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February 28, 2011

Ananda K. Radhakrishnan
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Washington, DC 20581

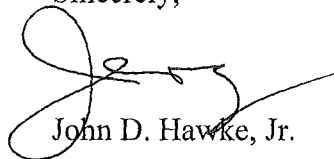
Dear Ananda:

Thank you for meeting with us last week. We greatly appreciate the time and attention that you and your colleagues gave us in discussing the Commission's recent rulemakings as to the use of shares of money market mutual funds ("money funds") for investment of swaps collateral and to hold customer cash. We intend to follow up shortly with additional thoughts in this regard. In the meantime, enclosed is a copy of comments we submitted on behalf Federated, to the Financial Stability Oversight Council on supervision and regulation of nonbank financial companies.

We appreciate the Commission's focus on the liquidity of money funds. In this regard, as you consider the proposed new rules, we would like to draw your attention to the SEC's recent amendments to Rule 2a-7 (see enclosed letter at 17-24). In particular, we note that money funds must now be able to redeem shares at a price based on current NAV even if the fund breaks the buck (see enclosed letter at 21). Essentially, this provision requires a money fund to move to a floating NAV, recognize portfolio losses and promptly honor redemption requests at less than a dollar in that event. This new requirement will enhance liquidity at money funds in the context of a money fund "breaking a buck" and address concerns on the ability of futures commission merchants and others to quickly access money invested in a Money Fund in that circumstance.

I hope that the enclosed letter will be helpful to you as you move forward. We appreciate the opportunity to provide you with our thoughts.

Sincerely,



John D. Hawke, Jr.

cc: Gary Gensler, Chairman

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February 24, 2011

Submitted By Electronic Transmission
Via www.regulations.gov

Financial Stability Oversight Council
Attn: Lance Auer
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Notice of Proposed Rulemaking Regarding Authority to Require
Supervision and Regulation of Certain Nonbank Financial Companies,
12 C.F.R. Part 1310. RIN 4030-AA00

Dear Ladies and Gentlemen:

I. Introduction and Summary of Conclusions

We are writing on behalf of our client, Federated Investors, Inc. and its subsidiaries (“Federated”), to provide comments in response to the Financial Stability Oversight Council’s (“Council’s”) Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (“NPR”).¹ Federated has served since 1974 as an investment adviser to money market mutual funds (“Money Funds”).² We appreciate the opportunity to assist the Council as it considers the regulatory framework proposed in the NPR.

¹ See Financial Stability Oversight Council, *Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 76 Fed. Reg. 4555, Jan. 26, 2011.

² Federated has more than thirty-five years in the business of managing Money Funds and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated’s Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating Money Fund to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

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The three purposes of the Council under Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“DFA”) are: to identify risks to the financial stability of the U.S. that could arise from large interconnected bank holding companies, nonbank financial companies or otherwise; to promote market discipline by eliminating expectations that the Government will shield shareholders, creditors, and counterparties of such companies from losses if they fail; and to respond to emerging threats to the stability of the U.S. financial system.³

Section 113 of DFA gives the Council authority to designate a U.S. nonbank financial company for supervision by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and subject it to the prudential standards of Title I if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, could pose a threat to the financial stability of the U.S. The NPR requests comments concerning the criteria proposed by the Council for its use in exercising this authority and the processes used in information-gathering, consultation with primary regulators, and in designations and appeals from designations. The designation criteria set forth in the proposed rule in most respects track the statutory criteria for designation and generally contain appropriate criteria for the Council to consider in making a determination under Section 113. Unfortunately, however, despite having published an Advance Notice of Proposed Rulemaking (“ANPR”) and received extensive public comments on these criteria before issuing the NPR, the NPR fails to describe the qualitative or quantitative considerations to be used in making assessments with regard to any of them and simply regroups the ten statutory criteria, for discussion purposes, into six categories. A purpose of an implementing rule, and an administrative rulemaking process, is to provide an analytical framework and context for the individual determinations that the Council will make in designating particular firms under Title I. Under the rule, firms notified of a proposed designation will have 30 days or less to respond as to why they should not be so designated. Without more context and elaboration in the rule, it will be difficult for a firm receiving that Council notice to know how to respond or what criteria or facts are relevant to include in a response.

We believe, as did many commentators on the Council’s ANPR, that one metric in particular should outweigh all others and should be used to exclude a firm from designation: “those firms that are already subject to consolidated supervision and/or heightened reporting requirements.”⁴ We believe that this exclusion from designation under Section 113 should apply where (1) the Council has access to comprehensive and timely information concerning the firm, either through its primary regulator or directly, and (2) the primary regulator is a member

³ Pub. L. No. 111-203, § 112.

⁴ 76 Fed. Reg. at 4557.

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organization of the Council and has comprehensive supervisory and rulemaking authority over the type of entity comparable to those of the Federal Reserve. If this criteria (the eighth criterion listed in Section 113 and the sixth criterion as grouped in the NPR), is given an appropriate weight in light of the purposes of the statute and its interaction with other programs of federal oversight and regulation, Money Funds would not be designated for regulation under Title I of the DFA.

For the reasons discussed in this Letter, Money Funds registered with the Securities and Exchange Commission (“SEC”) should not be designated for regulation by the Federal Reserve under Section 113. We note as an initial matter that it is far from clear that *any* open-end investment company (e.g. a mutual fund), including a Money Fund, is within the definition of a “nonbank financial company” that is subject to designation under Title I of the DFA.⁵

Moreover, even if Money Funds were deemed to be “nonbank financial companies” within the meaning of Title I of DFA, Federal Reserve prudential regulation would be inappropriate and unnecessary in view of the SEC’s authority, regulation and oversight over Money Funds – including its recent amendments to Rule 2a-7 under the Investment Company Act of 1940 (“Investment Company Act”) and related rules, as well as its continuing review of these issues, a review in which we understand the Council will participate. Moreover, although the Council has yet to develop recommendations concerning the prudential standards under Section 115 of the DFA for entities designated for Federal Reserve regulation, it is clear that the

⁵ Section 102 of DFA defines the universe of “nonbank financial companies,” that potentially are subject to designation under Title I, by reference to the financial powers of Section 4(k) of the Bank Holding Company Act, 12 U.S.C. 1843(k) (the “BHC Act”). Section 4(k) in turn has its own list of activities, including those permitted under Section 4(c)(8) of the BHC Act and Regulation K, 12 C.F.R. § 211. Other parts of the BHC Act (Sections 4(c)(5), 4(c)(6) and 4(c)(7) of that Act) authorize investing in securities and in investment companies, and 4(c)(8) and Regulation K have been interpreted by the Federal Reserve to include sponsoring, advising, administering and providing other services to open-end and closed end investment companies, as well as dealing and underwriting in securities (as contrasted to investing, reinvesting and trading). But the Federal Reserve has gone out of its way *not* to determine that being, or controlling, an open-end investment company is a permitted Section 4(c)(8) or 4(k) activity. See 12 C.F.R. §§ 211.10(a)(11), 225.28(b)(6), 225.86(b)(3), 225.125; *Petition of the United States in Board of Governors of the Federal Reserve System v Investment Company Institute* (in U.S. Supreme Court Docket No. 79-927, October Term, 1979), 450 U.S. 46 (1981). The Federal Reserve has *not* reinterpreted these provisions in wake of the Gramm Leach Bliley Act’s 1999 repeal of Section 20 of the Glass-Steagall Act to permit bank holding companies or financial holding companies to be or control an open-end investment company using BHC Act Section 4(c)(8) or 4(k) powers. Because the Federal Reserve has not determined that being or controlling an open-end investment company is an eligible activity under those provisions, it would appear that the activity of being an open end investment company is not a “financial” activity and thus mutual funds are not “nonbank financial companies” for purposes of Title I of Dodd Frank. *Cf. Citicorp v Bd. of Governors*, 936 F.2d 66 (2d Cir. 1991), *cert. denied* 502 U.S. 1031 (1992) (Federal Reserve Board cannot simultaneously interpret the BHC Act in two different, conflicting ways).

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general standards identified by statute in Section 115 and Section 165 (directing and authorizing the Federal Reserve to adopt prudential standards for supervised nonbank financial companies) are either addressed in current regulation of Money Funds in a manner far more robust than for other financial institutions (*e.g.*, Money Funds' lack of leverage, liquidity requirements, resolution plan, enhanced public disclosure, and overall risk management requirements) or are requirements (*e.g.*, risk-based capital requirements) which, if applied to Money Funds, would undermine their vitally important role in providing highly liquid investments for individuals and institutions and critical short-term funding for issuers and others who rely upon them.

In October 2010, the President's Working Group on Financial Markets ("PWG") issued its Report on Money Market Fund Reform Options ("PWG Report" or "Report").⁶ The Report acknowledges the concern of financial regulators that, notwithstanding the Money Fund reforms adopted by the SEC earlier this year, more should be done to address Money Funds' susceptibility to runs, such as the run precipitated by the bankruptcy of Lehman Brothers Holdings, Inc. ("Lehman") in September 2008 and the resulting losses at the Reserve Primary Fund, which held Lehman commercial paper. While the Report sets forth eight policy options which its drafters suggest could mitigate the susceptibility of Money Funds to runs, the discussion of the various options is accompanied by a sobering discussion of the potential serious and adverse ramifications – for investors, issuers, other financial market participants, and taxpayers – of the various courses of action. Thus, after an 18-month review, the PWG recommended further study and public comment.

The process recommended by the PWG that the SEC publish the various options in the PWG Report for public comment and that the Council also review these matters is the appropriate process to address any remaining concerns regarding Money Funds. During the comment period on the Council's earlier ANPR release, the SEC requested comments on the PWG Report and received over 75 public comments not only from the fund industry but also from a broad range of state and local governments, large and small businesses, retail investors and other members of the public.⁷ With only three exceptions,⁸ the commenters overwhelmingly supported the retention of the current program of SEC regulation of Money Funds and stable NAV, with continued incremental improvements to the SEC's program of Money Fund

⁶ REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS - MONEY MARKET FUND REFORM OPTIONS (Oct. 2010), *available at* <http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf>.

⁷ Submissions in response to the SEC's Request for Comment on PWG Report are available at: <http://www.sec.gov/comments/s7-04-09/s70409.shtml>.

⁸ Letters from Federal Reserve Bank of Richmond President Jeffrey Lacker (*available at* <http://www.sec.gov/comments/4-619/4619-54.pdf>); Paul A. Volcker (*available at* <http://www.sec.gov/comments/4-619/4619-79.pdf>); Shadow Financial Regulatory Committee (*available at* <http://www.sec.gov/comments/4-619/4619-81.pdf>).

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regulation.⁹ This is an overwhelming affirmation -- from industry participants, issuers, and other users of Money Funds -- that the SEC's regulation of Money Funds, including its more recent rules to strengthen Money Fund regulations, is appropriate and more than sufficient.

Section 113 designation and the accompanying Federal Reserve prudential regulation of nonbank financial companies are best utilized to address large, systemically important institutions that previously lacked comprehensive consolidated supervision (or, if they were subject to it, were inadequately supervised) and which, when overly dependent upon the short-term markets, pose the threat of creating the type of panic in the short-term markets that occurred in September 2008. Indeed, it was the precarious state of these entities and their exposure to the collapse in mortgage-related instruments that caused the 2008 market panic. Section 113 designation is unnecessary, inappropriate, and potentially harmful if applied to Money Funds.

The major points in this letter are as follows:

- Money Funds are a regulatory success. They are subject to robust regulation by the SEC, which has an excellent record in its oversight of Money Funds and a superior track record in this area in comparison to bank-type prudential regulation.
- Section 113 designation is for individual companies, not for an entire industry as a whole. There are over 650 separate Money Funds. Money Funds generally are not permitted to lend to one another or co-invest as groups. As a result, unlike banks, the financial conditions of different Money Funds are not linked to one

⁹ See e.g., Letters from the Financial Services Roundtable; Port of Houston Authority; Cincinnati/Northern Kentucky International Airport; Treasurer of the State of New Hampshire; the Business Council of New York State; Dallas Regional Chamber; Associated Industries of Florida; New Jersey Chamber of Commerce. Letter filed by the following associations of state and local entities: the American Public Power Association; the Council of Development Finance Agencies; the Council of Infrastructure Financing Authorities; the Government Finance Officers Association; the International City/County Managers Association; the International Municipal Lawyers Association; the National Association of Counties; the National League of Cities; the National Association of Local Housing Financing Agencies; the National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Treasurers and the U.S. Conference of Mayors. Letter from the following businesses and associations: Agilent Technologies, Inc.; Air Products & Chemicals, Inc.; Association for Financial Professionals; The Boeing Company; Cadence Design Systems; CVS Caremark Corporation; Devon Energy; Dominion Resources, Inc.; Eastman Chemical Company; Eli Lilly & Company; Financial Executives International's Committee on Corporate Treasury; FMC Corporation; Institutional Cash Distributors; Kentucky Chamber of Commerce; Kraft Foods Global, Inc.; National Association of Corporate Treasurers; New Hampshire Business and Industry Association; Nissan North America; Pacific Gas and Electric Company; Safeway Inc.; Weatherford International; U.S. Chamber of Commerce.

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another. They cannot be lumped together as a single entity and designated significant under Section 113.

- Individual Money Funds should not be designated for prudential regulation by the Federal Reserve under Section 113. The prudential standards specified for Section 113 entities under the Federal Reserve's Section 165 authority are either addressed in current Money Fund regulation in a manner far more robust than for other financial institutions, or they are an inappropriate fit for Money Funds.
- Because Money Funds are already subject to comprehensive SEC regulations and the SEC has robust regulatory tools to address any situation in which a Money Fund presents undue risk, Money Funds should be excluded from designation where (1) the Council has access to comprehensive and timely information concerning the Money Fund, either through the SEC or directly, and (2) the primary regulator, the SEC, is a member organization of the Council and has comprehensive supervisory (examination, reporting and enforcement powers) and rulemaking authority over Money Funds comparable to those that the Federal Reserve exercises over bank holding companies or that the Federal Reserve can exercise over Section 113 designated nonbank financial firms.
- Regulators should proceed with caution on changes to Money Fund regulation that would impose undue burdens on their continued operation or that would create in investors an expectation of a *de facto* federal guarantee.
- There are major flaws and gaps in the NPR, both substantive and procedural, including the failure to describe with specificity the quantitative and qualitative considerations to be used in making designations, the failure to propose exemptions as required by Section 170 of the DFA, failure to consider the impact on small business, failure to evaluate the paperwork and reporting burden associated with the proposed rules and related expansion of the mandate to designate firms as systemically important well beyond what was contemplated by Congress, failure to address the Constitutionality of Titles I and II of the DFA on which the rule is based, and proposal of the rules before the Council has been fully constituted with all of its statutorily-required members.

