

# The Systemic Risk Council

January 18, 2013

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

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform  
Docket: FSOC-2012-0003

Dear Financial Stability Oversight Council:

The Systemic Risk Council<sup>1</sup> (SRC) is writing to commend and support the FSOC for seeking public comment on proposals to reform money market funds. It has been more than four years of study since taxpayers were forced to guarantee money market funds and the structural risks remain. We believe strong reform – namely strong capital or a floating NAV – is essential to protecting the financial markets from the systemic risks posed by money market funds. Never again should policymakers be forced to choose between a financial meltdown or a taxpayer bailout of money market funds.

**The Systemic Risk Council Supports the FSOC's Efforts to Reform Money Market Funds.** As we have previously noted, the SRC believes prompt and decisive action is needed to curb systemic risks posed by money market mutual funds. When the Reserve Primary Fund “broke the buck” in 2008, extraordinary actions were required to back-stop and calm investors in money market funds and protect the short-term lending markets. The risk that emergency government support may again be needed to stem destabilizing runs from money market funds remains a serious challenge for policymakers. The SRC applauds former SEC Chairman Mary Schapiro, FSOC Chairman and Treasury Secretary Timothy Geithner, and members of the FSOC for their vigilance on this issue and we support strong capital or floating NAV as appropriate policy responses.

Given the current impasse at the SEC, we encourage the FSOC to use the full range of authorities given it under Dodd-Frank to effectuate needed reforms. These authorities include using Section 120 to formally recommend that the SEC move forward on reform, and using Title 8 to designate certain money market mutual fund “activities” as “systemically important” – and requiring that the SEC impose heightened risk management standards as the FSOC determines necessary to address the risk. Clearly the SEC is best positioned to address this issue most efficiently, but, given the SEC's unwillingness to act with the necessary speed and strength, the FSOC should push ahead with all its existing authority until the SEC promulgates, and makes effective, rules that the FSOC agrees will address this systemic risk.

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<sup>1</sup> Systemic Risk Council: The independent non-partisan Systemic Risk Council was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This letter fairly reflects the consensus views of the Council, but does not bind individual members. [www.systemicriskcouncil.org](http://www.systemicriskcouncil.org)

**The Stable NAV is the Cause of Money Funds' Structural Weakness.** Money market funds are used as “cash management” products – often as bank deposit substitutes – that, like deposits, are redeemable on demand. Unlike deposits, however, they have no capital, no insurance, no access to Federal Reserve liquidity and no legal requirements that their parent companies operate as a “source of strength.” While the value of their underlying assets change with the market every day *like every other mutual fund*; unlike every other mutual fund, the SEC permits money market funds to price their shares at a \$1.00 even when the value of the assets underlying the fund are not worth \$1.00. As has been highlighted at length by the FSOC, President’s Working Group on Financial Markets, SEC, and others, this special exemption creates significant structural instability that – given the enormous role played by money market funds in the global lending markets – exacerbates crises and can threaten the functioning of our financial markets. We believe the structural weakness must be addressed head-on: either through strong capital requirements or a floating NAV.

**Floating NAV is the Simplest and Most Direct Solution.** As noted in the FSOC proposal, money market funds’ unique pricing convention is a structural weakness that makes them vulnerable to destabilizing runs. This weakness can best be addressed by requiring that money market funds – like all other mutual funds – simply price their shares accurately (i.e., to reflect the market price of the fund’s underlying assets). This floating NAV would reinforce the fact that these funds are “investment products” whose value is subject to change and not stable \$1.00 deposits. Linking money funds’ price to the value of the underlying assets would dramatically reduce the threat these funds pose to the financial system in times of crisis while making the market more flexible and resilient.

Eliminating this artificial pricing convention and making money funds operate like other mutual funds would also substantially reduce the structural incentives investors now have to flee money funds en masse during a crisis. First, it would simply remove the “cliff” associated with “breaking a buck” making money fund pricing and the markets more flexible and dynamic. Second, with a floating NAV investors would be much more likely to use MMFs as “investment products” rather than being lured into treating MMFs as risk-free cash substitutes for bank deposits and treasury securities. Finally, with the floating NAV money market fund investors – like all other mutual fund investors today – would actually bear some of the liquidity and credit costs that their redemptions impose on the fund. This would dramatically reduce the pro-run arbitrage opportunity that exists in money market funds today and has been highlighted by the FSOC and SEC staff.<sup>2</sup>

Floating NAV avoids a number of unintended consequences that flow from a stable NAV. As a direct capital market product, investors in a floating NAV money market fund would receive the benefit of good investment decisions (a higher NAV) – and suffer the consequences of bad investment decisions (a lower NAV). This provides more market accountability and better investment decisions. Right now – with the stable NAV – fund investors have a host of perverse incentives. In addition to the arbitrage incentive noted above, implicit sponsor support gives investors an incentive to invest in funds with large institutional sponsors, because those sponsors might be more likely (or able) to support their funds. This moral hazard fuels the growth of larger fund sponsors (often large, complex financial institutions) and reduces the efficient allocation of capital.

