DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

September 27, 2012

Members of the Financial Stability Oversight Council,

Last month, the Securities and Exchange Commission (SEC) announced that it would not proceed with a vote to solicit public comment on potential structural reforms of money market funds (MMFs). This comes after a long and concerted effort by the SEC to develop reform options.

Further reforms to the MMF industry are essential for financial stability. MMFs are a significant source of short-term funding for businesses, financial institutions, and governments. The funds provide an important cash-management vehicle for both institutional and retail investors. However, the financial crisis of 2007–2008 demonstrated that MMFs are susceptible to runs and can be a source of financial instability with serious implications for broader financial markets and the economy. In the days after Lehman Brothers failed and the Reserve Primary Fund, a $62 billion prime MMF, "broke the buck," investors redeemed more than $300 billion from prime MMFs. Commercial paper markets shut down for even the highest quality issuers. Only Treasury's guarantee of more than $3 trillion of MMF shares, a series of liquidity programs by the Federal Reserve, and support from many fund sponsors stopped the run and helped MMFs meet their shareholders' redemption requests in a timely manner.

The SEC took important steps in 2010 to improve the resilience of MMFs by amending Investment Company Act Rule 2a-7 to strengthen the liquidity, credit-quality, maturity, and disclosure requirements of MMFs. But the effort toward reform should not stop there. The 2010 reforms did not attempt to address two core characteristics of MMFs that leave them susceptible to destabilizing runs: (1) the lack of explicit loss-absorption capacity in the event of a drop in the value of a portfolio security and (2) the "first-mover advantage" that provides an incentive for investors to redeem their shares at the first indication of any perceived threat to the fund's value or liquidity.

Both the President's Working Group on Financial Markets and the Financial Stability Oversight Council (Council) have consistently called for the SEC to pursue additional reforms to address structural vulnerabilities in MMFs, including unanimous recommendations in the Council's 2011 and 2012 annual reports. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gives the Council both the responsibility and the authority to take action to address risks to financial stability if an agency fails to do so. Accordingly, I would like the Council to consider taking a series of additional steps to address this challenge.

Path Forward to Protect Investors and the Economy

As its Chairperson, I urge the Council to use its authority under section 120 of the Dodd-Frank Act to recommend that the SEC proceed with MMF reform. To do so, the Council should issue for public comment a set of options for reform to support the recommendations in its annual reports. The Council would consider the comments and provide a final recommendation to the SEC, which, pursuant to the Dodd-Frank Act, would be required to adopt the recommended standards or explain in writing to the Council why it had failed to act. I have asked staff to begin drafting a formal recommendation immediately and am hopeful that the Council will consider that recommendation at its November meeting.

The proposed recommendation should include the two reform alternatives put forward by Chairman Schapiro, request comment on a third option as outlined below, and seek input on other alternatives that might be as effective in addressing MMFs' structural vulnerabilities.

Option one would entail floating the net asset values (NAVs) of MMFs by removing the special exemption that allows them to utilize amortized-cost accounting and rounding to maintain stable NAVs. Instead, MMFs would be required to use mark-to-market valuation to set share prices, like other mutual funds. This would allow the value of investors' shares to track more closely the values of the underlying instruments held by MMFs and eliminate the significance of share price variation in the future.

Option two would require MMFs to hold a capital buffer of adequate size (likely less than 1 percent) to absorb fluctuations in the value of their holdings that are currently addressed by rounding of the NAV. The buffer could be coupled with a "minimum balance at risk" requirement, whereby each shareholder would have a minimum account balance of at least 3 percent of that shareholder's maximum balance over the previous 30 days. Redemptions of the minimum balance would be delayed for 30 days, and amounts held back would be the first to absorb any losses by the fund in excess of its capital buffer. This would complement the capital buffer by adding loss-absorption capacity and directly counteract the first-mover advantage that exacerbates the current structure's vulnerability to runs.

Option three would entail imposing capital and enhanced liquidity standards, potentially coupled with liquidity fees or temporary "gates" on redemptions that may be imposed as an alternative to a minimum balance at risk requirement.

We should also be open to alternative approaches that satisfy the critical objectives of reducing the structural vulnerabilities inherent in MMFs and mitigating the risk of runs. We should use this opportunity to seek informed perspectives on the extent to which any mix of the specific reforms described above or other reforms would achieve the same level of protection for investors and the broader economy. The Council should engage with key stakeholders as part of this overall process.

The proposal should take into account the concern expressed that reform of MMFs may result in outflows from MMFs to less-regulated parts of the cash-management industry. While investors should welcome enhanced protections in MMFs, experience tells us that we cannot ignore the potential for capital, in times of relative stability, to flow to less-regulated sectors with fewer protections. Our objective should be to propose reforms to MMFs that protect the stability of MMFs without creating a competitive advantage for unregulated cash-management products.

Alternative Paths to Reform

The SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risks that MMFs present to the economy. However, while we pursue this path, the Council and its members should, in parallel, take active steps in the event the SEC is unwilling to act in a timely and effective manner.

Under Title I of the Dodd-Frank Act, the Council has the authority and the duty to designate any nonbank financial company that could pose a threat to U.S. financial stability. The Council should closely evaluate the MMF industry to identify firms that meet this standard. Designating MMFs or their sponsors or investment advisers would subject those firms to supervision by the Federal Reserve and would give the Federal Reserve broad authority to impose enhanced prudential standards, potentially including the options discussed above. Alternatively, the Council's authority to designate systemically important payment, clearing, or settlement activities under Title VIII of the Dodd-Frank Act could enable the application of heightened risk-management standards on an industry-wide basis.

Other Council member agencies have the authority to take action to address certain of the risks posed by MMFs and similar cash-management products. For example, the bank regulatory agencies should evaluate their authorities to impose capital surcharges on regulated entities that sponsor MMFs, or restrict financial institutions' ability to sponsor, borrow from, invest in, and provide credit to MMFs that do not have structural protections. As currently conducted, such activities can pose risks to financial institutions' safety and soundness in a variety of ways, including the potential for MMFs to curtail funding for financial firms abruptly in times of market stress and the implicit support provided by firms that sponsor MMFs. Additionally, the potentially destabilizing role of MMFs in the tri-party repo market should be carefully assessed as part of the ongoing efforts to improve the safety, soundness, and resiliency of that market.

I urge the members of the Council to accelerate their evaluation of these alternatives. The members of the Council should move ahead to consider how best to give effect to these alternative paths as they consider public comments on reform options for the SEC.

Conclusion

Without further reform of MMFs, our financial system will remain vulnerable to runs and instability, which are harmful for retail and institutional investors, businesses that need a reliable source of funding, the MMF industry, and the financial system as a whole. We will seek broad input from the full range of stakeholders on how best to design further reforms.

Four years after the instability of MMFs contributed to the worst financial crisis since the Great Depression, with the failure of the SEC to act, the Council should now move forward with the tools provided by Congress.

Sincerely,

Timothy F. Geithner