Treasury Strategies
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1/10/2011

By Electronic Mail

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

Re: <u>Request For Comment: Money Market Fund Reform Options (File No. 4-619)</u>

Dear Ms. Murphy:

Treasury Strategies, Inc. has prepared the following opinion in response to your request for comment regarding the Money Market Fund (MMF) Reform Options proposed by the President's Working Group (PWG) in October 2010. Treasury Strategies is the leading Treasury consulting firm working with corporations and financial institutions in the area of treasury, liquidity, and payments.

Money market funds (MMFs) exist because they provide numerous benefits to borrowers, investors, and the overall financial system. In particular, they provide diversification, liquidity, convenience, economies of scale, and credit management.

The fact that investors have placed nearly $3 trillion of assets into MMFs is evidence of the value these funds provide. With such significant assets, and with today's liquidity markets being as global and fluid as they are, any regulatory change to MMFs will have far-reaching impacts.

In its report, the PWG outlined eight policy options aimed at reducing systemic risk and the risk of "runs" on MMFs.

- Floating Net Asset Values (NAV)
- Private emergency liquidity facilities for MMFs
- Mandatory redemptions in kind
- Insurance for MMFs
- Two-tier system with enhanced protection for stable MMFs
- Two-tier system with stable NAV MMFs reserved for retail investors
- Regulating stable NAV MMFs as special purpose banks
- Enhanced constraints on unregulated MMF substitutes

Treasury Strategies strongly endorses the proposal to place enhanced constraints on unregulated MMF substitutes. However, we believe the other policy options should be rejected at present on the basis of the multi-trillion dollar unknown downstream consequences.

Only if and when thorough research and economic modeling can demonstrate that the value of these policies outweighs their negative impacts should they be considered. We believe such research will show that the January, 2010 changes to money fund regulations are far more than adequate to meet the safety, soundness and liquidity needs of the marketplace.

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Treasury Strategies believes the PWG proposals, with the exception of regulating MMF substitutes, should be rejected.

- MMFs have nearly 40 years of almost flawless performance during challenging market conditions
- New, stronger rules reducing MMF risks have already been put in place
- Investors continue to recognize the *existing* utility of MMFs, as evidenced by the nearly $3 trillion that they have invested
- The PWG admits their proposals will "reduce the appeal of MMFs to many investors"
- There is an absence of significant research, testing, and analysis to demonstrate that the benefits, if any, of these proposals outweigh the risks and negative impacts.

How Did We Get Here?

In September 2008, several factors, including the failure of Lehman Brothers Holdings, Inc., led to the rare event of a MMF "breaking the buck," or falling below a $1 NAV.

When the Reserve Primary Fund (RPF) broke the buck, it was only the second time in the nearly 40-year history of MMFs that investors lost any principal by investing in these funds. Even in this worst-case scenario for MMFs, RPF investors still received 99¢ for every $1 invested. And, we know now it was the significant deterioration of the Reserve Fund's underlying commercial paper holdings (primarily Lehman Brothers) and imprudent fund management that led to breaking the buck and not a flaw in the structure of MMFs. Thus, the Reserve Primary Fund situation is a red herring in the MMF industry debate.

Reserve's managers pushed every investment boundary to its limits, without restraint. Every reasonable stress test confirms the RPF was taking substantially more risk than other MMFs. The added risk produced higher yields, and as a result attracted substantial "hot money" from highly sophisticated, institutional investors. These investors were fully knowledgeable of the risks they were taking, and assumed they would be the first to be able to sell their investments if the Reserve Fund's bet on a government bailout of Lehman Brothers failed.

Rating agencies apparently assumed a government bailout of Lehman Brothers, evidenced by their failure to downgrade Lehman commercial paper until after their demise was at hand. They encouraged Reserve's imprudent investment behavior by upholding Lehman's improperly high ratings well beyond the obvious time to downgrade.

Unlike most other types of financial intermediaries, MMFs successfully dealt with serious challenges during this widespread financial hardship. No other MMF broke the buck or drew on the government-established temporary emergency facility. This testifies to the resiliency of these funds and the fact that the RPF situation was an isolated outlier. Although some sponsors provided support to their MMFs, it is not at all clear that the support was necessary to maintain the $1.00, rather than simply a move to instill public confidence.

Despite this remarkable performance, the SEC in January, 2010 adopted strict new rules for MMFs, which according to the PWG:

> *"…make MMFs more resilient and less risky and therefore reduce the likelihood of runs on MMFs, increase the size of runs that MMFs can withstand, and mitigate the systemic risks they pose…(but)…may also reduce the appeal of MMFs to many investors."*

To paraphrase:

These new rules are more than sufficient to resolve the problems, if in fact there were any. Furthermore, they may have already gone so far as to needlessly damage a very efficient investment instrument.