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II. Money Funds Represent a Regulatory Success, Particularly As Compared to Regulation of Depository Institutions

History and Importance of Money Funds

Money Funds are leading investors in the short-term debt instruments that are issued and traded in the “money market,” including Treasury bills, bankers’ acceptances, certificates of deposit, federal funds and commercial paper.¹⁰ The money market is the single most important source of liquidity funding for the global financial system. It permits large institutions to meet short-term borrowing needs and invest cash holdings for brief periods. Issuers in the money market include companies whose financial strength allows them to issue commercial paper directly to buyers, without credit support or collateral. Other companies issue “asset-backed” commercial paper, secured by the pledge of mortgage loans, auto loans, credit card receivables, or other assets. Federal, state and local governments also use the money market to meet liquidity needs by issuing short-term paper, including municipal paper and Treasury bills. The Federal Reserve utilizes Money Funds in its reverse repurchase program.

Money Funds were first offered in the U.S. in 1971 as a way to preserve investor principal while earning a reasonable return – and for the first time made a market interest rate available to retail investors. They have become widely held by many types of investors and are subject to pervasive regulation and oversight by the SEC. Due in large part to SEC rules that require them to invest exclusively in specific high-quality, short-term instruments issued by financially stable entities, they also have enjoyed a high degree of success, greatly increasing in number and in assets under management. Thus, Money Funds are now among the most widely held, low-risk and liquid investments in the world.¹¹

For investors of all types, Money Funds offer numerous benefits. They come in several forms, including both taxable funds (which invest in securities such as Treasury bills and commercial paper) and tax-free funds (which generally invest in municipal securities). Funds

¹⁰ Commercial paper consists of short-term, promissory notes issued primarily by corporations with maturities of up to 270 days but averaging about 30 days. Companies use commercial paper to raise cash for current operations as it is often cheaper than securing a bank loan. Federal Reserve Board, *Commercial Paper*, available at <http://www.federalreserve.gov/releases/cp/about.htm>.

¹¹ According to the Investment Company Institute, as of February 16, 2011, Money Funds had over \$2.7 trillion in assets under management. See Investment Company Institute, *Money Market Mutual Fund Assets*, Feb. 17, 2011, available at http://www.ici.org/research/stats/mmf/mm_02_17_11. Investment Company Institute historical weekly money market data show that assets under management have declined significantly since January 2009. As of January 7, 2009, Money Funds had over \$3.8 trillion in assets. See Investment Company Institute, *Weekly Total Net Assets (TNA) and Number of Money Market Mutual Funds*, available at http://www.ici.org/pdf/mm_data_2010.pdf.

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that invest in short-term corporate and bank debt, but not government securities, are also known as “prime” Money Funds.¹² Investors can choose between and among funds that offer slightly higher yields, funds that offer less credit risk, and funds that offer tax advantages. For institutional investors, Money Funds offer low cost, convenient ways to invest cash in the short-term. Many institutional investors, including companies and governmental entities, have cash balances swept from their operating accounts into Money Funds on a nightly basis. For retail investors, Money Funds continue to offer a low-risk, low-expense way to diversify liquid holdings.

Based on Investment Company Institute data, as of December 2010, there were approximately 652 Money Funds.¹³ As of February 16, 2011, Money Funds held over \$2.7 trillion in assets under management.¹⁴ Money Funds account for investments in almost 40% of outstanding commercial paper, approximately two-thirds of short-term state and local government debt, and a substantial amount of outstanding short-term Treasury and federal agency securities.¹⁵ During the more than 25 years since Rule 2a-7 was adopted in 1983, over \$335 trillion has flowed in and out of Money Funds.¹⁶

Performance Comparison of Money Funds to Bank Failures

In their early years, banks and their trade associations viewed Money Funds as competitors for retail business, and supported efforts to subject Money Funds to “bank-like” or “prudential” supervision.¹⁷ Policy makers, however, recognized that bank-like regulation would

¹² See Sue Asci, *Prime Money Funds See Recent Inflows*, Investment News, Feb. 22, 2009.

¹³ Investment Company Institute, *Trends in Mutual Fund Investing*, Jan. 27, 2011, available at http://www.ici.org/research/stats/trends/trends_12_10.

¹⁴ Of this amount, retail Money Funds held an estimated \$932 billion of this sum, while institutional funds held close to \$1.8 trillion – though this distinction is somewhat arbitrary. Investment Company Institute, *Money Market Mutual Fund Assets*, Feb. 16, 2011, available at http://www.ici.org/research/stats/mmf/mm_02_17_11.

¹⁵ See REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 7, available at <http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf>.

¹⁶ See Investment Company Institute, *Report of the Money Market Working Group*, Mar. 17, 2009 (hereinafter “ICI Money Market Working Group Report”), at 38, available at www.ici.org/pdf/ppr_09_mmwg.pdf.

¹⁷ See, e.g., *Shooting at Money Market Funds*, Time, Mar. 23, 1981, available at <http://www.time.com/time/magazine/article/0,9171,952946,00.html>. The article states that that banking and savings institutions had “undoubtedly been hurt by the Money Funds” and that “banks and savings and loans have launched drives to bring them down... Last week the U.S. League of Savings Associations urged the Government to impose sharp restrictions on the money market funds and asked the Federal Savings and Loan Insurance Corporation to pledge up to \$7 billion in low-cost loans.” The article further notes that “Senate Banking Committee Chairman Jake Garn of Utah wants to prevent money market funds from offering check-writing privileges; Congressman James

Footnote continued on next page

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effectively kill off what has become not only an important investment choice for millions of individuals and institutions,¹⁸ but also a highly efficient and essential mechanism to fund the needs of business and government borrowers in the short-term market.¹⁹

Moreover, Money Funds have enjoyed a stunningly superior safety record compared to insured depository institutions. Only two Money Funds have “broken the buck” and returned shareholders less than 100 cents on the dollar: the Community Bankers U.S. Government Fund, which in 1994 repaid its investors 96 cents on the dollar,²⁰ and the Reserve Primary Fund, which

Footnote continued from previous page

Leach of Iowa has introduced a bill that would diminish the funds' appeal by setting reserve requirements on them... The funds are also under heavy assault in several state legislatures.” See also Karen W. Arenson, *Volcker Proposes Money Funds Be Subject to Rules on Reserves*, N.Y. TIMES, June 26, 1981 (noting that former Federal Reserve Chairman Paul A. Volcker testified before a Congressional subcommittee that money market funds should be subject to regulations that would make them more competitive with banking institutions and less attractive to investors. Mr. Volcker also testified that reserve requirements were a key part of monetary policy and because they could not be removed from banking institutions, also should apply to other investment vehicles); Beatson Wallace, *Money Funds Aren't Banks*, BOSTON GLOBE, May 21, 1981 (noting that “[m]oney market funds continue to be the whipping boy of the banking industry and the delight of the small sum investor.”) The article explains that Treasury Secretary Donald T. Regan testified that “imposing new controls on our financial markets would be the wrong approach to assisting the thrift industry,” but that nevertheless Senator Jake Garn “persists in his effort to curry support for legislation to curb the funds' check-writing feature and make the funds maintain a percent of their assets in a reserve account.”

¹⁸ See, e.g., *Competition and Conditions in the Financial System*, Hearings Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 97th Cong., 939 (1981) (statement of former SEC Commissioner John R. Evans, who testified that “we are very concerned with suggestions that legislation should be enacted which would impose bank-type regulation on money market funds to the detriment of [public] investors.” Noting that “many depository institutions are having difficulty attracting savings during a period when money market funds are experiencing dramatic growth... We can understand why certain depository institutions might like their competitors to be restricted. We believe, however, that any consideration of legislation to impose bank-type regulatory burdens and limitations on money market funds should include an evaluation of the existing regulation of such funds, the present protection provided to investors, and the negative impact that such proposals would have on the millions of people who invest in money market funds.” Further, “[i]t is the Commission's view that the harm to small investors, and the inconvenience to large investors, which could result from the imposition of bank-type regulations on money market funds may not be significantly offset by any benefit to banks and thrift institutions.”

¹⁹ See Phillip R. Mack, *Recent Trends in the Mutual Fund Industry*, 79 Fed. Reserve Bull. 1001(1993), available at http://findarticles.com/p/articles/mi_m4126/is_n11_v79/ai_14714669/pg_5/?tag=content;coll, stating that “[m]oney market mutual funds grew rapidly in the late 1970s and early 1980s, when interest rates on money market instruments exceeded regulatory ceilings that applied to depository institutions. Flows from depositories to money funds supported expansion of the commercial paper market, an important alternative to bank loans for businesses.”

²⁰ Note that the fund had only institutional investors, so individual investors were not directly harmed. See ICI Money Market Working Group Report, at 39, available at www.ici.org/pdf/ppr_09_mmwg.pdf. See Saul S. Cohen, *The Challenge of Derivatives*, 63 Fordham L. Rev. 1993, 1995 n.15 (1995) (internal citations omitted).

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was forced to liquidate in September 2008 as a result of a run triggered by Lehman's bankruptcy and the fund's holdings of Lehman commercial paper. The Reserve Primary Fund has returned to shareholders more than 99 cents on the dollar.²¹ Significantly, no taxpayer funds were used to bail out shareholders.

Money Funds achieved this success under the regulation and oversight of the SEC and its Division of Investment Management, which, with a staff of 162 in fiscal year 2009, is relatively small in comparison with that of the banking agencies.²² In fiscal year 2009, total funding appropriated for SEC programs was \$960.2 million. Of that amount, funding for the Division of Investment Management was only \$47.6 million.²³ At the core of this regulatory program is SEC Rule 2a-7, which in eleven pages imposes sound principals that are the secret of the stability and solvency of Money Funds: invest only in very short-term, high quality, marketable debt instruments in a diversified manner, and do not use any leverage. Rule 2a-7 is the Occam's Razor of financial regulation.

In comparison, the prudential regulation of banks involves four (formerly five) federal regulators and over fifty regulators in states and other districts. The federal agencies alone require over 26,000 full-time employees.²⁴ The federal banking code – Title 12 of the United States Code and Title 12 of the Code of Federal Regulations – totals fourteen volumes and many thousands of pages of requirements and prohibitions. Yet, during the 40 years since the launch of the first Money Fund – a period during which the Money Fund industry experienced exactly two “failures” – some 2,830 depository institutions have failed, and an additional 592 were the subject of “assistance transactions” in which the government injected capital to keep them

²¹ See Press Release, *Reserve Primary Fund to Distribute \$215 Million* (July 15, 2010), available at http://www.reservefunds.com/pdfs/Primary%20Distribution_71510.pdf; see also SEC Press Release: *Reserve Primary Fund Distributes Assets to Investors* (Jan. 29, 2010), available at <http://www.sec.gov/news/press/2010/2010-16.htm>.

²² See U.S. Securities and Exchange Commission, In Brief, FY 2011 Congressional Justification, at 8, available at <http://www.sec.gov/about/secfy11congbudgjust.pdf>. We note that the SEC's program of regulating and supervising investment companies has been extraordinarily efficient and effective to date and that the SEC is appropriately seeking additional funding to carry out its new responsibilities under the DFA.

²³ *Id.*, at 10.

²⁴ FDIC 2009 Annual Report; FRB 2009 Annual Report; OCC 2009 Annual Report; OTS 2009 Annual Report.

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afloat.²⁵ From 1971 until February 4, 2011, total estimated FDIC losses incurred in connection with failed banks or assistance transactions amount to \$164,820,462,000.²⁶

Performance of Money Funds During the Financial Crisis

Even in times of greatest financial stress, Money Funds have proved to be more stable than depository institutions. Since January 2008, as a result of the financial crisis that followed the burst of the housing bubble and the collapse of mortgage-backed securities investments, at least 344 banks have failed,²⁷ and even more would have failed but for dozens of federal programs that infused banks with cash. The Federal Reserve, Department of the Treasury, and FDIC spent approximately \$2 trillion on an array of programs to infuse cash into the banking system.²⁸ In addition, the Federal Reserve has kept interest rates close to zero, allowing banks to borrow at almost no cost and to lend at higher rates so as to practically guarantee risk-free profits. This is estimated to cost savers \$350 billion each year as banks do not have to compete for depositors' funds, and therefore may offer only low interest rates on deposits.²⁹

During the same period, only one Money Fund, the Reserve Primary Fund, failed to return investors' shares at less than 100 cents on the dollar.³⁰ Nonetheless, the massive requests for redemptions by the Reserve Primary Fund shareholders beginning on September 15, 2008

²⁵ FDIC Database of Failures and Assistance Transactions, available at <http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30>.

²⁶ FDIC Database of Failures and Assistance Transactions, available at <http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30>.

²⁷ FDIC Failed Bank List, available at <http://www.fdic.gov/bank/individual/failed/banklist.html>.

²⁸ Congressional Oversight Panel, *September Oversight Report: Assessing the TARP on the Eve of Its Expiration*, at 145-146 (Sept. 16, 2010).

²⁹ Yalman Onaran and Alexis Leondis, *Wall Street Bailout Returns 8.2% Profit Beating Treasury Bonds*, Bloomberg (Oct. 20, 2010), available at <http://www.bloomberg.com/news/2010-10-20/bailout-of-wall-street-returns-8-2-profit-to-taxpayers-beating-treasuries.html>.

³⁰ On September 16, 2008, the Reserve Primary Fund's shares were priced at 97 cents after it wrote off debt issued by Lehman Brothers, which had declared bankruptcy the day before. Even so, this event was in large part due to misconduct by the Fund's management, as the SEC has alleged in a pending enforcement proceeding. See SEC Press Release: *SEC Charges Operators of Reserve Primary Fund With Fraud*, May 5, 2009, available at <http://www.sec.gov/news/press/2009/2009-104.htm> and related SEC Complaint, available at <http://www.sec.gov/litigation/complaints/2009/comp21025.pdf>, at 35. Moreover, Reserve Fund shareholders recovered more than 99 cents on the dollar after it closed. Press Release, *Reserve Primary Fund to Distribute \$215 Million* (July 15, 2010), available at http://www.reservefunds.com/pdfs/Primary%20Distribution_71510.pdf; SEC Press Release: *Reserve Primary Fund Distributes Assets to Investors* (Jan. 29, 2010), available at <http://www.sec.gov/news/press/2010/2010-16.htm>.

