
**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 Two: NAV Buffer with Minimum Balance at Risk

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 an NAV buffer and Minimum Balance at Risk (MBR).

Treasury Strategies (TSI) 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 *perceived* 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 an NAV buffer, paired with a three percent 30-day MBR requirement will reduce MMF's **perceived and heretofore unproven** susceptibility to runs. This amount is essentially a holdback of an individual shareholder's investment balance that would be retained in the fund if the shareholder sought to redeem more than 97% of his/her account. Every MBR would be in a subordinated position; aggregate MBRs would be first to absorb losses beyond the NAV buffer if the fund breaks the buck within the 30-day period following redemption.

We believe you are attempting to address a problem that is arguably not a problem. During the 40-year history of MMFs, there have only been two instances of any MMF investors incurring even a small loss. Although it has demonstrated remarkable reliability, the $2.6 trillion MMF industry is in danger of being dismantled by draconian proposals such as those suggested in the Proposal.

Significantly, the Proposal minimizes the very real possibility that institutional investors **would abandon MMFs en masse** as a cash management tool if the

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proposal were adopted.[1] The Proposal does not adequately consider potential damage to short-term liquidity markets, investors, or the financial system as a whole that would result if MMF assets shrank drastically.

In this submission, we urge you to consider the following:

- The proposal introduces bias and places Prime MMFs at a competitive disadvantage**;**
- An MBR requirement is unlikely to brake a run by MMF investors during a crisis;
- The MBR would *create* a first mover advantage that may precipitate a run;
- "First mover advantage" is an inherent characteristic of any financial market, and attempting to penalize the first mover flies in the face of market logic;
- The proposed MBR requirement punishes the diligent investor;
- The subordination feature changes the nature and risk of the investment;
- The Proposal oversimplifies the operational difficulties associated with omnibus accounts, and overlooks other critical problems, such as reduced liquidity, changes in investor behavior, and implementation costs;
- The MBR requirement introduces complex and undefined accounting treatment for cash as well as the call option inherent in the subordination feature;
- The MBR requirement is not substantially different from other holdback concepts that have been criticized as flawed and unworkable; and
- MMFs have performed flawlessly through severe market turmoil, including the recent Eurozone uncertainty.

We conclude that the NAV buffer with MBR requirement will not only **fail** to achieve the regulatory objective of preventing a run on MMFs (a rare occurrence to begin with), but will significantly **hamper or destroy the $2.6 trillion market for MMFs** in the process, creating a huge vacuum in the short-term credit markets. Furthermore, Treasury Strategies believes the MBR requirement will have **severe negative consequences** for investors, short-term borrowers, banks, businesses of all sizes, and the broader global economy.



[1] Treasury Strategies, "Money Market Fund Regulations: The Voice of the Treasurer," April 2012.

## The Proposal Introduces Bias and Places Prime MMFs at a Competitive Disadvantage

The Council proposes introducing up to a 1% NAV buffer, or capital requirement, in conjunction with up to a 3% MBR on Prime MMF funds. The Council recommends that Treasury MMFs be excluded from these requirements. This proposal introduces clear bias in the MMF space, and would result in disproportionate and undue complexities and increased operating costs for Prime MMF fund managers.

Imposing an NAV buffer on Prime MMFs will decrease yields to investors and increase costs for advisors, destroying the economic value of Prime MMFs for both investors and advisors, especially in the current rate environment.

The Council recommends three alternatives for advisors to fund the NAV buffer – an escrow account, subordinated buffer shares, or retained earnings. However, the Council does not adequately acknowledge that each option, or any other funding alternative, imposes the following realities on Prime fund advisors:

- Increased costs;
- Decreased yield to investors;
- Reduced profit margins; and
- Increasingly narrow spreads between Treasury MMFs and Prime MMFs.

In addition, The Council does not adequately address how these negative consequences would be avoided or prevented:

- Increased risk of MMF runs due to a mass exodus by investors;
- Increased systemic risk due to greater concentration of assets at large, complex financial institutions; and
- Monoline and boutique fund providers and retail MMF investors taking on a disproportionate part of the additional capital burden.

