



MUTUAL FUND DIRECTORS FORUM
The FORUM for FUND INDEPENDENT DIRECTORS

February 8, 2013

Financial Stability Oversight Council
Attn: Mr. Amias Gerety
Deputy Assistant Secretary
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform
(FSOC-2012-0003)

To the Financial Stability Oversight Council:

The Mutual Fund Directors Forum (“the Forum”)¹ welcomes the opportunity to respond to the request for comments by the Financial Stability Oversight Council (“the Council”) on its recent Proposed Recommendations Regarding Money Market Mutual Fund Reform (“Proposed Recommendations”).

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

I. The Commission, not the Council, Should Identify Any Necessary Regulatory Reforms

The Forum and its members recognize the importance of designing a regulatory system for money market funds that allows them to operate efficiently, results in the fair treatment of all who invest in money market funds and mitigates, to the extent feasible, any excessive systemic risk posed by the funds. We agree that, following the financial crisis of 2007-2009, a review of money market fund regulation was necessary, and indeed, we supported the amendments that the Securities and Exchange Commission (“the Commission”) adopted in 2010 to improve the liquidity of and reduce the investment

¹ The Forum’s current membership includes over 695 independent directors, representing 94 independent director groups. Each member group selects a representative to serve on the Forum’s Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum’s Board of Directors, although it does not necessarily represent the views of all members in every respect.

risk posed by money market funds.² Moreover, we agree with numerous other commentators and industry participants that these amendments have been highly effective in both making money market fund portfolios less risky and reducing significantly the chances that any money market fund will “break the buck.”

We also understand that the Council has a unique role under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Dodd-Frank Act”) in assessing the overall systemic risks present in the United States financial system and both taking and recommending further regulatory action to mitigate identified systemic risks. Nonetheless, we urge the Council to refrain from acting at this point, and instead allow the Commission to continue to address how to regulate money market funds. By doing so, we believe that money market funds will be regulated in a manner that best serves their investors, those that rely on the credit they provide and the financial system generally.

In contrast to the Commission, the Council does not itself have primary jurisdiction over any financial services provider or product, including money market funds. Given this fact, whether it is money market funds, other investment products or other features of the financial system, the Council should exercise its powers judiciously, taking significant account, in any individual matter, of the views and conclusions of the regulator that does have primary jurisdiction. The Council is better positioned to act when a primary regulator abdicates its responsibilities – that is, when it fails to analyze a potential systemic risk, and thus fails either to take action to reduce that risk or explain why action is unnecessary.

The Commission has not abdicated its responsibilities with respect to money market funds. Although the Commission did not take additional action in 2012, the Commission did adopt significant amendments to the regulations governing money market funds in 2010 and continues actively to analyze the impact of these amendments, both on the risks posed by individual funds and on the nature of the risk that these funds pose to the broader financial system. Moreover, recent comments and actions by individual Commissioners demonstrate that the Commission is continuing to work with the industry and internally to identify and analyze varying approaches to the regulation of money market funds. Indeed, regulatory approaches not fully addressed in the *Proposed Recommendations*, such as the use of liquidity fees, are now being actively discussed in the industry.³

² See Final Rule: Money Market Fund Reform, Release No. IC-29132 (Feb. 23, 2010) [hereinafter “2010 Amendments”]; Letter from David B. Smith, Jr., Executive Vice President, MFDF to Elizabeth M. Murphy, Secretary (Sept. 8, 2009) at 2 (“[W]e broadly support the proposed rule amendments that seek to tighten the credit quality, durational and liquidity limits placed on money market fund portfolios.”).