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when Lehman declared bankruptcy, and Reserve's announcement the following day that it would re-price its shares, triggered a run by investors in other prime Money Funds who feared that those funds' holdings of commercial paper of other financial institutions would decline in value. Numerous Money Funds liquidated assets or imposed redemption limits³¹ and a number of funds obtained support from their advisers or other affiliated persons.³² As the PWG Report describes, the liquidation of Money Fund assets to meet redemptions led to a reduction of Money Fund holdings of commercial paper by about 25 percent.³³

No Money Funds were "bailed out" by the government, but the extraordinary conditions in the market, including illiquidity in the secondary market for commercial paper, led to the adoption of special measures to restore confidence in the money markets and Money Funds and address the freeze-up in the commercial paper market. The Treasury Department implemented a limited "Temporary Guarantee Program for Money Market Funds" whereby Money Funds could, in exchange for a payment, receive insurance on investors' holdings such that if shares broke the buck, they would be restored to a \$1 net asset value ("NAV").³⁴ The program expired about one year later, experienced no losses (because the insurance guarantee was never called upon), and earned the Treasury about \$1.2 billion in participation fees.³⁵

The Federal Reserve also created an "Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility" ("AMLF") to provide credit for banks and bank holding companies to finance their purchases of commercial paper from Money Funds.³⁶ This program

³¹ In response to a request, the SEC, by order, permitted suspension of redemptions in certain Reserve funds in order to allow for orderly liquidation. See *Matter of The Reserve Fund*, Investment Company Act Release No. 28386 (Sept. 22, 2008), 73 Fed. Reg. 55572 (Sept. 25, 2008); *Reserve Municipal Money-Market Trust, et al.*, Investment Company Act Release No. 28466 (Oct. 24, 2008), 73 Fed. Reg. 64993 (Oct. 31, 2008).

³² The SEC notes that with the exception of the Reserve Primary Fund, all of the funds that were exposed to losses during 2007-2008 from debt securities issued by structured investment vehicles or as a result of the default of debt securities issued by Lehman Brothers Holdings Inc. obtained support of some kind from their advisers or other affiliated persons, who absorbed the losses or provided a guarantee covering a sufficient amount of losses to prevent these funds from breaking the buck. See Release No. IC-29132, 75 Fed. Reg. 10060, 10061 (Mar. 4, 2010).

³³ See REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 12, available at <http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf>.

³⁴ Press Release, *Treasury Announces Guaranty Program for Money Market Funds* (Sept. 29, 2008), available at <http://www.treas.gov/press/releases/hp1147.htm>.

³⁵ Press Release, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 19, 2009), available at <http://www.ustreas.gov/press/releases/tg293.htm>.

³⁶ Federal Reserve Board, *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility*, available at <http://www.federalreserve.gov/monetarypolicy/abcpmmmf.htm>.

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lent \$150 billion in just its first 10 days of operation and was terminated with no credit losses.³⁷ All loans made under the AMLF were repaid in full, with interest, in accordance with the terms of the facility.³⁸ Indeed, the Federal Reserve Bank of Boston Statements of Income and Comprehensive Income for the years ended December 31, 2009 and December 31, 2008 show the total amount of interest income made on “other loans” (which refers to the AMLF program) during 2008 and 2009 was \$543 million (\$470 million and \$73 million in 2008 and 2009, respectively).³⁹ Advances made under the AMLF were made at a rate equal to the primary credit rate offered by the Boston Federal Reserve Bank to depository institutions at the time the advance was made.⁴⁰ In sum, the program was extremely profitable to the government. Both programs were limited in scope and involved relatively low risk to taxpayers when compared to other steps taken by the government during the financial crisis.

Going forward, the type of intervention in which the Government may engage will be limited. Congress has forbidden the use of the Exchange Stabilization Fund to guarantee the obligations of Money Funds.⁴¹ The Federal Reserve Board’s lending authority has been restricted by Section 1101 of the DFA, so that it is not permitted to lend to individual firms that are insolvent.⁴² In addition, under Section 214 of the DFA, financial companies placed in receivership under Title II of the DFA cannot receive bailouts or taxpayer-funded expenditures to prevent their liquidation.⁴³ It is anticipated that these limitations will go a long way in promoting market discipline by eliminating expectations of a Government “bail out” – either of Money Funds or other financial institutions.

³⁷ Burcu Duygan-Bump, Patrick M. Parkinson, Eric S. Rosengren, Gustavo A. Suarez, and Paul S. Willen, QAU Working Paper No. QAU10-3, *How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility* (available at <http://www.bos.frb.org/bankinfo/qau/wp/2010/qau1003.htm>). The program ceased operation in February, 2010. Federal Reserve Board Press Release, FOMC Statement (Jan. 27, 2010), available at <http://www.federalreserve.gov/newsevents/press/monetary/20100127a.htm>.

³⁸ Federal Reserve Board, *Monthly Report on Credit and Liquidity Programs and the Balance Sheet*, Appendix B at 31 (October 2010), available at <http://www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport201010.pdf>.

³⁹ See The Federal Reserve Bank of Boston, Financial Statements as of and for the Years Ended December 31, 2009 and 2008 and Independent Auditors' Report, available at <http://www.federalreserve.gov/monetarypolicy/files/BSTBostonfinstmt2009.pdf>.

⁴⁰ *Id.*, at 19.

⁴¹ Economic Emergency Stabilization Act of 2008, Div. A of Pub. L. 110-343 (Oct. 3, 2008), §131(b).

⁴² Pub. L. No. 111-203, § 1101.

⁴³ Pub. L. No. 111-203, § 214.

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Moreover, although the Council has just begun to consider the use of the Government's new tools under the DFA to identify and apply new prudential regulation to systemically significant nonbank institutions that, like Lehman, may rely heavily upon short term funding, the SEC, as discussed below, already has acted to substantially enhance the liquidity of Money Funds and further enhance their ability to withstand the potential failure of institutions in whose securities they invest. In addition, the SEC in September 2010 proposed new rules that will shed new light on a company's short-term borrowing practices, including balance sheet "window dressing."⁴⁴ The SEC's proposed rules require public companies to disclose additional information to investors about short-term borrowing arrangements, including commercial paper, repurchase agreements, letters of credit, promissory notes, and factoring, used to fund their operations.⁴⁵ These actions by the SEC, in combination with future actions by the Council and Federal Reserve to apply prudential regulation to certain financial institutions that are issuers of the commercial paper purchased by Money Funds, should, in combination, amplify and reinforce each other to prevent or mitigate the impact of future failures of systemically significant financial institutions and, in particular, mitigate the impact of their failures on investors, such as Money Funds, in the short-term markets.

SEC Regulation of Money Funds

A former federal bank regulator recently testified before the Financial Crisis Inquiry Commission ("FCIC") that Money Funds were not regulated, and the FCIC summarized in its report that:

money market funds had no capital or leverage standards.... The funds had to follow only regulations restricting the type of securities in which they could invest, the duration of those securities, and the diversification of their portfolios.

⁴⁴ See Release No. 33-9143, *Short-Term Borrowings Disclosure*, 75 Fed. Reg. 59866 (Sept. 28, 2010). Currently, SEC rules require public companies to disclose short-term borrowings at the end of the reporting period, but generally there is no requirement to disclose information about the amount of short-term borrowings outstanding throughout the reporting period. The only exception is for bank holding companies, which must disclose annually the average and maximum amounts of short-term borrowings outstanding during the year.

⁴⁵ See Release No. 33-9143, *Short-Term Borrowings Disclosure*, 75 Fed. Reg. 59866 (Sept. 28, 2010). The proposed rules distinguish between "financial companies" and other companies. Financial companies would be required to report data for the maximum daily amounts outstanding (meaning the largest amount outstanding at the end of any day in the reporting period) and the average amounts outstanding during the reporting period computed on a daily average basis (meaning the amount outstanding at the end of each day, averaged over the reporting period). All other companies would be permitted to calculate averages using an averaging period not to exceed a month and to disclose the maximum month-end amount during the period. See *id.* See also, Release No. 33-9144, *Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis*, 75 Fed. Reg. 59894 (Sept. 28, 2010).

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These requirements were supposed to ensure that investors' shares would not diminish in value and would be available anytime-- important reassurances, but not the same as FDIC insurance.⁴⁶

The truth is that Money Funds are *comprehensively regulated* by the SEC under a statute and regulations that essentially require them to be capitalized entirely with equity and that preclude the use of leverage. The SEC regulations restricting the type of securities in which Money Funds can invest and their maturity and duration are a central reason why only two Money Funds have broken the buck in forty years of the industry's existence; and in those two cases investors got back the overwhelming majority of their investments relatively quickly. The regulatory regime governing Money Funds is not the same as FDIC insurance, it is far more effective than the FDIC and the regime of federal banking regulation, both in protecting Money Funds and their customer/investors against insolvency and in protecting the federal government from having to bail them out. Money Funds do not represent a case of no regulation, but of profoundly successful, yet simple and extraordinarily elegant, regulation.

The stability of Money Funds – especially when compared with banks – is due in large part to a regulatory system that provides for investor protection, active oversight, inspections and a competitive environment. The investment restrictions applicable to Money Funds are far more stringent than those that apply to banks in terms of duration, credit quality, and liquidity. In brief, Money Funds may invest in debt instruments in which a national bank may invest, including prime commercial paper, bank deposits, short-term U.S. government securities, and short-term municipal government securities.⁴⁷ However, they may not invest in many of the higher risk, less liquid and longer-term investments that national banks may own, such as medium and long-term government or corporate debt and most types of loans (*e.g.*, mortgages and consumer loans). In short, Money Fund investment portfolios are far less risky and far more liquid than those of banks. They need to be. Money Funds do not rely on a Federal government guarantee to operate.

Money Funds are a type of mutual fund. As such, they must register with the SEC as “investment companies” under the Investment Company Act, which subjects them to stringent regulatory, disclosure, and reporting provisions. Thus, they must register offerings of their securities with the SEC and provide perpetually updated prospectuses to potential investors. They must also file periodic reports with the SEC and provide shareholders with annual and semi-annual reports, which must include financial data and a list of portfolio securities. In

⁴⁶ Final Report of the National Commission on the Causes of the Financial and Economic Crisis In the United States, January 2011, at 33.

⁴⁷ 12 U.S.C. 24 (Seventh), 12 C.F.R. Part 1.

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addition, the Investment Company Act governs virtually every aspect of a mutual fund's structure and operations, including its capital structure, investment activities, valuation of shares, the composition of the board, and the duties and independence of its directors. Mutual funds also are subject to extensive recordkeeping requirements and regular inspections. In addition, the advisers to mutual funds, including Money Funds, are subject to SEC registration under the Investment Advisers Act of 1940 ("Advisers Act"), which imposes its own reporting and recordkeeping requirements, prescribes the terms of advisory contracts, and provides for SEC inspections and examinations. Of particular significance to the Section 113 analysis, investment companies (including Money Funds) are restricted from investing in securities firms or their holding companies,⁴⁸ from lending to or borrowing from other investment companies with whom they are affiliated,⁴⁹ or from jointly investing alongside other related Money Funds in other companies.⁵⁰ As a result, the financial conditions of different investment companies (even if they have the same investment adviser) generally are not linked to one another in the way that is common, for example, among correspondent or affiliate banks.⁵¹

⁴⁸ Investment Company Act § 12(d).

⁴⁹ See Investment Company Act §§ 17(a)(3),(4) (restricting borrowing and lending by investment companies and their affiliates).

⁵⁰ Investment Company Act §§ 12(a)(2); 17(d).

⁵¹ See, 12 U.S.C. §§ 371c, 371c-1; 12 C.F.R. § 223 (sister bank exemption permitting lending and other transactions between affiliate banks), 12 U.S.C. § 1815(e) (cross-guarantee liability of affiliated banks). In this fashion, losses at one bank can precipitate losses at other banks. In fact, it was in this very context that the term "too big to fail" was first used – as an explanation of the bailout of Continental Illinois National Bank and Trust Company in 1984. The FDIC has explained that in that case

the regulators' greatest concern was systemic risk Continental had an extensive network of correspondent banks, almost 2,300 of which had funds invested in Continental; more than 42 percent of those banks had invested funds in excess of \$100,000, with a total investment of almost \$6 billion. The FDIC determined that 66 of these banks, with total assets of almost \$5 billion, had more than 100 percent of their equity capital invested in Continental and that an additional 113 banks with total assets of more than \$12 billion had between 50 and 100 percent of their equity capital invested.

See FDIC Study: *History of the Eighties — Lessons for the Future*, Part 2.7, Continental Illinois and "Too Big to Fail," at 250 (available at <http://www.fdic.gov/bank/historical/history/vol1.html>). In this situation, the FDIC concluded that "handling Continental through a payoff and liquidation was simply not . . . a viable option." Instead, the bank was provided with a \$2 billion government rescue package and the FDIC purchased 4.5 billion in bad loans. *History of the Eighties — Lessons for the Future*, Part 2.7 at 244. See also FDIC *Managing the Crisis: The FDIC and RTC Experience* at 542 (describing how the failure of Penn Square Bank led to the forced merger of the holding company of Seattle First National Bank) (available at <http://www.fdic.gov/bank/historical/managing/history2-03.pdf>).

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Money Funds are subject to an additional SEC regulation: Rule 2a-7 under the Investment Company Act.⁵² Money Funds seek to generate income and preserve investor funds by investing in short-term, high-quality debt. At the same time, they seek to maintain a stable NAV of \$1 per share, so Rule 2a-7 permits a Money Fund to maintain a stable net asset value by using the “amortized cost” method of accounting.⁵³ This comes subject to the strict requirements of Rule 2a-7 to ensure that these funds are as stable and low risk as possible. Thus, a Money Fund must meet stringent portfolio liquidity, credit quality, maturity, and diversification requirements. These were strengthened by amendments in 2010 that were “designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market mutual fund that is unable to maintain a stable net asset value per share.”⁵⁴ In particular, Rule 2a-7 and related SEC rules impose requirements on Money Funds in the following areas:

Liquidity. Under the 2010 amendments to Rule 2a-7, a Money Fund is required to have a minimum percentage of its assets in highly liquid securities so that it can meet reasonably foreseeable shareholder redemptions.⁵⁵ Under new minimum daily liquidity requirements applicable to all taxable Money Funds, at least 10 percent of the assets in the fund must be in cash, U.S. Treasury securities, or securities that convert into cash (e.g., mature) within one business day. In addition, under a new weekly requirement applicable to all Money Funds, at least 30 percent of assets must be in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within five business days. No more than 5 percent of a fund's portfolio may be “illiquid” (i.e., cannot be sold or disposed of within seven days at carrying value). Prior to the 2010 amendments, Rule 2a-7 did not include any minimum liquidity requirements.

