be reversed, however, by the simple expedient of restricting the extent to which investors can fully redeem all of their shares in a short time frame, for example, by delaying redemption of a specified percentage of an investor's stake for a period of time. Proposal Two calls for a 3 percent holdback of amounts over $100,000 for 30 days. This makes all investors residual risk bearers in event of losses associated with a run – there are no first mover advantages to running -- and should reverse the run dynamics. Such a "holdback" means that in most circumstances an individual investor's best chance to avoid loss is from *not* running. This effect is strengthened by the feature of Proposal Two that calls for subordination of an MBR of a "running" MMF user to the claims of the non-running MMF

[17] At least if the loan is effected through the customary repurchase agreement.
[18] Presumably recourse to a Fed facility means that the sponsor is itself tapped out as a source of liquidity.

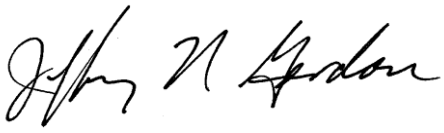
users. Because MMF users are made to internalize some of the costs of runs, the incidence of runs will decrease. This in turn increases the systemic stability of MMFs.

To be sure, this is a novel approach, not found for other financial intermediaries that otherwise promise daily liquidity. But we should appreciate that MMFs are a novel financial intermediary, which arose out of regulatory arbitrage with an appeal principally for retail users who wanted a better interest rate deal than banks could offer. Some years later, institutional users found MMFs. These are cash-laden parties who want more safety than what the official banking system offers and also unrestricted liquidity, all without paying the costs of systemic stability. That is not possible -- unless, as now, the taxpayers bear the costs when the systemic bill comes due. The appeal of MMFs is the offer of a credit-screened diversified portfolio of financial assets that is safer than deposits in a single bank but highly liquid. If that value proposition holds, then the small restriction on liquidity and remote loss-bearing contingency should not be a significant disincentive for the institutional MMF user.

There is an estimated $1.5 *trillion* in short term funds in the global financial system looking for safety and liquidity. It is important to devise financial institutions that can manage such cash flows in a systemically robust way and that does not depend on a taxpayer subsidy for its rescue. The prior design of MMF was an experiment that produced a bad outcome. So we must experiment again, learning from experience and being willing to revise our institutions in light of new economic challenges.

My apologies for the late submission of this comment. I respectfully ask that it be added to the record of these proceedings.

Sincerely,



Jeffrey N. Gordon
Richard Paul Richman Professor of Law
Columbia Law School

Attachments

Columbia University in the City of New York | *New York, N.Y. 10027*
SCHOOL OF LAW 435 West 116th Street

Jeffrey N. Gordon Voice: 212/854-2316
Richard Paul Richman Professor of Law Fax: 212/854-7946
Co-Director, Center for Law and Economic Studies jgordon@law.columbia.edu

August 12, 2011

Via SEC Internet Comment Form

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

Re: File No. S7-11-09
Release No. IC-28807
Money Market Reform

To the Commission:

This letter offers a specific proposal for the regulation of Money Market Funds (MMFs). The proposal responds to comments made at the Commission's Roundtable Discussion on May 10, 2011 and the public comments on the President's Working Group report on Money Market Fund Reform, per Investment Company Act Release No. IC-29497. I respectfully request that this correspondence be included in the record of the Commission's rule-making in this area.

I will assume without further argument a general consensus that the Commission's prior Money Market Fund reforms ("the Reforms") – which require more liquidity and portfolios of shorter maturity and higher quality – are insufficient to address the systemic risks of this particular financial intermediary. These Reforms do not address a central weakness: the inability of MMFs to bear the default of *any* portfolio security. Presumably a MMF is not entitled to use amortized cost accounting for a security that has defaulted and penny-rounding is also unlikely to be available. [1] Unless the Fund's sponsor steps in to buy the defaulted security at par, the Fund will "break the buck." The Reforms at best partially address the limited capacity of MMFs to bear market risk associated with increased default risk of assets on MMF balance sheets, which can reduce

[1] See Investment Company Act Rule 2a-7(c) (2010) (use of either amortized cost or penny rounding requires directors' good faith belief that such valuation "fairly reflects the market-based net asset value per share").

the market value of a Fund's portfolio below the permitted lower bound under penny-rounding. The Reforms have value because tightened credit quality should reduce value fluctuations, and greater liquidity and shorter maturities make it more likely that a Fund would be able to satisfy redemption requests without a "fire sale" disposition of Fund assets, thus reducing the risks of a negative valuation spiral.

In response to the proposals discussed in President's Working Group, three main reform proposals have emerged. The first is to permit net asset values (NAV) to float, in order to desensitize investors to relatively small valuation fluctuations in money market funds. The second is to create a liquidity back-up facility that could lend against money market fund assets at par, to avoid asset fire sales that would depress values. The third is to provide a capital cushion that could absorb losses in respect of a default on a portfolio security or upon the below-par sale of a portfolio asset. In my view the third general proposal, for a capital cushion, is the best approach for addressing the systemic risks of money market funds, given existing practical constraints, including the desirability of a proposal that can be effectuated under existing statutory authority. This letter offers a specific proposal designed to achieve goals of systemic stability and simplicity in implementation.

The proposal in rough form is this: All money market funds will issue two classes of equity, Class A, designed to retain a fixed NAV, and Class B, whose value will float to cover outright defaults or depreciation in market value of portfolio securities. Class B issuances must equal (or exceed) the largest single portfolio position permitted by regulation or by the fund's fundamental policy (a self-imposed limitation) plus an additional amount to reflect the risk of a general decline in money market asset values outside of such a default. Because Class B is loss bearing, Class A will be able to retain a fixed NAV in virtually all circumstances.[2] The proposal treats institutional funds and retail funds differently as to the source of the Class B capital. For institutional funds, the investors in the fund must buy the class B shares; for retail funds, the sponsor must buy the Class B shares. The following discussion therefore treats these two types of funds separately. The discussion also separately treats government funds.

Institutional Funds. Others such as the Squam Lake group have proposed a two class structure to provide an equity cushion.[3] The novel element of my proposal is the source of the equity: investors in institutional funds will provide the additional equity, as follows. An investor will initially be required to buy a "unit" that consists of Class A and Class B shares. However, the investor's subsequent purchases and redemptions of Class

[2] In the event that the combination of default losses and market value losses exceed the Class B buffer, then the fund should suspend redemptions and liquidate. See below.
[3] See Squam Lake Group, Reforming Money Market Funds (Jan. 14, 2011).

A shares need not be accompanied by the purchase of additional Class B shares so long as the investor's Class B ownership is at least as large as the required initial ratio.

An example will illustrate: Assume the required capital cushion is 5 percent. Then a party putting $100 in an institutional fund would buy a "unit" $95 of Class A shares and $5 of Class B. Each day the net asset value of the unit would be measured at fair market value. Any variation from par would be allocated to the Class B shares, which floats; the Class A shares would retain a fixed NAV. Thus although the value of the unit may fluctuate, the Class A NAV remains fixed.

Assume further that the party redeems $10 of Class A shares. It can choose to retain its corresponding investment in Class B shares ($.50 in this example), meaning that when it subsequently buys (up to) $10 in Class A, no further Class B purchases are required. Should it want to redeem the Class B shares, it can, but only a week later, at the then-NAV of those shares.

Notice what this proposal accomplishes: it requires the users of institutional money market funds to supply the capital necessary for their stability and it creates disincentives for such investors to "run." These are advantages over proposals that contemplate sale of Class B shares to a separate group of capital suppliers. In particular, the "unit" concept means that an investor who "ran" by redeeming Class A shares at par at a time of falling asset values could not thereby impose losses on non-redeeming investors. The losses would be borne by the matched Class B shares, including shares held by the "running" investor, which cannot be disposed of except after a week's lag.