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<sup>2</sup> See, most recently, SEC Staff Report on Money Market Funds “Response to Questions Posed by Commissioners Aguilar, Paredes and Gallagher,” (November 30, 2012) at 3. <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>

A floating NAV would also reduce the unintended consequences that flow from rule 2a-7 – namely that the government, through the stable NAV fiction, is encouraging funds to flow to certain assets (those that are 2a-7 eligible). This concentrates short-term “risk averse” funding into this “government sanctioned” pool and changes the flow of credit in the market place.

Finally, the risks associated with a stable NAV fund “breaking the buck” result in the SEC spending an inordinate amount of staff time and resources monitoring MMF exposures and compliance with 2a-7. Without a “buck” to break, floating share prices would greatly reduce the need for SEC staff to constantly try to monitor money fund exposures and identify where “breaks” might happen.

**Strong Capital Requirements Would Also Be An Improvement But This Approach Has Shortcomings.** Strong capital requirements would provide an important improvement to the existing money market fund structure by providing an *explicit* buffer against losses that would help protect fund investors – and the public – from a destabilizing run in money market funds. It is, however, a second best option for several reasons:

Capital is difficult to set and imperfect. Capital is a very good shock absorber for financial intermediaries. That being said, the amount of capital needed to avoid another Lehman Brothers/Reserve Primary Fund event is high. Given the lack of data and impossibility of modeling future events, even this number runs the risk of being too high, or too low to protect the system in the future. While we would shy on the side of *3 percent or higher*<sup>3</sup> to better protect taxpayers and the financial system from uncertainties, we worry that policy makers might be pushed to select a lower number. Unfortunately, too little capital could provide a false sense of security in a crisis.

Capital would create another layer of oversight and market complexity. Not only would the SEC continue to have to diligently monitor money market funds’ holdings, it would have to monitor their capital relative to those holdings as well. To be effective, this would require more filings, examinations and oversight. Moreover, to test the standards and avoid gaming or other unintended consequences these capital standards would need to be periodically tested and revised. Not only does this level of oversight require significant resources that the SEC currently lacks – it also is premised on a “prudential” approach to oversight and regulation rather than the SEC’s traditional “market” regulation approach. Having this capital backstop could also further *increase* the incentives for investors to move into money funds and, as a consequence, 2a-7 eligible investments relative to similar investments that are *not* 2a-7 eligible.

Capital requirements would likely encourage money market fund consolidation – particularly toward larger bank-affiliated sponsors (who traditionally have, and can access, more capital than traditional, independent asset managers). If so, this could further concentrate systemic risk from these institutions, and create conflicts of interest in the short-term funding markets (as fewer money funds would control a larger share of the short-term lending markets). Floating NAV, by contrast, allows all money funds to compete equally based on their asset management, rather than on sponsor support.

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<sup>3</sup> While we agree that certain *permanent* hold-back provisions or redemption fees could supplement the protections potentially justifying a lower capital number, such arrangements would also add new layers of complexity and unintended consequences.

**Other options: e.g., lower capital levels, higher liquidity thresholds or temporary gates or fees that come down in a crisis do not address the structural problem of the \$1.00 NAV.** These weaker approaches could make a crisis worse by providing a false sense of security and moving up a run on money market funds.

A floating NAV, by contrast, does not suffer from these shortcomings. It is the same, simple, regulatory framework (and tax and accounting treatment) that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.

Respectfully submitted,



The Systemic Risk Council

[www.systemicriskcouncil.org](http://www.systemicriskcouncil.org)

*Chair:* Sheila Bair, The Pew Charitable Trusts, Former Chair of the FDIC

*Senior Advisor:* Paul Volcker, Former Chair of the Federal Reserve Board of Governors

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John Rogers, CFA, President and Chief Executive Officer, CFA Institute

Chester Spatt, Tepper School of Business Carnegie Mellon University, Former Chief Economist,  
Securities and Exchange Commission

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cc:

The Honorable Luis Aguilar, Commissioner, Securities and Exchange Commission

The Honorable Daniel Gallagher, Commissioner, Securities and Exchange Commission

The Honorable Troy Parades, Commissioner, Securities and Exchange Commission