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January 2010

### Breaking Bucks: SEC Regulation by Obfuscation

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## **BREAKING BUCKS: SEC REGULATION BY OBFUSCATION**

*William A. Birdthistle* \*

*This Article argues that the Securities and Exchange Commission's first and most significant response to the economic crisis profoundly contradicts widely accepted theoretical and regulatory approaches to financial oversight. More alarmingly, the SEC's newest rules **increase** rather than decrease the likelihood of future failures in money market funds and the broader capital markets.*

*Scholars – of both neoclassical and behavioral economic theory – have long insisted that transparency and disclosure play essential roles in ensuring efficient capital markets and sound financial regulation. Professors Gilson and Kraakman notably argued that the efficient capital market hypothesis, and its reliance on a market for information, “is now **the** context in which serious discussion of the regulation of financial markets takes place.” The SEC itself subscribes – at least publicly – to a corresponding regulatory framework: its mission statement declares that “[o]nly through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.”*

*Yet in newly promulgated regulations addressing the “breaking of the buck” in the \$3-trillion money market – an unstudied debacle at the fulcrum of the 2008 financial meltdown – the SEC endorses practices that obfuscate rather than illuminate the capital markets, including fixed pricing for money market funds and the continued use of discredited ratings agencies. These policies, premised implicitly upon doubt in the ability of markets to process information effectively, obscure true perils of money market funds. Rather than swaddling investment risks in these misleading, self-sabotaging regulatory buffers, the SEC should emphasize the menace of these funds. This Article offers transparent solutions to alleviate moral hazard and systemic risk in the broader market and to end the regulatory subsidy of these specific investments.*

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\* Assistant Professor of Law, Chicago-Kent College of Law. I thank Alison LaCroix, John Bilson, Peter Crane, Tamar Frankel, J.B. Kirtredge, and Erik Sirri, as well as participants in the 2009 Mutual Fund Roundtable at Boston University, fellows and faculty at the Searle-Kauffman Institutes on Law, Innovation, and Growth, and workshop participants at Chicago-Kent College of Law for their helpful comments and insights. I am also grateful to Lucy Moss and Benjamin Wilensky for their excellent research assistance.

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The purpose of a money market fund is to provide safety of principal, liquidity, and a reasonable rate of return – all while boring investors into a sound sleep.

- Bruce R. Bent, chairman, The Reserve<sup>1</sup>

They [The Reserve] didn't just break the buck, they shattered it.

- Don Phillips, managing director, Morningstar<sup>2</sup>

#### INTRODUCTION

Sheer terror in horror films grabs hold not when imminent victims frolic in sinister cornfields or other obviously creepy locales – rather it clutches tightest when protagonists retreat to the safest of stuffed-animal-strewn havens and yet are ambushed there by lurking evil. The appalling gravity of the financial crisis similarly grew most alarming not with the failure of exotic derivatives but with the malfunction of the most mundane and reliable financial instruments: money market mutual funds, the home of more than three trillion dollars of America's most conservative investments.<sup>3</sup>

Subprime mortgage unpleasantness metastasized into systemic calamity on September 16, 2008,<sup>4</sup> when one of oldest, most

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<sup>1</sup> Floyd Norris, *Pride Goeth Before a Fall*, N.Y. TIMES, Sept. 16, 2008 (noting “What is most amazing is the way bragging goes before a fall,” and quoting Bent’s aphorism from two letters Bent sent to Reserve shareholders directly before the breaking of the buck in the Reserve’s Primary Fund.).

<sup>2</sup> Sam Mamudi & Jonathan Burton, *Money Market Breaks the Buck, Freezes Redemptions*, MARKETWATCH, Sept. 17, 2008 (“The size and speed of the withdrawals was stunning. At 3 p.m. on Tuesday, Primary Fund’s assets stood at \$23 billion, a \$40 billion hit from the \$62.6 billion in the fund on Friday.”), available at <http://www.marketwatch.com/story/money-market-fund-breaks-the-buck-freezes-redemptions>.