The unit concept therefore provides an additional element of systemic stability beyond proposals that just call for a capital cushion. A capital cushion cannot, by itself, fully protect against runs. Even if the capital could absorb the loss of the largest portfolio position, another default could break through the Class B. Thus in periods of financial instability, runs remain a threat despite first loss protection, because the run strategy presents no downside for the individual running investor. A Class A/Class B unit changes the dynamic. Default risk, especially risk of multiple defaults that break through the Class B, is fact low. By contrast, given a run, the chance of fire sale losses is much higher. A holder of matching Class B shares now sees downside in the decision to run, with a much greater probability of loss because of the run itself. The combination of the capital layer and the unit approach should significantly increase money market fund stability.

What share of the fund's capital should be represented by the Class B shares; meaning, how large an equity cushion? One straightforward approach is this: the Class

B percentage should at least equal the largest permitted portfolio position plus an additional amount to reflect the volatility of asset values apart from a default on that position. In the unlikely event of a default, the potential loss of an unsecured debt position is total (as with Lehman Brothers commercial paper). An additional cushion should be available to cover market value losses of securities that have not defaulted. So, if the fund was permitted by the SEC regulation and the fund's fundamental policy to invest up to 5 percent of the securities of any given issuer, the relevant history suggests that the right amount of capital should be 5.5 percent.[4] But this 5.5 percent in Class B shares is not particularly costly for the investor, because the full unit will be invested in portfolio securities. Default, after all, will be a very low probability risk. In normal times, the only cost is the diminished liquidity of a week's delay for complete close-out of a position at the fund. This is a small cost.

In the debate around the President's Working Group report, institutional users of money market funds have strenuously argued on behalf of fixed NAV as an essential feature. Fixed NAV makes money market fund transactions as smooth as cash transactions at a bank, avoiding the accounting and tax issues that would burden MMF transactions with costs and inconvenience. Such a non-bank transaction account comes at a cost, however, in terms of systemic stability. It seems entirely right that the beneficiaries of such accounts should internalize those costs, which this proposal for a Class A/Class B unit does.

Think of it this way: Money market funds permit institutional users to outsource the cash management function while obtaining money market rates that have been higher on average than bank rates. MMFs provide efficient diversification and credit investigation in money market instruments. If MMFs did not exist, large institutions would have to assemble their own staffs to perform such functions. Purchase of the Class B shares is an efficient alternative to such on-going costs; it can be seen as a relatively small one-time commitment that provides indefinite benefits, not unlike being required to maintain a minimum balance in a bank account to obtain its benefits.

[4] This figure reflects a .5% volatility bound drawn from prior MMF experience that funds rarely "broke the buck" (i.e., exceeded that bound) even without sponsor support. The volatility percentage could be set on the basis of historical data, for example, by looking at the lowest bound of average MMF "shadow" NAVs during fall 2008, without giving effect to sponsor support. Conceivably funds could lower the required volatility cushion by a fundamental policy that limited assets to particular classes of low volatility assets. This would be relevant in setting the capital policy for government funds or funds that promised a specific mix of prime and government assets.

As noted above, a fund could reduce required capital by limiting portfolio positions through its fundamental policy, but there should be a minimum level of capital for all funds, because of the correlation risk, meaning the risk of default contagion among issuers with counterparty relationships or similar business models.

Moreover, in forcing investors to internalize some of the costs of a run, the unit approach reduces the risk of a run in the first place. There are two reasons investors might run. If investors lose confidence in a broad asset class, they will want to quickly disinvest, even if their position suffers a loss, before further defaults materialize. But in the case of money market instruments, default risk is quite low, as demonstrated by the 2008-09 financial crisis. A more common source of run risk arises from the collective action problem: if there is slightest risk of loss, an investor wants to be at the head of the disinvesting line to maximize the chance for a full payout. If all costs are borne by others, why not run? By contrast, internalization of this risk among the Class A holders (through their matching Class B positions) is likely to produce a cooperative outcome of "don't run."

In short the proposal promotes systemic stability for two reasons: Knowing that there is a mechanism for loss-bearing that protects the liquid Class A shares reduces the incentive to run. Knowing that all Class A shareholders will internalize some of the run costs also will reduce the propensity to run.

Moreover, the proposal will have an additional pro-stability effect in the money market fund world by reducing the "hot money" character of institutional behavior. Currently corporate treasurers monitor money market fund rates via portals that let them quickly switch to pursue higher yield, or perhaps in troubled times, to pursue greater safety. The small liquidity costs of the Class A/Class B unit structure would add a friction to rapid switching. For example, assume an investor had placed $100,000 with Fund One but saw that Fund Two paid 10 basis points more. The investor's initial purchase of Fund One shares would have been split between Class A shares, $94,500, and Class B, $5500. The one week delay in Class B redemption means that the investor could immediately move no more than $99,450, which itself would be allocated between the Class A and Class B. Rapid switching among several different money market funds would entail accumulating liquidity costs, frictions that would reduce the underlying activity.

The remaining questions relate to addressing circumstances of defaults and value changes to the Class B shares. *Case 1.* In the case where losses and market value declines exceed the fund's capital cushion, redemptions should be suspended and the fund should engage in orderly liquidation. This refers to cases in which the market value of the Class B stock is zero or in deficit (including "retained" Class B stock attributable to investors who have sold their matching Class A positions in whole or in part). This is likely to be a very rare circumstance.

Case 2. Rules for the case in which losses and market value declines are less than the fund's capital cushion should be fashioned to avoid "zombie" funds and to enhance MMF stability. The key is to assure that new purchases do not bear losses associated with prior purchases, that is, to avoid discouraging new investment because of the "buoying up" problem. Over time the fund will rebuild its capital cushion, through new transactions with existing and new investors. *Case 2A.* For example, assume Fund Three has experienced a portfolio loss of two percent. Investors will able to redeem Class A shares at par, but loss-bearing Class B shares will be worth approximately 45 percent of their value[5], meaning they will be valued at approximately $.55, not $1.00 a share. Assume that all Class B shares would be valued identically regardless of vintage. The key to Fund Three's viability, and its capacity to rebuild its capital cushion over time, is to price the newly purchased Class B shares at the market price, not a par, at the time of purchase. This means that in respect of its 5.5 percent Class B investment, New Investor will receive approximately 1.8 times the number of Class B shares as would have been received in the non-defaulted state. In other words, as part of the loss bearing associated with the Class B shares, the existing Class B holders will be diluted by the entry of new investors into the Fund. But they are no worse off than otherwise had Fund Three been forced to wind down because of the dearth of new investment and are better off because of the option value in preserving a transactional relationship.[6]

Case 2B. By contrast, assume Fund Four suffers no realized losses but portfolio values move negatively so that Class B shares are valued below par. As noted above, market fluctuations have historically been tightly bound. Nevertheless the pricing formula of Case 2A best protects against the risk that existing funds might become "zombie" funds.[7] This pricing method has pro-stability features, since the high probability of gain on the Class B shares as portfolio investments in fact pay without default will draw new investment into money market funds at times of market instability. In other words, the Class A/Class B unit structure can be an anti-run feature for money market funds.

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[5] The math is ($2/5.5%). The relatively sharp fall (in percentage terms) of the Class B shares is because they bear all of the loss.

[6] "New Investor" in this example includes existing investors who add to their fund balances. Their matching Class B share purchases will also be priced at the actual Class B price.