In its report, the PWG outlined eight policy options aimed at reducing systemic risk and the risk of "runs" on MMFs. Below, we comment on each.

- Floating Net Asset Values (NAV)
- Private emergency liquidity facilities for MMFs
- Mandatory redemptions in kind
- Insurance for MMFs
- Two-tier system with enhanced protection for stable MMFs
- Two-tier system with stable NAV MMFs reserved for retail investors
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Our analysis follows.

Floating Net Asset Values

A floating NAV will severely impact investors and fails to address systemic risk.

Through its corporate consulting, Treasury Strategies has learned that the stable $1 NAV feature of MMFs is critical to corporations because it adds convenience, simplifies accounting and tax reporting, and ensures preservation of capital.

Administrative Efficiencies – MMFs help investors minimize transaction costs. The dollar-in dollar-out stability provided by the constant NAV makes tracking and reporting vastly simpler for corporate investors.

Accounting/Tax Reporting Simplicity – The stable NAV also provides accounting simplicity, because there are no capital gains or trading gains/losses to account for with MMFs. This simplicity of accounting is highly valued by Corporate Treasurers because it reduces the potential for accounting errors and improves their overall effectiveness.

Preservation of Capital – Preservation of capital is a primary focus of a Corporate Treasurer's daily cash management because stability of a firm's operating cash is essential to smooth day-to-day business operations. In fact, since 2a-7 was established, approximately $325 trillion have passed through MMFs – over four and a half times the 2009 total nominal GDP of the entire world. A vast majority of these funds have flowed through MMFs without any loss of principal. In fact, throughout the history of MMFs, there have only been two funds that have "broken the buck." Both repaid investors only slightly less than they initially invested.

In addition, many corporate investment policies do not permit investment of short-term cash in instruments with a floating NAV. Requiring money market funds to adopt a floating NAV would undermine the convenience and simplicity they offer to investors and would raise new accounting, legal, and tax hurdles for investors who would likely discontinue their use.

In a June 2009 survey, Treasury Strategies took the pulse of the corporate market and found that 77% of corporate MMF users would move money out of MMFs and reallocate their portfolios in the event of a NAV rule change – in particular, a change from a constant $1 NAV to a floating NAV pricing method. Companies indicated they would move funds predominantly into bank deposits, offshore instruments, sweep products, and direct commercial paper.

Private Emergency Liquidity Facilities for MMFs

Establishment of an emergency liquidity facility will create moral hazard. Knowing that such a facility exists, fund managers will have incentive to take additional portfolio risk by investing in longer-term assets (as allowed under Rule 2a-7), in order to increase yields and gather more assets.

Creating an incentive for fund managers to take more risk contradicts the purpose of SEC rule changes, which are aimed at reducing risky practices.

Mandatory Redemptions in Kind

Mandatory redemptions in kind will create moral hazard because it reduces fund manager responsibility to ensure redemption liquidity. Fund managers will be less concerned with structuring asset maturities to meet anticipated redemptions. They will invest in instruments with longer maturities and, if a run occurs, simply pass the securities on investors.

Distribution in kind will raise additional challenges for both investors and fund managers. Fund managers will need to devise an equitable distribution of unique securities, which may have varying yields and maturities. Investors (especially retail investors) will be challenged with selling these securities. Receiving commercial paper rather than the $1 per share they expect will also confuse retail investors.

Additionally, MMFs already have the ability to redeem shares in kind under certain situations, although this option is rarely exercised or needed.

Insurance for MMFs

An insurance program to address credit risk will create moral hazard. Knowing that underlying securities are insured, fund managers will have incentive to invest in riskier securities (as allowed under Rule 2a-7), in order to increase yields and gather more assets.

Creating an incentive for fund managers to take more risk contradicts the purpose of SEC rule changes, which are aimed at reducing risky practices.

Two-Tier System With Enhanced Protection for Stable MMFs

A two-tier system of stable NAV and floating NAV investment options ***already exists*** in the marketplace and the marketplace has ***rejected it*** by overwhelmingly investing in stable NAV MMFs over floating NAV options. Many ultra-short bond funds have fluctuating NAVs. These fluctuating NAV funds have attracted relatively few assets compared with the nearly $3 trillion in MMFs.

