BETTER MARKETS

January 5, 2018

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: The Need to Maintain Vital Money Market Fund Reforms to Prevent Runs, Fire Sales, Contagion, Financial Crashes, Taxpayer Bailouts and Economic Catastrophe

Dear Chairman Clayton,

Given the destabilizing runs and fire sales ignited by a single money market fund (MMF) "breaking the buck" in September of 2008, no one can question that MMFs are systemically significant. Confirming that, the Treasury Department and the Federal Reserve responded – for the first time in history – by implemented a series of emergency measures effectively guaranteeing a single financial product. The full faith and credit of the United States was put behind the entire $3.7 trillion MMF industry. This was the single largest taxpayer-backed rescue program during the 2008 crisis and the largest the financial industry has ever received.

While we at Better Markets[1] argued for stronger reforms,[2] the SEC adopted critically important measures in 2010 and 2014, which increased investor confidence in MMFs, reduced the likelihood of runs on these funds, and made another devastating financial crisis less likely. We

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more. See Annual Report available at https://bettermarkets.com/sites/default/files/2016%20Annual%20Report%20%28Better%20Markets%29.pdf.

2 *See* Better Markets Letter to the Securities and Exchange Commission., September 17, 2013, available at https://bettermarkets.com/sites/default/files/SEC-%20MMF%20Reform-%209-17-13.pdf; *see* also Better Markets Letter to the Financial Stability Oversight Council, February 15, 2013, available at https://bettermarkets.com/sites/default/files/documents/FSOC-%20CL-%20MMF%20Recommendations-%202-15-13.pdf; Better Markets comment letter to the Financial Stability Oversight Council, March 5, 2013, available at https://bettermarkets.com/sites/default/files/documents/Letter-%20Lew-%20FSOC%20MMF-%203-5-13.pdf; and Better Markets Letter to the Financial Stability Oversight Council, March 25, 2015, available at https://bettermarkets.com/sites/default/files/documents/FSOC%20-%20CL%20-%20Asset%20Management%20Products%20and%20Activities%203-25-2015.pdf.

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applaud your ongoing efforts to support those reforms, as reflected in your recently disclosed October 5, 2017 letter to the Chairman and Ranking Member of the House Financial Services' Subcommittee on Capital Markets, Securities and Investments.

We too share the goals of preserving liquidity in the short-term funding markets and minimizing disruptions to investors, markets and market participants. However, protecting investors, markets and systemic stability during periods of market stress and volatility has to be an equally important goal, which require rules that also avoid devastating runs, fire sales, contagion, financial crashes and taxpayer bailouts.

Money Market Funds Are Systemically Significant, Fragile, and Destabilizing

MMFs are susceptible to runs and, when they do occur, the financial system can experience major disruptions that cripple the short-term credit markets and the overall flow of credit to the economy. MMFs do not come with any form of reliable capital buffer or government insurance that can prevent or mitigate the effect of a run. The MMF market is also large and relatively concentrated. Compounding the resulting fragility, MMFs are highly interconnected with other financial institutions, the payment systems and the economy as a whole because they are widely used by individuals, institutions, businesses, and state and local governments as cash management vehicles or as sources of credit. By virtue of these characteristics, MMFs present an ongoing risk of runs that can spread widely and rapidly throughout the financial system.

The financial crisis of 2008 made this threat painfully clear. In the most compelling example of run risk, the Reserve Primary Fund "broke the buck" on September 16, 2008 due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. Although that debt was only 1.2 percent of the fund's total assets, a run ensued when the fund sponsors declined to provide support. Within two days, investors sought to redeem $40 billion from the fund. This required the fund to dump tens of billions of dollars in assets immediately so that it could pay for the flood of shareholder redemptions. This fire sale in turn depressed asset values, further weakening the fund. The run quickly became generalized and spread to the prime MMF industry.[3] During the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) from prime MMFs.[4]

This widespread run caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, falling asset prices, and mounting redemption requests. The run abated **only** after the Treasury established the Temporary Guarantee Program to guarantee money

3 Some have sought to minimize the run by claiming that it was limited to only institutional investors, not retail investors. That, however, ignores the fact that professional institutional investors, many if not all with fiduciary duties, are at their screens 24-7, poised, prepared and capable of reacting quickly and, inevitably, much faster than retail investors. Thus, while it is largely accurate to say that retail investors did not join in the run, that is because the government rescue was enacted so quickly in response to the run that they did not need to run to protect themselves. There can be little doubt that if the primarily institutional run was not stopped, then retail investors would have joined in the run, compounding it many times over, precipitating even more widespread fire sales, intensifying the contagion, and exacerbating the crash.