³ See, e.g., Letter from Barbara Novick, Vice Chairman, Blackrock & Richard K. Hoerner, Managing Director and Head of Corporate Cash, Blackrock to the Financial Stability Oversight Council at 10-13 (Dec. 13, 2012), Letter from James E Roselle, EVP and Associate General Counsel, Northern Trust Corp. to the Financial Oversight Stability Council at 6 (Jan. 14, 2013) and Letter from Edward Bernard, Director and Vice President, T. Rowe Price Associates, Inc. to the Financial Stability and Oversight Council at 5 (Jan 30, 2013); see also Ross Kerber & Sarah Lynch, *Vanguard, SIFMA, back liquidity fees for Money Funds*, Reuters, Jan. 15, 2013 (noting that “[t]he two Republicans, Daniel Gallagher and Troy Paredes, have said they would be open to an alternative rule that would permit board directors to limit withdrawals -- like SIFMA's ‘gates’ -- in times of stress.”) (available at <http://www.reuters.com/article/2013/01/15/us-money-funds-fees-idUSBRE90E18L20130115>).

Finally, the Council should not act to address what it perceives as flaws in an existing regulatory system unless those flaws create a significant systemic risk. For example, in the case of money market funds, the Council should not supplant the mission of the Commission of ensuring investor protection merely because it perceives that the regulation of money market funds could be altered in a manner that it believes would better protect investors.

Hence, although we recognize the role that the Council is intended to play in identifying and mitigating systemic risk in the financial system, we firmly believe that the Commission is best positioned to address how money market funds should be regulated and how any systemic risks related to money market funds should be managed and mitigated. As the Commission staff's recent work demonstrates,⁴ the Commission, its individual Commissioners and its staff continue to analyze data related to money market funds, and are actively engaged in determining how best to regulate these funds. Given the Commission's expertise in this area, we believe its conclusions, including -- potentially -- a conclusion that no or limited further regulation is needed, should be entitled to significant deference by other regulators.

II. Relevant Factors in the Analysis of the Regulatory System for Money Market Funds

The Council's *Proposed Recommendations* nonetheless does suggest various approaches to reducing the systemic risk it believes that money market funds pose. The Council's specific proposals are similar to those discussed in the President's Working Group Report⁵ and in other regulatory discussions. We have expressed our concerns about these approaches in the past, and will not repeat our specific concerns here.⁶ However, as many studies have suggested, adoption of any of these proposals would likely render money market funds less attractive to at least some investors, and these investors will consequently shift to managing some or all of their cash through other techniques or investment vehicles.

In particular, as the Council's release and numerous other reports and proposals demonstrate, money market funds are deeply intertwined in the fabric of the financial system and the economy of the United States. Most notably, money market funds both represent an important competitive option for those who need to manage their cash as effectively as possible and are an important provider of credit to governmental entities, financial institutions and other short-term borrowers of cash. Further, because money market funds are regulated under the Investment Company Act of 1940 ("the 1940 Act") as registered investment companies, they have a unique structure that produces other benefits,

⁴ See, e.g., "SEC's Gallagher: Money Market Overhaul Plan Coming Soon," Money News, Jan. 25, 2013 (reporting that SEC Commissioner Gallagher expects a formal SEC proposal by the end of March); (available at <http://www.moneynews.com/StreetTalk/SEC-Gallagher-Money-Market-Overhaul/2013/01/16/id/471778>); see also Division of Risk, Strategy and Financial Innovation, Securities and Exchange Commission, Response to Questions Posed by Commissioners Aguilar, Paredes and Gallagher (Nov. 30, 2012) [hereinafter "SEC Staff Report"].

⁵ Report of the President's Working Group on Financial Markets: Money Market Reform Options (Oct. 2010) [hereinafter "PWG Report"].

⁶ See Letter from David B. Smith, Jr., Executive Vice President, MFDF to Elizabeth M. Murphy, Secretary (Mar. 29, 2012) (commenting on PWG Report); Letter from David B. Smith, Jr., Executive Vice President, MFDF to Elizabeth M. Murphy, Secretary (Jan. 10, 2011) (same).

including the benefits of being overseen by independent directors. Finally, an investor shift away from money market funds could have unexpected or unintended consequences, including consequences that increase systemic risk elsewhere in the financial system or otherwise reduce the flexibility and growth potential of the economy.