> *Ultra-Short Bond Funds* – Ultra-short bond funds generally have higher risk than MMFs because they are not subject to the same credit quality and maturity standards as 2a-7 funds. They have both credit risk and basis risk and thus have recently seen dramatic NAV fluctuations. Some of these are unable to provide investors with same-day liquidity. As a result, corporate investors have been less comfortable using them for short-term cash investment.

With such a two-tier system already available to investors, it is clear that such a redundant proposal will add little or no value. Investors will simply continue to invest in stable NAV funds over floating NAV alternatives. PWG proposals that make MMFs even less attractive versus these alternatives by adding “enhanced protection” for stable NAV funds will risk ballooning the assets of these problematic instruments or other unregulated alternatives. This will further exacerbate financial system risk.

Two-Tier System with Stable NAV MMFs Reserved for Retail Investors

A two-tier system with institutional investors forced into floating NAV funds and retail investors in constant NAV funds has the same shortcomings noted above. As demonstrated above, both institutional and retail investors have shown their desire for stable NAV funds by voting with their dollars and rejecting floating NAV funds.

Ultimately, upon eliminating stable NAV funds from their investment options, the bulk of corporate and institutional investors will have little desire to invest in floating NAV funds. The end result will be an outflow of funds from MMFs into unregulated domestic funds or driving them offshore entirely.

Regulating Stable NAV MMFs as Special Purpose Banks

This idea ignores the fundamental fact that ***investments*** (in MMFs) are ***not deposits*** (in banks). Institutional MMF investors understand this clearly.

Bank-type regulation will in effect place a tax on MMFs due to the capital and added regulatory reporting that will be required. This will erode or wipe out yield, destroying much of the value MMFs provide to investors.

Bank regulation will create new costs for funds, which will ultimately be passed to investors. The increase in reporting, compliance, and legal costs from reporting to multiple regulators will have to be included in management fees. Such requirements could raise management fees by as much as two percentage points, which will effectively be passed on as a tax on shareholders[1].

Enhanced Constraints on Unregulated MMF Substitutes

Unregulated investment pools will grow exponentially larger if MMFs are made less attractive. Investors fleeing MMFs can easily move into these substitutes with the click of a mouse. In fact, many groups of investors will find it attractive to create their own less regulated substitutes.

Thus, regulating MMF substitutes is not only worthy of consideration, it is overdue and essential for our financial system. The problem has been apparent, yet ignored, since the Orange County crisis in 1994. Investments falling into this category include enhanced cash funds (3c-7), Local Government Investment Pools (LGIPs), collective investment pools and special purpose trusts such as the Commonfund.

Standard & Poor's estimates there are over 125 LGIPs in operation today that, according to iMoneyNet, maintain assets of over $250 billion[2]. Tighter portfolio composition rules for Local Government Investment Pools (LGIPs) would directly reduce systemic risk for these crucial public monies. Since many municipal and state government bodies are already strapped for cash, preventing potential investment loss by regulating these pools is a clear public service.

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[1] Demonstrated by Prof John F. O. Bilson, “The Economic Value of Money Market Funds,” May 2009

[2] iMoneyNet Special Report “Government Investment Pools: Investment Strategies, Facts, Figures and Trends” by Michael Krasner, February 2009

The fact that LGIPs have experienced numerous failures and losses versus the nearly spotless record of MMFs is evidence of the relative risks posed by these vehicles. LGIPs are currently not subject to Rule 2a-7 and can invest in securities without satisfying the credit quality standards, maturity limits, or diversification requirements of 2a-7 MMFs.

As a testimony to their relative risks, aggregate LGIP assets have shrunk following LGIP failures in Florida, Colorado, and Washington. LGIPs and other unregulated collective investment pools may be a ticking time bomb for municipalities, public and private universities, and other investors.

Notable LGIP events or failures:

- In early 2009, the $9.3 billion Commonfund short-term portfolio for universities had to halt redemptions.
- In November 2007, the state-run Local Government Surplus Funds Trust Fund Pooled Account in Florida (then around $27 billion) revealed that nearly $2.1 billion of its holdings were in defaulted asset-backed securities and other troubled assets.
- In late 2007, the King County (Washington state) fund required county intervention to buy out troubled securities from the LGIP portfolio.
- In late 2007, the Orange County LGIP (which also went bankrupt in 1994) along with Maine, Connecticut, and Montana held close to $1 billion combined in defaulted SIVs (structured investment vehicles) and ABCP (asset-backed commercial paper) short-term debt.
- In late 2007, the Florida LGIP experienced a run (from $27 billion to $15 billion) before it froze withdrawals in November. 6% of their portfolio was held in ABCP and SIVs, and 4% was in CDs at Countrywide Bank, which collapsed in 2008.
- The Colorado Diversified Trust, with total assets of $275 million, held 1.8% of its assets in Lehman Brothers commercial paper, purchased in March of 2008. This fund was rescued by being absorbed into the $3.5 billion asset ColoTrust.