High Credit Quality. Rule 2a-7 limits a Money Fund to investing in securities that are, at the time of their acquisition, “Eligible Securities.” “Eligible Securities” include a rated security with a remaining maturity of 397 calendar days or less that has received a rating by two

⁵² See 17 C.F.R. § 270.2a-7.

⁵³ Under the “amortized cost” method of accounting, Money Funds value the securities in their portfolios at acquisition cost as adjusted for amortization of premium or accretion of discount rather than market value. See 17 C.F.R. § 270.2a-7(a)(2). The Rule also allows Money Funds to use the “penny-rounding” method of pricing, which permits rounding to one cent rather than one-tenth of a cent. 17 C.F.R. § 270.2a-7(a)(20). However, this method is seldom used because it does not eliminate daily “mark to market” accounting requirements.

⁵⁴ See Release No. IC-29132, 75 Fed. Reg. 10060 (Mar. 4, 2010).

⁵⁵ Depending upon the volatility of the fund’s cash flows (in particular shareholder redemptions), a fund may be required to maintain greater liquidity than would be required by the daily and weekly minimum liquidity requirements set forth in Rule 2a-7. See Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

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designated nationally recognized statistical rating organizations (“NRSROs”) in one of the two highest short-term rating categories and unrated securities of comparable quality.⁵⁶ Under the 2010 amendments, 97% of a Money Fund’s assets must be invested in “First Tier Securities.”⁵⁷ Only 3 percent of its assets may be held in lower quality, “Second Tier Securities.”⁵⁸ Previously, a Money Fund was permitted to invest 5% of its assets in “Second Tier Securities.” In addition, a Money Fund may not invest more than ½ of 1 percent of its assets in “Second Tier Securities” issued by any one issuer (rather than the previous limit of the greater of 1 percent or \$1 million). Under the 2010 amendments, a Money Fund also is prohibited from purchasing “Second Tier Securities” that mature in more than 45 days (rather than the previous limit of 397 days).

Short Maturity Limits. Rule 2a-7 limits the exposure of Money Funds to risks like sudden interest rate movements by restricting the average maturity of portfolio investments. (This also helps a Money Fund maintain a stable NAV). Under the 2010 amendments to Rule 2a-7, the “weighted average maturity” of a Money Fund’s portfolio is restricted to 60 days (compared to the previous limit of 90 days). In addition, the 2010 amendments limit the maximum “weighted average life” maturity of a fund’s portfolio to 120 days. This restriction limits the fund’s ability to invest in long-term floating rate securities. (Previously, there was no such restriction.) Thus, the “maturity mismatch” that Money Funds are subject to is far smaller than that faced by banks, which offer demand deposits, but make long-term loans.

⁵⁶ Under Rule 2a-7(a)(12), if only one designated NRSRO has rated a security, it will be considered a rated security if it is rated within one of the rating agency’s two highest short-term rating categories. Under certain conditions, a security that is subject to a guarantee or that has a demand feature that enhances its credit quality may also be deemed an “Eligible Security.” In addition, an unrated security that is of comparable quality to a rated security also may qualify as an “Eligible Security.”

⁵⁷ A “First Tier Security” means any Eligible Security that:

- (i) is a Rated Security (as defined in Rule 2a-7) that has received a short-term rating from the requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing);
- (ii) is an unrated security that is of comparable quality to a security meeting the requirements for a rated security in (i) above, as determined by the fund’s board of directors;
- (iii) is a security issued by a registered investment company that is a Money Fund; or
- (iv) is a Government Security.

The term “requisite NRSROs” is defined in Rule 2a-7(a)(23) to mean “(i) Any two Designated NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) If only one Designated NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that Designated NRSRO.”

⁵⁸ Second Tier Securities are any Eligible Securities that are not First Tier Securities.

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Periodic Stress Tests. Under the 2010 amendments to Rule 2a-7, the board of directors of each Money Fund must adopt procedures providing for periodic stress testing of the funds' portfolio. Fund managers are required to examine a fund's ability to maintain a stable NAV per share based upon certain hypothetical events. These include a change in short-term interest rates, higher redemptions, a downgrade of or default on portfolio securities, and widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. Previously, Money Funds were not subject to stress test requirements.

NRSRO Ratings. Rule 2a-7 limits a Money Fund's investment in rated securities to those rated in the top two rating categories or unrated securities of comparable quality. It also requires Money Funds to perform independent credit analyses of every security they purchase. Credit ratings help funds screen credit quality, but are never the sole factor relied upon in making an investment decision.⁵⁹ Under the 2010 amendments, improvements were made to the way that funds evaluate securities ratings by NRSROs. A Money Fund's board is required to designate annually at least four NRSROs that will be used by the fund based on the board's determination on at least an annual basis that such credit ratings are sufficiently reliable. This permits a Money Fund to disregard ratings by NRSROs that have not been so designated for purposes of satisfying the Rule's minimum rating requirements. The previous requirement that funds invest only in those asset-backed securities that have been rated by an NRSRO was eliminated.⁶⁰ Consistent with the DFA, the SEC is expected to further amend its rules to reduce the role of ratings in the process of selecting investments by Money Funds.

⁵⁹ The DFA gave the SEC new authority to regulate NRSROs in order to improve the quality and reliability of credit ratings. A new Office of Credit Ratings to be established within the SEC in order to protect users of credit ratings and promote credit rating accuracy will administer the SEC's rules with respect to the practices of NRSROs in determining ratings. The SEC is required to examine NRSROs at least once a year and make its inspection reports publicly available. The SEC has been given additional rulemaking authority to take steps to enhance the accuracy and integrity of credit ratings and increase the transparency of the credit rating process. The DFA also increases the potential liability of credit rating agencies. The increased oversight of NRSROs by the SEC authorized by the DFA helps ensure that issues and risks associated with inappropriate credit ratings of commercial paper held by Money Funds are less likely to occur.

⁶⁰ The SEC noted in the release adopting the 2010 amendments that as part of the minimal credit risk analysis that any Money Fund must conduct before investing in an asset-backed security ("ABS"), the fund's board should: (i) analyze the underlying ABS assets to ensure that they are properly valued and provide adequate asset coverage for the cash flows required to fund the ABS under various market conditions; (ii) analyze the terms of any liquidity or other support provided by the sponsor of the ABS; and (iii) perform legal, structural, and credit analyses required to determine that the particular ABS involves appropriate risks for the fund. See Release No. IC-29132, 75 Fed. Reg. 10060, 10070 (Mar. 4, 2010). In October, 2009, the SEC deferred consideration of proposals to remove NRSRO references from Rule 2a-7. Release No. IC-28940, 74 Fed. Reg. 52374 (Oct. 9, 2009).

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Repurchase Agreements. Money Funds generally invest a significant part of their assets in repurchase agreements. Many such agreements mature the following day and provide an immediate source of liquidity. In 2010, the SEC adopted two changes to Rule 2a-7 that strengthen the requirements for permitting a Money Fund to “look through” the repurchase issuer to the underlying collateral securities for diversification purposes. First, the SEC limited Money Funds to investing in repurchase agreements collateralized by cash items or government securities (in contrast to the prior requirement of highly rated securities) in order to obtain special treatment of those investments under the diversification provisions of Rule 2a-7. Second, the fund’s board of directors must evaluate the creditworthiness of the counterparty. This amendment requires a fund adviser to determine that the counterparty is a creditworthy institution, separate and apart from the value of the collateral supporting the counterparty’s obligation under the repurchase agreement. The 2010 amendments are designed to prevent losses caused by a counterparty’s default.⁶¹

Monthly Disclosure of Portfolio Information. Under the 2010 amendments, Money Funds must post their portfolio holdings each month on their websites and maintain this information for no less than six months after posting.⁶² (Previously, Money Funds were not required to disclose information on their websites). Under the 2010 amendments, Money Funds also must now file monthly reports of portfolio holdings with the SEC,⁶³ which must include the market-based values of each portfolio security and the fund’s “shadow” NAV.⁶⁴ The information becomes publicly available after 60 days.⁶⁵ (Previously, a Money Fund’s “shadow” NAV was reported twice a year with a lag of 60 days).

Redemptions / Know Your Customer. Under a new requirement added to Rule 2a-7 in 2010, Money Funds must hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions. (Previously, there was no such requirement). To satisfy this new requirement, a Money Fund must adopt policies and procedures to identify the risk characteristics of large shareholders and anticipate the likelihood of large redemptions.⁶⁶ Depending upon the volatility of its cash flows, and in particular shareholder redemptions, this

⁶¹ See Release No. IC-29132, 75 Fed. Reg. 10060, 10081 (Mar. 4, 2010).

⁶² 17 C.F.R. § 270.2a-7(c)(12).

⁶³ 17 C.F.R. § 270.30b1-7(a).

⁶⁴ See Release No. IC-29132, 75 Fed. Reg. 10060, 10083 (Mar. 4, 2010).

⁶⁵ 17 C.F.R. § 270.30b1-7(b).

⁶⁶ See Release No. IC-29132, 75 Fed. Reg. 10060, 10075, n.198 and accompanying text (Mar. 4, 2010).

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may require a fund to maintain greater liquidity than would be required by the daily and weekly minimum liquidity requirements discussed above.⁶⁷

Processing of Transactions. Under a new requirement adopted in 2010, Rule 2a-7 requires a Money Fund to have the capacity to redeem and sell its securities at a price based on its current NAV. This requirement applies even if the fund's current net asset value does not correspond to the fund's stable net asset value or price per share. The new requirement minimizes operational difficulties in satisfying shareholder redemption requests and increases speed and efficiency if a fund breaks the buck. This change requires Money Funds to be able to process redemptions and thus provide liquidity if market prices of their portfolio assets decline, rather than defer share redemptions and corresponding sales of portfolio assets in order to avoid recognizing that decline in portfolio value. In essence, if market conditions dictate a movement to a floating NAV in order to process transactions and provide liquidity to redeeming shareholders, Rule 2a-7 requires Money Funds to do so. By forcing shareholder transactions to be processed at a price other than \$1.00 when portfolio asset market conditions dictate, this rule change both enhances liquidity and addresses policy concerns over potential "runs" by shareholders seeking to redeem Money Fund shares ahead of unrecognized portfolio price declines or related deferrals by Money Funds of processing of redemptions.

Handling Default in a Portfolio Instrument. Rule 2a-7 establishes procedures that a Money Fund must follow if a portfolio instrument is downgraded or a default or other event occurs with respect thereto. In some cases, a fund may be required to dispose of, or reduce its investments in, the issuers of such instruments.

Shadow Pricing. To reduce the chance of a material deviation between the amortized cost value of a portfolio and its market-based value, Rule 2a-7 requires Money Funds to "shadow price" the amortized cost net asset value of the fund's portfolio against its mark-to-market net asset value. If there is a deviation of more than ½ of 1 percent, the fund's board of directors must promptly consider what action, if any, it should take,⁶⁸ including whether the fund should discontinue using the amortized cost method of valuation and re-price the securities of the fund below (or above) \$1.00 per share.⁶⁹ Regardless of the extent of the deviation, Rule 2a-7 obligates the board of a Money Fund to take action whenever it believes any deviation may result in material dilution or other unfair results to investors.⁷⁰

⁶⁷ See Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

⁶⁸ 17 C.F.R. § 270.2a-7(c)(8)(ii)(B).

⁶⁹ See Release No. IC-29132, 75 Fed. Reg. 10060, 10061 (Mar. 4, 2010).

⁷⁰ 17 C.F.R. § 270.2a-7(c)(8)(ii)(C).

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Diversification. In order to limit the exposure of a Money Fund to any one issuer or guarantor, Rule 2a-7 requires the fund's portfolio to be diversified with regard to both issuers of securities it acquires and guarantors of those securities.⁷¹ Money Funds generally must limit their investments in the securities of any one issuer (other than Government securities) to no more than five percent of fund assets.⁷² Money Funds also must generally limit their investments in securities subject to a demand feature or a guarantee to no more than ten percent of fund assets from any one provider.⁷³ As noted above, under the 2010 amendments to Rule 2a-7, a Money Fund may not invest more than ½ of 1 percent of its assets in "Second Tier Securities" issued by any one issuer.

Risk Management. Money Funds have robust risk management requirements, beginning with Rule 2a-7's requirements that they limit holdings to the safest, most liquid and short-term investments and strict diversification requirements. Moreover, boards of Money Funds have substantial, detailed, and ongoing risk management responsibilities. For example, Money Fund boards must adopt written procedures regarding:

- Stabilization of NAV (which must take current market conditions, shadow pricing and consideration of material dilution and unfair results into account);
- Ongoing review of credit risks and demand features of portfolio holdings;
- Periodic review of decisions not to rely on demand features or guarantees in the determination of a portfolio security's quality, maturity or liquidity; and
- Periodic review of interest rate formulas for variable and floating rate securities in order to determine whether adjustments will reasonably value a security.

In order to ensure that boards are diligent and act in good faith, funds must also keep and maintain records of board consideration and actions taken in the discharge of their responsibilities. Management's decision-making processes must also be reflected in records such as whenever a security is determined to present a minimal credit risk, or when it makes a determination regarding deviations in amortized value and market value of securities and others.

⁷¹ 17 C.F.R. § 270.2a-7(c)(4)(i).

⁷² Rule 2a-7(c)(4)(i)(A). Rule 2a-7 includes a safe harbor that permits a taxable and national tax exempt fund to invest up to 25 percent of its assets in the first tier securities of a single issuer for a period of up to three business days after acquisition (but a fund may use this exception for only one issuer at a time). Rule 2a-7(c)(4)(i)(A).

⁷³ Rule 2a-7(c)(4)(iii). With respect to 25 percent of total assets, holdings of a demand feature or guarantee provider may exceed the 10 percent limit subject to certain conditions. *See* Rule 2a-7(c)(4)(iii)(A), (B), and (C). *See also* Rule 2a-7(a)(8) (definition of "demand feature") and (a)(15) (definition of "guarantee").

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Delegations of responsibilities by the board must be pursuant to written guidelines and procedures, and the Board must oversee the exercise of responsibilities. Even then, boards may not delegate certain functions, such as any decisions as to whether to continue to hold securities that are subject to default, or that are no longer eligible securities, or that no longer present minimal credit risk, or whose issuers have experienced an event of insolvency, or that have been downgraded under certain circumstances. Nor may boards delegate their responsibility to consider action when shadow pricing results in a deviation of 1/2 of 1%, or to determine whether such deviations could result in dilution or unfairness to investors.

