



January 15, 2013

Financial Stability Oversight Council
Attention: The Honorable Timothy Geithner
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

By Internet: <http://www.regulations.gov>

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003) – Alternative One: Floating Net Asset Value

Members of the Financial Stability Oversight Council:

We are writing in response to the Financial Stability Oversight Council's (the Council) recommendations on money market mutual fund (MMF) reform, "*Proposed Recommendations Regarding Money Market Mutual Fund Reform*," (the Proposal(s)). Treasury Strategies, Inc. has prepared the following opinion regarding the Council's recommendation that MMFs adopt a floating NAV.

Treasury Strategies is the world's leading Treasury consulting firm working with corporations and financial institutions in the areas of treasury, liquidity, and payments.

The Council is focused on reducing the risk of runs on MMFs, as one way to lower the likelihood of systemic breakdown in the larger financial sector. You believe requiring MMFs to have floating or variable net asset values (NAVs) will reduce the risk of runs. You also argue that "re-pricing" funds from \$1 to \$100 will improve investors' understanding of MMF risk as they see their share values frequently fluctuate.

Implementing a floating NAV would produce severe market consequences. At the same time, no evidence has been offered to support the claim of reducing susceptibility to a run. Furthermore, changing the price from \$1 to \$100 is irrelevant in how investors perceive MMFs. The pricing change implies that investors, especially institutional investors, enter into an investment with an MMF based on the unit of cost, rather than the diversification, liquidity, safety, and operational simplicity offered by MMFs.

The proposal to require MMFs to adopt a floating NAV is deeply flawed for the following reasons:

- A floating NAV increases the likelihood of runs for all types of runs: credit-driven, liquidity-driven, and speculative;
- History has proven floating NAV funds are susceptible to runs;
- Floating NAV MMFs will be prone to runs triggered by interest rate changes;

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- A floating NAV will impose additional costs on investors, significantly hampering the appeal of MMFs;
- The same-day liquidity feature of MMFs will disappear, causing many investors to exit;
- A floating NAV will lead to assets leaving MMFs, impairing credit markets that depend on MMFs for short-term financing;
- Displaced MMF assets will be lost from regulatory oversight, and will exacerbate the “Too Big to Fail” problem; and
- Current MMF regulations are sufficient to prevent runs.

Treasury Strategies believes this proposal will result in severe negative consequences for investors and fund advisors, without accomplishing the primary regulatory goal of reducing the likelihood of a run. We strongly recommend that you withdraw this proposal.



A Floating NAV Increases the Likelihood of Runs for All Types of Runs: Credit-driven, Liquidity-driven and Speculative

The Council justifies the push for additional MMF regulation by asserting it will help prevent a run on MMFs. The Council argues that these runs have destabilizing implications for financial markets and the economy. However, the Council did not present any quantitative or historical data to prove MMF susceptibility to runs, outside of the Reserve Fund breaking the buck during the financial crisis. That black swan situation should hardly be the regulatory baseline.

Indeed, the Council underplays the role the financial crisis and the ensuing fear-based investor mindset had in triggering the alleged run on MMFs – while simultaneous runs occurred in nearly all equity and debt sectors. Even physical assets declined in price, as illustrated by the oil price drop of over 60% in the fourth quarter 2008.

At the same time, the Council overemphasizes the need for added MMF regulation, which the crisis supposedly revealed. During the worst financial crisis since the Great Depression, investors of *only a single* money market fund experienced a loss of *just under a penny a share*.

Requiring funds to move to a floating NAV will not prevent a run and may actually be *less* effective in preventing a run than a constant NAV (CNAV) fund. A run is caused by depositors who believe that if they wait too long to withdraw their money, there may be none left. It is this psychological aspect combined with people's natural aversion to loss that make runs so dangerous.

As the Federal Reserve Bank of New York explained in its July 2012 working paper on MMFs, "A floating NAV might lead to a steep decline in investor demand for MMF shares and a migration of assets to less regulated vehicles that continue to offer stable NAVs. Moreover, even if MMFs with floating NAVs remain sizable, they might continue to be vulnerable to runs, since *investors in distressed funds still would have strong incentives to redeem.*"¹ [emphasis added]

Three types of runs are relevant to financial institutions:

- Credit-driven runs occur as a result of a confirmed negative credit event in a security in which the institution is invested; this leads investors to liquidate shares to limit possible losses.
- Liquidity-driven runs are precipitated by investors redeeming shares out of fear that, if they fail to do so immediately, they will be unable to do so later.
- Speculative runs occur as a result of rumors or speculation about events or actions that may or may not occur within a fund.