Conclusion

Treasury Strategies rejects all PWG proposed policy options for MMF reform, other than adding regulation to unregulated MMF substitutes. As we have argued, the proposed options create additional moral hazard and duplicate market offerings that already exist and which are relatively unattractive to the investing marketplace. Implementation of ***any*** of the first seven options presented by PWG would essentially dismantle a $3 trillion, smoothly functioning aspect of the U.S. money markets, which has proved remarkably resilient and reliable for 40 years.

Sincerely,

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APPENDIX I — Events of the Reserve Primary Fund Failure

The following section represents what we believe happened at the Reserve Primary Fund (RPF). It is instructive at two levels.

> First, it shows that RPF's operations were conducted in broad daylight in full view of the investors, regulators, rating agencies and the fund's own board. The fund had become a well-known $62 billion bet that that government would rescue the financial system.
>
> Second, it provides a glimpse of things to come, should Moody's institute its new fund rating system in which the top rating is based on sponsor support. Essentially, a fund in distress will find investors making the same bet they did with RPF. Will the sponsor support the fund or not? Fed Chairman Bernanke himself has expressed concern in this area.

From January through August 2007, the RPF had approximately 1.8% market share of total prime MMF assets. During this time, both its institutional and retail share class yields lagged the peer group by up to 5 bps.

Through 2008, RPF's yield led its peer group by 18-38 basis points (bp). This was during the same period when the benchmark yield was sometimes under three percent.

Reserve's market share doubled as it paid higher yields and took more risk. By October of 2007, Reserve's market share was 2.6%; in May of 2008 it reached 3.3%, where it remained through the beginning of September.

In published financial reports, on November 30, 2007, Reserve had total assets of $39 billion. $375 million was held in Lehman Brothers commercial paper, and approximately $18 billion was in other ABCP (almost 50% of total assets, which was considerably different than most other MMFs).

Over the next 6 months, total assets grew to $64 billion. Lehman CP holdings were $785 million and ABCP accounted for $22 billion (May 31, 2008). This was 36% of a much larger pool.

On Monday, September 15, Lehman Brothers declared bankruptcy. Through mid-day, Reserve received redemption requests for and paid out $11.5 billion (nearly 20% of fund shares).

Over the next 24 hours, Reserve received and acknowledged an additional $29 billion of redemption requests, but did not pay these out. Reserve removed all these shares from the calculation of the Fund's NAV, despite having not paid them out. At this point, nearly two-thirds of the fund shares had been redeemed or counted as redeemed. This point is significant because any subsequent write-downs would be borne by an increasingly small portion of the shareholders of record as of Monday morning.

Throughout Monday, Reserve priced the RPF at $1 per share. At 4 PM Monday, the Reserve Board valued the Lehman CP at 80¢ on the dollar. This was the maximum write-down that would have allowed the NAV to remain at $1 per share. On Tuesday morning, a Reserve clerical error in a valuation spreadsheet revalued the Lehman CP back to 100%. Prior to 4 PM Tuesday, the NAV continued to be struck at $1 (oddly, this error was not discovered until November 9). At mid-day Tuesday the 16th, Reserve halted redemptions completely. Fund assets had dropped to $22 billion. At 4 PM Tuesday, the Board valued the Lehman CP at zero, breaking the buck with an NAV of 97¢.

This set off a market panic lasting several days, in which investors exited MMFs broadly and Prime funds particularly. About $210 billion was redeemed during the week of September 15. Liquidity flowed into Treasury Funds and bank deposits, and Treasury yields dropped to nearly zero.

Since October 2008, MMFs have retaken the high ground. Assets are flowing into these funds and no further failures have been reported. The SEC's new regulatory rules, adopted in January 2010 have mitigated risks related to MMFs breaking the buck.

APPENDIX II — Background of Authors

Treasury Strategies, Inc. is the leading Treasury consulting firm working with corporations and financial institutions. Our experience and thought leadership in treasury management, working capital management, liquidity and payments, combined with our comprehensive view of the market, provides us a unique perspective and unparalleled insights into both the corporate and financial sectors. The fact that our clients include corporate investors, financial institutions, regulators, and fund companies is further evidence of our involvement within the money market fund industry. Anthony J. Carfang and Cathryn R. Gregg are Partners of Treasury Strategies. Jacob Nygren is a Manager at Treasury Strategies.