Large investors can easily move funds among various asset classes and geographies. They are highly likely to leave MMFs in search of higher market yields during the buffer accumulation phase. Thus, the cost of the capital requirement will be borne almost entirely by retail investors.

In the current rate environment, having funds accumulate capital is infeasible. MMF rates are already at an all-time low and teeter on the edge of being completely uneconomic. A buffer charge of even 1 basis point would cut the average investor's yield in half.

Assuming this reduced yield remains above that of Treasury MMFs, fund advisors and investors will reassess whether the Prime MMF fund is worth the operational complexity and reduced liquidity. Any rational investor will demand a premium for these two restrictions, which fund advisors will be hard-pressed to offer. In essence, this The Council proposal would allow Treasury MMFs to survive, while severely disadvantaging if not eliminating the market for Prime MMFs.

Additionally, accumulating a buffer from investors will almost assuredly result in a mass exodus, i.e., a run. No rational investor will accept zero or negative return when zero-yield federally insured deposit accounts are available at banks.

Faced with this trade-off, investors will exit MMFs en masse for more attractive instruments. Institutional investors, who hold the bulk of MMF assets, are able to move hundreds of million dollars instantly – likely producing the type of firestorm run regulators seek to prevent.

## An MBR Will Not Brake a Run

The Council justifies the NAV buffer with MBR requirement as a means to reduce MMFs' perceived and quantitatively unproven susceptibility to runs. The Proposal assumes a NAV buffer and subordinated holdback would brake a run by incenting investors to remain invested in a troubled fund, to avoid forfeiting a portion of their assets.

A large body of research concerning bank runs resoundingly disputes the Proposal's thesis that investors will remain invested in a troubled situation.[2] Academic research,[3] as well as studies by the IMF[4] and the World Bank,[5] show that once begun, panics will run their course until all conflicts are resolved. For this same reason, so-called exit gates also do not work. Only in the "deus ex machina" case, with direct government intervention via declared bank holiday or engineered takeover, have financial panics been stopped before running their course.

The idea that holdbacks or fees can prevent or slow a run ignores 150 years of evidence. Given the psychological and fear-based nature of a run, any holdback provision is likely to be ineffective.[6]

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[2] Huberto M. Ennis and Todd Keister, "Run Equilibria in the Green-Lin Model of Financial Intermediation," 4 May 2009; Lee J. Alston, Wayne A. Grove, and David C. Wheelock, "Why Do Banks Fail? Evidence from the 1920s*," 1994; Clifford F. Thies and Daniel A. Gerlowski, "Deposit Insurance: A History of Failure," 1989.

[3] Isabelle Distinguin, Tchudjane Kouassi, and Amine Tarazi, "Bank Deposit Insurance, Moral Hazard and Market Discipline: Evidence from Central and Eastern Europe," June 2011.

[4] Jeanne Gobat, "Banks: At the Heart of the Matter – Back to Basics, Finance & Development," March 2012.

[5] Asli Demirgüç-Kunt, Edward J. Kane, and Luc Laeven, "Deposit Insurance Design and Implementation: Policy Lessons from Research and Practice*," 19 June 2006.

[6] For additional detail, view the Appendices to this paper for the following: "The Anatomy of a Financial Run" and "The Timing of a Financial Run."

## The MBR Creates a First Mover Advantage That Will Precipitate Runs

The MBR requirement actually creates a first mover advantage that could, in and of itself, precipitate a run. It merely moves the first mover advantage out in time by 30 days. But by doing so, it increases the potential for speculative judgments by investors attempting to analyze how developments in the financial markets will affect their MMF investments 30 days hence.

Instead of exiting MMFs in response to actual, real-time market developments, investors may be more likely to exit based on fears that could potentially materialize 30 days in the future. Such investor judgments not only will lead to less rational investor behavior, but also will cause self-fulfilling problems. These markets thus would become less rational and potentially more volatile.