CNAV structures, such as today's MMFs, are more resilient than floating NAV structures against all three types of runs, as explained in the following pages.

¹ Federal Reserve Bank of New York Staff Report, "The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds," July 2012.

Credit-Driven Runs

The need to maintain a constant value acts as discipline on fund managers. It causes them to manage in a way that makes the funds more resilient and less prone to credit-driven runs than floating NAV funds.

A credit-driven run occurs as a result of a confirmed negative credit event in a security in which the fund is invested; this leads investors to liquidate shares to limit possible losses. In a CNAV fund, managers maintain high credit quality and low risk holdings, beyond that required by Rule 2a-7, to avoid runs resulting from credit downgrades.

In fact, a recent academic study sponsored by the U.S. Chamber of Commerce notes that prime MMFs have become much less risky since the start of the financial crisis. This is evidenced by their increased holdings in treasuries (5% vs. <1%), increased repo (up 5%) and decreased commercial paper (down 10%).²

Because there is no stigma associated with value fluctuations in a floating NAV fund, the manager may have incentive to take additional credit risk in the quest for a higher yield and to attract more assets. CNAV funds, in contrast, have incentive for more conservative portfolio management. In the event of credit downgrades, floating NAV funds would be more likely than CNAV funds to hold downgraded assets – the trigger for a credit-driven run.

Liquidity-Driven Runs

Liquidity-driven runs are precipitated by investors redeeming shares out of fear that, if they fail to redeem immediately, they will be unable to do so later.

CNAV fund managers realize that falling below par, or breaking the buck, is fatal, and therefore manage portfolio holdings diligently to avoid it. One aspect of doing this is ensuring that a fund has sufficient liquidity at all times to meet redemptions.

In CNAV funds, the majority of fund managers maintain shorter maturities, and therefore higher liquidity, than required by Rule 2a-7. While this practice likely sacrifices yield, it adds additional buffer to help the fund absorb redemptions in the case of market disruption or distress. The U.S. Chamber of Commerce study notes that since 2010, the weighted average maturity of all types of MMFs has been less than 45 days, well below the 60-day maximum afforded by Rule 2a-7.³

In a VNAV fund, fund managers are less constrained in managing holdings. While they may strive to stay at or above par, it is not a critical requirement. High redemptions that require liquidating part of the portfolio at a loss and dropping below par would not be fatal.



² U.S. Chamber of Commerce, “Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk,” Fall 2012.

³ U.S. Chamber of Commerce, “Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk,” Fall 2012.

Absent the incentive to maintain a CNAV, managers may well forego extra liquidity buffers, extend asset maturities, and accept more credit risk to offer higher yield. A VNAV fund with such portfolio composition would be unable to meet high liquidity-driven redemptions much sooner than a more conservatively managed CNAV counterpart. It is this characteristic that could fuel investors to run – fear that they would not be able to access their liquidity in a timely fashion.

Speculative Runs

In a speculative run, investors act on available information, and many times misinformation. They do not wait for clarification; they exit immediately.

CNAV funds are used by corporate treasurers and institutional investors as important liquidity tools. These funds generally strike their NAVs several times throughout the day. All purchase and redemption orders are executed at the first strike following receipt of the order. Funds are received or disbursed the same day, and customers have their liquidity.

Floating NAV funds, however, typically strike their NAVs after the markets close. Orders received during the day are executed after the markets close and funds are moved the following day.

When there are rumors or speculation about a fund's status, floating NAV investors will have an increased tendency to rush the exits. This is because of less frequent information transparency and the next-day liquidity of VNAV funds.

Furthermore, in a CNAV structure, sponsors are incentivized to maintain the par value of the fund. As the Federal Reserve Bank (FRB) of Boston noted in its August 2012 working paper, sponsor support from 2007 to 2011 totaled \$4.4 billion for 78 funds.⁴ The support instances referenced by this study were due to the Lehman Brothers insolvency, or the purchase of assets no longer allowed under 2a-7, e.g., structured investment vehicles. Sponsors are not required to support their funds, but fund managers and sponsors understand it is in the best interest of the fund to prevent speculative runs. As a result, sponsors have injected liquidity when needed.