Note that the fund sponsor always has the option to replace the defaulted security at par (as has commonly occurred), to protect the sponsor's reputation. But to protect systemic stability, the Rule needs to address circumstances in which such voluntary actions may not occur.

[7] This can be illustrated by an example in which new Class B shares are sold at par in such circumstances. Assume Fund Five has $1000 in assets, which now have a market value of $995, meaning a decline of .5%. New Investor buys a $100 unit, $94.50 in Class A, $5.50 in Class B. New Investor's Class B shares will be worth only $.82 a share, meaning an immediate loss from $5.50 in Class B to $4.50. Once again this is because all the losses are concentrated on the Class B shares.

Retail Funds. Retail funds present a distinct situation from institutional funds because of the different nature and goals of the investors. Retail investors generally regard money market funds as a higher-yielding substitute for a bank account.[8] They depend on the check-writing feature and the fixed redemption amount. For a retail investor, the MMF alternative is not assembling and managing a diversified portfolio of money market instruments.

Another important difference is the relationship between the MMF sponsor and the MMF investor. In the case of the retail investor, the MMF is generally packaged with other mutual funds and other financial services offered by the sponsor. In most cases, the sponsor's core business is not providing transactional services to retail investors. Rather, the retail MMF account represents one aspect of a multi-faceted relationship the goal of which is to serve all of the investor's wealth management and other financial services needs (e.g., credit cards). Institutional MMF sponsorship is simply a different business. Some institutional fund sponsors, banks, for example, provide other corporate finance services, but others, such mutual fund complexes, generally do not.

Perhaps the overarching difference is the comparative sophistication of retail vs. institutional customers. This was demonstrated in the financial crisis, in which institutional MMF participants were much more prone to run than retail investors. Retail MMF positions are much "stickier" than institutional positions and present much less run risk. Moreover, although both classes of MMF investors want a simple product, institutional investors have greater capacity to see through and manage complexity.

These differences argue for a somewhat different structure for retail MMFS. The main difference is that the sponsors themselves should be responsible for assuring the supply of matching Class B capital. Sponsors should have the choice of (i) purchasing and holding Class B shares to match retail customer Class A purchases or (ii) underwriting the sale of matching Class B shares to third party capital suppliers, or (iii) combining both.[9] In other respects the Class A and Class B shares would pay out and be valued as in the institutional fund case. This means that in ordinary times, Class B holders would receive the same return as Class A holders but would also provide first loss-protection against portfolio defaults.

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[8] MMFs are really a partial substitute, since most funds have a minimum withdrawal amount, often $250 or $500, that means that the investor also needs a bank account for daily transactional purposes. Perhaps for this reason the Federal Reserve counts money market fund deposits in M2, which includes savings accounts, rather than M1, which includes checking accounts.

[9] I would not favor substituting a third party guarantee for actual capital, because of the correlation risks. Defaults that require guarantor performance are likely to be (i) correlated across MMFs, so the guarantor may have to perform on multiple guarantees, and (ii) correlated with stresses in the guarantor's other financial businesses, which will undermine the guarantor's performance capabilities.

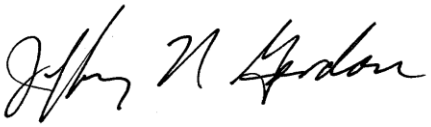
This arrangement will impose costs on sponsors in this arrangement, but those costs could be mitigated by portfolio diversification decisions that would reduce the required level of matching Class B and by fees charged to MMF investors. These costs will also be covered by cross-subsidy from other elements of the sponsor's relationship with the retail investor. To be clear, sponsors should have the option of offering only "institutional funds" to all of its customers, meaning requiring retail investors to buy matching Class B shares. This may not find acceptance in the marketplace. Thus the proposal also offers a "retail" MMF alternative that the sponsor can choose to offer. Because of the greater cost imposition, the sponsor should be free to limit access to the retail MMF as it chooses.[10] For example, the sponsor could limit the availability of its retail MMF to investors who do other financial business with the sponsor.

Government Funds. Government money market funds present a special case because of the negligible default risk and the pattern demonstrated in fall 2008 that in a financial crisis investors run *toward* government funds. Thus government funds do not present the same systemic risk concerns as other MMFs. One possible concern is that investors who urgently need cash to cover losses in other positions would demand immediate liquidity, at a level that might exceed the "cash in the market" and thus lead sales below par even in government funds. In the case of government funds, this issue should be addressed by the current liquidity standards, including the recent Reforms. Assuming that the definition of a security eligible for a government fund remains stringent, I think that no further rule change would be necessary. In other words, for government funds only, shares could be sold without the Class A/Class B unit structure, and the current amortized cost/penny rounding accounting could be retained. Alternatively, if the goal is to provide a uniform product, government funds could be sold in institutional or retail variants, with a small Class B capitalization amount, perhaps 0.50% or 0.25%.

[10] For example, the sponsor is unlikely to offer a retail MMF to an institutional investor because the absence of the institutional purchase of matching Class B shares exposes the sponsor to greater run risk. As observed previously, the financial crisis showed that the run risk associated with a retail investor is smaller.

The guiding principle of this proposal is straightforward: Money market mutual funds impose systemic risk costs on the entire financial system. The costs should be internalized. These proposals for institutional MMFs and retail MMFs should achieve that goal while preserving the key attributes of fixed NAV, relative simplicity, and access to money market rates that make the MMF attractive in the marketplace.

Very truly yours,



Jeffrey N. Gordon
Richard Paul Richman Professor of Law
Co-Director, Center for Law and Economic Studies
Columbia Law School

cc: Chairwoman Mary L. Schapiro
Commissioner Luis A. Aguilar
Commissioner Kathleen L. Casey
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Commissioner Elisse B. Walter
Division of Investment Management Director Eileen Rominger
Division of Investment Management Associate Director Robert E. Plaze

Appendix, "Impact on Specialized Systems that Use Money Market Funds to Hold Temporary Liquidity Balances"

Filed with a submission to the SEC by Arnold & Porter, dated November 2, 2012, Economic Consequences of Proposals to Require Money Market Funds to "Float" Their NAV; File No. 4-619.

Appendix

Impact on Specialized Systems That Use Money Funds to Hold Temporary Liquidity Balances

The Money Fund business developed during a period in which a wide range of businesses moved from archaic manual systems to automated systems for processing the posting and settlement of various types of transactions. As a result, use of stable value Money Funds to hold short-term liquidity was incorporated into many of the accounting systems and the automated interfaces used in these systems. Examples, which are discussed in more detail below, include trust accounting systems at bank trust departments, corporate payroll processing, corporate and institutional operating cash balances, federal, state and local government cash balances, municipal bond trustee cash management systems, consumer receivable securitization cash processing, escrow processing, custody cash balances and investment manager cash balances, 401(k) and 403(b) employee benefit plan processing, broker-dealer and futures dealer customer cash balances, and cash management type accounts at banks and broker-dealers.

The systems changes that have been implemented in many different businesses over the past four decades have greatly reduced (i) the time required to post and settle transactions, (ii) the personnel required to post and settle transactions (and thus the overhead costs associated with those functions), (iii) the errors associated with posting and settling those transactions, (iv) the "fails" involved in settling those transactions, (v) the size and length of time outstanding of the "float," "due to," and "due from" balances tied up in processing of transactions, and (vi) the counterparty default risk associated with transactions between and among companies. These changes have had the net result over the past four decades of reducing risk and increasing the efficiency of many business activities and greatly reducing the amount of funding required for businesses to conduct transaction processing.