4 *See* Former Federal Reserve System Chairman Ben Bernanke, "Financial Reform to Address Systemic Risk," speech at the Council on Foreign Relations (March 10, 2009) available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

market funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis. The entire $3.7 trillion money market fund industry was backstopped and de facto nationalized, putting taxpayers on the hook for any losses.

The collapse of the Reserve Primary Fund was not the first time—or the last—when MMFs faced significant stresses and potential collapse. During the crisis, other money market funds experienced significant stress levels requiring their sponsors to provide support. Going further back in time, one study found 144 cases from 1989 to 2003 in which MMFs would have "broken the buck" had it not been for sponsor support.[5] Another survey revealed 78 instances between 2007 and 2011 in which sponsors provided support to their MMFs in the form of either cash contributions or purchases of securities from the fund at inflated prices.[6] Relying on sponsors to maintain an artificially stable and misleading NAV is an unreliable approach, as we learned from the financial crisis.

Floating the NAV Is a Critical and Necessary Reform

As the SEC and the Financial Stability Oversight Council concluded, requiring MMFs to maintain and disclose on a daily basis an accurate net asset value is one of the most important and effective ways to reduce this systemic run risk. Accordingly, in 2014, building upon its 2010 reforms, the SEC further adopted rules to better protect investors and mitigate runs. These rules require a floating NAV for institutional prime and municipal MMFs so that the daily share prices of these funds reflect accurately the market-based value. The rules also give non-government MMFs discretionary tools such as liquidity fees and redemption gates that funds can use to help inhibit or halt any runs that may occur in times of significant market stress. While, as noted above,[7] Better Markets argued for stronger reforms, it was nonetheless a strong supporter of these reforms and commented extensively on them during the proposal stage.[8]

As you know, floating the NAV offers several benefits. First and foremost, it accurately informs investors and markets of the true market value of the securities. It thereby reduces the incentive of any investor to expedite withdrawals from a stressed MMF in hopes of redeeming at the $1.00 price as opposed to something lower. Investors who withdraw first no longer benefit from a "first mover advantage," since they receive the actual market-based value of their shares. Eliminating this first mover advantage substantially reduces run risk.

Second, the floating NAV also promotes greater fairness among investors. As a result of the artificially stable and misleading NAV, an investor that succeeds in redeeming early in a market spiraling downward may receive more than they are due by liquidating at $1.00 per share even though the underlying assets are actually worth less. Without a sponsor contribution or other rescue, the differential value between the inaccurately stated $1.00 per share and the actual asset

5 *See* Moody's Investors Service, Special Comment, August 9, 2010, available at http://www.alston.com/files/docs/Moody's_Report.pdf.

6 *See* Steffanie A. Brady, *et al*., "The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011." , Federal Reserve Bank of Boston; Risk and Policy Analysis Unit, August 13, 2012, available at http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1203.pdf.

7 *See supra* n. 2.

8 *See* Better Markets Letter to the Securities and Exchange Commission., September 17, 2013, available at https://bettermarkets.com/sites/default/files/SEC-%20MMF%20Reform-%209-17-13.pdf.

values will be a loss sustained by the shareholders remaining in the fund. Early redeemers receive a windfall and later redeemers pay the cost all because the $1.00 per share was artificial and inaccurate. The floating NAV eliminates this disparity, unfairness and incentive to run and run fast.

Finally, floating the NAV also enhances transparency. A fluctuating NAV helps correct the basic misconception among many investors that their MMF investment cannot lose value. Instead, investors see plainly that they bear the risk of loss as to MMFs, just as they do with other investment vehicles. Acclimating MMF investors to share price fluctuations will further mitigate their tendency to run in panic at the prospect that their MMF will break the buck.

Repealing Reforms Needlessly But Inevitably Puts Investors, Markets and Taxpayers at Greater Risk

Unfortunately, some are now actively pushing to repeal or substantially weaken SEC's critically important 2014 reforms. Given that the industry had two years to prepare for and implement the reforms and given that they have only been in place since October of 2016, such suggestions are extremely premature. Moreover, any such suggestions should only be *considered* if there is substantial, independently verified data that conclusively demonstrates material damage *caused* by the reforms *and that undermine and outweigh* the multiple goals of the reforms.