Consider a situation with a rumor today. It will take until the close of business today to know whether the rumor is true (reflected in the NAV struck at the market close). At that point, a sell order for tomorrow could lose more value and would not provide liquidity until the third day. Investors worried about the rumor would rather sell today and be liquidated tomorrow than wait for facts at the end of the day and be liquidated the day after tomorrow.

Given this choice, most investors will exit immediately and precipitate a run. The lack of intraday transparency and the delay in trade settlement associated with a floating NAV fund would contribute to a speculative run.

Institutional investors, especially corporate treasurers, rely on MMFs as a liquidity tool, with over \$450 billion in assets as of year-end 2011.⁵ Even the *chance* they may not be able to redeem their full investment will almost certainly drive them to redeem their positions and abandon MMFs.



⁴ Federal Reserve Bank of Boston Risk and Policy Analysis Unit Working Paper, "The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011," August 2012.

⁵ 2012 Investment Company Institute Factbook.

History has proven that floating NAV funds are susceptible to runs

The flaws in the Council's assertion that floating NAV funds are less prone to runs can be seen in the recent failure of floating NAV funds. Four types of liquidity pools do not have the CNAV characteristics of 2a-7 MMFs: ultra-short bond funds, enhanced cash funds, local government investment pools (LGIPs) and collective investment pools. Although such funds may try to manage to a price that does not fluctuate, many are, in reality, floating NAV products.

The Council did not provide any evidence to show that floating NAV funds are less subject to runs than constant NAV funds. To the contrary, funds in these floating NAV categories were prone to both firestorm and prolonged runs during the credit crisis.⁶ ***They experienced runs in 2007 and early 2008, nearly a year before one MMF broke the buck.***

Ultra-Short Bond Funds: Ultra-short bond funds tend to have higher risk than MMFs; they may lack the ability to provide same-day liquidity. Despite being referred to as "stable value funds," most are not operated to maintain a constant NAV and some have seen dramatic NAV fluctuations.

Corporate investors have been less comfortable using ultra-short bond funds to invest short-term cash, and assets peaked in 2007 at about \$250 billion. Some of these funds lost as much as 33% of their share value during 2008. By 2009, we estimate the entire ultra-short market had dropped to less than \$30 billion, a drop of nearly 90%.

Enhanced Cash Funds (3c-7): Enhanced cash funds (ECFs) are not subject to 2a-7 and typically invest in a wider array of securities that do not meet the credit quality standards of MMFs. ECFs may hold securities with longer maturities and generally afford investors more restrictive access to their liquidity. Such funds target a \$1 NAV, but have much greater portfolio value fluctuation and are therefore much more likely to break the buck. Corporate investors have been decidedly less comfortable placing short-term cash into enhanced cash funds, as reflected in their low total asset levels.

ECF assets peaked at an estimated \$200 billion in total assets in 2007. When the asset-backed commercial paper market froze in late 2007, several of these funds were forced to halt redemptions. The first ECF to lose value was a \$5 billion General Electric fund. Stress quickly spread to ECFs managed by Bank of America (\$40 billion Strategic Cash Portfolio) and Charles Schwab (\$13 billion YieldPlus).⁷ We believe all ECFs now hold less than \$50 billion in assets, a 75% drop.

LGIPs and Collective Investment Pools: These VNAV pools, used by state, municipal and educational entities to invest excess liquidity, are unregistered. They possess features of both ultra-short bond funds and enhanced cash funds and have suffered similar problems.



⁶ Refer to "Appendix II: Timing of a Financial Run" for a description of prolonged and firestorm runs.

⁷ Treasury Strategies, "The Financial Meltdown of 2007-2008," August 1, 2012.

The LGIPs have seen assets shrink substantially following LGIP failures in Florida and other states in 2008. More recently, the \$9.3 billion Commonfund Short-Term Fund for universities failed and was liquidated. This fund had to halt redemptions when a liquidity-driven firestorm run exhausted its liquid assets.

Floating NAV MMFs Will be Prone to Runs Triggered by Interest Rate Changes

An unintended consequence that the Council has not considered in its recommendation is that by requiring MMFs to float its NAV, funds will be susceptible to fluctuations simply as a result of changing interest rates.

As the SEC staff presented in its recent working paper, “Deviations that arise from changes in interest rates are temporary as long as securities are held to maturity because amortized costs and market values converge. If, however, a portfolio asset defaults or an asset sale results in a realized capital gain or loss, deviations between the stable \$1.00 NAV and shadow NAV become permanent.”⁸ This will have the effect of MMFs potentially falling under \$1.00 NAV due to rising interest rates, and the drop becoming a self-fulfilling prophecy when investors redeem to deploy their funds elsewhere.