Many of these systems have as a key element the use of Money Funds to hold short-term liquidity in connection with settlement of the transactions. The features of Money Funds that are ideal for holding temporary balances in these systems include (1) stable $1 per-share value during the time the transaction is being processed to allow certainty of the day of the exact dollar amounts that are being processed between different counterparty accounting systems so that the amount due and the amount paid do not diverge even by a few cents during the time in which the transaction is being processed, (2) same-day settlement capability (T+0 processing) which is possible only because of the use of amortized cost by Money Funds, (3) high credit quality and underlying portfolio issuer diversification which reduces risk of insolvency during the time the transaction is being processed, and (4) operation within a highly-automated secure computer environment that allows for 24/7 no downtime interfaces with accounting and data processing systems of all parties to the transactions.

The use of amortized cost and the resulting stable NAV are crucial features of Money Funds that allow them to work with automated processing systems. Amortized cost allows the use of a stable $1 per-share pricing by money funds. The valuation method accretes one additional day's worth of imputed interest on each portfolio asset each day using factors and information known in advance. This means that, absent a material credit event during the day that drops NAV below 99.5 cents per share, at 6:00 a.m., the system operators know what a share

will be worth at 6:00 p.m. It will be priced at exactly $1.00 per share. If Money Funds were required to use continuously floating NAV, the exact price of a share as of the close of the day would not be known until after the markets close that day. Floating NAV funds must determine the purchase or redemption price of a share using the market-closing prices of the portfolio securities that are not known until the next close of markets *after* that purchase or redemption order is placed.[101]

In other words, if Money Funds used a floating NAV, the system operator would not know until 4:00 p.m. whether a share would be worth $1.00001 or $0.99999 at the end of the day. When the automated system learned in the morning that it must purchase or liquidate Money Fund shares to process a payment of say, $10,000,000 that afternoon, and placed that order, it would not be clear at the time the order was placed exactly how many Money Fund shares would have to be liquidated to reach that exact amount. It might be a few cents more or less at the end of the day than anticipated. This few extra or short pennies would be a discrepancy that would need to be manually reconciled and the difference trued up before the transaction could be finished. Manual processing would mean more staffing requirement, more costs associated with staffing the function, and errors and delays in completing the process.

Furthermore, because the purchase and redemption price would not be known earlier, and the market-closing prices from after the purchase or redemption order was placed must be used to set the price for the purchase or redemption order, the settlement payment could not occur the same day the order is placed (T+0), but instead is made the next business day (T+1). This means one party to the transaction owes the other money for one more day (three if it is a weekend, four if a holiday weekend). Both parties would carry the unsettled transaction as an open position for one extra day and each party would be exposed for that time to the risk that its counterparty would default during the extra day, or that the bank holding the cash overnight (or over the weekend) would fail. For a bank involved in making a payment in anticipation of an incoming funds transfer as part of these processing systems, this change from same-day to next-day processing of money fund redemptions would turn intra-day overdrafts into overnight overdrafts, resulting in much greater default and funding risks to the bank. This extra day's float would mean more risk in the system and a larger average float balance that each party must carry and finance.

The net result of a floating NAV would be to make Money Funds not useful to hold the large, short-term cash balances used in these automated transaction processing systems across a wide variety of businesses and applications. A generation's worth of work in automating settlement systems, shortening settlement times, and limiting counterparty risk would be undermined. At a minimum this would require systems to be re-programmed on a wide scale, involving substantial personnel, time and years to complete. This would be comparable in some ways to the Y-2K effort, although the effort would be concentrated at fewer firms, but more work required at each affected firm to redesign and reprogram their processing and accounting systems. Completion of the systems would take many years and hundreds of millions of dollars to complete across a wide range of businesses and applications for which stable value money funds currently are used to hold short-term liquidity. Until these systems could be redesigned,

[101] 17 C.F.R. §§ 270.2a-4, 270.22c-1.

reconfigured and rebuilt, processing of transactions would essentially be back to the manual processes that existed in the early 1970s.

If Money Funds no longer provide a business solution for holding short-term cash balances for each of these various processing functions, something else would need to be used. The vehicles that formerly held these pending balances before Money Funds filled this need included credit balances at the commercial counterparty (due to and due from amounts at a commercial company, or free credit balances at a broker), bank short-term investment funds, corporate variable amount notes, and bank deposits. These vehicles have fallen out of use for this purpose or might no longer be available, and each carries with it much greater and more concentrated default risks.

Examples of some of the transaction processing systems that use Money Funds to hold short-term cash balances are set forth below, along with a description of how Money Funds fill a business need of that particular system.

Bank Trust Accounting Systems. Bank trust departments are responsible for receiving, tracking, accounting for, holding in custody, investing, and paying out cash balances for large numbers of trust accounts. This cash includes balances from many different trust and fiduciary accounts. It represents cash received from the proceeds of sales of securities or other assets, dividends and interest on client investments, and new balances placed in trust. The cash is held briefly pending distribution to beneficial owners, payment of expenses and taxes on behalf of clients, and payments for purchases of securities and other assets for client fiduciary accounts. At any given time, the balance for any one client account may be very large or very small, but in the aggregate the trust department as a whole represents a very large, short-term cash balance. Trust departments have an obligation to keep trust assets productive, minimize the time cash balances remain uninvested, and seek a competitive return on cash balances consistent with prudent investment principles.[102]

Tracking, investing and accounting for these cash balances is a complex effort, due to the large numbers of fiduciary accounts which must be tracked, the many and varied inbound and outbound streams of cash, the need to plan and manage payments and distributions for the various client accounts, tax considerations, the non-uniform provisions of the many different trust instruments that govern the requirements of each different account, and the complex and overlapping requirements of state and federal laws governing fiduciary accounts. Fiduciary laws in many jurisdictions designate certain types of assets as permitted investments for trusts and certain other fiduciary accounts. Money Funds have been recognized as permitted fiduciary investments in many states.[103] A change to the regulatory requirements for Money Funds that precluded Money Funds from using amortized cost or seeking to maintain a stable net asset value per share could require state fiduciary statutes to be amended by state legislatures to permit the continued use of Money Funds to hold trust cash balances in certain states.

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[102] 12 C.F.R. § 9.10.

[103] *See, e.g.*, Ala. Code § 19-4A-3; Cal. Prob. Code § 9730; Fla. Stat. Ann. § 736.0816;.

Among the many complexities of applicable fiduciary laws is a requirement in many jurisdictions to track and separately account for principal and income on each account, and requirements on diversification and in what assets a particular type of fiduciary account can be invested, as well as restrictions on conflicts of interest by the trustee bank.

Most bank trust departments operate on trust accounting systems provided by one of ten large national vendors. These automated, computer-based systems are designed to maintain records of client accounts, generate internal and external reports used by the trust department, as well as tax records and client statements, and interact with the investment and cash management programs of the bank on an automated basis.

In the past, trust departments generally held trust cash either on deposit with the commercial side of the bank, or in a "short term investment fund" maintained by the trust department. Both of these alternatives had significant operational problems. If placed on deposit with the commercial side of the bank, the fiduciary account deposit generally must be collateralized by high quality bonds,[104] and must bear a competitive rate of interest.[105] Depositing with the commercial side presents a conflict of interest that must be carefully managed and maintained only for a short period.[106] This presents further complications under the reserve requirements of Regulation D, which require reserves to be placed by the bank with the Federal Reserve equal to 10% of a "demand deposit" portion of these cash balances.[107] The combination of these factors makes it impractical in many cases for the commercial side of the bank to accept fiduciary deposits.