<sup>3</sup> See INV. CO. INST., 2009 Investment Company Fact Book 146 (49th ed. 2009) (listing total net assets of all U.S. money market funds as \$3,832,244,000,000 as of 2008) [*hereinafter* ICI FACT BOOK].

<sup>4</sup> See HENRY M. PAULSON, JR., ON THE BRINK 234 – 237 (2010) (“I [then-Treasury Secretary Hank Paulson] feared the start of a run on the \$3.5 trillion industry.”).

venerable, and largest money market funds – the Reserve Primary Fund<sup>5</sup> – broke the buck.<sup>6</sup> For only the second time in history,<sup>7</sup> a money market fund failed to return one hundred cents on the dollar to its investors. To the many who considered these funds as safe as bank savings accounts, this startling breach of faith triggered dramatic exit, prompting a run of hundreds of billions of dollars not just on the Primary Fund but across the entire money market industry.<sup>8</sup> Dysfunction in money market funds cascaded into credit markets, as funds liquidated their holdings and deprived corporations of lenders willing to extend vital credit for day-to-day business operations.<sup>9</sup> Within days, the Treasury Department and the Federal Reserve intervened to forestall meltdowns of the fund industry, the credit markets, and the broader capital markets by announcing that the United States of America would temporarily guarantee all 800 money market funds against losses of up to \$50 billion per fund.<sup>10</sup> One year later, on September 18, 2009,<sup>11</sup> the government terminated this guarantee. In its place, the Securities and Exchange Commission has

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<sup>5</sup> See Press Release, The Reserve, Sept. 16, 2008 (“[T]he NAV of the Primary Fund, effective as of 4:00PM, is \$0.97 per share.”), available at [http://www.reservefunds.com/pdfs/Press%Release%202008\\_0916.pdf](http://www.reservefunds.com/pdfs/Press%Release%202008_0916.pdf).

<sup>6</sup> See Diya Gullapalli, *Money Fund, Hurt by Debt Tied to Lehman, Breaks the Buck*, WALL ST. J., Sept. 17, 2008, at C1 (noting that the “huge money market fund, Reserve Primary Fund,” has broken the buck, “marking the first time a conservative money-market fund has lost money in 14 years.”).

<sup>7</sup> In 1994, the Community Bankers U.S. Government Fund – an institutional, not retail fund – became the first money market fund to break the buck, returning 96 cents per share. See John Waggoner, *Billions Stream into Ultrasafe Government Funds*, USA TODAY, Aug. 22, 2007, at 9A (opining that the fund was “tiny” and that “Most analysts suggest that worries about money funds . . . are unfounded.”)

<sup>8</sup> See LAWRENCE G. McDONALD, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS 325 (2009) (noting the demise of Lehman Brothers and resulting decisions that “would obliterate the world’s economy.”).

<sup>9</sup> See generally MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER’S VIEW (2008); MARCIA STIGUM, ANTHONY CRESCENZI, ET AL., STIGUM’S MONEY MARKET 1110 - 1115 (2007).

<sup>10</sup> See Press Release, U.S. Department of the Treasury, *Treasury Announces Guaranty Program for Money Market Funds*, Sept. 19, 2008 (announcing the authorization of “the assets of the Exchange Stabilization Fund for up to \$50 billion to guarantee” each money market fund), available at <http://www.ustreas.gov/press/releases/hp1147.htm>.