⁸ Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission, “Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher,” November 30, 2012.

Floating NAV Will Impose Additional Costs and Complexity on Investors, Significantly Lessening the Appeal of MMFs

The constant \$1 NAV feature of MMFs is critical to investors, especially corporations, because of its administrative efficiencies and accounting/tax reporting simplicity. For these investors, floating the NAV destroys the value and market appeal of the product.

As previously discussed, floating NAV alternatives, such as enhanced cash funds and ultra bond funds, already exist in the marketplace. Yet, assets in VNAV funds barely topped \$500 billion at their peak, versus over \$3.5 trillion placed in MMFs. The fact that investors largely bypassed VNAV alternatives testifies to the appeal of the constant \$1 NAV.

As the Council acknowledges, if MMFs change to a floating NAV, operational issues will arise. However, the Council underestimates and remains largely silent on how they could be managed. These issues are complex and costly enough that they will ultimately lead to investors fleeing MMFs.

Administrative and Accounting Burdens: MMFs help investors minimize transaction costs. The dollar-in dollar-out stability provided by the constant NAV makes tracking and reporting simple and efficient for corporate investors. Corporate investors rely on money market funds as a cash management tool, and place absolute value on the certainty and accuracy of a constant value MMF.

In addition, the stable NAV provides accounting simplicity, because there are no capital gains or trading gains/losses to account for. This accounting simplicity is highly valued by corporate investors because it reduces the potential for accounting error and improves accounting efficiency.

Moving to a floating NAV will eliminate these efficiencies and value and add cost for investors, fund managers and banks. Accounting standards for MMFs would have to be redefined; they would no longer qualify as cash equivalents. Every redemption would be a taxable event with associated gains and losses. New costs would come in the form of reprogramming (if not replacing) accounting, trading and settlement systems to accommodate floating NAV instruments with daily mark-to-market fluctuations.

The Council acknowledges these considerations. However, it did not present any solutions to minimize such costs.

Accommodating a floating NAV will require significant industry resources and money. MMF advisors are already under sharp profit pressure from prolonged low rates and regulatory changes. Costs to accommodate a floating NAV will be significant, and will either wipe out advisors' narrow profit margins or further diminish investor returns if passed along. Sophisticated institutional investors will redeploy assets elsewhere for better net yield, putting the entire resource burden on less sophisticated, individual investors.



Additionally, since the Council's floating NAV proposal would apply only to Prime funds, added administrative costs will further tighten already narrow spreads between Prime and Government funds. At the point of spread parity, rational investors will opt for the security of Government funds, bypassing Prime funds, which are critical to short-term financing markets.

Operational Complexities: Sweep platforms, through which most retail and institutional investors invest in MMFs, would be rendered inoperable, because they are not equipped to track floating NAV instruments. We would expect sweep operators to replace MMFs with alternative constant value products, such as bank deposits.

Investors Precluded from Floating NAV Instruments: Many corporate investment policies do not permit short-term cash to be invested in floating NAV instruments. Some firms must invest in stable value products to receive cash-equivalent status on their balance sheets. Others are required by regulation to use only CNAV investments with daily liquidity. Were MMFs forced to adopt a floating NAV, such companies would obviously have to discontinue using them.

Opens MMFs to Hedge & Arbitrage Risk: Migrating MMFs to a floating NAV opens the industry to an unseen risk, the possibility for traders to use MMFs to hedge interest rates and to use them as arbitrage trades. By opening MMFs to this market, MMF trading volume and volatility could change drastically, impacting fund managers' ability to effectively structure their funds' credit and liquidity risks.

The Same-day Liquidity Feature of MMFs will Disappear, Causing Many Investors to Exit

Same-day settlement is a critical characteristic for liquidity management.

Inherent in the nature of VNAV funds is that they do not settle the same day, as the NAV is determined once the market closes.⁹ This would severely impact institutional investors in two ways:

- *Delayed Redemption:* Inability to redeem and access cash same day would destroy MMFs as a cash management tool. Treasurers use MMFs to safeguard operational cash in low-risk, high-quality, diversified instruments. It is not uncommon for treasurers to redeem investments to cover operating needs that must be satisfied that same day. Delayed settlement would have such negative consequences for these investors that they would invest their funds elsewhere.
- *Uncertain Redemption Value:* An investor would not know the value of their redemption until after markets close. Not wanting to risk having insufficient funds from their redemption to meet their requirements, they would be forced to redeem excess funds from their MMF or be prepared to borrow from credit facilities. Either option would be inefficient and, in most cases, unacceptable.