A 30-day MBR requirement essentially requires investors to look ahead 30 days and ask whether it is possible for conditions to deteriorate to the point at which the fund or a major fund holding might be in distress. If the answer is "yes" or "maybe," then the threat of a subordinated holdback encourages the investors to sell in the hopes of exiting at least 30 days prior to the expected problem. This definitely creates a first mover advantage. It may lead to increased volatility, especially as large investors, with the most exposure to a subordinated holdback, are incented to move out of MMFs more regularly. It may also precipitate a prolonged run by investors looking to act ahead of possible turbulence, with assets leaving the fund and accelerating into a full-fledged run once news is out that a fund may have trouble. In addition, the 1% NAV buffer would be ineffective in absorbing the large redemptions.

Had the MBR holdback requirement been in place during a number of recent events, it could have caused investors to prematurely exit MMFs to avoid the 30-day MBR, igniting a damaging run. For example, during the summer of 2011, at the height of the European debt crisis and the U.S. budget impasse, MMFs had more than sufficient liquidity to meet all redemption requests and no MMF broke the buck, despite severe market strain. With an MBR holdback in place, however, investors might have acted more precipitously and forced MMFs to sell off assets more rapidly, potentially exacerbating financial stresses.

## Market Discipline and the First Mover Advantage

For smoothly functioning capital markets, investors must be readily able to buy and sell their financial instrument holdings. Limits on investor ability to transact freely adds market friction and reduces market efficiency.

The fact that investors are free to exercise their judgment ensures market discipline for both investors and issuers of securities. Investors have incentive to protect themselves against loss, conducting due diligence and monitoring their holdings. Conversely, issuers have incentive to act prudently and promote investor confidence. This ensures sufficient demand for their securities in the marketplace.

In much the same way, the first mover advantage helps ensure market discipline. At its core, the investment axiom “buy low, sell high” presumes a first mover advantage.

The MBR requirement, which seeks to reduce or eliminate first mover advantage, achieves nothing more than adding speculation and volatility to an otherwise stable instrument. A 30-day holdback requirement would essentially reposition the first mover advantage to those investors who can best forecast disruptions and redeem their shares at least 30 days in advance. This provides incentive for investors to speculate on even the slightest rumors and would certainly introduce greater volatility into MMFs.

## The MBR Requirement Punishes Prudent Investors

One of the most glaring weaknesses of a subordinated holdback is that it punishes investors who actively monitor their investment holdings or who seek to fulfill a fiduciary duty to act in the best interest of their customer.

The Council argues that the MBR can act as a method to discourage investors from exiting a fund when they see trouble. Those that do exit should be the first to shoulder losses, which is a somehow “fairer allocation of losses among investors.” We are aware of no comparable investment situations where concern for the second mover (i.e., the lackadaisical investor) takes priority over sound financial decision-making by the first mover.

A prudent investor is responsible for monitoring his/her investments, which includes acting on market information when appropriate. The MBR requirement punishes the diligent investor who redeems his/her investment and rewards the less diligent investor by limiting his/her potential losses. Any market where an investor is artificially prevented from making a rational investment decision becomes a distorted and inefficient market. The MBR would deprive MMF shareholders of the benefit of their own rational investment decisions.

The Proposal fails to consider another consequence of the subordinated holdback. It could create an irrational “Catch-22” situation where large investors with fiduciary responsibilities cannot act responsibly. Consider a situation where a 401(k) manager believes a certain MMF may have problems, and notifies the MMF manager of an intention to redeem their holdings. They cannot avoid losses by redeeming their shares, due to the MBR, nor can they avoid losses if their assessment is correct but they remain in the fund.

## Short-Term Market Stability at the Expense of MMF Investors

The Council seeks to prevent MMF runs by discouraging first-mover advantage. Additionally, it aims to protect short-term funding markets from curtailment or seizing that would presumably accompany MMF failures.

MMFs are of course one of the largest purchasers of short-term debt securities, issued by many highly rated public companies, banks, and municipal entities for short-term financing.

The end result of the proposed MBR arrangement is, then, that short-term financing for large banks, corporations, and municipalities should be protected at the direct expense of prudent investors who seek to redeem their holdings.

The irony of this is that the MBR requirement will not protect, but will instead **severely restrict the financing available in short-term debt markets**. As mentioned elsewhere in this response, corporate Treasurers will abandon MMFs at the introduction of an MBR or holdback.