Rule 2a-7 provides that if a “First Tier Security” is downgraded to a “Second Tier Security” or the fund’s adviser becomes aware that any unrated security or Second Tier Security has been downgraded, the board must reassess promptly whether the security continues to present minimal credit risks and must cause the fund to take actions that the board determines is in the best interests of the fund and its shareholders.⁷⁴ A reassessment is not required if the fund disposes of the security (or it matures) within five business days of the event.⁷⁵

If securities accounting for 1/2 of 1% or more of a Money Fund’s total assets default (other than an immaterial default unrelated to the issuer's financial condition) or become subject to certain events of insolvency, the fund must promptly notify the SEC and indicate the actions the Money Fund intends to take in response to such event.⁷⁶ If an affiliate of the fund purchases a security from the fund in reliance on Rule 17a-9, the SEC must be notified of the identity of the security, its amortized cost, the sale price, and the reasons for such purchase.⁷⁷

In the event that after giving effect to a rating downgrade, more than 2.5 percent of the Money Fund's total assets are invested in securities issued by or subject to demand features from a single institution that are “Second Tier Securities,” the fund must reduce its investments in such securities to 2.5% or less of its total assets by exercising the demand features at the next exercise date(s), unless the fund's board finds that disposal of the portfolio security would not be in the best interests of the fund.⁷⁸

⁷⁴ See 17 C.F.R. § 270.2a-7(c)(7)(i)(A).

⁷⁵ Where a Money Fund’s investment adviser becomes aware that any unrated security or “Second Tier Security” held by the fund has, since the security was acquired by the fund, been given a rating by a Designated NRSRO below the Designated NRSRO's second highest short-term rating category, the board must be subsequently notified of the adviser’s actions. See 17 C.F.R. § 270.2a-7(c)(7)(i)(B).

⁷⁶ See 17 C.F.R. § 270.2a-7(c)(7)(iii)(A).

⁷⁷ See 17 C.F.R. § 270.2a-7(c)(7)(iii)(B).

⁷⁸ See 17 C.F.R. § 270.2a-7(c)(7)(i)(C).

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When a portfolio security defaults (other than an immaterial default unrelated to the financial condition of the issuer), ceases to be an Eligible Security, has been determined to no longer present minimal credit risks, or certain events of insolvency occur with respect to the issuer of a portfolio security or the provider of any demand feature or guarantee of a portfolio security, the Money Fund is required to dispose of the security as soon as practicable consistent with achieving an orderly disposition of the security (by sale, exercise of a demand feature, or otherwise), unless the fund's board finds that disposal of the portfolio security would not be in the best interests of the fund.⁷⁹

Fund Liquidation. New SEC Rule 22e-3,⁸⁰ adopted in 2010, permits a Money Fund's board of directors to suspend redemptions and postpone payment of redemption proceeds if the fund is about to break the buck and the board decides to liquidate the fund. Previously, the fund board was required to obtain an order from the SEC before suspending redemptions. This amendment is designed to facilitate an orderly liquidation of fund assets in the event of a threatened run on the fund.⁸¹

Purchases by Sponsors or Other Affiliated Persons. The SEC also adopted new rules in 2010 that expand the ability of affiliated persons to purchase distressed assets from a Money Fund in order to protect the fund from losses.⁸² Prior to the 2010 amendments to Rule 17a-9 under the Investment Company Act, an affiliate could not purchase securities from the fund before a ratings downgrade or a default of the securities without receiving individual relief from the SEC. The 2010 amendments permit such purchases without the need for relief from the SEC under conditions that protect the fund from transactions that disadvantage the fund.⁸³ The SEC

⁷⁹ See 17 C.F.R. § 270.2a-7(c)(7)(ii).

⁸⁰ See 17 C.F.R. § 270.22e-3.

⁸¹ The rule permits a fund to suspend redemptions and payment of proceeds if (i) the fund's board, including a majority of disinterested directors, determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results to investors, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.

⁸² See 17 C.F.R. § 270.17a-9.

⁸³ Rule 17a-9 provides an exemption from Section 17(a) of the Investment Company Act to permit affiliated persons of a Money Fund to purchase distressed portfolio securities from the fund. Absent an SEC exemption, Section 17(a)(2) prohibits any affiliated person or promoter of or principal underwriter for a fund (or any affiliated person of such a person), acting as principal, from knowingly purchasing securities from the fund. Rule 17a-9 exempts certain purchases of securities from a Money Fund from Section 17(a), if the purchase price is equal to the greater of the security's amortized cost or market value (in each case, including accrued interest). See Release No. IC-29132, 75 Fed. Reg. 10060, 10087 (Mar. 4, 2010), at n.365.

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also adopted a related amendment to Rule 2a-7, which requires funds to report all such transactions to the SEC.

Explicit Disclosures to Investors that the Fund is Not Federally Insured. Money Fund investors receive explicit disclosure that investments in Money Funds are not insured or guaranteed by the Federal Deposit Insurance Corporation. Item 4(b) of the Form N-1A registration form that is used by open-end management investment companies to register under the Investment Company Act and to offer their shares under the Securities Act states that if a fund is a Money Fund, it must state:

An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund.

In addition, if a Money Fund is advised by or sold through an insured depository institution, the above disclosure must be combined in a single statement with disclosure that an investment in the fund is not a deposit of the bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

For those Money Funds that are rated by NRSROs, additional stringent criteria beyond the requirements of Rule 2a-7 must be met to achieve the top ratings. The ratings criteria of the NRSROs recently have been made even more stringent based upon the lessons learned in 2008.

Standard & Poor's ("S&P") assigns "principal stability fund ratings" ("PFSRs") to Money Funds based on an analysis of the creditworthiness of a fund's investments and counterparties, the market exposure of its investments, its portfolio liquidity, and management's overall ability to maintain a stable NAV.⁸⁴ S&P does not rely on a fund sponsor's willingness and/or ability to support the fund's NAV, but does review and evaluate the measures that a sponsor chooses to take to support its NAV during times of market stress or when a fund sponsor decides to take action to support the fund's NAV or liquidity. S&P has recently proposed

⁸⁴ See Standard & Poor's, *Principal Stability Fund Ratings Criteria*, published Feb. 2, 2007, on RatingsDirect® and at www.standardandpoors.com.

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additional requirements for Money Funds to achieve its top ratings,⁸⁵ and has also proposed to modify its criteria for assessing counterparty credit risk.⁸⁶

Fitch Ratings Research has Money Fund rating scale and rating definitions, from 'Bmmf' to 'AAAmmf.' To be rated 'AAAmmf,' a fund must have "extremely strong capacity to achieve its investment objective of preserving principal and providing shareholder liquidity through limiting credit, market, and liquidity risk."⁸⁷ Money Funds given Fitch's top rating of 'AAAmmf' meet more stringent criteria than is required under Rule 2a-7.⁸⁸

Moody's Investors Service has also proposed a new rating scale and methodology for rating Money Funds. Its proposed new methods are meant to better assess factors such as liquidity risk, market risk, asset quality and obligor concentrations.⁸⁹

III. Money Funds Should Not Be Designated for Prudential Regulation under Section 113

Section 113 Standards for Designation as Applied to Money Funds

Under Section 113 of the DFA, the Council has the authority to designate a U.S. nonbank financial company for supervision by the Federal Reserve and subject to its prudential regulation. To make this determination, the Council must find that material financial stress at the nonbank financial company or the nature, scope, size, scale, concentration, interconnectedness, or mix of

⁸⁵ See Standard & Poor's, *Principal Stability Fund Rating Criteria* (Jan. 5, 2010), available at <http://www2.standardandpoors.com/spf/pdf/events/FITcon11410RFC.pdf>. See also Release No. IC-29132, 75 Fed. Reg. 10060, 10073 n.176 (Mar. 4, 2010).

⁸⁶ These counterparty transactions include repos, reverse repurchase agreements, swaps, forward purchases, foreign-exchange contracts, and other hedging positions. See *Request for Comment: Fund Ratings Criteria*, Sep. 17, 2010, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245224119805>.

⁸⁷ See Fitch Ratings, *Global Money Market Fund Rating Criteria* (Oct. 5, 2009), available at http://www.fitchratings.com/creditrisk/reports/report_frame.cfm?rpt_id=470368; *Fitch Implements New Money Market Fund Criteria; Revises Ratings*, Business Wire, Jan. 19, 2010, available at <http://www.businesswire.com/news/home/20100119007345/en/Fitch-Implements-Money-Market-Fund-Criteria-Revises>.

⁸⁸ See Fitch Ratings, *U.S. Money Market Funds: A Year of Changes and Challenges - and More to Come?*, Oct. 26, 2010, available at <http://insurancenewsnet.com/article.aspx?id=232263&type=newswires>.

⁸⁹ *Moody's Proposes New Money Market Fund Rating Methodology and Symbols*, Sept. 17, 2010, available at http://www.v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_126642.

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its activities could pose a threat to U.S. financial stability. Paragraph 113(b)(2) sets out ten risk-related factors the Council must consider in making the determination, and permits the Council to consider other risk-related factors it deems appropriate. The NPR sets out the text of a proposed rule implementing this provision, which repeats the same ten specific factors as well as the eleventh statutory catch-all of unspecified factors deemed appropriate by the Council by regulation or on a case-by-case basis. While not embodied in the proposed rule text, the NPR contains a discussion of these ten criteria that groups the ten criteria into six categories (size, lack of substitutes for the financial services and products the company provides, interconnectedness with other financial firms, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) for the Council to use in making a Section 113 designation.

The lack of specificity in the proposal and failure to describe the quantitative and qualitative considerations that underlie the Council's application of these criteria in assessing any potential institution in the proposal is troubling. After publishing an ANPR and a receiving in response a wealth of commentary, the Council has merely repeated the statutory factors for designation, explained some of their similarities, and stated that it will consider them in light of broader themes. While the NPR states that the Council will seek to use quantitative methods where it can, no objective quantitative measures are set forth in rule text, and it appears that the Council is not proposing to clarify how it plans to arrive at a systemic risk designation.

This does not move the ball forward. If the Council does not create regulations that are reasonably specific, they will be subject to varying interpretations and unpredictable application. For example, the Council has not described how it would determine whether a firm is "highly" leveraged. The members of the Council are quite familiar with presently-used quantitative measures of leverage, and surely the Council could have proffered some of these as starting points for a discussion on standards. If rules are adopted as they are now proposed, firms (and investors in those firms) will not be able to accurately predict how they might be treated and what they should plan for, or what information would be appropriate to include in a response to a notice of designation (which response must be submitted in 30 days or less). The U.S. economic system demands stability and a clear regulatory framework. Indeed, the President's recent Executive Order directs that regulations "must promote predictability and reduce uncertainty." Accordingly, we urge the Council to defer action on the rules as proposed until they can be refined with further precision.⁹⁰

Whatever factors or criteria are used, Section 113 clearly does not contemplate designation of an entire industry as systemically significant. The designation is for individual companies. There are currently 652 separate money market mutual funds. Each one has a

⁹⁰ *Improving Regulation and Regulatory Review*, Executive Order 13563 (Jan. 18, 2011).

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separate investment portfolio. Even when two money market mutual funds share a single investment adviser, their investments are segregated, and typically have investment specializations. For example, one fund may invest only in short-term U.S. government securities, another may invest in short term municipal government securities, and a third may invest more broadly in commercial paper, government securities and other money market instruments. Consequently, each fund caters to different groups of investors. They cannot be lumped together and designated *en masse* as systemically significant under Section 113.

The size of a particular Money Fund varies over time due to the significant liquidity required of a Money Fund portfolio through its investment in high-quality, marketable, short-term money market instruments, and the fact that financing is entirely equity. A Money Fund by its very nature is scalable and can expand or contract dramatically based upon investor demand within a few months with little impact on its risk profile, liquidity or profitability. Thus, use by the Council of size as the primary factor in designating a Money Fund as systemically important, particularly if that designation imposes material costs or other regulatory burdens on a fund that make it unattractive to investors, would be an inherently fruitless exercise.

The second broad criteria, whether there is a lack of substitutes, similarly weighs against designation of Money Funds under Section 113. There are currently over 650 Money Funds that are to some degree substitutes for one another, and few barriers to creating additional Money Funds. Moreover, direct investment in money market instruments, and use of bank deposits, remain as far less efficient substitutes for Money Funds. What could impact this factor is the potential for new regulatory burdens imposed on Money Funds under Section 113 (or otherwise) that might render them less attractive as a class to investors and less efficient at rechanneling investor cash to financing the cash needs of businesses and governmental entities, thereby creating a lack of efficient substitutes for investors seeking to manage a cash position and for companies seeking short term financing.⁹¹ Presumably, the regulatory risks and burdens associated with being designated under Section 113 is not a legitimate basis for designating Money Funds as systemically important under Section 113.

The third criteria, interconnectedness, similarly weighs against designation of a Money Fund under Section 113. The portfolio exposure of a Money Fund to any one issuer or group of related issuers is sharply limited by SEC Rule 2a-7. Money Funds do not have “contagion” risk in the way that banks or certain other categories of financial firms do. Money Funds are not like Penn Square Bank, Continental Illinois or the Herstatt Bank where losses at a Money Fund results in insolvencies of other firms with which that Money Fund does business. At worst, investors in the two Money Funds that have broken a buck over the past 40 years have had a

⁹¹ See note 9, *supra*.

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relatively short wait to recover the overwhelming majority of their cash, and companies whose commercial paper is owned by a Money Fund that is being wound down simply sell future issuances of their commercial paper to other Money Funds, banks, insurance companies or institutional investors.

As regards the fourth, fifth and sixth criteria: leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny-- as discussed above-- Money Funds are precluded from using leverage to any material degree and are instead financed by equity, and under SEC rules the portfolio of a Money Fund is limited to short-term, high quality debt instruments. This is a central part of the comprehensive program of SEC regulation of Money Funds, and a main reason that Money Funds have had (as discussed elsewhere in this letter) a far better track record in maintaining their solvency than have, for example, banks. As noted above, Money Funds do not have the kind of asset/obligation mismatch that plagues the banking industry. And as discussed at length elsewhere in this letter, Money Funds are comprehensively regulated and supervised by the SEC which is a member organization of the Council. Accordingly, the fourth, fifth and sixth criteria listed in the NPR weigh strongly against designating a Money Fund under Section 113.