These suggestions – which are opposed by some prominent sponsors of MMFs – would replace substantive reforms with certain additional disclosure requirements in fund prospectuses and/or sales literature. These disclosure-only suggestions claim to correct the widespread misimpression that MMFs cannot sustain losses or that they carry bank-like deposit insurance.[9] However, disclosure alone simply will not alter investors' inflated and inappropriate confidence in the stability of MMFs. While disclosure has been proved time and again in numerous studies to be insufficient,[10] it has also been *proven in the MMF industry* which already has numerous disclosures about loss of value and lack of insurance.

In fact, **these disclosures were in the Prospectus of the Primary Reserve Fund** that "broke the buck" and ignited the MMF run in September of 2008:

> "The Funds are money market mutual funds that **seek to maintain** a $1.00 price per share. An investment in a Fund is **not insured or guaranteed by the U.S. government, FDIC or any other government agency**. Although each Fund seeks to preserve the value of your

9 Some of the other suggested changes would actually increase rather than further mitigate the vulnerability to runs that the SEC's 2014 rule was written to address by instituting a floating NAV for at least some MMFs. For example, some versions of these suggestions would restore the unfair advantage that some investors can gain by redeeming shares early in times of stress under a fixed NAV.

10 *See, e.g.*, "When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest." Daylian M. Cain, George Loewenstein & Don A. Moore. J. of Consumer Res. 836, Feb. 1, 2011, available at https://www.cmu.edu/dietrich/sds/docs/loewenstein/WhenSunLightFails.pdf, *see also* Sunita Sah & Daniel Read, "Disclosure and the Dog That Didn't Bark: Consumers Are too Forgiving of Missing Information." Academy of Management Best Paper Proceedings, Aug. 2017, available at http://docs.wixstatic.com/ugd/4aa4b7_33aaf219a2b640d4841a593739aa98f2.pdf.

investment at $1.00 per share, **it is possible to lose money** by investing in a Fund. Each Fund has maintained a constant share price since inception, and will strive to continue to do so. **The value of each Fund's net assets may change based on changes in market, economic, political and financial developments**."[11]

Thus, September 2008 was an actual, real-time stress test at the Primary Reserve Fund of the very type of disclosure being suggested now and it failed miserably. This starkly illustrates that technical and legal disclosure is overwhelmed by marketing and promotional language leaving the investors confused at best, and misled at worst. This is all the more true in light of the misleading but blaring message sent on a daily basis by the artificially stable and inaccurate $1.00 per share purported market price, which itself overwhelms disclosure in some long, complicated document buried somewhere. [12]

Only accurate, timely, and prominent disclosure of the true variable market price of MMFs on a day-to-day basis through transparent price fluctuations will properly inform investors and markets. Disclosure that the price can vary, that investors might lose money and/or that the funds are not guaranteed will inevitably be insufficient, as proved by the Primary Reserve Fund.

Importantly, as you too have recognized, the operational changes required by the SEC's reforms are now firmly in place and are workable. The Treasury Department and the IRS have addressed the tax and accounting concerns previously raised. These reforms are working, and, in fact, it has been reported that many fund managers have deep concerns about the disruption that repeal or substantial modification of the 2014 MMF reforms could cause. If anything, the SEC should be considering *additional* measures to further strengthen the MMF sector, including establishing a floating NAV for *all* MMFs, as we have previously advocated.[13]

Conclusion

The SEC's actions have protected investors, markets, the financial system, our economy and taxpayers by requiring the disclosure of accurate market price information and by increasing the transparency of MMF risks. It has also reduced the potential for systemic contagion by taking away the incentive to be a first mover, reducing the likelihood and intensity of future runs, another financial crisis, and need for more taxpayer-backed bailouts.

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11 Prospectus for the Primary Reserve Fund, October 28, 2006, available at https://web.archive.org/web/20070625070614/http://www.ther.com/pdfs/rsvPGTprospectus.pdf, accessed January 4, 2018 (emphasis added).

12 Ignoring contrary disclosure is also more likely given that the federal government so quickly bailed out the entire industry so recently; it would be reasonable for investors to expect such a rescue in the future as well, regardless of fine print to the contrary.

13 *See* Better Markets' Letters *supra* n. 2.

We urge you to continue to strongly resist any attempts that will undermine these vital reforms to the MMF markets and to consider strengthening those reforms by extending the accurate market price NAV mandate to all MMFs. We will support you in that effort and would welcome the opportunity to do so.

Sincerely,

Dennis M. Kelleher
President and CEO

Lev Bagramian
Senior Securities Policy Advisor

Stephen Hall
Legal Director and Securities Specialist

CC: Commissioner Kara Stein
Commissioner Michael Piwowar