U.S. Securities and Exchange Commission

Statement on the Regulation of Money Market Funds

by

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U.S. Securities and Exchange Commission

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We were dismayed by the Chairman's August 22, 2012, statement on the proposal she advanced to restructure money market funds. The current discourse about the Commission's regulation of money market funds is rife with misunderstandings and misconceptions. This joint statement is intended as one step in setting the record straight. Our colleague, Commissioner Luis Aguilar, has already responded separately, and we respect the views presented in his response. We also commend Commissioner Aguilar for his efforts to engage in a constructive dialogue on money market fund reform.

The Chairman has recommended that the Commission approve a regulatory proposal that would have altered several fundamental features of money market funds. After careful consideration, we determined that the changes the Chairman advocated were not supported by the requisite data and analysis, were unlikely to be effective in achieving their primary purpose, and would impose significant costs on issuers and investors while potentially introducing new risks into the nation's financial system.

As an initial matter, the Chairman's statement creates the misimpression that three Commissioners — a majority of the Commission — are not concerned with, or are somehow dismissive of, the goal of strengthening money market funds. This is wholly inaccurate.

The truth is that we have carefully considered many alternatives, including the Chairman's preferred alternatives of a "floating NAV" and a capital buffer coupled with a holdback restriction, and we are convinced that the Commission can do better. Our view of the complex issues involved has been informed by the input of a range of market participants, including the many retail and institutional investors who have implored the Commission not to deprive them of the choice to invest in money market funds, as well as the interests of states, municipalities, and businesses that rely on money market funds as a key source of financing. We have also considered various pronouncements by other regulators on the topic.

Our decision not to support the Chairman's proposal, based on the data and analysis currently available to us, has also been informed by our concern that neither of the Chairman's restructuring alternatives would in fact achieve the goal of stemming a run on money market funds, particularly during a period of widespread financial crisis such as the nation experienced in 2008. The Reserve Primary Fund did not "break the buck" in a vacuum, but rather in the midst of a financial crisis of historic proportions.

Since the Commission adopted Rule 2a-7, the principal rule that governs money market funds, the Commission on multiple occasions has reviewed the efficacy of the rule and has adopted amendments to make improvements. Most recently, in 2010, the Commission adopted changes to Rule 2a-7 that have improved the liquidity and transparency of money market funds and decreased the credit risk of their portfolios with the objective of making such funds more resilient.

We want to emphasize that, just as the Chairman's proposal reflects the Chairman's good faith view as to what is best, our inability to support her proposal reflects what we believe is best for investors, issuers, the financial system, and the nation's economy at this time. In our judgment, the Chairman's proposal is flawed because it is premised on an incomplete perspective on the 2008 financial crisis — the effects of which both of us confronted directly at the SEC at the time and continue to grapple with today — and on the drivers of a financial run occurring in the midst of a crisis. Although there is a great deal to say about this, we will touch on just two points in this statement.

First, the Commission's 2010 money market fund reforms have not been shown to be ineffective in enabling money market funds to satisfy large redemptions and to remain resilient in the face of a sharp increase in withdrawals. In fact, the empirical evidence we have so far, such as the performance of money market funds during the ongoing Eurozone crisis and the U.S. debt ceiling impasse and downgrade in 2011, suggests just the opposite — that money market funds can meet substantial redemption requests, in large part, we have heard, because of the 2010 reforms. Second, the necessary analysis has not been conducted to demonstrate that a floating NAV or capital buffer coupled with a holdback restriction would be effective in a crisis. Indeed, both alternatives disregard the predominant incentive of investors in a crisis to flee risk and move to safety. Reason indicates that such behavior — the "flight to quality" — is likely to overwhelm the buffer proposed by the Chairman and swamp the effect of a holdback. As for the floating NAV proposal, even if there is no stable $1.00 NAV — i.e., even if, by definition, there is no "buck" to break — investors will still have an incentive to flee from risk during a crisis period such as 2008, because investors who redeem sooner rather than later during a period of financial distress will get out at a higher valuation. Thus, if neither the floating NAV proposal nor the capital-buffer-with-holdback proposal will solve the money market fund run problem, then neither proposal will foreclose the possibility that policymakers might once again face the prospect of supporting the commercial paper market in response to a widespread financial crisis.