Similarly, certain of the ten specific factors set forth in Section 113 and in the text of the proposed rule implementing Section 113 weigh against designating any Money Fund for supervision under Section 113, due to the way Money Funds are required to operate. For example, a Money Fund does not employ leverage in its operation (DFA §113(b)(2)(A) & (J), Proposed Rule at § 1310.10(c)(1) & (10)); is it not permitted to create off-balance sheet liabilities (DFA §113(b)(2)(B) & (J), Proposed Rule at § 1310.10(c)(2) & (10)); it is not a source of credit for low-income, minority, or underserved communities (DFA §113(b)(2)(E), Proposed Rule at § 1310.10(c)(5)). The nature of the assets of Money Funds are that they invest only in certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments (DFA §113(b)(2)(I), Proposed Rule at § 1310.10(c)(9)).⁹² The only activity of a Money Fund is investing in these high-quality, liquid securities, a large percentage of which must be readily converted to cash to pay redeeming shareholders, as described above. Money Funds are required to “shadow price” their portfolio investments, which requires them to monitor the market value of these assets and to make adjustments if the market value of their assets varies significantly from their amortized cost value. Money Funds are not permitted to

⁹² SEC Office of Investor Education and Advocacy, *Mutual Funds — A Guide for Investors*, at 8, available at <http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf>. The description of Money Funds on the SEC’s website similarly states: “[a] money market fund is a type of mutual fund that is required by law to invest in low-risk securities. These funds have relatively low risks compared to other mutual funds and pay dividends that generally reflect short-term interest rates.” See SEC, *Money Market Funds*, available at <http://www.sec.gov/answers/mfmmkt.htm>.

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make loans or offer mortgages. The liquid nature of Money Fund portfolios gives them the ability to meet usual and even high-level shareholder redemption requests. Money Funds are prohibited from purchasing any security on margin, except short-term credits as required for clearing transactions.

While the Money Fund industry, as a whole, supplies liquidity to the U.S. financial system (DFA §113(b)(2)(D), Proposed Rule § 1310.11(c)(4)) and to significant nonbank financial companies and significant bank holding companies (DFA §113(b)(2)(C)), it does so only through the investment activities of 652 individual Money Funds. Furthermore, the governmental units and businesses that tap Money Funds as a source of short-term financing have come out very strongly *against* imposing additional burdensome regulatory restrictions on Money Funds (such as a floating NAV) that would undermine the effectiveness and efficiency of Money Funds in supplying that financing.⁹³ Presumably the purpose of this factor is to evaluate whether additional regulation is appropriate to protect that source of financing, rather than to choke it off.

Moreover, because each Money Fund is “already regulated by one or more primary financial regulatory agencies” (DFA §113(b)(2)(H), Proposed Rule § 1310.11(c)(8)) – it is subject to pervasive and effective SEC regulation and oversight – the exercise of matching up a Money Fund to one or more of the above Section 113 criteria does not answer the question of whether it should, in fact, be designated for prudential regulation by the Federal Reserve. The appropriate question should be whether the type of Federal Reserve prudential regulation envisioned by Section 165 of DFA is necessary or appropriate, in light of the SEC’s authority, regulation, and oversight of Money Funds. As discussed below, in most of the areas of prudential standards identified under Section 165 (relating to Federal Reserve authority for nonbank financial institutions) and Section 115 (relating to the Council’s authority in Section §115 to make recommendations to the Federal Reserve regarding prudential standards), the current regulatory standards for Money Funds are far more robust than standards for other financial institutions. In a few narrow areas not currently addressed by SEC rule, the application of inappropriate prudential standards, such as risk-based capital standards, would effectively destroy a Money Fund.

⁹³ See note 9, *supra*.

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The Prudential Standards Applicable to Systemically Important Nonbank Financial Companies under Title I of the DFA are Not Appropriately Applied to Money Funds

Under Section 165 of DFA, the Federal Reserve must establish, on its own or pursuant to the Council's recommendations, prudential standards for nonbank financial companies that it supervises that are more stringent than otherwise applicable. Paragraph (b)(1)(A) provides that the Federal Reserve shall provide certain specified prudential standards, discussed below.⁹⁴

- (i) *Risk-based capital requirements and leverage limits.* These standards must be applied unless the Federal Reserve, in consultation with the Council, determines that they are not appropriate because of the activities of such company (such as investment company activities or assets under management) or structure, in which case, the Federal Reserve "shall apply other standards that result in similarly stringent risk controls." While it is unclear what those other standards would be, it is clear that a requirement for risk-based capital standards for entities that currently rely entirely on equity financing is inappropriate and unnecessary. In contrast to banks, Money Funds do not accept deposits or make loans or use other forms of debt financing. The assets of Money Funds are comprised only of the investments permitted by Rule 2a-7, rather than the riskier assets held by banks. These assets are financed entirely by the equity capital of the investor/shareholders of the Money Fund.

Similarly, in contrast to banks, Money Funds do not leverage their assets, securitize them, hold assets off-balance sheet, or engage in any of the other risky activities in which banks engage. Therefore, leverage limits are similarly not appropriately applied to Money Funds. They do not use leverage at all.

- (ii) *Liquidity requirements.* As discussed above (*see p. 17, supra*), liquidity requirements are the core of existing Money Fund regulation, and these requirements were enhanced with the SEC's recent amendments to Rule 2a-7. By law, Money Funds can invest in only certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments.⁹⁵ A Money Fund is required to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder

⁹⁴ Pub. L. No. 111-203, § 165(b)(1)(A).

⁹⁵ SEC Office of Investor Education and Advocacy, *Mutual Funds — A Guide for Investors*, at 8, available at <http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf>.

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redemptions in light of the fund's obligations under Section 22(e) of the Investment Company Act and any commitments the fund has made to shareholders.⁹⁶

- (iii) *Risk management requirements.* It is difficult to conceptualize what new prudential risk management requirements the Federal Reserve could craft for a Money Fund, beyond those required under current law and regulation. (See pp. 17-23, *supra.*) Money Fund regulation manages portfolio risk by limiting holdings to the safest, most liquid and shortest-term investments in existence. Money Fund boards have rigorous, detailed, and ongoing risk management responsibilities with respect to pricing, review of credit risks, and other aspects of Money Fund operations. Designation of an entity as systemically significant would not be appropriate where the risk management requirements that might be imposed would not materially enhance those already in place.
- (iv) *Resolution plan and credit exposure report.* Rule 2a-7 includes a regulatory scheme that effectively makes them self-liquidating, and mandates a resolution plan and liquidation procedure for Money Funds, including reporting to the SEC under certain circumstances. Rule 2a-7 requires Money Funds to invest predominantly in securities that can be sold at book value in short order and have a weighted average maturity of 60 days or less. All taxable Money Funds must hold at least 10 percent of their assets in cash, U.S. Treasury securities, or securities that convert into cash within one business day. All Money Funds must hold at least 30 percent of assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within five business days. No more than 5 percent of a fund's portfolio may be "illiquid" (i.e., cannot be sold or disposed of within seven days at carrying value). In addition, a Money Fund generally may not acquire any securities with a remaining maturity greater than 397 days.⁹⁷ Because Money Funds invest only in short-term, high-quality securities in accordance with the requirements of Rule 2a-7, a Money Fund can self-liquidate in a short period of time as long as it stops reinvesting the proceeds of such securities as they come due. Money Funds are also permitted to defer redemption requests for seven days (like a bank is permitted to defer withdrawals from a money market deposit account, savings account or NOW account) to address liquidity needs. In addition, as discussed above, SEC Rule 22e-3 permits a Money Fund's board of directors to suspend redemptions and postpone payment of redemption proceeds if the fund is about to break the buck and the board decides to liquidate the fund. This facilitates an orderly liquidation of fund assets in the event of a threatened run on the fund by ensuring

⁹⁶ See 17 C.F.R. § 270.2a-7(c)(5).

⁹⁷ See 17 C.F.R. § 270.2a-7(c)(2). The SEC used its existing powers under the federal securities laws to oversee the liquidation of the Reserve Primary Fund in a judicial proceeding brought for that purpose.

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that no one is advantaged by redeeming early. Although Money Funds extend credit via their purchases of commercial paper and by engaging in repurchase agreements, Rule 2a-7 contains several conditions (which the SEC refers to as “risk-limiting conditions”) that “limit the funds exposure to certain risks, such as credit, currency, and interest rate risks.”⁹⁸ For example, a Money Fund must limit its portfolio investments to securities that meet certain credit quality requirements under Rule 2a-7. The fund’s portfolio must be invested only in “Eligible Securities” that are rated in the top one or two rating categories by designated NRSROs and unrated securities of comparable quality as determined by the fund’s board of directors. In addition, a Money Fund may only invest 3 percent of its portfolio in “Second Tier Securities” that are rated in the second highest rating category.⁹⁹ Each Fund reports its portfolio securities to the SEC on a monthly basis, including the market-based values of each security and the Fund’s shadow NAV. Nothing could be accomplished by requiring a Money Fund to submit its resolution plan to the Federal Reserve, or to submitting a “credit exposure” plan to the Federal Reserve.¹⁰⁰

- (v) *Concentration limits.* As of February 2011 there were approximately 652 Money Funds. Total estimated assets under management are approximately \$2.7 trillion. The Money Fund industry is highly competitive. The size and the depth of the industry poses little risk of concentration that could potentially harm issuers of commercial paper or other users. Moreover, because of the nature of money funds, investors can easily and quickly redeem shares of one fund and reinvest in another.

In addition, under paragraph (b)(1)(B) of Section 165 of the DFA,¹⁰¹ the Federal Reserve may establish additional prudential standards for nonbank financial companies supervised by the Federal Reserve, including the following. These, too, are inappropriate as applied to a Money Fund.

⁹⁸ See Release No. IC-29132, 75 Fed. Reg. 10060, 10061 (Mar. 4, 2010).

⁹⁹ See 17 C.F.R. § 270.2a-7(c)(3).

¹⁰⁰ These features of Money Funds similarly address the need for resolution authority that underlies Title II of the DFA. Title II provides for orderly liquidation of large interconnected nonbank financial companies where there may be no other practical means for the government to wind them down in an orderly manner. The procedures already in place for the liquidation of a Money Fund are highly effective. Therefore, it is unnecessary for a Money Fund to be designated under Section 113 in order to give the FDIC authority to provide for an orderly resolution of the entity under Title II.

¹⁰¹ Pub. L. No. 111-203, § 165(b)(1)(B).

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- (i) *Contingent capital requirement.* As noted above, Money Funds are capitalized solely with equity. They do not use leverage.
- (ii) *Enhanced public disclosures.* Money Funds are transparent. Their portfolio holdings must be posted to their websites on a monthly basis. Their activities are limited to investment activities, and the range of their investments is limited. They are easy to understand. Money Funds register with the SEC and provide a fund prospectus to investors, which is updated on a continual basis. The fund must keep its prospectus “current” by periodically filing post-effective amendments to its Securities Act registration statement. A fund prospectus for a mutual fund includes important information for investors, such as investment objectives and strategies, risks, performance pricing, and fees and expenses. Some funds provide a summary prospectus containing key information about the fund, in which case the long-form prospectus is available on an internet website and a paper copy may be obtained by shareholders free of charge upon request. The registration statement for a mutual fund also includes a statement of additional information, which must be furnished upon request to fund shareholders. Money Funds are subject to stringent regulatory, disclosure, and reporting provisions. Registered investment companies are required to file periodic reports with the SEC and must provide shareholders with annual and semi-annual reports, including updated financial information, a list of the fund’s portfolio securities, and other information.
- (iii) *Short-term debt limits.* Money Funds are not operating companies. Their only activity is investing in certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments. Money Funds do not leverage their assets and do not have debt. Since they have no debt, there is no need to subject such funds to short-term debt limits.

A number of other provisions of the DFA require the Federal Reserve to impose additional prudential standards on nonbank financial companies supervised by the Federal Reserve, including:

- (i) *Stress Tests.* Section 165 requires the Federal Reserve to impose stress tests on nonbank financial companies subject to its supervision.¹⁰² As noted above, under Rule 2a-7, the board of directors of each Money Fund must adopt procedures providing for periodic stress testing of the fund’s portfolio. Fund managers are required to examine the fund’s ability to maintain a stable NAV per share based upon certain hypothetical events. These

¹⁰² See Pub. L. No. 111-203, § 165(i).

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include an increase in short-term interest rates, higher shareholder redemptions, a downgrade of or default on portfolio securities, and widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund.

- (ii) *Acquisition Limits.* Section 163 requires the Federal Reserve to impose restrictions on nonbank financial companies subject to its supervision that acquire companies engaged in financial activities.¹⁰³ Such a limitation would be irrelevant to Money Funds, which are owned by their shareholders.
- (iii) *Early Remediation.* Section 166 requires the Federal Reserve to impose early remediation requirements on nonbank financial companies subject to its supervision.¹⁰⁴ Current regulation of Money Funds includes significant requirements that are remedial in nature. For example, Rule 2a-7(c)(8) of the Investment Company Act requires Money Funds using the amortized cost method to “shadow price” their portfolio investments. The board must establish written procedures that require periodic calculations of the deviation between the current net asset value using available market quotations (or substitutions) and the fund’s amortized cost price per share. The board must promptly consider whether any action should be taken if the fund’s amortized cost price per share exceeds 1/2 of 1 percent, and must take prompt action if any deviation may result in material dilution or unfair results to investors or shareholders. Because of these requirements, additional early remediation requirements should not be necessary.

While many of the above requirements may be appropriate for large, interconnected nonbank financial institutions, many are either not appropriately applied to Money Funds, or if applicable, are addressed under the Investment Company Act and SEC rules in ways that are more stringent than bank-type prudential regulation.

Because the Money Fund industry operates on narrow margins, designating one or perhaps a handful of large Money Funds under Section 113 and subjecting them to additional prudential regulation under Section 165 would inevitably raise their costs, lower the rates they could pay to their customers, and result in a flight of investors from these funds to others that are not subject to these additional requirements.¹⁰⁵ Indeed, the President’s Working Group recognized this inevitable consequence of uneven regulation in its discussion of possible new

¹⁰³ See Pub. L. No. 111-203, § 163.

¹⁰⁴ See Pub. L. No. 111-203, § 166.

¹⁰⁵ Of course, it is possible that such designation would have the reverse effect by creating the perception that such an institution were “too big to fail.”

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regulations for registered Money Funds, which could drive investors to other unregistered substitutes.¹⁰⁶

The SEC has Ample Authority to Enforce Regulatory Requirements and Take Comprehensive Emergency Actions Involving Money Funds.