<sup>11</sup> See Press Release, U.S. Department of the Treasury, *Treasury Announces Expiration of Guarantee Program for Money Market Funds*, Sept. 18, 2009, available at <http://www.ustreas.gov/press/releases/tg293.htm>.

just promulgated a new set of rules<sup>12</sup> intended to “strengthen the resiliency of money market funds.”<sup>13</sup>

Until now, the placid calm of money market funds – and their quiet but critical role in the U.S. economy – has left this topic remarkably unstudied by financial or legal scholars.<sup>14</sup> But, for several reasons, the SEC’s regulatory response to the crisis is deeply troubling and warrants much closer scholarly attention. First, the SEC’s approach embodies a conception of financial regulation almost entirely at odds with leading economic and legal theory. Rather than remain agnostic as to the merit of specific investments (as neoclassical economic theory would require<sup>15</sup>) or privilege the choice of socially optimal investments (as behavioral theory would encourage<sup>16</sup>), the SEC appears instead to have picked the money market fund – an increasingly problematic and vulnerable investment – as a specific winner in this competition. Second, the SEC’s new

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<sup>12</sup> See Money Market Fund Reform, Investment Company Act Release No. 29,132 (Feb. 23, 2010) [*hereinafter* Final Rule].

<sup>13</sup> Speech by SEC Chairman Mary Schapiro, *Statement on Money Market Funds Before the Open Commission Meeting*, Jan. 27, 2010, available at <http://www.sec.gov/news/speech/2010.htm>.

<sup>14</sup> In the JLR database of Westlaw, only 27 pieces contain the phrase “money market fund” in their title; on SSRN, only 10 documents contain that phrase in their title, abstract, or keywords. Yet outside of academic scholarship, the SEC’s new rules, the Investment Company Act’s major study, the President’s Working Group on Financial Markets and the G-30’s new report all demonstrate that experts in this field are seriously concerned about the growing challenges and issues associated with money market funds. Final Rule, *supra* note \_\_; Proposing Release, *supra* note \_\_; INVESTMENT COMPANY INSTITUTE, REPORT OF THE MONEY MARKET WORKING GROUP, at 62 (Mar. 17, 2009) [*hereinafter* ICI REPORT]; PRESIDENT’S WORKING GROUP ON FINANCIAL REFORM, White Paper: *Financial Regulatory Reform – A new Foundation: Building Financial Supervision and Regulation* (June 16, 2009); GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (Jan. 15, 2009).

<sup>15</sup> See generally RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (7th ed. 2007); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1998); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

<sup>16</sup> See generally Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, J. LEG. STUD. 35 (2006); Dan M. Kahan & Donald Braman, *Cultural Cognition and Public Policy*, 24 YALE L. & POL. REV. 149 (2006); David Hirshleifer, *The Blind Leading the Blind: Social Influence, Fads, and Information Cascades*, in THE NEW ECONOMICS OF HUMAN BEHAVIOR (Mariano Tonmasi & Kathryn Ierulli eds., 1995); Amos Tversky & Daniel Kahneman, *Introduction*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman, Paul Slovic, and Amos Tversky eds., 1982).

rules fundamentally misapprehend the operational dynamics of money market funds, credit markets, and the sensitive interaction of the two. By accelerating the required maturity of portfolio holdings in money market funds and mandating the industry's continued reliance upon ratings agencies whose abysmal performance has been widely condemned, the rules *increase* rather than decrease the likelihood of future runs on money market funds and consequential failures of the credit markets. Third, even though the rescue of recent failures of these instruments required pledges of billions of dollars of public money, the SEC has failed to adopt any insurance facility – public or private – to underwrite future problems in this field.<sup>17</sup> As a response to the failure of money market funds, the SEC's action is inadequate and counterproductive; as a harbinger of the agency's oversight of future economic crises, it approaches regulatory malpractice.

To appreciate the ramifications of the SEC's actions, one must begin with an understanding of the operations of money market funds. Internally, and at their most fundamental, money market funds are simply a species of investment fund or collective investment vehicle.<sup>18</sup> While hedge funds, private equity funds, venture capital funds, and certain mutual funds regularly invest in high-risk, high-reward securities for their portfolios, money market funds are characterized by their relative conservatism. Indeed, the managers of these funds specifically promote them as low-risk, low reward financial havens – cash equivalents even – and often invest in only the safest and most highly rated securities issued by the government and large corporations. Nevertheless, as the collapse of the Primary Fund demonstrated so palpably, money market funds are far from risk-free nor are they insured against loss.<sup>19</sup> Indeed, because of the government's recent bailout, the absence of salutary changes to these funds is likely to increase moral hazard and future failure in this investing arena.