In a 2012 survey of over 200 U.S. corporate MMF users, Treasury Strategies found **90% of corporate Treasurers would reduce or stop using MMFs** if an MBR or holdback provision were instituted.[7] Based on this response, Treasury Strategies estimates total corporate assets in MMFs would decline 67% if this proposal were implemented.

As MMF assets contract sharply, MMFs will purchase correspondingly fewer short-term securities. Thus, the institution of a subordinated holdback provision will negatively impact the broader money markets.

### Subordination Changes the Nature and Risk of the Investment

The subordination proposed as part of the MBR concept essentially **introduces a collateralized call option** on the held-back part of a redeeming investor's position. The Proposal proposes that subordination go into effect whenever a fund breaks the buck, beyond the NAV buffer and acting as the second layer to absorb losses. This creates significantly greater risk for investors.

A foundational principle in capital markets is that increased risk demands a greater return or yield. The MBR requirement includes two elements of increased risk, for which a prudent investor would expect additional compensation:

- Decreased liquidity for a portion of the investment, due to the 30-day holdback, and
- A collateralized call option as a result of the subordination.

No other short-term investment instrument, in fact, *no other investment vehicle,* restricts liquidity and increases risk without compensating the investor. Yet for numerous reasons (strict investment requirements, low interest rates, higher costs for complexities imposed by the MBR proposal), MMFs are unlikely to be able to offer added yield to compensate for added risks. Furthermore, since the Council is proposing the NAV buffer and MBR requirement only on Prime Funds, this in effect further narrows the spread between prime and government funds. It is thus unreasonable to expect investor demand for prime MMFs to remain anywhere near current levels if the MBR requirement is imposed.



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

The subordinated holdback not only violates the SEC's longstanding edict that all investors be treated equally, but it also actually **punishes investors that use MMFs as a cash management tool.** A key MMF feature for institutional investors is liquidity. These investors actively invest and redeem, often several times within a given week. As currently proposed, the MBR would punish these investors by placing them in a subordinated position to less active investors, even when the active investor has no other motive in his/her redemptions than meeting short-term liquidity needs.

## The Problem of Omnibus Accounts

Banks and brokers conduct much of their customer-related MMF activity through omnibus accounts. A bank or broker may hold just one account with an MMF for the benefit of hundreds or thousands of customers, netting their activity into a single trade each day. If half a bank's customers invest in MMFs on a particular day and the other half redeem, the net transaction between the bank and the fund might be zero. Thus, there would be no holdback since there was no trade.

The Council acknowledges this, but remains largely silent on how it should be addressed. Given the size and critical complexities of the MMF markets, it is inadequate to simply say record holders should "allocate between themselves the responsibility (and associated costs) of applying the MBR requirements equitably."

*Operational Complexity*
Omnibus account sponsors would be faced with an increasingly complex, if not impossible, task of imposing redemption fees. As mentioned above, the omnibus account acts as an aggregator of purchase and redemption orders, resulting in one net purchase or redemption each day.

If omnibus accounts are treated as a single account in an MBR arrangement and the fund encountered losses, the omnibus account sponsor would need to filter through the hundreds, if not thousands, of trades that make up the net position to determine what holdback to apply to the individual investor. This could bring up a scenario where the sponsor requests a return of funds from the investors who were fully redeemed, or risks placing the full burden on the remaining investors that had not redeemed. The technical ability to attribute the holdback to each underlying shareholder would require costly new systems and complex operational coordination with all involved stakeholders.

## Other Overlooked Problems

*Restricted Liquidity for Institutional Investors*
Corporate treasurers use MMFs for three primary reasons:

- Stability of principal;
- Daily liquidity at par; and
- Diversification.

The MBR requirement drastically impacts the daily liquidity feature for these investors.

Instead of concentrating cash in the banking system and earning no interest, corporate investors use MMFs to earn a return while maintaining daily liquidity. Daily liquidity is vital to most MMF investors. The invested dollars represent short-term operating cash that corporate treasurers access on a daily basis for purposes such as:

- Funding payroll;
- Purchasing inventory;
- Business expansion;
- Covering trade payables.