In addition to its comprehensive program of regulation and supervision of Money Funds, the SEC has broad powers to take prompt action to address emergency situations at a Money Fund and promptly resolve the problem. In the Reserve Primary Fund situation, the SEC successfully invoked certain of these powers. Should such a situation arise again in the future, the SEC is able to draw upon the experience it gained in the Fall of 2008, and promptly intervene to oversee an orderly and prompt wind-down of the Money Fund. The SEC powers to address emergency situations at a Money Fund (some of which must by rule occur automatically without action by the SEC) include:

- SEC rules impose a requirement that the Money Fund make an immediate shift to floating NAV if it departs from the stable NAV;
- Money Fund trustees' are authorized to defer share redemptions, and liquidate the Money Fund, thus treating all investors the same;
- The SEC has the ability to immediately intervene and force a court-supervised liquidation of a troubled Money Fund where the trustees are unwilling or unable to take the above steps;
- The SEC has emergency power under Section 12(k) of the 1934 Act to act by order in an emergency with respect to any matter subject to its regulation, including investment companies;
- The SEC is authorized under Section 25 of the Investment Company Act to intervene in respect of reorganizations and liquidations of investment companies;
- The SEC has cease-and-desist powers under Section 9(f) of the Investment Company Act;

¹⁰⁶ See REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 21, 35, available at <http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf> ("Reforms that reduce the appeal of MMFs may motivate some institutional investors to move assets to alternative cash management vehicles with stable NAVs, such as offshore MMFs, enhanced cash funds, and other stable value vehicles. These vehicles typically invest in the same types of short-term instruments that MMFs hold and share many of the features that make MMFs vulnerable to runs, so growth of unregulated MMF substitutes would likely increase systemic risks. However, such funds need not comply with rule 2a-7 or other ICA protections and in general are subject to little or no regulatory oversight. In addition, the risks posed by MMF substitutes are difficult to monitor, since they provide far less market transparency than MMFs.")

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- The SEC has power to obtain injunctive relief under Sections 36 and 40(d) of the Investment Company Act;
- The SEC has power to impose civil money penalties on Money Funds and their related persons under Sections 9(d) and 40(e) of the Investment Company Act;
- The SEC can bring a judicial action and invoke the Federal courts' 1934 Act § 21(d)(5) equitable remedies powers; and
- The SEC can bring a judicial action and petition the Federal court to invoke the All Writs Act¹⁰⁷ powers to enjoin other proceedings that interfere with the court's jurisdiction over the matter.

Other than a federal guarantee of investors, an injection of liquidity into a Money Fund, or a bail-out of Money Fund shareholders (the "too big to fail" federal safety net that Title I of the Dodd Frank Act was designed to limit and which public opinion strongly opposes) there are no additional steps involving Money Funds that the Federal Reserve could take under Title I of the Dodd-Frank Act that have not already been addressed by the SEC or for which the SEC does not have ample statutory authority to address going forward.

IV. Regulators Should Proceed with Caution in Altering Current Regulation and Oversight of Money Funds

As discussed above, the current comprehensive regulatory system governing Money Funds has been very successful in maintaining the solvency of Money Funds. Significant enhancements were put in place by the SEC in 2010, building upon the lessons of the financial crisis, which further enhanced the program of regulation applicable to Money Funds and further reduced the risks associated with them. As the Council considers the instant proposal, it must bear in mind the President's recent Executive Order, which emphasizes that agencies must "seek to find the least burdensome tools for achieving regulatory ends," and notes that "[s]ome sectors and industries face a significant number of regulatory requirements, some of which may be redundant, inconsistent, or overlapping. ... In developing regulatory actions and identifying appropriate approaches, each agency shall attempt to promote ... coordination, simplification, and harmonization."¹⁰⁸ In keeping with the Executive Order, care should be taken in any change to these rules not to undermine the strength and simplicity of the current system of regulation in a way that would increase risks or impair the ability of Money Funds to continue to provide a high quality product for consumers and businesses.

¹⁰⁷ 28 U.S.C. § 1651.

¹⁰⁸ *Improving Regulation and Regulatory Review*, Executive Order No. 13563 (Jan. 18, 2011).

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In this regard, we note that it was the bankruptcy of Lehman Brothers that triggered the problem at the Reserve Primary Fund in 2008, not the other way around. As discussed above, Section 113 designation, together with the regulatory tools that flow from such designation, is designed and necessary to address the risk posed by large, interconnected nonbank financial institutions like Lehman – the company whose financial stress and ultimate failure actually did destabilize the financial markets. Lehman was already overly leveraged in 2008. In 2004, as part of its Consolidated Supervised Entities program for the supervision of investment banks, the SEC permitted the firm to calculate capital requirements by alternative methods based on Basel II standards, and which relied on Lehman's internal risk models.¹⁰⁹ The result was that Lehman and other investment banks more than doubled their leverage ratios – for Lehman, this meant a gross leverage ratio of average assets to net capital of almost 32 to 1.¹¹⁰ In fact, Lehman's situation was even more precarious according to the Bankruptcy Examiner, as it projected the appearance of financial health by using accounting methods that disguised repurchase agreements as outright sales.¹¹¹ Yet, notwithstanding its status as an SEC-supervised firm and a primary dealer subject to applicable capital and related standards of the Federal Reserve,¹¹² Lehman's regulators either did not have or did not use authority to limit its activities or institute prudential measures to reduce the systemic risk posed by its operations and potential failure.

Lehman was also heavily reliant upon short-term funding, and its paper was held by many companies. The Reserve Primary Fund's loss on Lehman commercial paper that led to its share repricing was a symptom, but not a cause, of the systemic risk posed by Lehman's failure, although mismanagement at Reserve undoubtedly compounded its problems, and, ultimately, compounded the uncertainty among Money Fund investors in September 2008 that led to the broader run on Money Funds.¹¹³

¹⁰⁹ SEC Rel. No. 34-49830, *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Supervised Investment Bank Holding Companies; Final Rules*, (Jun. 8, 2004) 69 FR 34428 (Jun. 24, 2004).

¹¹⁰ SEC Office of the Inspector General Report: *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program*, at 120 (Sept. 25, 2008), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf>.

¹¹¹ *Report of Anton R. Valukas, Examiner*, In re Lehman Brothers Holdings, Inc., Chapter 11 Case No. 08-13555 (JMP) (Bankr. S.D.N.Y., Mar. 11, 2010).

¹¹² See Federal Reserve Bank of New York, Operating Policy: *Administration of Relationships with Primary Dealers* (Jan. 22, 1992), available at http://www.ny.frb.org/markets/pridealers_policies_920122.html.

¹¹³ The Reserve Primary Fund was a large fund that held debt owed by many issuers and that had many investors. Yet, as the stability of other money funds in 2008 shows, being large or having many relationships did not increase its chances of failure. The Reserve Primary Fund broke the buck because management unduly concentrated assets in Lehman debt, notwithstanding numerous warning signs as to Lehman's weakness. Moreover, management

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Investment risks in the portfolios of Money Funds have historically been the result of problems at issuers of commercial paper, particularly at financial services firms. In addition to the solvency of the issuers of commercial paper, the solvency of banks that issue letters of credit that backstop commercial paper is also significant to the strength of the investment portfolios of Money Funds.

Title I (and other provisions) of the DFA is intended to address and control the risk at financial services firms – particularly those entities which are so interconnected that they present “systemic risk” – and thus controls risk in the financial services industry as a whole. If implemented effectively by regulators, this will have the effect of significantly reducing the risks in the portfolios of Money Funds as investors in commercial paper issued by those companies. These changes at financial services firms include increased oversight of the holding companies of nonbank financial services firms, increased capital requirements, reduction in counterparty exposure, and significantly, measures to reduce liquidity risk and over-reliance on short term funding of financial services firms. Particularly as regards the larger and systemically significant companies that have been major issuers of commercial paper, the changes being put in place under the DFA in the regulation of the financial services firms as issuers or guarantors of commercial paper will have the added benefit of further reducing portfolio risks at Money Funds. Had Title I of the DFA been in place prior to 2008, Lehman may not have failed and, thus, the Reserve Primary Fund might not have broken a buck and consequently suffered a run and been forced to liquidate.

Similarly, the DFA’s new requirements for regulation and SEC oversight of credit rating agencies and the movement away from excessive reliance on their ratings, is a systemic change that will have the effect of further reducing risk in Money Fund portfolios.

Care should be taken not to impose excessive regulatory burdens on Money Funds that would effectively force them out of business. Several sponsors of Treasury-only funds have had

Footnote continued from previous page

fraudulently “significantly understated the volume of redemption requests received ... and failed to provide [the fund’s] trustees with accurate information concerning the value of Lehman securities.” SEC Litigation Release No. 21025, *SEC v. Reserve Management Company, Inc., Reserve Partners, Inc., Bruce Bent Sr. and Bruce Bent II* (May 5, 2009). Indeed, the fund’s management assured shareholders, ratings agencies and the fund’s trustees that the fund’s adviser had agreed to provide capital to the fund, even though this was not true. See Complaint of the SEC, *SEC v. Reserve Management Company, Inc., Reserve Partners, Inc., Bruce Bent Sr. and Bruce Bent II*, Civ. No. 09 CV 4346 (May 5, 2009), available at <http://www.sec.gov/litigation/complaints/2009/comp21025.pdf>. If management had not made such false statements, but had priced holdings as required by law or had supplied the price support that they had stated they would, the resulting run on the fund might have been significantly reduced or even averted.

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to close their funds, or limit new investments to existing investors.¹¹⁴ Recently, the seven-day average yields on taxable Money Funds fell to a record low, according to data published by iMoneyNet. Narrow margins are leading to a shake-out in the industry. Despite these enormous pressures on Money Funds, they remain popular due in large part to their stable NAV.¹¹⁵ Major regulatory change, such as forcing these funds to adopt a floating NAV, is likely to lead to few funds surviving.¹¹⁶

The consequences of doing away with Money Funds would have far-reaching implications. For example, if Money Funds were to be regulated out of existence, the balances would need to go somewhere. The most likely destination for a large portion would be into money market deposit accounts at banks. But the addition to bank balance sheets of a large portion of the \$2.7 trillion currently invested in Money Funds would require a significant amount of new equity capital in banks to offset the added leverage of the new deposits, just as banks are scrambling to increase capital for the balance sheet sizes they currently carry. Moreover, the net result would be to greatly increase the size of the federal safety net, to cover these new FDIC-insured deposits. One of the fundamental purposes of the DFA was to scale back the size of the federal safety net and the amount that taxpayers are on the hook for in the future. Forcing investors out of Money Funds and into bank deposits will have the perverse effect of increasing the size of the federal safety net.

¹¹⁴ See Andrew J. Donohue, Director, SEC Division of Investment Management, *Keynote Address at the Practising Law Institute's Investment Management Institute*, April 2, 2009, available at <http://www.sec.gov/news/speech/2009/spch040209ajd.htm>. Mr. Donohue points out that “money market funds have also had to address the challenges posed by low or non-existent yields in treasury securities — in fact, we have been seeing the lowest yields on Treasuries in 50 years. These low yields are driven by the flight to quality as institutions increasingly move into U.S. government money market funds. As some portfolio securities mature and these funds purchase new treasuries with new money the yield is diluted even further. As a result we have seen a number of treasury money market funds close to new investors and we understand funds have waived fees and expenses in order to avoid negative yields.”

¹¹⁵ See Steve Watkins, *Money Market Industry Opposes Mandate for Floating Share Value*—Some managers fear change could kill the industry, Aug. 2010, available at http://www.heartland.org/full/28211/Money_Market_Industry_Opposes_Mandate_for_Floating_Share_Value.html (noting that according to Brian Reid, the ICI's chief economist, demand for Money Funds has held up even with interest rates so low that funds averaged a 0.11 percent yield in early August 2010, based on data from Crane Data, which tracks Money Funds. Mr. Reid “fears the industry would be severely damaged if funds are forced to switch to a floating NAV. Institutions would likely form their own investment pools, and individuals would likely turn to banks. You would very likely see significant outflows.”)

¹¹⁶ See *id.* (noting that Brian Kalish, director of the finance practice at the Bethesda, Maryland-based Association for Financial Professionals, believes that requiring a floating NAV “will pretty much kill the money market product... The reason investors buy money markets is for the stable NAV.”)

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Some balances from Money Funds might be invested in floating NAV funds. But those funds, in the form of ultra short bond funds, have been around for many years and have never been particularly popular with either retail or institutional investors.

Some balances from Money Funds might be invested directly in money market instruments. For retail investors and smaller businesses and institutions that do not have a large, sophisticated treasury desk, this is not a realistic alternative. For larger corporations and institutional investors with a large treasury function, this may simply transform the risk of institutional runs on Money Funds to a risk of runs by investors on particular issuers of commercial paper. This would not protect the commercial paper market and the financing needs of issuers; instead, it might amplify the problem and trigger more insolvencies of issuers of commercial paper by removing Money Funds as a buffer against the nervous impulses of institutional investors that are loaded up on paper from underlying issuers.

Money Funds provide essential short-term funding for corporations and municipalities. They account for almost 40% of outstanding commercial paper, approximately two-thirds of short-term state and local government debt, and a substantial amount of outstanding short-term Treasury and federal agency securities.¹¹⁷ Banks are not equipped to provide short-term funding through the purchase of commercial paper and other short-term debt instruments.¹¹⁸ Banks are unable to pass through tax-exempt income to depositors and therefore cannot replace tax-exempt Money Funds, which would deprive state and local governments of an important source of financing.¹¹⁹ Moreover, if funds withdrawn from Money Funds were reinvested with banks, this would result in tighter short-term credit for U.S. companies unless banks raised significant amounts of capital to support their expanded balance sheets.

Even then, the cost of short-term credit is likely to rise and would be less efficient.¹²⁰ As letters submitted to the SEC in response to the PWG Report make clear, Money Funds are a significant source of short-term financing of state and local governments, purchasing about 65%

¹¹⁷ See REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 7, available at <http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf>.

¹¹⁸ See BlackRock, Inc., *Viewpoint: Money Market Mutual Funds*, July 13, 2010 (stating BlackRock's belief that "banks are not equipped to provide short-term funding to the economy in the way that money market funds are through the purchase of commercial paper and other short-term debt instruments. This could result in a meaningful disruption to corporations, municipalities, our entire financial system and our economy.") Available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111117211.

