Statement of Commissioner Kara M. Stein

Washington, D.C.

July 23, 2014

I want to thank the staff for your thoughtful engagement with my office and all of the hard work that went into these recommendations. These rules are better for your great work, and your tireless efforts to reach the best policy outcome are commendable.

While the rules before us today are important, it is critical to remember why we are considering them. We are trying to strengthen a part of our markets that was at the heart of the last financial crisis. We know firsthand the significance of, and risks related to, the wholesale funding markets and money market funds in particular.

The 2008 financial crisis revealed key weaknesses in the fabric of our financial system. Hundreds of firms were rescued and others failed. And when Lehman Brothers failed, one prominent money market fund "broke the buck" even though it had invested only 1.2% of its assets in Lehman securities.[1] When investors realized that the sponsor to the fund would not be able to support it, they rapidly redeemed their shares. This caused chaos by sparking mass redemptions in other prime money market funds, with devastating consequences to the entire economy.[2]

Our government and taxpayers were forced to take extraordinary measures to save the day, pouring trillions of dollars into the financial markets. Many remember the Troubled Asset Relief Program, which provided billions of dollars to banks. But that was just one of many unprecedented initiatives. The Federal Reserve created several programs to support the liquidity of financial institutions, borrowers, and investors.[3] And the Treasury Department guaranteed nearly $2.4 trillion in money market fund assets through its Temporary Guarantee Program.[4] These and other efforts helped stem the credit crisis, and brought into sharp focus the interconnectedness and fragility of our wholesale funding markets.

Most of the time, the wholesale funding markets work well. Investors in money market funds earn good returns on their cash, broker-dealers and financial institutions are able to fund their positions cheaply with high-quality collateral, and businesses are able to get the capital they need to grow and create jobs. But as we learned in the most recent crisis, these markets can come under stress. When the capital provided by money market funds evaporated, the wholesale funding markets froze, ultimately crippling the economy. While an over-reliance on short-term funding can accelerate credit supply and asset price increases in good times, it also can accelerate precipitous declines in asset prices and credit in bad times.

Although the financial crisis is now behind us, its damaging effects are not. We cannot forget the chaos that can spread when there is trouble at any one participant in our wholesale funding markets. We must strive, together with our fellow regulators, to make these markets stronger and more resilient.

Today's rule focuses on money market funds. That focus is appropriate given the sizeable role that these funds play in the wholesale funding markets and the structural features that make them susceptible to runs. But the Commission simply cannot address all of the vulnerabilities in these vibrant and important markets through money market fund rules. It also must strengthen capital, leverage, liquidity, and margin rules for broker-dealers. And it must leverage market forces by empowering investors to better police issuers who may become over-reliant on short-term credit.

For example, the Commission should move to finalize rules that it proposed in 2010 to improve disclosures regarding issuers' short-term borrowings.[5] To be effective, these disclosures must shed light on balance sheet window dressing and provide insight into the tenor of a dealer's collateral financing. Such reforms should be done with an eye towards addressing systemic risks, something that we must be ever cognizant of moving forward.

Further, the Commission cannot address all of the weaknesses in the wholesale funding markets by itself. It is vital that each of our efforts be complemented by other regulators who have jurisdiction over other participants in these markets. For example, the funding disclosures that the Commission should act on could be reinforced by the Federal Reserve Board, which could take more direct measures to regulate the use of short-term credit by financial institutions.

Making these markets more resilient to inevitable stresses requires regulators to work together. This means that we at the Commission need to step outside of our jurisdictional silo, and think broadly with our fellow regulators, both domestically and internationally. Collaboration has been promising in the reform of the tri-party repo market, where our staff has been working with staff at the Federal Reserve Bank of New York. This has resulted in the significant accomplishments of reducing intraday credit risk, and minimizing weaknesses in credit risk management. We need to build on these accomplishments to address remaining issues in the tri-party repo market, such as fire-sale risks.