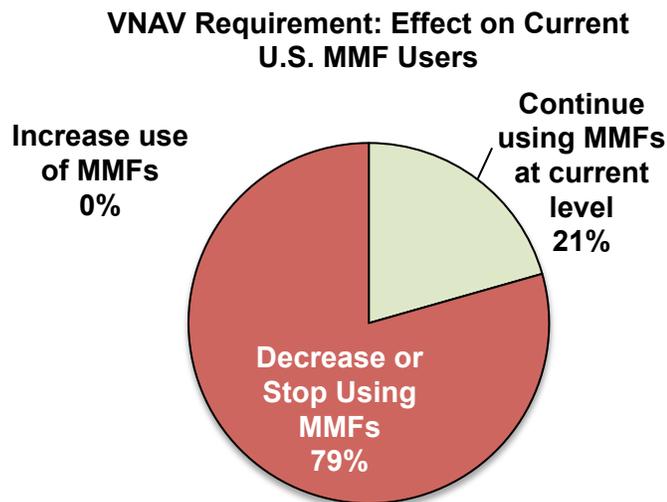


⁹ Same day liquidity could be achieved if the funds set an early cutoff time for redemption orders. However, this too would impair liquidity.

Floating NAV will lead to assets leaving MMFs, impairing credit markets that depend on MMFs for short-term financing

The Council concedes that a possible consequence of a floating NAV is that investors will migrate to other investment vehicles. The Proposal does not attempt to quantify or model that impact.

In fact, as a direct result of increased operational complexity, reduced yield, and diminished utility associated with a floating NAV, investors will flee MMFs en masse. In a 2012 survey of 200+ U.S. corporate MMF users, Treasury Strategies found 79% of corporate treasurers would reduce or stop using MMFs if a VNAV were instituted.¹⁰



Companies indicated they would move their funds into a variety of other investments, including bank deposits, separately managed accounts, time deposits, and commercial paper.

In addition, many public and private companies, governments and municipal organizations have urged regulators to reconsider their pursuit of the floating NAV. They insist a VNAV would have severe consequences for their ability to invest their assets in diversified portfolios as well as to raise financing, and would have broader market disruptions.

MMFs play a critical role in meeting the short-term capital needs of American businesses. They act as a financial intermediary in helping businesses offset their mismatch in timing of inflows and outflows. When cash outflows are greater than inflows, they turn to short-term financing, and MMFs are often where these short-term instruments are ultimately placed. Over 40% of commercial paper funding comes from MMFs, which invest \$30 billion in short-term financing instruments that enable American businesses to make payroll and purchase inventory.



¹⁰ Treasury Strategies, Investment Company Institute, "Money Market Fund Regulations: The Voice of the Treasurer," April 2012.

The Council understands the vital role MMFs play in the financial system. However, they fail to recognize the severe consequences misguided regulation, such as mandating a floating NAV for MMFs, can have on the broader financial markets.

Main Street Businesses: Companies can have millions of dollars of cash fluctuations each day, and money market funds are a vehicle for them to earn a return on excess cash while being able to quickly withdraw funds to pay expenses. As noted above, MMFs are also major buyers of corporate commercial paper, a flexible short-term borrowing mechanism for larger businesses to fund their working capital needs.

Individuals: Consumers are directly and indirectly supported by MMFs. Retail MMF investors enjoy historically higher yields than average checking and saving accounts afford. Consumer credit vehicles such as credit cards, home equity lines of credit, and auto loans are heavily financed by asset-backed commercial paper, which is often held by MMFs.

State and Local Governments: State and local governments use money market funds to help manage cash fluctuations that arise from their uneven tax receipt and revenue generation cycles. Short-term municipal bonds are also sold to MMFs, financing which pays for local and state projects such as building schools, repairing roads and bridges, creating jobs, and spurring local economic activity. As of June 2008, MMFs held approximately one-fifth of all outstanding U.S. municipal securities and one-fifth of marketable treasury bills.

Other Organizations: Universities, endowments, charities, and nonprofit organizations also use money market funds as a safe, liquid, and affordable cash management tool.



Displaced MMF Assets will be Lost from Regulatory Oversight, and will Exacerbate the “Too Big to Fail” Problem.