Short-term investment funds (or STIFs) present other challenges as a cash management vehicle for trust department cash. STIFs are a form of bank common trust fund invested in relatively short-term high quality debt instruments,[108] and only certain types of bona fide fiduciary account balances from the bank that maintains the STIF and its affiliated banks can be placed in them. Revocable grantor trusts, investment management and custody accounts, IRA and pension and employee benefit plan assets cannot be placed with the other trust assets in a STIF due to requirements of the Investment Company Act exemption within which STIFs operate.[109] This results in a relatively small investable balance for each STIF (compared to Money Funds) and therefore a substantial challenge in keeping the portfolio of the STIF fully

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[104] *See* 12 U.S.C. § 92a(d); 12 C.F.R. § 9.10.

[105] 12 C.F.R. § 9.10; *Md. Nat'l Bank v. Cumins*, 322 Md. 570, 588 A.2d 1205 (Md. 1991); *Van de Kamp v. Bank of Am. Nat'l Trust & Savs. Ass'n,* 251 Cal. Rptr. 530, 538 (Cal. Ct. App. 1988); *In re Orrantia's Estate,* 285 P. 266 (Ariz. 1930); *New England Trust Co. v. Triggs,* 135 N.E.2d 541 (Mass. 1956); *In re Doyle's Will,* 79 N.Y.S.2d 695 (N.Y. Surr. Ct. 1948); *In re Haigh's Estate,* 133 Misc. 240, 232 N.Y.S. 322 (N.Y. Surr. Ct. 1928); *Reid v. Reid,* 85 A. 85 (Pa. 1912).

[106] *Id.*

[107] 12 C.F.R. § 204.

[108] 12 C.F.R. § 9.18(b)(4)(ii)(B).

[109] Investment Company Act 3(c)(3) (exemption for bank common trust funds), 3(c)(11) (exemption for bank collective funds for pension and employee benefit plans); *In the Matter of Commercial Bank and Marvin C. Abeene*, SEC Rel. 33-7116 (Dec. 6, 1994).

invested in a diverse pool of high quality assets while matching the timing of cash flow requirements dictated by trust account investments in and redemptions from the STIF.[110]

One of the first major uses of Money Funds was to hold these trust department temporary cash balances. Money Funds provided a useful solution to bank trust departments which allowed them to invest balances of fiduciary accounts for short periods of times in an asset permitted by state fiduciary laws and trust instruments, at a competitive yield in a liquid, diverse pool of high quality debt instruments. Because a Money Fund can accept investors from many different banks' trust departments as well as other types of retail or institutional investors, a Money Fund can be much larger than a STIF and can accordingly achieve more portfolio diversification, better management of liquidity needs, and lower operating costs per dollar of assets, as compared to a STIF, and pay higher returns with less concentration of risk to trust accounts than a bank deposit. Use of amortized cost permits a Money Fund to anticipate NAV and share prices at the beginning of the day for the entire day (subject to the remote possibility that there will be an unexpected substantial credit event during the day that drops NAV below 99.5 cents per share), rather than needing to wait until after the close of the trading markets at 4 pm to know end-of-day NAV. This means the price of a Money Fund share can be anticipated at 6 am when the processing day begins.

Trust accounting systems interface with many different external systems on a daily basis. These include interfaces with systems of broker-dealer firms through which the trust department executes purchases and sales of securities for fiduciary accounts, systems providing notification of dividend and interest payments received through securities clearinghouses and payment agent banks, and systems for receiving and sending incoming and outbound payments through the banking system on behalf of fiduciary accounts. These electronic data communications generally involve a bilateral exchange of pending payment amounts stated in dollars and cents, which are followed subsequently by deliveries of those amounts.

In order to reduce errors and cash shortfalls, trust accounting systems typically post a debit to the cash position in the account immediately before or simultaneously with the placement of an order to purchase a security, which is transformed into a redemption order for shares of the Money Fund to generate cash to pay, the next day, for the security being purchased.[111] These accounting systems require a predictable Money Fund NAV share value at the time the redemption order is placed for (i) the cash position to match the cash needed to settle the purchase order and (ii) the ending balance reflected as available in the Money Fund to be accurate for processing any other transactions in the customer account that day.

Predictability in the per share price of Money Funds is critical to the operation of trust accounting systems, allowing them to be more fully automated (rather than relying on manual processes and the staffing costs, delays and errors associated with manual posting and processing of transactions and cash balances), allowing an exact sweep of cash balances to the penny, and

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[110] *See* Martin E. Lybecker, *Regulation of Bank Trust Department Investment Activities: Eight Gaps, Seven Remedies, Part II*, 91 Banking L.J. 6 12-14 (1974); Martin E. Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 Yale L.J. 977, 984-86 (1973).

[111] *See* Letter from ASC to Eugene F. Maloney (Oct. 16, 2008) (on file with recipient).

permitting same day processing of cash payments. This permits same day (T+0) or next day (T+1) settlement of portfolio securities transactions for fiduciary accounts, which in turn reduces the amount of settlement cash, "due to" and "due from" "float" in the trust department and overnight overdrafts and out-of-balance trust accounts. This, in turn, means less counterparty risk and shorter time for client fiduciary assets to be less than fully invested.

Federated has been informed by the vendors of each of the major trust accounting systems that their systems are not designed to process cash balances using Money Funds with a continuously floating NAV. Forcing Money Funds to move to a continuously floating NAV would make Money Funds incompatible with the major trust accounting systems. Until these trust accounting systems could be redesigned and reprogrammed either to accept a continuously floating NAV (assuming it could be done at all and trust departments would accept it) or use some other vehicle to hold cash balances, trust departments would essentially be forced to use more manual processing, returning them essentially to the 1970s.

Corporate Payroll Processing. Most companies pay their employees either twice per month or every two weeks. Generally, pay is disbursed to all employees on the same days. The pay is either distributed in a direct deposit to an account previously designated by the employee, or in a physical paycheck given to the employee. The aggregate amount of money involved in each payroll disbursement is very large. The bigger the company, and the larger its employee base, the larger is the aggregate amount of cash involved. The corporate treasury department manages its cash availability through a variety of short-term investments that are sufficiently liquid to address scheduled payments that must be made. Payroll is a very large and recurrent payment amount.

Pending distribution to employees, the cash must sit somewhere. Large companies commonly use third-party vendors to handle payroll processing, but employers are not eager to incur the credit risk of such vendors on payroll balances, even for a short period of time. For a given pay period, the aggregate payroll amount for a large company is many millions of dollars, well in excess of the standard $250,000 FDIC deposit insurance limits (which limits are only temporarily suspended on noninterest bearing demand deposits until year-end 2012). If the entire balance is placed on deposit at a bank, and the bank fails, the company is at risk of losing a large portion of the payroll balance in excess of $250,000. Companies with large payrolls are understandably anxious about limiting their loss exposure in the event of the insolvency of a bank. From the bank's perspective, many banks are not eager to take on multi-million dollar deposit balances for periods of a few days each month, because there are costs involved with having those balances on the bank's balance sheet and the bank is not able to profitably invest the cash for such a short period of time.

As an alternative, many large employers place cash pending distribution of payroll into Money Funds, with an automated sweep into the payment system and vendor used by the employer. A Money Fund knows in advance, through communications with the employer and experience, how much money is coming in and out and when it will arrive and depart, and is able to profitably invest the proceeds through the Money Fund's portfolio for a few days in short term instruments, carefully managing the cash position of the Money Fund with advance knowledge of the amounts and schedules of the payroll arrival and disbursement.