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<sup>17</sup> See Final Rule, *supra* note \_\_\_\_.

<sup>18</sup> See Money Market Fund Reform, Investment Company Act Release No. 28,807 at 4-23 (proposed June 30, 2009) [74 FR 32688 (July 8, 2009)] [*hereinafter* Proposing Release]; JOSEPH NOCERA, A PIECE OF THE ACTION: HOW THE MIDDLE CLASS JOINED THE MONEY CLASS (1994).

<sup>19</sup> See Proposing Release, *supra* note \_\_\_\_ at 4-7.

When regulating a potentially dangerous investment, financial authorities regularly adopt neoclassical, behavioral, or prudential responses: that is, they (a) offer neither encouragement nor discouragement of the particular investment but require issuers to disclose clearly the dangers to the investing public, thus allowing market mechanisms to reward or punish the investment<sup>20</sup>; (b) promote to investors alternative, ideally more socially beneficial, investments while permitting sophisticated investors with full information to select the riskier investment if they so choose<sup>21</sup>; or (c) require the issuer to modify the investment to eliminate its dangers. In the United States, the first, neoclassical approach is the model most closely associated with our securities laws and regulations. Increasingly, though, legislators have adopted the second, behavioral approach. The third, merit-based or prudential model is rare in the United States but employed in foreign jurisdictions with greater command and control of their capital markets.

Unusual everywhere is the approach the SEC has adopted in the case of money market funds, in which it has abetted the promotion of a potentially dangerous investment by permitting its sponsors to downplay rather than to emphasize risks without requiring a substantive amelioration of those dangers. Such an approach is akin to government officials, when confronted with a deep crevasse in a sidewalk, choosing not to erect warning signs nor to direct traffic away from peril nor to fill in the hole, but instead to cover the hazard with a thin cloth and thereby to construct a camouflaged snare.

Rather than draw attention to the perils of money market funds, the SEC has aided the industry's attempt to create an appearance that these investments are as safe as bank deposits while as lucrative as mutual funds. The chief way in which advisors achieve this verisimilitude is through the use of a pricing system – used by no other kind of investment fund – that closely resembles that of bank accounts.<sup>22</sup> The price of a typical mutual fund, known as its net asset value (NAV), is a function of the value of its portfolio

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<sup>20</sup> See, e.g., POSNER, *supra* note \_\_.

<sup>21</sup> See, e.g., Jolls & Sunstein, *supra* note \_\_.

<sup>22</sup> See Proposing Release, *supra* note \_\_, at 4-23.



securities. As the value of underlying investments held by a fund continually change, the fund's NAV will typically fluctuate also.<sup>23</sup> When money market funds first became available in the early 1970s, they too featured this "floating NAV." In the late 1970s, however, financial advisors who managed these funds persuaded the SEC to permit the use of a fixed NAV.<sup>24</sup> By employing a method for calculating NAV that does not rely upon the daily value of portfolio securities (mark-to-market accounting) but instead permits the use of values that assume portfolio securities will be held to maturity and then fully paid (amortized cost accounting), money market funds can maintain a remarkably stable NAV of \$1.00 per share.<sup>25</sup> When this pricing scheme is combined with check-writing privileges, money market funds look and feel a great deal like bank savings accounts.