In fact, treasurers often transact with their MMFs multiple times in a single week, purchasing or redeeming shares.[8]

An MBR provision will make these investors hesitant to invest in MMFs because when they need operating cash, they may need *all* of it. With holdback funds unavailable when needed, a treasurer could be forced to borrow to cover cash needs, incurring interest expense which is undoubtedly greater than MMF yield.

In general, corporate treasurers are extremely risk-averse. Even the *chance* they may not have access to daily operating balances when needed will almost certainly drive them to abandon MMFs. In a liquidity survey of global multi-national corporations, **four in five financial professionals said their organization would stop investing in MMFs if holdback provisions are enacted.**[9] In addition, 43% indicated their organization would go as far as eliminating MMFs from their approved short-term investment instruments altogether.

If this proposal were implemented, we would expect to see a prolonged run out of MMFs and as a result, a drastic reduction in liquidity for the short-term financing market – precisely what regulators claim to want to prevent.

*Costs of the Proposal*

The Proposal considers in great detail the supposed benefits of the MBR proposal, yet it overlooks the costs[10]. The focus and entire analysis of the Proposal is investor behavior during "distressed times" vs. "normal times." **The benefits are only relevant to distressed times**, when they would theoretically be realized. Meanwhile, the costs would have **significant actual impact during both distressed and normal times**, affecting investors, MMF managers, the short-term funding markets, and the broader macro economy.

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[8] See the attached TSI report "Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective and Crippling Regulation," March 2012 for examples of how frequent MMF trading by corporate treasurers can create burdensome tracking and reporting requirements.

[9] Association for Financial Professionals, "2012 AFP Liquidity Survey", July 2012.

[10] See Robert W.Hahn, "In Defense of the Economic Analysis of Regulation," AEI-Brookings Joint Center for Regulatory Studies, 2005. Hahn argues for a regulatory "scorecard" that provides a comprehensive analysis of quantitative and qualitative benefits and costs of any proposed regulation.

## Complex and Undefined Accounting Treatment

With the added aspect of subordination, a portion of an MMF investment will no longer reasonably be treated as a cash equivalent. This is important to corporate investors, who routinely use MMFs as one way to hold their liquidity in cash and cash equivalents required of them by lenders and rating agencies.

Subordination of the MBR portion of an investor's MMF redemption introduces something in the nature of a call option. The investor would have little or no control of when the MBR balances might be called. At a minimum, this would require added financial accounting direction on how to report MMF holdings on corporate financial statements.

Further underscoring the complexity and impractical nature of the MBR, accounting treatment for omnibus accounts would need to be determined. As discussed above, omnibus accounts may have hundreds of investors in a single trading account. Significant analysis may be required to determine not only how the omnibus account holder would classify the encumbered and unencumbered MMF balances, but also how each individual investor would determine what could be reported as a cash equivalent, vs. what to report in the heretofore undefined category for the MBR/call option portion.

## MBR Proposal Similar to Other Flawed and Unworkable Holdback Concepts

In March 2012, Treasury Strategies issued a response to the SEC's idea of a holdback provision ("Proposed Holdback Requirement for Money Market Mutual Funds: Ineffective and Crippling Regulation"). As we assess The Council's MBR proposal, we find many similarities between the two, in their flawed logic and impractical nature. While the Proposal proposes an MBR subject to the previous 30-days' high-water mark, and not as a holdback of each redemption, the same limitations apply.

We highlight the key similarities below, and include the complete response to the holdback idea as an Appendix for your convenience.

*Maturity Extension Without Compensating Yield*
Imposition of an MBR provision restricts availability of some portion of the investor's MMF investment, effectively extending the maturity of that investment. This would happen with no corresponding increase in yield. Thus, the provision penalizes investors by failing to reward them for additional maturity risk.

Restricting a portion of the investment without additional yield compensation will indeed make investment in MMFs very unattractive. No other investment vehicle has such a restriction without compensating investors with additional yield, and investors will exit MMFs en masse as a result.

*Disenfranchised Fiduciaries*
Many advisors have fiduciary responsibility to act in the best interest of their customers. When these fiduciaries consider that an investment in MMFs may tie up their customers' assets when they are most needed, they will be compelled to avoid MMFs.