Key features that allow Money Funds to work to hold short-term balances for corporate payrolls pending distribution include the use of amortized cost and a stable NAV of $1 per share, which allows for a predictable value of share prices throughout the day (rather than needing to wait for end-of-day market close prices to know share prices and processing of purchases and redemptions after 4:00 p.m.) and same-day processing of investments and redemptions of shares. The bank that is processing the payroll distributions makes payments as checks and other items are presented through the banking system, and is able to redeem shares of the Money Fund and receive payment on a same day basis and avoid an overnight overdraft. If Money Funds were required to use a continuously floating NAV, purchases and redemptions would need to be processed on a next-day basis. This would require either (i) that large balances be redeemed and held as cash overnight or over a period of days as items are presented to the bank, creating an exposure by the employer to the credit risk of the bank for large amounts of money, or (ii) leaving the bank exposed to the risks associated with overnight overdrafts pending receipt of cash from the Money Fund or directly from the employer.

Moreover, if a continuously floating NAV is required for Money Funds, on a multi-million dollar balance, the value of the Money Fund shares would move around a small amount, such that the payment sent by the employer and held in the Money Fund for a few days would be a few dollars over or a few dollars short of the gross payroll amount each payroll period. This, in turn, would require more manual processing, creating more delays and errors, and significantly undermining the usefulness of Money Funds to employers, banks and payroll processors.

Corporate and Institutional Operating Cash Balances. In addition to payroll balances, companies have other payments received, as well as incoming cash from operations, and closely manage those cash balances in order to meet their payment obligations as they occur. Large companies typically have a corporate treasury management function to handle the liquidity needs and short-term investment of the company's assets.

The balances involved at a company at any given time can be very large. Due to low (or zero) interest rates on short-term corporate deposits and the risk of bank failure when balances are in excess of the $250,000 FDIC deposit insurance limits, leaving large amounts of cash on deposit at a bank is not a good alternative. Although the FDIC deposit insurance coverage on non-interest bearing demand deposits has been temporarily increased to an unlimited amount until December 31, 2012, that remains a short-term and not a highly attractive solution for corporate treasurers for holding large cash balances.[112]

Traditionally, larger corporate treasury departments managed cash balances by holding separately managed portfolios of direct investments in commercial paper, treasury bills, and other high quality short-term debt instruments. Many corporate treasurers have found it more efficient to invest a portion of those short-term balances in Money Funds. This allows for professional management at a lower cost of a diverse portfolio with greater liquidity than the

[112] The statutory deadline was imposed by Section 343 of the DFA and is codified in 12 U.S.C. 1821(a). As discussed below in Section II-D, further extension of unlimited deposit insurance would be inconsistent with the goal of reducing the size of the Federal safety net and would also further fuel the growth of the largest banks.

company's treasury desk could accomplish on its own. In this context, Money Funds are an alternative to an individually-managed portfolio of securities.

Use of amortized cost accounting which has resulted in nearly all circumstances over the past 35 years in a stable NAV of $1 per share provides a simple means for Money Fund balances to be integrated into the internal accounting and cash management systems used in corporate treasury departments. Same day processing of Money Fund share purchases and redemptions, which is not possible with a floating NAV Money Fund, allows Money Funds to be used more efficiently by corporate treasurers and permits a more automated interface among the internal accounting systems used by the corporate treasury department, the banks through which the company sends and receives payments, and the Money Fund's transfer agent. This, in turn, reduces float in the system, overnight overdrafts by the corporation's banks and the balances of the corporation with its banks in excess of FDIC deposit insurance limits.

Federal, State, Local Government Cash Balances. Like businesses, governments have cash management needs. Many state, local and federal government bodies use Money Funds as an efficient means to invest short term liquidity balances. Governments have payrolls to pay and operating cash balances to invest for short and medium periods of time. Government cash balances often are tied to tax payment cycles and expenditures tied to fiscal year budgets. Investment of the balances is subject to a myriad of state and local government requirements on investment of government assets, and in some cases to Internal Revenue Service requirements. These state and local laws commonly include lists of permitted investments that specifically authorize investments in Money Funds, defined in terms of a fund that seeks to maintain a stable net asset value per share.[113] A change to the regulatory requirements for Money Funds that precluded Money Funds from using amortized cost or seeking to maintain a stable net asset value per share would require many state and local government statutes to be amended by the state legislature to permit the continued use of Money Funds by the state or local government.

Although placing the funds on deposit at a bank is an alternative, government deposits frequently are required to be collateralized with high quality bonds,[114] which make them expensive for the bank to hold. Another alternative is for the state or local government to attempt to manage a portfolio of direct investments in individual money market instruments, although this is a more expensive, higher risk and ultimately less liquid means of investing cash balances of state and local governments than investing in Money Funds. An unintended consequence to a movement away from amortized cost and a stable value of $1 per share would be to diminish the ability of state and local governments to use Money Funds and to force them into less liquid, more expensive, higher risk alternatives for investment of cash portfolios.

Municipal Bond Trustee Cash Management Systems. State and local governments raise money for general operations and for specific projects through the issuance of municipal bonds. Each bond issuance has an indenture with a bank as bond indenture trustee and payment

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[113] *See, e.g.*, N.J. STAT. ANN. § 18A:20-37; S.C. CODE ANN.§§ 6-5-10(6), 12-45-220; Tex. Gov't Code Ann. § 2256.014 (West); COLO. REV. STAT. § 24-75-601; CONN. GEN. STATS. § 7-400(1)(B); MICH. COMP. LAW. §§ 129.91, 129.93; Op. Ind. A.G. No. 96-3 (Sept. 5, 1996).

[114] 12 U.S.C. §§ 1821(a)(2), 1823(e)(2).

agent to handle various aspects of the bonds' issuance, payment of interest and ultimate retirement. Substantial cash balances flow through the bond trustee and paying agent bank, with which cash payment must be made on time every time pursuant to the contractual terms of the bonds to avoid default. In many cases, the credit quality and credit rating of the bond issuance is tied to a very carefully developed cash management program designed to assure that there will be cash available to make scheduled interest payments and sinking fund retirements of the bonds. The trust indenture of the bond, as well as state and local government laws and IRS requirements dictate certain aspects of how and into what types of assets the cash balances can be invested pending payment or distribution.

Leaving large amounts of cash on deposit at a bank results in a concentration of credit exposure that in some cases is not acceptable to bondholders. In addition, because the liquidity balances flow through the bond trustee and payment agent over relatively short periods of time, a bank may not be able to profitably invest the cash on a short term basis. As a result, Money Funds are used in many cases to hold portions of the short term liquidity pending payment or distribution on scheduled dates.

Use of amortized cost accounting and a stable NAV of $1 dollar per share allows Money Fund balances to be integrated into the accounting systems used in the corporate trust department of the bank that serves as bond trustee. Same day processing of Money Fund share purchases and redemptions, which is not possible with a floating NAV Money Fund, allows Money Funds to be used more efficiently by the bond trustee and payment agent. This, in turn, reduces float in the system, overnight overdrafts by the payment agent bank and the balances of the issuer with its bank in excess of FDIC deposit insurance limits.

A trust company president described the importance of Money Funds with a stable NAV of $1 per share to the investment of cash amounts associated with municipal bonds as follows:

> Until the advent of money market mutual funds, state and local government entities investing bond proceeds for infrastructure projects were extremely limited in scope to the manner in which bond proceeds could be invested. The work that we did collectively to have state statutes passed to allow a broader investment product array by utilizing money market funds as "permitted investments" has allowed for the minimization of market risk . . . .
>
> If for some reason the maintenance of a stable $1.00 value by money market mutual funds is at risk, we will see a mass exodus of investors from the institutional side of the business, such as Reliance Trust Company. This exodus will expose all investors to increased processing costs, substantially greater risk and liability, limited choices of investment vehicles primarily because of statutory restrictions and far greater exposure to credit risk.[115]

[115] Letter from Anthony A. Guthrie, President, Reliance Trust Company to Eugene F. Maloney, Federated Investors, Inc. (Oct. 17, 2008) (on file with recipient).