Whatever other benefits a VNAV might theoretically offer, a dramatic decline of assets invested in MMFs will substantially increase systemic risk. Fund investors will have few options, other than depositing in large commercial banks. In a recent survey, 200+ corporate treasurers said that if MMFs switched to VNAV, they would move their MMF investments into:

- Bank deposits
- Managed accounts
- Direct instruments

If further MMF regulation were enacted, corporate treasurers would move assets from MMFs into a wide variety of instruments, the most common being bank checking/demand deposit accounts, separately managed outside accounts, government securities, and bank MMDA/savings accounts.

Instrument	Rank 1	Rank 2	Rank 3
Bank Checking/Demand Deposit Accounts	52	25	23
Separately Managed Outside Accounts	22	12	12
Government Securities	20	20	20
Bank MMDA/Savings Accounts	16	30	17
CDs/Time Deposits	16	19	24
Commercial Paper	15	16	13
LGIPs, Enhanced Cash, or Other Pools	9	12	18
Repurchase Agreements	7	13	7
Offshore Funds	5	2	3
Other	2	1	2

Note: Respondents were asked to designate their first, second, and third choice; the count of respondents in each category is above.

Source: Treasury Strategies, Investment Company Institute, April 2012.

All three options increase risk:

- Moving MMF assets to banks increases systemic risk. It further concentrates assets in the banking sector and exacerbates “Too Big to Fail” concerns. As the table above shows, virtually ALL treasurers surveyed indicated that some of their assets leaving MMFs would flow into bank accounts. Practically speaking, most of these flows would go into large banks since only they have the capacity to absorb large deposits.



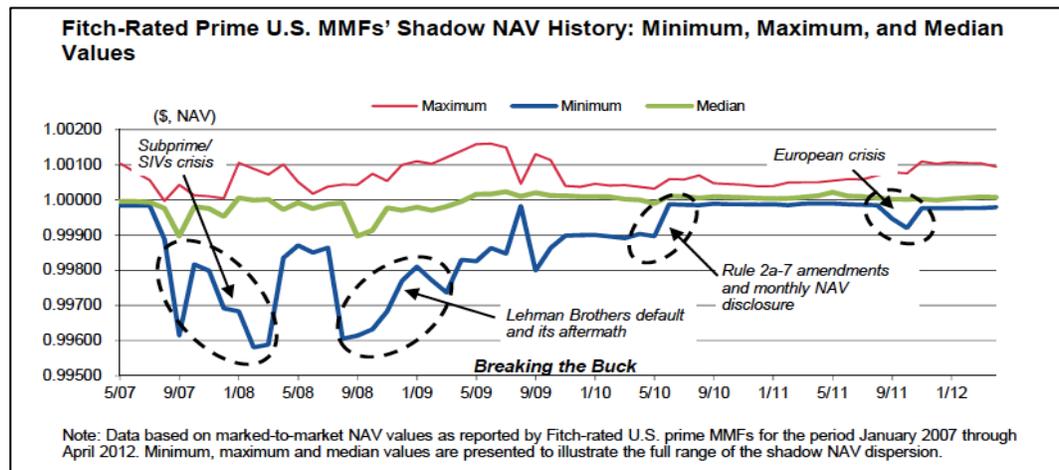
- Moving MMF assets to managed accounts simply removes them from regulatory view and eliminates the protections of Rule 2a-7. Consider the plight of collective investment pools and LGIPs. These unregulated pools have suffered difficulty at regular intervals.
- Moving MMF assets to direct instruments increases investor risk. Few investors will be able to replicate the same diversification and risk management that fund managers provide.

Current MMF Regulations Are Sufficient to Prevent Runs

The SEC enacted significant and important Rule 2a-7 changes in 2010. The Council continues to debate further changes to address run prevention concerns. However, the 2010 changes addressed all three types of runs: credit-driven, liquidity-driven and speculative. They substantially reduced the likelihood of a fund breaking the buck due to a run and were executed in a way that did not destroy the money fund business. They mandated:

- More robust fund liquidity measures;
- Stronger portfolio quality standards;
- Shorter maturity limits;
- Increased transparency of portfolio holdings and valuations; and
- Independent ratings and reporting requirements.