¹¹⁹ See ICI Money Market Working Group Report, at 111, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

¹²⁰ *Id.*

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of all short-term public debt.¹²¹ Commenters on the Report, such as the National League of Cities, noted that regulations that inhibit investment in money funds “would dampen investor demand for the securities we offer and deprive state and local governments of much-needed capital.”¹²² Letters from business associations describe how important Money Funds are as a source of short-term financing to small and large businesses for such things as inventory, receivables, and payroll. These letters also express similar concerns on restrictions that may result in investor money flowing out of money funds.¹²³ For example, the New Jersey Chamber of Commerce has noted that “[r]egulations that shrink the pool of money market mutual fund capital available to businesses will negatively impact their ability to meet their cash requirements, causing large disruptions in the nation's economy.”¹²⁴

Another potential downside to designation of a company as systemically significant under Title I is the increased public perception that it is “too big to fail” and will ultimately be bailed out by the government if things go wrong, as was the case in investor expectations with respect to the commercial paper of Lehman. Money Fund investors are advised in no uncertain terms in the prospectus and sales materials that the funds are not insured and may lose value. But a designation of a Money Fund for regulation like a bank may tend to confuse that message in the public's mind.

Designation of one or more Money Funds as systemically significant could be disruptive. As discussed above, Section 113 does not contemplate designation of an entire industry as significant; rather, it contemplates company-by-company designations. But designation of a few of the larger Money Funds under Section 113 would place those designated Money Funds at a competitive disadvantage (or possibly advantage) to the rest of the 652 Money Funds with which they compete. Continued regulation by the SEC of Money Funds allows the crafting of rules that

¹²¹ See Letters from state and local government entities listed in footnote 9 supra; Letter from the Treasurer of the State of New Hampshire.

¹²² Letters from state and local government entities listed in footnote 9 supra. See also letters from the Port of Houston Authority; Cincinnati/Northern Kentucky International Airport; Treasurer of the State of New Hampshire.

¹²³ Letters from the Financial Services Roundtable; Business Council of New York State; Dallas Regional Chamber; Associated Industries of Florida; New Jersey Chamber of Commerce. See also letter from the following businesses and associations: Agilent Technologies, Inc.; Air Products & Chemicals, Inc.; Association for Financial Professionals; The Boeing Company; Cadence Design Systems; CVS Caremark Corporation; Devon Energy; Dominion Resources, Inc.; Eastman Chemical Company; Eli Lilly & Company; Financial Executives International's Committee on Corporate Treasury; FMC Corporation; Institutional Cash Distributors; Kentucky Chamber of Commerce; Kraft Foods Global, Inc.; National Association of Corporate Treasurers; New Hampshire Business and Industry Association; Nissan North America; Pacific Gas and Electric Company; Safeway Inc.; Weatherford International; U.S. Chamber of Commerce.

¹²⁴ Letter from the New Jersey Chamber of Commerce.

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apply equally to all Money Funds – something that cannot be accomplished under Title I of the DFA.

Rather than imposing dramatic and potentially dislocative changes on the regulation of Money Funds through Title I of the DFA, we believe it would be more prudent to continue the careful fine-tuning of the SEC's highly successful regulatory program. The SEC has acted wisely in adopting new rules to substantially enhance the liquidity of Money Funds and further enhance their ability to withstand a potential run. Moreover, the SEC currently is evaluating the public comments submitted in response to its request for comments on the PWG Report on the results of its 18-month study of Money Funds. The PWG Report acknowledges the importance of the SEC's actions in making Money Funds more resilient. The PWG Report also presents eight separate options for additional reform, including a requirement to require floating net asset values for Money Funds generally, providing for differential requirements for different types of funds, providing various backstops (a private liquidity facility; Government insurance) and regulating stable NAV Money Funds as special purpose banks. A number of the options could be accomplished by SEC rule or, in the case of a private liquidity facility, by the private sector. Several options would require action by Congress. However, none of the options discussed in the PWC Report involve designation under Section 113 and prudential regulation by the Federal Reserve as a necessary or viable reform measure.

V. Other Flaws In the Proposed Rule

The rule proposed in the NPR contains a number of other flaws that are serious enough that the proposed rule should be withdrawn and re-proposed in a substantially modified form in order to address those flaws. To begin, as noted, the NPR fails to describe with specificity the quantitative or qualitative considerations used in making assessments under any of the criteria listed in the proposed rule or the statute. In addition, Section 170 of the DFA dictates that in connection with Council rules implementing Title I, the Federal Reserve “*shall* promulgate regulations in consultation with and on behalf of the Council setting forth the criteria for exempting certain types or classes of U.S. nonbank financial companies... from supervision by the” Federal Reserve, taking into account the ten criteria listed in Section 113(a)(2) that are discussed above. Section 170 is not merely a grant of authority, it is a specific rulemaking requirement that the exemptive rules *shall* be promulgated. The rules required by Sections 113 and 170 are inextricably intertwined, both operationally and textually, in the process of Council designation of certain nonbank financial companies for Federal Reserve supervision under Title I of the DFA and cannot operate independently. The Federal Reserve, working with the Council, has not yet promulgated rules implementing Section 170. Without the completion of the required Section 170 exemptive rulemaking, the Section 113 rulemaking is itself incomplete and should be stayed or withdrawn until the Section 170 exemptive rule is promulgated by the Federated Reserve in consultation with and on behalf of the Council.

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The NPR states that the proposed rule will have no direct impact on small businesses on the theory that small businesses themselves would not be directly designated. However, the imposition of Title I and II requirements on Money Funds would have an indirect, yet substantial, impact on small business enterprises if applied to Money Funds, as reflected in the comments submitted in the SEC docket on the PWG Report discussed above. Among other effects, the private rights of small businesses as investors in Money Funds, and the access by small businesses to funding available through Money Funds, would be substantially affected by a designation of a Money Fund under Title I or II. As a result, an assessment of the regulatory impact on small businesses is required in connection with consideration of the proposed rule.

The NPR estimates, for Paperwork Reduction Act purposes, that the total reporting burden on the financial service industry under the proposed rule will be 500 hours. In other words, the Council estimates that one individual, working ten hour days, could complete all of the paperwork and reporting required for the entire industry, working from Monday through Friday, in ten weeks. If one hundred bank and nonbank financial firms are designated, this would mean a firm, using only one employee could complete its reporting and paperwork in half a day. This is not a credible estimate of the reporting burden for one company, much less the entire universe of financial services companies in the aggregate. It is off by orders of many magnitudes. This error is central to the consideration of the proposed rule. Section 112(a)(2) of the DFA requires the Council to consider the impact on the efficiency and competitiveness of U.S. financial markets, a point which is emphasized in Section 112(d) and elsewhere in Title I. The President's recent Executive Order similarly required agency consideration of the time and burden associated with any new or amended regulation and its impact on efficiency and competitiveness.¹²⁵

When the estimated paperwork and reporting burden is so badly underestimated, the evaluation of the administrative and personnel costs and burdens associated with the rule, and their impact on the efficiency and competitiveness of financial firms, is necessarily flawed. This burden and benefit analysis, if done appropriately, should affect how broadly the Council chooses to go in sweeping in financial firms for additional supervision by the Federal Reserve under Title I.

When Congress was considering this provision, Federal Reserve Chairman Ben Bernanke testified that a total of roughly 25 firms, "virtually all of" which were bank holding companies already regulated by the Federal Reserve, would meet the test of systemic significance for

¹²⁵ *Improving Regulation and Regulatory Review*, Executive Order 13563 (Jan. 18, 2011).

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designation under the Act.¹²⁶ Now that Title I is being implemented, “mission creep” has entered the process. More recent testimony, while recognizing the need to consider the cost and economic burden associated with regulation, suggests that the Council plans to exercise its designation authority very broadly.¹²⁷ When the costs and economic burdens of a broad implementation are not accurately estimated, there is a significant risk that the Council will be overly inclusive in its designation of financial companies for supervision, in conflict with the intent of Congress, the terms of the statute, and the economic best interests of the American people.

More significantly, the interrelated provisions of Titles I and II relating to the designation of nonbank financial companies contain a number of Constitutional defects that have not been addressed, or even mentioned, in the NPR and ANPR.¹²⁸ As part of the process to taking agency action implementing these titles, the Council and Federal Reserve are required to consider the Constitutional issues associated with these provisions.¹²⁹ Banks voluntarily apply for and obtain FDIC insurance and thus opt in to the federal receivership provisions that come along with FDIC

¹²⁶ Regulatory Perspectives on the Obama Administration’s Regulatory Reform Proposals, Part II, Hearings before the Financial Services Committee, U.S. House of Representatives, 111th Cong., 1st Sess. July 24, 2009, H.R. 111-68 at 47-48 (testimony of Federal Reserve Board Chairman Ben Bernanke). Similar statements that only a very few firms were appropriate for designation under Title I were made on several occasions during consideration of the DFA. See, e.g. Written Statement of former Federal Reserve Board Chairman Paul A. Volcker to Senate Banking Committee (Feb. 2, 2010), Written Statement of former Federal Reserve Board Chairman Paul A Volcker to House Financial Services Committee (Sept. 24, 2009) (estimating number between 5 and 25 firms globally).

¹²⁷ Written Statement of FDIC Chairman Sheila C. Bair before Senate Banking Committee (Feb. 17, 2011) (available at <http://www.fdic.gov/news/news/speeches/chairman/spfeb1711.html>).

¹²⁸ The more obvious constitutional flaws include an inappropriate delegation of overly broad legislative power by Congress to the Council and other Federal agencies (see, e.g., *City of New York v. Clinton*, 985 F.Supp. 168 (D.D.C. 1998), *aff’d on other grounds*, *Clinton v. City of New York*, 534 U.S. 417 (1998), *Whitman v. American Trucking Co.*, 531 U.S. 457, 487 (2001) (concurring opinion of Justice Thomas); the normal cure for which is a narrow reading by the courts of the grant of authority in order to avoid the Constitutional issue, see e.g., *Almendarez-Torres v. United States*, 523 U.S. 224, 237-38 (1998); *Whitman*, 531 U.S. at 476 (concurring opinion of Justices Stevens and Souter), and the improper curtailment of the role and authority of Article III federal courts in the process of reviewing agency action associated with the designation of nonbank financial companies under Titles I and II of DFA, and in the adjudicating private rights. See *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982); Gray & Shu, *The Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010: Is It Constitutional?* (available at www.fed-soc.org); Federalist Society Panel Discussion on the Constitutionality of the Dodd-Frank Financial Services Reform Act (Nov. 19, 2010), webcast available at www.youtube.com/watch?v=qX2iDe1eox0; Cato Institute Policy Forum, *Is Dodd Frank Constitutional?* (Feb. 15, 2011), webcast available at <http://www.cato.org/event.php?eventid=7732>.

¹²⁹ See *Whitney Nat’l Bank v. Bank of New Orleans*, 379 U.S. 411, 418-425 (1965); *Iowa Indep. Bankers Ass’n v. Bd. of Governors*, 511 F.2d 1288, 1293 n. 4 (D.C. Cir. 1975).

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insurance and have direct access to Federal Reserve lending on a regular basis, enjoy a federal government-granted monopoly to subsidized deposit-taking as a means to finance their operations, and in the case of national banks and federal savings associations, are organized and exist under Federal law, and thus are both willing participants in, and direct beneficiaries of, a federal safety net that effectively subsidizes their costs of doing business. In contrast, nonbank financial entities are not voluntary participants in the Title I and Title II designation process and receivership provisions, nor are they participants in the federal safety net on a regular and continuous basis. Whatever may or may not be the Constitutionality of limited judicial involvement in and oversight of the designation and receivership powers as applied to banks that voluntarily elect into a federal receivership system outside of the normal bankruptcy process, the analysis is very different in the case of nonbank financial services firms. The Council must withdraw the proposed rule and consider the Constitutional issues associated with Titles I and II before re-proposing the rule for an additional comment period. If the Constitutional flaws in the statute can be fixed as part of the rulemaking, they must be fixed. If they are not fixable, then the rule cannot be validly adopted and must be withdrawn.

Finally, as a procedural matter, the Council has not yet been fully established. Section 111 of the DFA requires the appointment and confirmation of additional members, including among others, the Director of the Bureau of Consumer Financial Protection, the Director of the Office of Financial Research, and the Director of the Federal Insurance Office. This is not a situation of a board missing a member whose term has expired and a successor not yet confirmed to fill it. Rather, these seats have yet to be filled, and in some instances the agencies they are to represent have not yet been established. The purpose of a board with broad representation is to draw upon the viewpoints and expertise of all of the different members designated by statute. Without their participation, any action taken by the Council is taken without the inclusion of that expertise and viewpoint and is procedurally incomplete. Without these areas being represented by the members specified in the statute, the formation of the Council is not yet complete, and it cannot validly take action to propose or adopt regulations or designate any nonbank financial companies under Title I of the DFA.

VI. Conclusion

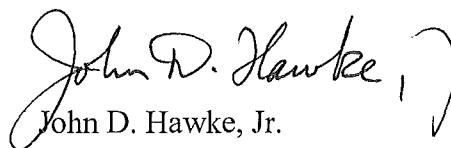
Money Funds have been a success story in U.S. financial regulation. Using a very simple, common sense approach, which permits investment only in short term, high quality money market instruments, the SEC has succeeded in supervising an efficient and effective program by which investors' cash balances provide financing for American businesses and governmental units. They are very popular with consumers, and very useful to the economy.

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Even if they were within the statutory definition of a “nonbank financial firm” and thus potentially subject to designation under Section 113, under an appropriate consideration of the statutory criteria for designation, as well as the potential damage and lack of benefit to the economic system from such a designation, Money Funds should appropriately not be designated for additional Federal Reserve regulation under Title I of the DFA. We suggest that the final rules or the release that will accompany the final rules provide more clarity on this point and indicate that due to the comprehensive SEC regulation and supervision of Money Funds, in light of the definitions and criteria in the statute, Money Funds will not be designated under Title I.

Although we recognize that some quarters continue to espouse the Carter Administration-era view that Money Funds should be regulated like banks, the reality is that the SEC’s regulation of Money Funds has been far more effective than the federal banking agencies’ regulation of banks. In the past 40 years only two Money Funds have broken the buck, and both were liquidated with relatively minimal losses to investors on a percentage basis and zero cost to the federal government. During that same period, more than 2,800 depository institutions failed, and almost 600 were kept afloat with government infusions of capital, at a total cost to the government of more than \$164 billion. There is nothing in the historical record to suggest that imposing “bank like” regulatory requirements on Money Funds through designation under Section 113 will make Money Funds, or the American economy, safer. The prudent course, in our view, is to continue to build upon what has worked and to refine the current program of regulation of Money Funds under the supervision of the SEC.

Sincerely,


John D. Hawke, Jr.