We therefore believe that the Council should carefully consider these possible costs and benefits prior to making any recommendation to the Commission. From the perspective of the independent directors who oversee money market funds on behalf of their investors, we believe that this analysis should address three fundamental issues:

1. *The Unique and Fundamental Role of Independent Directors*

Among cash management choices for investors and savers, money market funds are unique in that they are overseen by an independent board of directors that is responsible solely to those who invest in the product. This board oversees all operations of the money market fund, including how the fund's investment strategy is implemented by its adviser, how the adviser manages risk, and how the fund is valued. The Commission's 2010 amendments to rule 2a-7 under the 1940 Act heightened the role of boards. Boards now, for example, have a formal role in reviewing stress testing of a money market fund's portfolio. Boards also help ensure that the Commission's tighter regulations governing liquidity, credit quality and duration are appropriately implemented. Additionally, the amendments have enhanced the involvement of boards in understanding the investor base of their funds and overseeing how the nature of the investor base is being reflected in the fund's management of its liquidity.⁷

The nature of boards also enhances the effectiveness of fund regulation, including the effectiveness of the 2010 amendments. Fund boards are extremely valuable because they add a qualitative approach to a regulatory system that is mainly quantitative in nature (that is, it sets specific standards that funds must meet with respect to liquidity, average portfolio duration, and so forth) and often relies upon a one-size-fits-all approach. They accomplish this in two ways – by overseeing the fund's compliance with the law and by seeking to ensure that the fund is operating in the interests of its investors. Boards also supplement the efforts of regulators by being able to respond quickly to the specific situations their funds face and by having the flexibility to develop solutions, within the context of the regulatory structure, for the facts and circumstances of the funds they oversee.

The board's involvement thus tends to reduce the risk that a fund will break the buck even more than would otherwise be the case. Additionally, because the 2010 amendments make clear that boards will be explicitly involved in making decisions if a fund gets into trouble, boards will also help ensure that all fund investors are treated fairly and equitably in a fund that is at risk of "breaking the buck." The involvement of independent boards in overseeing all aspects of the management and operation of

⁷ Historically, the boards of many money market funds have recognized that the nature and redemption patterns of the individual investors in the funds they oversee impact on how much liquidity an individual fund needs to maintain. Many boards have thus reviewed both the efforts of the fund's adviser to ascertain investors' liquidity needs and how the adviser modulates its management of the portfolio in response. The 2010 Amendments imposed "know your customer" requirements that make clear the need for boards and advisers to engage in this inquiry. See 2010 Amendments at 51-54. The 2010 Amendments thus increase the likelihood that individual money market funds will have sufficient liquidity to meet redemption requests, even in times of market strain.

money market funds should serve to increase regulators' and investors' confidence in these vehicles in a manner that distinguishes them from all other options available for cash management. Regulators should be wary of imposing regulations that, by making money market funds less attractive as investments, diminish this benefit.

2. The Nature of Systemic Risk

As noted above, both the Council and the Commission should consider the costs and benefits of any further regulations they believe should be imposed on money market funds. Indeed, as the Council's *Proposed Recommendations* recognize, the Dodd-Frank Act requires the Council to take into account "costs to long-term economic growth" in making its recommendations. Considerable data on the long term costs and benefits of various approaches to regulating money market funds has already been filed at the Commission, and we believe that this data should play an important role in the analysis.

But even more broadly than this consideration of long-term costs, the Council should also identify and take into account the manner in which its recommendations will impact the overall amount of systemic risk in the financial system. Put most simply, reducing (or even eliminating) the systemic risk posed by money market funds is of little value if it increases systemic risk elsewhere in the financial system. Because imposition of new regulations will cause some investors to shift their funds to other vehicles, new regulations will have the effect of increasing the systemic risks of those products.

The *Proposed Recommendations* recognize this issue in part, noting that the Council, the Commission or other regulators may need to address the risks of other types of lightly regulated funds otherwise similar to money market funds, particularly if the adoption of new money market regulations incents investors to move more assets to these funds.⁸ However, neither the analysis nor the response can be this simple. The effect, for example, is not just limited to hedge-fund like alternatives to money market funds, but rather includes competing products as basic as bank deposit accounts. While further regulation of alternate products may serve to limit the systemic risk posed by those products, all cash management products (just like all products and services offered within our financial system) have some inherent risks, including some inherent systemic risks.