With these changes, MMFs have become even more stable, evidencing less underlying portfolio volatility, as demonstrated by a Fitch Ratings June 19, 2012 Special Report.¹¹



This chart shows that prior to the 2010 changes (a period during which only one MMF broke the buck), MMFs were capable of sustaining massive volatility during very turbulent market conditions. Since the changes, MMFs have endured both firestorm and prolonged credit-driven and liquidity runs with ease.¹²



¹¹ FitchRatings Special Report, "U.S. MMFs Show Shadow NAV Stability," June 19, 2012.

¹² Refer to Appendix II for a differentiation of prolonged vs. firestorm runs.

Conclusion

The stated objective of the Council is to reduce the likelihood of a financial run in MMFs. Your proposed requirement that all MMFs adopt a floating NAV assumes that this would limit the likelihood of a run by convincing investors they are purchasing an investment that can decline in value. In this paper, we argue this is **a flawed proposition with likely devastating effects** for MMF utility and market appeal.

Furthermore, we argue that regulators have not provided quantitative evidence to support their claims that floating NAV funds will be less subject to runs. We present numerous examples contradicting these claims and reinforcing the U.S. MMF market's continued strength and resiliency in the face of seemingly constant market turmoil.

We demonstrate that by moving to a floating NAV:

- A floating NAV increases the likelihood of runs for all types of runs: credit-driven, liquidity-driven, and speculative;
- History has proven floating NAV funds are susceptible to runs;
- Floating NAV MMFs will be prone to runs triggered by interest rate changes;
- A floating NAV will impose additional costs on investors, significantly hampering the appeal of MMFs;
- The same-day liquidity feature of MMFs will disappear, causing many investors to exit;
- A floating NAV will lead to assets leaving MMFs, impairing credit markets that depend on MMFs for short-term financing;
- Displaced MMF assets will be lost from regulatory oversight, and will exacerbate the "Too Big to Fail" problem; and
- Current MMF regulations are sufficient to prevent runs.

*Treasury Strategies believes the floating NAV requirement will result in **severe negative consequences for investors, fund advisors, businesses of all sizes, and the broader overall economy.** We strongly recommend that regulators abandon this proposal.*

Sincerely,



Anthony J. Carfang, Partner



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The Power of Experience®

cc: The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System

The Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
U.S. Department of the Treasury

The Honorable Richard Cordray
Director
Consumer Financial Protection Bureau

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

The Honorable Deborah Matz
Chairman
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The Honorable Elisse B. Walter
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The Honorable Luis A. Aguilar
Commissioner
Securities and Exchange Commission

The Honorable Troy A. Paredes
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Securities and Exchange Commission

The Honorable Daniel M. Gallagher
Commissioner
Securities and Exchange Commission



Appendix I: The Anatomy of a Financial Run

As discussed in an earlier Treasury Strategies publication, “Proposed Capital Requirement for Money Market Mutual Funds: A Disaster on all Fronts,” it is necessary to understand the anatomy of a financial run. Financial institutions are susceptible to runs because they support highly liquid short-term liabilities with less liquid and longer-term assets. This maturity transformation is crucial to a well-functioning economy, because it facilitates the flow of funds from those with surplus to those with a shortage, in the form of deposits/investments and loans.

However, a maturity mismatch can be problematic when many depositors want to withdraw funds over a short period of time. The financial institution is forced to sell assets prior to maturity and at a loss to meet depositor demands. At some point, the financial institution will run out of assets that can be readily liquidated. This is far more problematic with a bank than with a money fund. In a money fund, the difference between the average maturity of the assets and the liabilities can be measured in days or weeks. In a typical commercial bank portfolio, the difference is measured in months, if not years.

A run is caused by depositors who believe if they wait too long to withdraw their money, there may be none left. It is this psychological aspect combined with people’s natural aversion to loss that make runs so dangerous.

Three types of financial runs are relevant to financial institutions:

- Credit-driven runs occur as a result of a confirmed negative credit event in a security in which the institution invested; this leads investors to liquidate shares to limit possible losses.
- Liquidity-driven runs are precipitated by investors redeeming shares out of fear that, if they fail to do so immediately, they will be unable to do so later.
- Speculative runs occur as a result of rumors or speculation about what may or may not occur within a fund.

Although interrelated in terms of outcome, the proximate causes are quite different. Quite simply, the proximate cause of a credit-driven run is poor credit quality of the underlying assets. The proximate cause of a liquidity-driven run is an increased mismatch between the duration of financial liabilities and financial assets. The proximate cause of a speculative run is rumor based on a lack of transparency into the financial institution’s assets and liabilities.

The reforms instituted in early 2010 by the SEC and the MMF industry adequately deal with **each** of these three situations.