Indeed, in many situations the fiduciary may be legally precluded from using an MMF with a holdback provision as an investment.

- ***Escrow assets*** could not be invested in a fund with an MBR arrangement, because all escrowed assets must be immediately released to one of the parties by the escrow agent upon the occurrence of a stipulated event.
- ***Bond proceeds*** could not be invested in a fund with an MBR arrangement because indentured trustees would be precluded from investing in an instrument that could reduce the amount of these proceeds or limit availability of these funds.
- ***Collateral funds*** may not be eligible for investment in MMFs because the funds would not be entirely available on a next-day basis.
- ***Pension and health plan*** assets subject to the Employee Retirement Income Security Act (ERISA) could not be invested in MMFs because they would violate the exclusive benefit rule (redemption fee) or prevent a plan from becoming 404(c) eligible by the liquidity impairment.
- ***Bankruptcy trustees*** would be unable to use MMFs to invest assets from a bankruptcy proceeding, because they require immediate liquidity of trust assets to maximize the return of assets to creditors.
- ***Trustees, charitable foundations, estates*** and others would be prohibited from investing in an MMF that could impose a redemption fee or limit access to funds.
- ***Municipalities*** could be precluded from investing in MMFs subject to a redemption fee because their investment statutes commonly make reference to money fund investments being purchased and redeemed without the public entity incurring a cost or financial penalty in connection with the transaction.

Using an investment with an MBR arrangement would violate the fiduciary's duty to minimize cost and ensure access to the investor's money. If the MBR proposal were enacted, we could very well see a prolonged run[11] on MMFs as fiduciaries, along with retail and corporate investors, redeem MMF shares and seek alternatives.

*Funds Movement into Unregulated Investments: Exacerbation of "Too Big to Fail"*
Most corporate investment policies allow flexibility in investment choices, bounded by specific guidelines or restrictions. Firms consistently choose MMFs for their hallmarks of stability, liquidity, and diversification. Any proposal that diminishes these values will certainly drive investors to seek alternative investments for short-term needs.

Investors leaving MMFs will have three basic options:

- Riskier investments with higher yield;
- Off-shore investments; and
- Bank deposits.

[11] Reference Appendix II for a summary description of Prolonged vs. Firestorm runs.

The first two options increase systemic risk, because large amounts of assets move from relatively safe MMFs into riskier and less regulated investments. It is far more difficult for regulators to track these less-transparent asset flows and to manage the resulting dislocations.

The third option also increases systemic risk. It drastically expands asset concentration in the banking sector, exacerbating the "too big to fail" phenomenon.

### Flawless Performance Through Recent Market Turmoil

In concluding our response, we draw attention to the continued excellent performance of MMFs. In early 2010, the SEC implemented changes to further strengthen the already solid structure of MMFs. Since then, MMFs have continued to be a resilient investment vehicle, despite extremely challenging market conditions, such as the U.S. credit rating downgrade and persistent strains in the Eurozone.

Despite general market edginess and a rash of fearmongering in the press, MMFs were **able to satisfy all redemptions with internally-generated liquidity**. They then acted prudently and reduced exposure to euro-area counterparties. This is exactly the action that one would expect and hope MMFs to take in order to protect investors.[12]

[12] See Treasury Strategies' contention on page 10. This behavior by MMF management – in a challenging market – reduced the "x" factor (probability of breaking the buck) and thereby lowered "B" (the net benefit to a shareholder of redeeming funds from an account).

## Conclusion

The stated objective of The Council is to reduce the likelihood of a run in MMFs. The Proposal proposes an NAV buffer combined with a subordinated holdback, the MBR, to limit the likelihood of a run by providing a disincentive for investors to redeem their positions. In this Proposal we have argued this is a **flawed proposition with likely devastating effects** for MMF utility and market appeal.

In this letter, we demonstrate that the proposed NAV buffer with an MBR:

- Introduces bias among MMF asset classes;
- Will not stop a run;
- Will *create* a first mover advantage that may precipitate a run;
- Flies in the face of investment logic by trying to eliminate the first mover advantage;
- Punishes the prudent investor;
- Introduces numerous investment, accounting and operating difficulties;
- Will cripple MMFs' ability to attract assets and thereby remove a source of credit for corporate and municipal borrowers; and
- Will not treat all investors equally, in particular disadvantaging large corporate investors that use MMFs as a cash management tool.