The Financial Stability Oversight Council must continue to play a leading role in strengthening the resiliency of the wholesale funding markets. It is uniquely positioned to tap the expertise of each regulator to identify potential risks in these markets, and then enlist the help of the entire Council to address them. Members should be unified in making sure that our wholesale funding markets are strong enough to help support a robust and thriving economy. This will require addressing areas of known systemic risk and carefully examining areas of interconnectedness between market participants, such as securities lending, to determine whether they present risks to financial stability. Securities lending is evolving and complex, involves leverage, and can be opaque to both regulators and investors – all reasons why it needs to be analyzed very carefully.

These efforts to protect and strengthen our wholesale funding markets should be in addition to our money market fund rules. As for today's main proposal, my primary consideration is whether the reforms will mitigate the risks – to investors, businesses, municipalities, and our economy – posed by our wholesale funding markets.

When viewed through this lens, several parts of the rule are significant steps forward. For example, requiring institutional prime funds to have a floating net asset value directly addresses a structural feature of money market funds that makes them susceptible to redemption runs. It helps investors understand and experience that these funds are not risk free. And it nudges investors who are unable to tolerate any risk of loss towards other financial products better aligned with their risk-return preferences. I also am pleased that the rule has narrowed the definition of a government fund and tightened its diversification requirements.[6]

But while the rule contains improvements, I believe it has a significant shortcoming – redemption gates. I agree with the staff that a floating net asset value, even when combined with these other improvements and the 2010 amendments, is not a panacea. Money market funds remain vulnerable to runs because investors will still have an incentive to redeem in a crisis.

However, after careful study, I am concerned that gates are the wrong tool to address this risk. As the chance that a gate will be imposed increases, investors will have a strong incentive to rush to redeem ahead of others to avoid the uncertainty of losing access to their capital. More importantly, a run in one fund could incite a system-wide run because investors in other funds likely will fear that they also will impose gates. I share the concerns of many commenters and economists that while a gate may be good for one fund because it stops a run in that fund, it could be very damaging to the financial system as a whole.[7]

Even further, while a run by investors in one fund may be halted when the gate for that fund is used, that does not mean the impact on the wholesale funding markets will stop. To the contrary, a fund that drops a gate likely would need to build liquidity to meet redemption requests when the gate is lifted. This means the fund is likely to stop re-investing maturing securities during the gated period, or will invest primarily in government securities, thereby cutting off funding to issuers. This effect could be amplified by investors, who likely will redeem assets from other funds if one fund imposes a gate. And if investors are not able to redeem before the gate comes down, they will be harmed as they are deprived of access to their capital.[8] Ultimately, this contagion could freeze the wholesale funding markets in much the same way as occurred during the recent financial crisis.

I appreciate that the rule seeks to mitigate some of these concerns by allowing the fund's board to impose gates at a higher liquid assets threshold than was proposed, by shortening the length of the gate, and by requiring daily disclosure of a fund's level of liquid assets. However, I do not believe that these changes adequately address the risk of destabilizing pre-emptive runs for the following reasons.

First, adding discretion that makes it easier for a fund to impose a gate could actually increase an investor's incentive to redeem because it makes the use of a gate more likely. This could be especially problematic in a crisis, when an investor's preference to avoid uncertainty could be magnified. Second, shortening the gating period to ten business days may only marginally decrease the incentive to redeem since even a ten business day gate is significant, particularly for corporate treasurers or other investors seeking to make payroll or meet other daily demands. Third, while disclosure could help, it also could have the opposite effect by highlighting that a fund could be at or approaching a threshold that would allow it to impose a gate.

I also am not sufficiently persuaded by the argument that many investors with a low tolerance for gates will seek alternative financial products that are better aligned with their risk-return preferences. While this could happen, it seems just as likely that those same investors will continue to invest in money market funds because they believe they will be able to redeem before a gate is imposed, or that sponsor support will prevent the gate from ever being used. While the rule requires disclosure of sponsor support, it unfortunately does little to address the moral hazard that is created by it.