Furthermore, we are concerned that the Chairman's proposal would, at a minimum, severely compromise the utility and functioning of money market funds, which would inflict harm on retail and institutional investors who have come to rely on money market funds for investing and as a means of cash management and on states, municipalities, and businesses that borrow from money market funds. Such adverse outcomes would undercut the SEC's mission.

There is no consensus of support among stakeholders for what the Chairman has offered. Instead, there is a serious debate over the appropriateness of those measures and the extent to which they would even achieve their primary objective. We agree with Commissioner Aguilar that even just proposing rule amendments that advance the Chairman's alternatives at this time could have harmful consequences.

Although we cannot support the Chairman's specific proposals, we are not opposed to further improvements to the Commission's oversight and regulation of money market funds. But further action must be advanced on the basis of data and rigorous analysis showing that any such changes to our existing rules would be workable, would be effective in achieving their purpose, and would not unwisely disrupt the functioning of money market funds and short-term credit markets. Ultimately, there must be a reasonable basis to conclude that the benefits of any new initiatives justify their costs, a straightforward premise that the Chairman herself espoused when committing the SEC to a thoughtful standard of economic analysis earlier this year.

We believe we share a common goal with other members of the Commission and other financial regulators. We have urged that the Chairman take a different way forward for strengthening the resiliency of money market funds. This approach would (i) empower money market fund boards to impose "gates" on redemptions; (ii) mandate enhanced disclosure about the risks of investing in money market funds; and (iii) conduct a searching inquiry into, and a critical analysis of, the issues raised by the questions we pose below.

In particular, it would be useful to receive comment on a proposal that would permit money market fund boards, as they deem appropriate and consistent with their fiduciary obligations to investors and without having to seek an exemptive order from the Commission, to "gate" redemptions to stave off a run and to allow the fund manager time to mitigate the concerns of investors who otherwise may be inclined to redeem. The Commission's 2010 amendments allowed boards to unilaterally suspend redemptions if the fund is put into liquidation. At that time, the Commission received input recommending that the Commission allow boards to impose a gate when they deemed appropriate, consistent with the boards' fiduciary duties to the fund's shareholders.

Discretionary gating directly responds, we believe, to run risk, both as to an individual fund and across multiple funds, as well as to the potential disparate treatment between retail and institutional investors. This should have the effect of addressing the conditions that gave rise to certain forms of governmental support in 2008, when money market funds had to sell portfolio assets to meet redemptions and scaled back their participation in short-term credit markets. These significant benefits of discretionary gating could be achieved by a straightforward amendment to the Commission's rules to expand a money market fund board's authority to impose gates, a change that would build on the 2010 reforms.

Such a proposal would, of course, require enhanced disclosures to investors that would clearly explain the liquidity and principal reduction risks that could accompany a fund board's discretionary gating authority. Beyond that, we would recommend other disclosure enhancements that may be warranted to clear up any misunderstandings investors may have as to the riskiness of their money market fund holdings.

Regrettably, the Chairman dismissed this approach. Instead, the draft release presented to the Commission relegates gating to a limited discussion of options that are implied to be inferior to the Chairman's preferred alternatives. Gating is never considered as a standalone proposal, but instead is coupled with a capital buffer.

Before the Commission intervenes in a way that threatens to jeopardize a $2.5 trillion sector of the economy — one that has efficiently facilitated capital formation for governmental and corporate issuers, as well as proven to be an attractive investment for investors and means of cash management — it is only reasonable to ask that the Commission have the best possible understanding of what is likely to happen. We have consistently stressed that we should obtain the required data and undertake a rigorous analysis to determine whether any remaining risks associated with money market funds warrant fundamental structural changes like the ones the Chairman has urged. At present, we lack satisfactory answers to many crucial questions, including, but not limited to, the following:

- During the peak of the financial crisis, in September 2008, investors redeemed assets from prime money market funds and, to a great extent, reinvested those assets into Treasury money market funds with the same structural features as prime money market funds. Do the sizeable *inflows* into Treasury money market funds during this period belie the claim that investors fled prime money market funds because of any structural flaws of money market funds? Did investors instead behave this way for another reason, such as a general aversion to risk or a "flight to quality" during the crisis? Did investors redeem from prime money market funds primarily in response to a single event, specifically the "breaking of the buck" by the Reserve Primary Fund? Or did other events, such as the failure and, in some cases government-sponsored rescue, of prominent financial institutions Lehman Brothers and AIG, as well as Fannie Mae, Freddie Mac, and Bear Stearns, contribute to the conditions that resulted in the run? If a money market fund were to break the buck outside a period of financial distress, would it cause a systemic problem, or only a problem limited to that particular fund?

- What have been the effects of the money market fund regulatory reforms that the SEC promulgated in 2010? To what extent have those reforms improved the liquidity of money market funds? Reduced the credit risk of money market funds? Reduced the interest rate risk of money market funds? Has the increased transparency into the portfolio holdings of money market funds made funds less susceptible to runs? Has the establishment of an orderly wind-down procedure mitigated the risk of a run? If so, to what degree? What do the available data tell us about how money market funds performed following the implementation of the 2010 reforms, considering, for example, the performance of funds during the European sovereign debt crisis and the 2011 U.S. debt ceiling impasse and ratings downgrade? How would money market funds have performed during the events of September 2008 had the 2010 reforms been in place at the time?

- If money market funds were to be fundamentally restructured and investors were then to shun such funds, to where would those assets migrate? What would be the implications of such a reallocation of capital for investors, financial institutions, systemic risk, and the overall economy?

- If substantial assets were to flow out of money market funds, what impact would that have on the commercial paper market and the market for municipal debt? What would be the impact on corporate borrowers, municipalities, and states that sell their debt to money market funds?

A searching inquiry to answer these questions must be undertaken. Had the staff been directed to perform this crucial work when the Chairman first announced her views in November 2011, we might now have the information required to determine what further action is necessary.

Regulatory intervention into a $2.5 trillion industry — an industry that is integral to meeting the funding needs of major American institutions, both public and private — must not be done on the basis of incomplete data and analysis, including a less than up-to-date understanding of the efficacy of the Commission's 2010 money market fund reforms. To date, no convincing evidence has been produced demonstrating that the fundamental restructuring of money market funds that the Chairman urges would be the appropriate means for addressing any remaining risks. To the contrary, what we have been shown tells us that the Chairman's proposal risks effectively ending prime money market funds as we know them, a result that cannot be justified given the significant doubt that the Chairman's alternatives would be effective in halting a run during another financial crisis and our present view that targeted reforms, such as the approach we outline above, would strike a better balance between costs and benefits.

The Chairman's approach would deprive investors of two fundamental benefits of money market funds: stability and liquidity. Regarding the capital buffer, which would be mandated along with the holdback, we understand, based on the discussions we have had and our consideration of the Chairman's proposal, that it could result in prime money market funds yielding to fund investors a return similar to that provided by Treasury money market funds. If this were to occur, one has to wonder why investors would invest in prime money market funds as opposed to investing in Treasury money market funds. In other words, the capital buffer, even by itself, would seem to risk substantially crowding out the prime money market fund sector at the expense of both corporate borrowers and investors.

We wish to stress that money market funds are squarely within the expertise and regulatory jurisdiction of the SEC. We do not intend to abdicate our responsibility to regulate money market funds, which would be unjustified and at the expense of our mission to oversee the securities markets. Accordingly, in the spirit of moving the agenda forward so that there can be constructive dialogue and engagement in this area, we ask that the Commission's staff of economists conduct detailed research and analysis on money market funds, including the staff's best efforts to answer the questions we have listed above, as well as others that are germane.

We look forward to reviewing the results of the work of the Commission staff in response to our request and to a constructive dialogue with the staff, our fellow Commissioners, and other regulators and stakeholders on what additional measures might warrant further consideration.

http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm