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on

Oversight of the Mutual Fund Industry:
Ensuring Market Stability and Investor Confidence

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Chairman Garrett, Ranking Member Waters, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss market stability and investor confidence in relation to the mutual fund industry. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Associate Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified before various Congressional committees, and published articles on regulatory issues. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the CFP Board's Public Policy Council; and a co-founder of and faculty advisor to the Self-Regulatory Organization for Independent Investment Advisers. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee;¹ an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

I. Introduction

The Subcommittee's interest in a wide range of issues related to mutual funds is timely, particularly as to the resiliency and security of money market funds ("MMFs"). It is now generally accepted that MMFs, in certain scenarios, pose systemic risk. Regulators and industry members should be applauded for their efforts to determine what reforms, if any, are needed to address this risk.

¹ The SEC's Investor Advisory Committee considered the floating NAV issue at its May 2010 meeting. See memorandum from Investor as Purchaser Subcommittee to Investor Advisory Committee (May 3, 2010) available at <http://www.sec.gov/spotlight/invadvcomm/iacmemo-mmf.pdf>.

However, the debate surrounding MMF risk has veered dangerously from the realm of reality into the realm of rhetoric. To believe certain critics of MMFs, one would think that there has been run on MMFs every year for the last decade, that a few dozen funds failed last week, and that more are likely to fail this afternoon. My testimony focuses on correcting some of the misconceptions about the nature of MMFs and their regulation that threaten to undermine reasonable efforts to improve MMF regulation. In particular, the misguided proposal to prohibit MMFs from using a stable net asset value (“NAV”) would unnecessarily eliminate an investment vehicle that has been chosen for decades by tens of millions of Americans as a safe place for their cash holdings. As is so often the case, retail investors’ interests will have been virtually ignored, as pointedly illustrated by the participant list and discussion at the SEC’s recent MMF roundtable.

II. Money Market Fund Regulation

a. Money Market Funds: The Historical Record

The evaluation of MMF systemic risk should be based on actual facts and events and not false generalizations.

The current MMF debate has been replete with misleading characterizations of the actual performance of MMFs during their thirty-year history. For example, statements that MMFs are “prone” or “susceptible” to runs are patently false. There have been dozens of instances of market stress during the last three decades that have affected MMFs, but only two MMFs have failed. One failure was extremely small (and did not trigger a run). The other occurred during the most extreme financial crisis since the Great Depression. To characterize MMFs as being “prone” (*i.e.*, having a natural tendency to an action) or “susceptible” (*i.e.*, being especially vulnerable to a particular influence) to runs directly contradicts the historical record. The empirical evidence demonstrates unequivocally that MMFs are *not* “prone” or “susceptible” to runs.

Nor is it accurate to describe MMFs as “prone” or “susceptible” to runs in times of crisis. The MMF run in 2008 was a single event from which no responsible statistician would derive reliable predictive value. The causes of the run were complex and numerous. However one defines “crisis,” MMFs have performed perfectly during 9 of the 10, 99 of the 100, or 999 of the 1,000 largest crises of the last three decades. The one crisis that MMFs did not successfully navigate was arguably a perfect financial storm that might never be repeated. Yet some MMF critics appear to view MMFs’ performance in the 2008 “crisis” as reflecting how they have performed in every crisis and would perform in every future crisis.

The recent claims that MMFs are at risk because of their holdings of short-term European banks are similarly misleading. There is no empirical basis for the assertion that these holdings pose a threat to MMFs’ NAVs. The data on which these claims have been made are stale and inadequate to reach a reasonably informed judgment about the safety of MMFs individually or as a group.

For example, a Federal Reserve Bank of Boston President Eric Rosengren recently stated publicly that,

[d]espite the regulatory changes that have occurred, MMMFs still remain vulnerable to an unexpected credit shock that could cause investors to doubt the ability to redeem at a stable net asset value.²

Mr. Rosengren had no empirical basis on which to evaluate the effect of “regulatory changes that have occurred,” such as greatly enhanced liquidity requirements, greater redemption suspension rights, and increased portfolio monitoring by the SEC. The claim that MMFs are vulnerable to “unexpected credit shocks” is belied by the fact the MMFs have experienced frequent unexpected credit shocks and survived

² Statement of Eric Rosengren, President, Federal Reserve Bank of Boston (June 3, 2011) *available at* <http://www.bostonfed.org/news/speeches/rosengren/2011/060311/index.htm>.

all but one.³ His related comments about MMFs' exposure to short-term European bank obligations was not based on any empirical analysis of the actual risk posed to MMFs by these holdings.⁴

The most insidious aspect of Mr. Rosengren's comments is the statement that these shocks "could cause investors to doubt the ability to redeem at a stable net asset value." Unwilling to make the objective claim that a credit shock could cause an MMF to break a dollar, presumably because that claim would have no historical or current empirical basis, he chose the subjective claim that shareholders could "doubt" their MMFs. The irony, of course, is that it is such pronouncements by banking regulators that can themselves cause shareholders to doubt their MMFs, even if there is no objective basis on which to do so. His comment generated substantial press coverage, including the headlines: *Fed's Rosengren: Money Market Funds Remain Vulnerable To Shocks*⁵ and *Rosengren Warns on Vulnerability of Funds*.⁶

Effective reforms to address MMF systemic risk should not be based on assumptions about the safety of MMFs that have no basis in fact. The scenario in which MMFs failed – the *only* scenario in which they have failed – was a financial crisis the likes of which has been experienced only twice in the last 100 years. This is not to downplay the need to address the very real systemic risk posed by MMF failure. Rather, it is to emphasize the need to design regulatory reforms that are

³ See *Sponsor Support Key to Money Market Funds*, Moody's Investors Service at 4 (Aug. 9, 2010) (majority of MMF sponsor support events triggered by credit quality issues).

⁴ Statement of Rosengren, *supra* ("some MMMFs are potentially sensitive to a disruption in the European banking system, should one arise from the fiscal and sovereign-debt problems we are seeing in some European countries."); see Sean Collins and Chris Plantier, *Money Market Funds and European Debt: Setting the Record Straight*, Investment Company Institute (June 20, 2011) available at http://www.ici.org/viewpoints/view_11_mmfs_european_debt; *U.S. Money Fund Exposure to European Banks Remains Significant*, Fitch Ratings (June 21, 2011) available at http://www.politico.com/static/PPM191_moneyfundexposure621.html

⁵ Michael Derby, WSJ.com (June 3, 2011).

⁶ Boston.com (June 4, 2011).

actually based on the historical record. That record is conclusive. Under any reasonable definition of “safe,” money market funds are safe.

b. Safety Regulation and Infinite Liquidity

Only a form of infinite liquidity guarantee ultimately can prevent an MMF run; the MMF reforms being considered generally do not address the central question of the optimal structure of such a guarantee.

The systemic risk posed by MMFs is not created by the potential failure of a single MMF. Rather, it is created by the potential that an MMF failure could trigger a run on a large number of MMFs. The MMF reforms that have been adopted or proposed generally would not have had a material effect on the behavior of shareholders who fled MMFs in September 2008. Granted, the reforms have reduced or would reduce the likelihood that any given MMF will break a dollar. But almost none of the reforms would have a material, direct effect on the likelihood of a post-failure run.

For example, buffers and other forms of capital requirements are designed to reduce the likelihood that an MMF’s NAV will decline below \$0.995 per share. They do so by increasing the amount by which an MMF’s portfolio would have to decline in value before breaking a dollar. They also reduce failure risk by directly or indirectly imposing costs on risk-takers for taking risks (*i.e.*, by reducing moral hazard). Either the sponsor’s implied promise to rescue the fund is made contractually binding, or some alternative mechanism is used to transfer the costs of the buffer to shareholders and MMF sponsors. Capital requirements would undoubtedly make MMFs safer and reduce failure risk.

Capital requirements do not, however, address run-risk that has a systemic impetus. The 2008 MMF run resulted from systemic run-risk, that is, fears *not* about whether particular MMFs’ portfolios posed a relative risk of loss, but about whether

MMFs as a group would hold their \$1.00 NAV. Institutional shareholders decided *indiscriminately* that the prime MMF as a cash management vehicle was no longer a structure that provided adequate safety of principal.

Recent reforms undoubtedly have enhanced the perceived safety of MMFs.⁷ However, it is in the nature of systemic shocks that market participants revert to simplistic evaluative tools and make quick decisions based on limited information. While the idea that shareholders would stop to ponder that MMFs now have shorter maturities, greater liquidity, enhanced regulatory oversight⁸ and a public record of shadow \$1.00 NAVs is theoretically comforting, it is not consistent with the dynamics of financial contagion. If the purpose of MMF reform is to prevent a run like that of 2008, it will not be achieved by capital requirements and other changes that are essentially internal to the very systemic structure in which a run demonstrates a loss of confidence. It can only be achieved by a source of confidence that stands outside of that systemic structure, such as the full faith and credit of the United States.

The addition of some form of buffer to reduce the likelihood of an MMF failure might reduce run-risk at the margins, but it is unlikely to affect the kind of dynamics that dominated MMF shareholders' actions in September 2008. In response to a buffer proposal made at the SEC roundtable, a fund industry executive said that it was too complex. Indeed, it is too complex. It is not too complex to make failure less likely, but it is far too complex to be relied on to have a material effect on

⁷ There are also persuasive arguments that safety reforms have not achieved any material safety improvements and will themselves accomplish the elimination of MMFs that some critics seek. Each reform provides an additional increment of safety – as would adding a rubber bumper to the nose of a commercial jet – while stripping away another basis point of yield. Eventually, MMFs will reach the tipping point at which they collapse under the weight of safety rules.

⁸ In 2010, the Commission adopted rules requiring the monthly reporting of money market fund portfolios. See *SEC Approves Money Market Fund Reforms to Better Protect Investors* (Jan. 27, 2010). available at <http://www.sec.gov/news/press/2010/2010-14.htm>. Fund Democracy and a number of other parties had filed a rulemaking petition in early 2008 asking that the Commission impose such a requirement. See Letter from Fund Democracy, *et al.* to Securities and Exchange Commission (Jan. 16, 2008) available at <http://www.funddemocracy.com/MMF%20Rulemaking%20Petition.pdf>.

systemic run-risk. There is simply no substitute for an infinite liquidity guarantee as a means of substantially mitigating systemic run-risk. Virtually all other reforms and reform proposals are reducible to a relative position on MMF portfolio safety, as opposed to run-risk that arises apart from objective portfolio safety.

c. The Floating NAV and Expectations of Safe Money

The systemic risk posed by MMFs reflects the intrinsic expectations of safe money, not the structure of MMFs, and these expectations and the systemic risk they create will follow safe money wherever it goes, including floating NAV funds.

Some commentators have suggested that the systemic risk created by MMFs would be eliminated by requiring that MMFs permit their NAVs to float. The floating NAV proposal is, however, fatally acontextual. Critics assume that the expectations of safe money, which expectations are the seeds of systemic risk, will disappear if MMFs' NAVs are required to float. This argument misunderstands the nature of safe money and its attendant expectations.

The safe money currently invested in MMFs is money with respect to which shareholders have an expectation of safety (that is what makes it "safe money" as that term is used here). If MMFs are no longer available, safe money will move to the investment option that the MMF shareholder determines to be the next best safe investment vehicle. The shareholder's expectation of safety will move with it. The move will not affect shareholders' expectations regarding their safe money. The cash for which safety is a priority will still be cash for which safety is a priority. They will no longer be able to invest it in the vehicle that they deem to best serve their needs – MMFs – but that would not change their need for safety. If their safe money did not simply move to a new "safe home," it would not be the safe money that it is.

Thus, safe money MMF assets that move to floating NAV funds will do so because shareholders believe that floating NAV funds are safe. And these funds probably will, in fact, be safe. It is not entirely clear what form these funds would take, but they would likely maintain a constant per share NAV of \$10.00, with sales and redemptions almost always occurring at precisely that value. Occasionally, transactions will be effected for a few cents more or less than \$10.00 per share, but the funds will manage their portfolios in order to maintain a stable NAV consistent with their shareholders' expectations of safety of principal. Those expectations will be reinforced by experience, and the circle of trust will have been re-established in the form of the floating NAV fund (again, assuming that floating NAV funds win the competition for safe money formerly held by MMFs).

At some point, a floating NAV fund will break this circle of trust. An ensuing run on floating NAV funds will confront regulators with the same dilemma that confronted them during the 2008 run – only the systemic risk is likely to be much greater. Floating NAV funds may not be subject to rule 2a-7's portfolio restrictions, which will greatly expand the size of potential losses of any given floating NAV fund. The funds' directors will not be subject to any of rule 2a-7's monitoring requirements. The Commission will not have the authority to enforce safety-based regulations. The only mechanism serving to keep the actual investment of the funds' portfolio in line with the expectations of safe money will be the funds' prospectus disclosure. One need only review some of the recent litigation involving short-term bond funds to appreciate the flimsy discipline that this mechanism imposes. Alternatively, if rule 2a-7 requirements are imposed, safety will be enhanced, but the expectation of safety will have been strengthened. Eliminating the vehicle in which safe money expectations are housed does nothing to eliminate safe money expectations.

In short, requiring MMFs to float their NAVs would eliminate an investment option chosen by tens of millions investors as the best option for their safe money, only to re-create precisely the same problem in floating NAV funds that these funds

were intended to solve. This problem will follow safe money wherever it goes, including banks, where the systemic risk is far greater than that posed by MMFs. It is banks that historically have been and continue to be the primary source of runs and systemic risk. During a period in which two MMFs have failed, *thousands* of banks have failed. To the extent that institutional MMF shareholders move their safe money into banks, they will have exchanged a diversified pool of safe, short-term money market securities for an uninsured investment in a single issuer whose assets include high-risk, long-term assets.⁹ To the extent that safe money moves to unregulated hedge funds and/or offshore funds, the systemic risk that is necessarily attendant upon the expectations of safe money will have moved underground.¹⁰

A truly contextual analysis of MMF systemic risk would approach the question of infinite guarantees of liquidity as one of finding the path of least insurance.¹¹ Money market funds have been and continue to be the lowest overall cost mechanism for providing a safe investment vehicle for cash. Federally insuring MMFs while weaning banks from the use of insured deposits to invest in high-risk, long-term assets would result in a net reduction in systemic risk and improve financial stability.

⁹ See *Reforming Money Market Funds*, Squam Lake Group at 3 (Jan. 14, 2011) (“Because the bank deposits of large institutional investors are uninsured, this could simply move the threat of runs from money market funds to the banking sector. Given that banks are less transparent than money market funds, the likelihood of a damaging run could theoretically increase as a result of this shift.”).


¹⁰ See *Money Market Fund Reform Options*, President’s Working Group on Financial Markets at 21 – 22 (Oct. 2010) available at <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>.

¹¹ See generally Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (Mar. 2, 2009) available at SSRN: <http://ssrn.com/abstract=1351987>; Mercer Bullard, *Will Obama Kill Money Market Funds?* Morningstar.com (Oct. 2, 2009) available at <http://news.morningstar.com/articlenet/article.aspx?id=310677>; *Enhancing Investor Protection and the Regulation of Securities Markets*, Hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, at 4 – 10 (Mar. 11, 2009) (testimony of Mercer Bullard) available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a22c0391-db89-4e18-a40c-e9e6caddabae.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Mercer Bullard	2. Organization or organizations you are representing: University of Mississippi School of Law
3. Business Address and telephone number: [REDACTED]	
4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
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