In the end, these are difficult issues with uncertain answers. Ultimately, despite the rule's efforts to mitigate the risks posed by gates, I believe the incentives to avoid them will remain powerful. I fear these incentives may result in a greater chance of fire sales during times of stress, and a spread of the panic to other parts of our financial system, while also denying both investors and issuers access to capital. I am, therefore, in the unfortunate position of not being able to support the rule that the staff recommends adopting today, despite some of its well-considered and thoughtful components.

Whatever the result today, money market funds are only one part of the wholesale funding markets that needs to be strengthened. We and our fellow regulators need to take additional steps to improve the transparency and resiliency of these markets. I look forward to working with the staff, my fellow Commissioners, and my fellow regulators on this more comprehensive and necessary project as we move ahead.

[1] *See* Release No. IC- 31166 (July 23, 2014) ("Adopting Release") at 29.

[2] During the crisis month (September 2, 2008 to October, 7, 2008), prime money market fund assets fell by $498 billion or 24%. During the calendar week of the crisis, institutional prime money market funds had large outflows every day of the week and retail prime money market funds had net outflows Wednesday through Friday. Institutional prime money market funds continued with net outflows every day of the following two weeks with the exception of one day. Retail prime money market funds also experienced net outflows during those two weeks. *See* Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, a report by staff of the Division of Risk, Strategy, and Financial Innovation (Nov. 30, 2012).

[3] *See, e.g.*, Commercial Paper Funding Facility (CPFF), Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Money Market Investor Funding Facility (MMIF), and the Term Asset-Backed Securities Loan Facility (TALF). For descriptions of these programs, *see* http://www.federalreserve.gov/newsevents/reform_cpff.htm (reflecting $739 billion in CPFF loans and $738 billion in purchases of commercial paper), http://www.federalreserve.gov/newsevents/reform_amlf.htm (reflecting $217 billion in AMLF loans), http://www.federalreserve.gov/newsevents/reform_mmiff.htm (reflecting $0 in total loans as the MMIF facility was never used), and http://www.federalreserve.gov/newsevents/reform_talf.htm (reflecting $71.1 billion in TALF loans).

[4] *See* Press Release, Treasury Announces Temporary Guarantee Program for Money Market Funds (Sept. 29, 2008), available at http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx.

[5] Release No. 33-9143, Short-Term Borrowing Disclosure (Sept. 17, 2010).

[6] We learned from the Reserve Primary Fund that a very small investment by a stable value fund in an impaired credit can have significant consequences. Even at capital losses of only 0.75% of the fund's non-weekly liquid assets and with no investor redemptions, funds are already more likely than not (64.6%) to "break the buck." *See* Adopting Release at 38.

[7] *See, e.g.*, Comment Letters from the Federal Reserve Bank of Boston (Sept. 12, 2013), The Systemic Risk Council (Sept. 16, 2013), Samuel Hanson, David Scharfstein, and Adi Sunderman (Sept. 16, 2013), Goldman Sachs Asset Management (Sept. 17, 2013 and July 21, 2014), Deutsche Investment Management Americas (Sept. 17, 2013), Committee on Capital Markets Regulation (Sept. 17, 2013), The Squam Lake Group (Sept. 17, 2013), and Americans for Financial Reform (Sept. 17, 2013). *See also* Federal Reserve Bank of New York, Staff Report No. 670, Gates, Fees, and Preemptive Runs (Apr. 2014).

[8] *See* Kevin McCoy, Primary Fund Shareholders Put in a Bind, USA Today, Nov. 11, 2008 (discussing hardships faced by Reserve Primary Fund shareholders due to having their shareholdings frozen); John G. Taft, STEWARDSHIP: LESSONS LEARNED FROM THE LOST CULTURE OF WALL STREET (2012), at 2 ("Now that the Reserve Primary Fund had suspended redemptions of Fund shares for cash, our clients had no access to their cash. This meant, in many cases, that they had no way to settle pending securities purchases and therefore no way to trade their portfolios at a time of historic market volatility. No way to make minimum required distributions from retirement plans. No way to pay property taxes. No way to pay college tuition. It meant bounced checks and, for retirees, interruption of the cash flow distributions they were counting on to pay their day-to-day living expenses.").

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