Consumer Receivable Securitization Cash Processing. The structures used for issuance of mortgage-backed bonds and other securitizations of consumer receivables share some of the attributes and cash management needs of municipal revenue bonds, but the cash flows are far more complicated and less predictable. Many of the structures require an initial cash balance and additional retention, build-up and hold back of significant amounts of cash from payments received on the underlying consumer receivables as a "prefunded account" in order to assure timely payment of the senior tranches of the securitization.[116] These cash hold-backs serve some of the same purposes as a back-stop letter of credit from a bank, which may also be in place in addition to the cash hold-back. The prefunded account reduces the likelihood of the need to draw on the letter of credit and the potential size of that draw. Money Funds are used as a more efficient and lower risk alternative to direct investment by the indenture trustee of the prefunded balances in a portfolio of individual money market instruments.

Money Funds are used in some cases to hold portions of these cash balances, for essentially the same reasons described above -- Money Funds limit counterparty risk exposure to any one bank, and the stable NAV permits same day processing of share redemptions and more convenient inclusion of balances in the complex accounting systems needed to track payments and disbursements in these securitization structures.

The permitted instruments into which cash balances can be invested generally are specified in the trust indenture and other governing documents of the structure and cannot readily be changed after the securitization structure is launched and its securities sold to investors. Changing the regulatory attributes of Money Funds could compromise their role in holding short-term liquid assets in securitization structures.

Escrow Processing. Money is placed in escrow in connection with a variety of transactions ranging from the purchase of a home to corporate acquisitions. The basic purpose is similar -- to place a cash balance into the hands of an independent party to make a payment on a contractually specified amount when certain conditions are met. The amounts per customer may be a few thousand dollars for mortgage escrows to hold tax and insurance payments, or billions of dollars in a corporate M&A transaction. The funds may be held for a few hours, days or months. The amounts held by an escrow agent commonly exceed deposit insurance limits of $250,000. If pass-through deposit insurance treatment is not available, or if the amounts per ultimate beneficial owner exceed $250,000, allowing the escrow agent to place the escrow balance in a bank deposit may not be an acceptable risk to the parties. Escrow agreements commonly allow the parties to direct the escrow balances be held in shares of a designated Money Fund, as a way of limiting counterparty risk.

Money Funds are useful for this purpose because they do not represent the credit risk of a single issuer, but instead represent a diversified pool of high-quality short term debt obligations of many underlying issuers. In addition, because the value of the shares do not fluctuate, the escrow agent can hold an amount representing exactly what must be paid if the conditions to completion are met and the escrow amounts paid out on settlement. For escrows on purchases of

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[116] *See Federated Investors, Inc.*, SEC Staff Letter 1997 SEC No-Act LEXIS 716 (July 8, 1997).

companies with many shareholders, the accounting systems needed to assure exactly the correct amounts are paid to the proper shareholders are complex. Similarly, escrow agents that process mortgage-related tax and insurance escrows use complex automated accounting systems that must track and account for a large number of consumer escrow accounts each with different balances and payment amounts.

The use of amortized cost permits the share price of a Money Fund to be anticipated in the morning (because the daily amortization factors are known for each portfolio security) for the day, rather than known only after the closing of the markets at 4:00 p.m. This permits a share price to be used at a stable dollar amount throughout the day by the automated accounting and payment processing systems used by escrow agents. Moreover, the use of amortized cost also permits same-day settlement of purchases and redemptions of Money Fund shares. These two features – a stable share price throughout the day and same-day settlement – are key to the utility of Money Funds to hold temporary cash balances for escrow agents. If Money Funds were required to use a continuously floating NAV, they would not be as useful to escrow agents, the escrow agents' accounting systems would need to be redesigned and reprogrammed to accommodate a floating NAV, and payment cycles would be delayed by a day. If escrow agents continued to use Money Funds at all, there would be one extra day to closing required, and that delay means one extra day of counterparty risk. In addition, the cash balance would likely need to sit in a bank account overnight, adding the risk of bank failure during that period.

Custody Cash Balances and Investment Manager Cash Balances. Banks serve as custodians for securities accounts of commercial and individual customers. Securities purchases and sales orders are placed by the customer (or its investment adviser)[117] with a securities broker and the custodian bank is notified of the transaction. The custodian bank communicates settlement instructions with the broker-dealer. Custodial cash is commonly invested in Money Fund shares, in part because the cash balances commonly exceed the $250,000 FDIC deposit insurance limit. When it receives instructions to deliver cash to a broker-dealer to settle a transaction, the custodian bank redeems shares of the Money Fund. Same-day settlement of Money Fund shares (T+0) permits the cash to be available to settle the securities transactions the next day (T+1). With a continuously floating NAV, there would be an additional business day required to redeem Money Fund shares, which would move the settlement cycle for the securities transaction back one day (T+2).

401(k) and 403(b) Employee Benefit Plan Processing. Private employers over the past few decades have shifted from defined benefit retirement plans to defined contribution plans due to the high costs and potentially large unfunded liabilities associated with defined contribution plans. Two common and highly popular forms of participant-directed defined contribution plans are 401(k) and 403(b) plans, which draw their names from provisions of the Internal Revenue Code. Among the requirements applicable to these plans under the Department of Labor rules implementing the Employee Retirement Income Security Act (ERISA) are that, in order to limit the liability of plan trustees, a stable value option be included as part of the plan to hold cash

[117] *See* 17 C.F.R. § 275.206(4)-2 (customer accounts of registered investment advisers required to be held in custody of bank or broker-dealer).

contributions for which a participant has not yet provided investment instructions.[118] Money Funds are an investment option eligible to meet this requirement for up to 120 days.

In addition, cash balances in participant accounts must be segregated from the assets of the plan trustee and held during brief periods of time when a plan participant is changing the investment allocation of the participant's account. Money Funds serve this purpose within 401(k) and 403(b) plans.

The use of amortized cost and $1 per-share pricing at Money Funds allows for same-day settlement, and allows the value of shares to be known throughout the day. If Money Funds were required to use a continuously floating NAV, it might further delay the settlement of transactions and share prices could fluctuate very slightly and would not be known with certainty until after 4:00 p.m. each business day. This would limit the utility of Money Funds for use with the automated accounting and processing systems used by vendors that provide 401(k) and 403(b) plans, and if Money Funds continued to be used at all, would increase settlement times by at least one day, increase float in the system, require a process for reconciling and truing up order amounts to reflect small variations in the value of Money Fund balances and require a significant redesign and reprogramming of the accounting and processing systems used by 401(k) and 403(b) plans to accept a floating NAV Money Fund to hold temporary cash balances.

Broker-Dealer and Futures Dealer Customer Cash Balances. Customer accounts at securities broker-dealers carry cash balances that are used to make payments on amounts owed by the customer on purchases of securities. This cash belongs to the brokerage customer. Cash flows into the brokerage account through cash amounts added to the account by the customer, dividends and interest on investments held in the account, and from the proceeds of sales of securities.

If the brokerage customer's cash balance is not invested in something, it sits as a "free credit balance" which is simply a "due to" amount owed to the customer by the brokerage firm. To protect customers against the risk of a failure of the broker-dealer firm (and ultimately the SIPC which guarantees customer cash balances up to $250,000 per account), the broker-dealer is required to hold bank deposits or certain types of securities in a segregated account for the exclusive benefit of its customers, in an amount at least equal to the net unencumbered amounts of customer "free credit balances."[119]

As an alternative to holding customer cash as free credit balance liabilities of the broker-dealer, brokerage firms normally provide a cash sweep program by which customer cash balances are "swept" into investments in shares of Money Funds which are then owned by the customer but held in custody through the broker-dealer. Investment of the cash balances into Money Fund shares segregates these customer assets from the assets of the broker-dealer and removes them from the balance sheet liabilities of the broker-dealer.