The MBR proposal will not only **fail** to achieve regulators' objectives of preventing a run and protecting the short-term liquidity markets, but will **destroy** MMFs in the process.

Treasury Strategies believes the MBR proposal **would have severe negative consequences for investors and the short-term funding markets and as such should be removed from further consideration.**

Sincerely,

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cc: The Honorable Ben S. Bernanke
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The Honorable Thomas J. Curry
Comptroller of the Currency
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The Honorable Richard Cordray
Director
Consumer Financial Protection Bureau

The Honorable Martin J. Gruenberg
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The Honorable Gary Gensler
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## Appendix I: The Anatomy of a Financial Run

Before evaluating a proposal's effectiveness in preventing a run, it is important 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 investors want to withdraw funds over a short period of time. 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 investors who believe if they wait too long to withdraw their money, they may lose some or all of it. 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 a seizing up of the markets. 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 have already adequately dealt with ***each*** of these three situations.

| Type of Financial Run | Proximate Cause | 2010 MMF Regulations |
|---|---|---|
| Credit Driven Run | Credit Loss | Tightened Credit Standards |
| Liquidity Driven Run | Market Seizing | Instituted Liquidity Requirement of 10% Next Day, 30% Weekly<br>Shortened Maturity Structure |
| Speculative Run | Uncertainty / Misinformation | Reporting of Holdings<br>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 Proposal 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 Two – NAV Buffer with Minimum Balance at Risk

1. **Would requiring most MMFs to maintain NAV buffers and MBRs make the funds less susceptible to runs?**

   An NAV buffer will not make MMFs less susceptible to runs and may increase the likelihood of such a run.

   With a buffer, it is likely a run would start at the first sign of buffer impairment. An NAV buffer would encourage the false notion that MMFs are more like bank deposits than investments. Investors would be more likely to tolerate risk in an MMF portfolio, knowing the buffer provided a cushion of protection. However, once the buffer was utilized, investors would likely swing to the opposite extreme and move their funds from the MMF before the buffer could be exhausted.

2. **Would this alternative reduce the potential financial instability associated with MMFs?**

   The establishment of a capital buffer will increase fund volatility by creating new moral hazard for fund advisors and investors, incenting them to take additional risks in search of higher yield, and transferring that risk to the fund buffer. An NAV buffer of 1% would widen the underlying NAV fluctuation range to $.99-$1.01 without triggering a loss to investors. This would lessen the market discipline on fund advisors regarding portfolio risk, consequently increasing potential instability.

3. **Would the MBR requirement make MMFs more resilient by requiring some redeeming investors to remain partially invested in an MMF for 30 days?**

   No, it will do just the opposite. The MBR would establish a 30-day tail for full liquidation of an investor's position. Investors currently have full same-day access to their funds. With a 30-day MBR, investors would have to extrapolate risk a month into the future. Because full liquidation of their position would take 30 days, they would be prompted to start that clock ticking to ensure they were fully liquidated well in advance of any adverse events at a specific fund.

   Because the MBR primarily affects institutional investors, the very investor most likely to sell a position in a troubled fund would be encouraged to move faster than ever. Situations that would otherwise resolve themselves within a brief time would now precipitate a run, because the institutional investor would have 30 days during which a portion of their investment would be trapped. Under these circumstances, their safest course of action would be to start the 30-day clock as soon as possible.

4. **How would the combined effects of any reduction in yield from the NAV buffer and inconvenience caused by restrictions on redemptions from the MBR affect investor demand for MMFs?**

   The combined effects of both provisions will be a deterioration of both yield and liquidity, making MMFs a less attractive investment option for investors. Countless studies have shown that an overwhelming majority of institutional investors will flee MMFs if the proposed requirements are enacted. This includes our study of 135 multinational corporations, which found that 90% of current MMF users would decrease or stop using MMFs if a holdback requirement were enacted. Based on this response, we estimated that total corporate assets in MMFs would see a net decrease of 67% due to this proposal. [13]



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