Type of Financial Run	Proximate Cause	2010 MMMF Regulations
Credit Driven Run	Credit Loss	Tightened Credit Standards
Liquidity Driven Run	Maturity Mismatch	Instituted Liquidity Buffer Shortened Maturity Structure
Speculative Run	Uncertainty / Misinformation	Reporting of holdings Reporting shadow NAV

Source: Treasury Strategies, Inc.



Appendix II: The Timing of a Financial Run

It is also important to understand that there are two ways in which a financial run plays out:

- Firestorm runs occur in a panic environment in which investors rush cash out at any price, notwithstanding any barrier. In today's electronic world, these are likely to play out within hours or a day or two at most.
- Prolonged runs occur when investors fail to roll over maturing investments or reinvest in instruments upon which the institution had come to rely.

Given its nature and speed, it is unlikely that any intervention or barriers to exit will succeed in preventing the firestorm run. A holdback provision will be useless in this type of run since investors will most certainly want to exit at any cost. It is best to have in place the safeguards that prevent the proximate causes of the run. These are precisely the safeguards that went into effect for the money market fund industry with the Securities and Exchange Commission's Rule 2a-7 amendments in early 2010.

A prolonged run, on the other hand, occurs over an extended period of time. It is usually quite visible well ahead of time. For example, investors refuse to roll over their maturing commercial paper or holders of auction rate securities fail to bid at future auctions. Because of the slow nature of these runs, regulators have a number of tools at their disposal. However, efforts to "bar the door" have no usefulness, since these runs are not caused by investor withdrawals, but rather by investors refusing to reinvest.

Appendix III: Treasury Strategies' Response to Selected Questions: Alternative One – Floating NAV

1. Would requiring that all MMFs operate with a floating NAV make them less susceptible to runs?

No. In a literal sense, *MMFs already have floating NAVs*. Funds whose NAV translates to \$0.99 or \$0.98 are required to report and execute trades at those prices. What the committee is proposing is changing the practice of rounding to the nearest penny.

A floating rate NAV, *without* penny rounding, will cause investors to treat them like ultra-short bond funds, which already have floating NAVs without the penny rounding accounting protocol. The slightest change in NAV is immediately translated into the share price of these funds. In 2007, investors in ultra-short bond funds withdrew most of their money very quickly from these funds and have never returned. At the time, ultra-short bond funds had \$250 billion in assets; today they have approximately \$30 billion in assets. Not only will most investors flee – they will not return for many years.

One cause of a run is the perceived or actual inability of security *issuers* to pay on the securities they issue. Because this happens outside the context of an MMF, the manner in which shares are valued is not material to the risk of default by the issuers of securities. Because investors understand the substance of credit risk, they understand it exists regardless of penny rounding on share prices.

In 2007, the instability of issuers of residential mortgage securities, and the associated credit default swaps, destabilized all financial markets. Had MMFs had floating NAVs at that time, investors would still have withdrawn funds from all nongovernment MMFs. Investors did not act on the pricing protocol of MMF shares, but on concern about any institution with direct or indirect exposure to residential mortgage securities. Because MMFs do not issue securities, they do not contribute to the susceptibility of credit-driven runs.

The penny rounding accounting protocol permits a very small, but critical, *window of stability* in MMF share pricing. All studies of MMF NAVs relative to the \$1 share price indicate that at any given time, MMF NAVs are fractionally above or below the \$1 share price. This permits the funds to execute the necessary mitigation work to preserve the funds' value without interfering with investors' ability to buy and sell shares at a constant \$1 price.

2. Would it reduce or increase the potential financial instability associated with MMFs?

By definition, the adoption of floating NAVs will increase potential financial instability associated with MMFs. Currently, slight changes in fund value that are less than a half-penny per share are mitigated internally by the funds without interfering with the \$1 per share price at which investors buy and sell. With the floating NAV proposal, the fleeting movements of prices around \$1 will immediately interfere with investors' ability to buy and sell at \$1 per share.



Investors will act on the information provided to them. The committee should seriously consider the ramifications of that and the wisdom of prior generations of regulators in granting the slight, but not complete, exemption to traditional mark-to-market accounting.

3. Would floating the NAV alter investor expectations and make them substantially more willing to bear losses from their MMF investments?

No. Investor willingness to bear losses is not affected by the practice of amortized cost accounting/penny rounding. Investor willingness to bear losses is based on their risk tolerance relative to the credit risk of the issuers of the securities.