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[118] *See* 29 C.F.R. § 2550.404c-5 (Department of Labor Qualified Default Investment Alternative Regulations).

[119] 17 C.F.R. § 240.15c3-3.

Because Money Fund redemptions settle same day (T+0), cash is available very quickly to pay for customer purchases of securities, or to receive incoming cash from the sale by the customer of a security. This same day cash availability is important to avoid customer "fails," and to assure compliance with the margin rule requirements applicable to brokerage accounts which require cash availability in the account when a customer places an order in a customer cash account and margin collateral coverage in a customer margin account.[120] In addition, the use of amortized cost and a stable NAV of $1 per share allows efficient processing of cash balances by the accounting system of the broker-dealer throughout the transaction processing cycle at a known and predictable amount, and communication with the accounting systems of the transfer agent of the Money Fund. This allows the use of Money Funds as a means to hold cash balances within the automated accounting and transaction processing systems used by the broker-dealers, which in turn reduces settlement times, pending transaction float balances and fails, and the counterparty risk in the system.

Similarly, rules of the Commodity Futures Trading Commission ("CFTC") require the segregation of customer cash balances at a futures firm used to pay for (and provide margin collateral for) futures transactions place by a customer.[121] Money Funds serve the same function at futures firms as they serve at securities broker-dealers -- hold customer cash balances, and to collateralize amounts due or potentially due on futures positions of the customer held through the futures firm. The CFTC reaffirmed the continued appropriateness of Money Funds to hold customer liquidity balances in December 2011 after careful review and a lengthy rulemaking proceeding.[122] The CFTC determined through this process that Money Funds satisfy the statutory objective that "customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers ... and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk"[123] as well as the Regulation 1.25 prudential standard that all permitted investments be "consistent with the objectives of preserving principal and maintaining liquidity."[124]

Broker-dealers and futures dealers are subject to regulatory requirements specifying the types of assets that the entity can own and the types of assets that can serve as collateral or be used to invest client cash balances. Many of these regulatory provisions specifically include as a permitted investment Money Fund shares that seek to maintain a stable net asset value per share.[125]

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[120] *See* Regulation T, 12 C.F.R. pt. 220. The margin rule treats Money Funds shares essentially as the equivalent of cash for this purpose.

[121] 17 C.F.R. § 1.20.

[122] CFTC, *Investment of Customer Funds and Funds Held in an Account for Foreign Futures*, 76 Fed. Reg. 78775 (Dec. 5, 2011) ("CFTC 2011 Release").

[123] CFTC 2011 Release at 5.

[124] *Id.* at 6, citing 17 C.F.R. § 1.25(b).

[125] N.Y. Mercantile Exchange Letter to Mr. Richard Recker, Federated Securities Corp. (May 18, 2001); Options Clearing Corp. Memorandum to all Clearing Members (Feb. 18, 2005).

The ability of securities broker-dealers and futures commission merchants to shorten settlement times and reduce the systemic risks associated with unsettled transactions has been facilitated by the ability of Money Funds to process purchases and redemptions of shares on a same day (T+0) basis, which in turn is only possible as a result of using the amortized cost method of accounting. Requiring Money Funds to use a continuously floating NAV would require them to move to next-day settlement and lengthen settlement times of securities transactions by at least one day. The securities industry has spent the past 35 years shortening settlement times to in order to reduce systemic risk. Using Money Funds to hold short-term cash balances in connection with the transaction settlement process has been an integral part of how that was accomplished. An unintended consequence of the movement of Money Funds to a continuously floating NAV (or the elimination altogether of Money Funds) would be longer securities transaction settlement cycles and an increase in systemic risk.

Cash-Management Type Accounts at Banks and Broker-Dealers. Brokerage firms and banks offer "cash management" type accounts that permit customers to access cash balances in their brokerage accounts by check or debit card. Millions of retail customers find these accounts to be convenient. Cash balances in these accounts are held either in Money Funds or in brokered deposits at banks. Checks and debit cards are processed by a bank for the brokerage firm. The payments of these items are funded by cash received from redemptions of Money Fund shares held in the customer's brokerage account. The bank runs nightly files of items presented for payment, which triggers a redemption of Money Fund shares. The bank advances payment on the items after confirming electronically Money Fund shares are being redeemed to repay the bank on the advance of Funds. The cash from the redemptions is then sent to the bank.

Processing the transactions is done on an automated basis, requiring a series of electronic data exchanges among the bank that issues the debit card and processes the checks, the brokerage firm that carries the customer's brokerage account, and the transfer agent of the Money Fund which processes the redemption requests and forwards payment to the bank.

Use of amortized cost and stable value of $1 per share is crucial to processing these accounts because it permits same-day processing of Money Fund share redemptions. This allows the bank to limit its credit exposure and avoid overdrafts and "NSF" or "bounced" checks. Use of a predictable $1 per share value is also critical to the interface among the accounting systems. The systems are programmed to work on a stable value of $1 per share. A continuously floating NAV would result in transactions being a few pennies over or short each day, which would require manual processing of the transactions. In the alternative, if the accounting systems were reprogrammed to address a continuously floating NAV by submitting the redemption request as a dollar amount rather than a number of Money Fund shares, the account balance remaining after a Money Fund share redemption is processed would be off by a few pennies per day, requiring inclusion of a larger buffer balance in the customer's account to ensure a sufficient available cash balance to avoid fails and overdrafts in subsequent transactions by the customer in the account, and additional work by the customer to keep track of available balances in the account.

For debit cards, there is a two step-process notification and payment of items is separated by a few days. First, at point of sale, the merchant sends an electronic signal through the banking system that the customer is buying something at a certain price, and the available balance is confirmed and a hold placed on that balance at the Money Fund. A few hours or days

later, the merchant submits the debits for payment through the banking system, which submits the items for payment to the bank that issued the debit card and, which makes the payments. The bank then sends a signal to redeem the Money Fund shares that are on hold, to repay the bank for the advance. If the Money Fund shares continuously floated up and down in price between the time between when the hold was placed and the shares redeemed, the payments would be off a little bit each time, requiring manual processing. If same day settlement of Money Fund redemptions were not available, the bank would not be reimbursed on the same day that it advanced payment on the debit card items. Same-day cash would not be available to the entity "sourcing" the transaction. This would require cash funding flow changes throughout the funding chain and could require some participants in the process to carry an overnight overdraft until the cash arrives the next business day. Additionally, as entities authorizing debit/POS/ATM transactions based on an "Available Balance" data delivered to them by the transfer agent or brokerage platform, that balance could be slightly off as the shares representing that balance change based on end-of-day floating NAV pricing. Currently, these workflows and systems all assume a stable NAV of $1 per share throughout the chain of processing and same day processing of Money Fund share redemptions. Any change to that assumption will require a retooling of the workflow and cashflow timing to accommodate cash availability and delivery.

Banks offer a substantially similar product without the brokerage account. In the bank version, the bank offers a checking account with a debit card and ATM access, with balances above a set dollar minimum (which often is $0) swept into shares of a Money Fund.[126] The bank pays items after they are presented and after verifying there are enough Money Fund shares owned by the Customer. The bank places an order to redeem Money Fund shares to repay the advance.

[126] *See* 1934 Act § 3(a)(4)(B)(v) (Money Fund sweep account exemption for banks in definition of securities "broker"), Regulation R, 12 C.F.R. § 218.741, 17 C.F.R. § 247.741 (same).