Hence, there is no way to just eliminate systemic risk on a product-by-product basis. Instead, in considering how to regulate a single product such as money market funds, regulators such as the Council must carefully consider how the new regulation will affect the balance of risks, systemic and otherwise, within a system of alternative products. While the staff of the Commission has begun to examine this issue in its most basic form,⁹ the Council's *Proposed Recommendations* simply do not address this issue in any detail. It makes little sense to proceed further without engaging in this analysis.

3. The Extent to which Money Market Funds Create Systemic Risk

We also urge the Council to consider carefully the extent to which potential runs on money market funds, in and of themselves, are a source of systemic risk or are instead a symptom of other

⁸ See Proposed Recommendations at 7.

⁹ See SEC Staff Report at 38-46.

problems in the financial system. According to the *Proposed Recommendations*, the primary risk posed by money market funds is the risk that a run on those funds, particularly a situation in which a run on a single fund has spread industry-wide, will “impair[] liquidity broadly and curtail[] the availability of short-term credit.”¹⁰

Assuming that a broad-based run on money market funds were to occur again in spite of the recent changes to the regulatory structure, it is unclear whether money market funds would themselves damage the stability and liquidity of the financial system, or would instead just be one of the means through which investors’ lack of confidence in the financial system is transmitted. Specifically, as the events of 2007 and 2008 demonstrate, broad-based runs are likely to occur not just because a single fund (or fund complex) has experienced an event that has caused it to “break the buck,” but because investors in financial markets, particularly investors who provide short-term credit to the financial system, have lost confidence in the system broadly, and thus are reluctant to put their money at risk, even for short periods of time to borrowers highly likely to repay the funds. While the bankruptcy of Lehman Brothers, the resulting problems at the Reserve money market funds and the strains that were then transmitted to short-term credit markets served to highlight the lack of confidence in the financial system at that time, it is not obvious that the Reserve funds’ problems, in and of themselves, were the precipitating cause of that financial instability.¹¹

Rather, the problems in the underlying commercial paper and short-term credit markets suggest that investors were not just concerned with the risk of further failures in the money fund industry, but were also unwilling, in a time of crisis, to lend money, even for short periods of time to high quality borrowers, irrespective of whether that lending was intermediated by money market funds. In this sense, money market funds were less a cause of the problems in September 2008 than they were a victim of other significant problems in the financial system. If this is true, imposing further significant regulation on money market funds is unlikely to reduce this type of risk within the financial system while at the same time doing unwarranted damage to the money market fund industry. We therefore believe that further significant analysis of this issue is necessary before additional regulation could be justified.

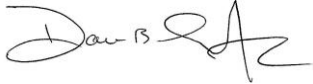
In conclusion, we very much appreciate the opportunity to comment on the Council’s *Proposed Recommendations* on behalf of our independent director members. As our comments, and the likely comments of many other industry participants demonstrate, while money market funds play a key role in our financial markets and provide investors an important competitive option for managing their cash and liquidity needs, the extent to which money market funds pose a real systemic risk to the financial system remains unclear. Many recent studies, including the SEC staff’s recent report, are positive first steps in attempting to answer this question. We therefore urge the Council and other regulators to continue to analyze these questions before imposing costly new regulations on the money market fund industry that will render these funds a less competitive, less compelling option for their investors.

¹⁰ Proposed Recommendations at 17.

¹¹ The SEC’s recent Staff Report addresses a number of competing explanations for investors’ behavior, particularly their decision to move cash from prime funds to Treasury funds. The potential explanations include a flight to quality, a flight to liquidity and a flight to transparency. See SEC Staff Report at 7-10.

We would welcome the opportunity to discuss our comments with you in more detail. Please feel free to contact Susan Wyderko, the Forum's President, at 202-507-4490 or David Smith, the Forum's General Counsel, at 202-507-4491, if you would like to follow up on any of our comments.

Sincerely,

A handwritten signature in black ink, appearing to read "David B. Smith, Jr.", with a stylized flourish at the end.

David B. Smith, Jr.
Executive Vice President and General Counsel
Mutual Fund Directors Forum