Through another infelicitous and anti-competitive side-effect of regulation in this arena, bank savings accounts in the late 1970s and early 1980s were forbidden by regulation from offering an interest rate of greater than five and one quarter percent.<sup>26</sup> Money market funds could and did offer much higher returns, while projecting this appearance of as much security as bank accounts, and thereby attracted massive inflows from investors. Were these funds required to use the same pricing system as every other mutual fund or to contribute the same deposit insurance premiums as bank accounts, they would either look a great deal less like those bank accounts or generate far lower yields. In essence, without a compelling regulatory or theoretical justification, the SEC is providing this particular species of investment with a regulatory subsidy that enables these funds to win market share from bank accounts and short-term mutual funds by generating higher rewards than the former while appearing to have less risk than the latter.

In addition to the effect that this obfuscation has upon investors within money market funds, the SEC's newest regulations

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<sup>23</sup> See generally William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401 (2006).

<sup>24</sup> See Viktoria Baklanova, *Money Market Funds: An Introduction to the Literature* (Jan. 2010), available at <http://www.ssrn.com/abstract=1542983>.

<sup>25</sup> See Proposing Release, *supra* note \_\_\_, at 4-11.

<sup>26</sup> See Part I.B.2, *The Rise & Demise of Regulation Q*, *infra*, text accompanying notes \_\_.

may also have deleterious effects on credit and capital markets outside of these funds. The new rules are likely to exacerbate the same forces that previously conspired in the breaking of the buck in money market funds. Because the SEC has declined to mitigate the risk in these funds by returning to a floating NAV or deposit insurance, the agency has had to look elsewhere for “risk-limiting conditions” to ensure the safety of the fund’s investments.<sup>27</sup> The SEC has chosen instead to require money market funds to invest only or predominantly in securities with maturities of very short duration, on the theory that shorter-term investments are generally less risky than longer-term ones. Simultaneously, the SEC has reiterated its requirement that funds invest only in securities awarded high ratings from four credit rating agencies, on the theory that such a system will eliminate the least risky investments.<sup>28</sup> Both of these suppositions are ill-founded and have been rebutted by scholarly studies. On the question of investment maturity, Professor Jeffrey Gordon argues persuasively that shorter maturations will only accelerate future defaults in the event of market stresses.<sup>29</sup> If borrowers have several weeks to repay loans, the market will have more time to react but if, instead, borrowers must repay or default within only a few days, a cascade of defaults will come in a quicker flurry with less time for rational reflection and intervention. On the question of ratings agencies, Professor Frank Partnoy has extensively catalogued the problems of systems that rely on misleading credit ratings, which have been shown to enhance a false sense of security rather than to convey accurate information.<sup>30</sup> These rules are thus likely to make future effects of money market funds on capital markets worse, not better.

An obvious alternative prophylaxis in this system would be the establishment of a public or private insurance pool to guarantee the holdings in money market funds. As FDIC insurance has demonstrated well, insurance can be an excellent mechanism for

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<sup>27</sup> See Final Rule, *supra* note \_\_\_, at 3-15.

<sup>28</sup> See *id.*

<sup>29</sup> Jeffrey N. Gordon, *Comment Letter to SEC re: Money Market Fund Reform*, Sept. 9, 2009, available at <http://www.sec.gov> [hereinafter Gordon Letter].

<sup>30</sup> Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999).

circumventing bank runs.<sup>31</sup> All insurance costs money, however, and any premiums paid to support future money market funds that threaten to break the buck would almost certainly be drawn from assets in those funds, thereby reducing their yield and net investment returns. Sponsors of money market funds have previously resisted such an approach and their position, while perhaps lacking in civic-mindedness, was certainly shrewd. When these funds desperately needed insurance recently, the federal government provided it free of charge, thus rewarding the sponsors' apathy.<sup>32</sup> Unless concrete changes are adopted now, fund sponsors may reasonably believe that implicit governmental insurance will support funds in future also. The market may thus suffer from the moral hazard of fund sponsors who aggressively pursue higher returns without internalizing the costs of such risks.<sup>33</sup> Again, the SEC has declined to adopt a position that might favor investors or the markets over the industry by requiring some form of insurance in these funds.

In Part I of this Article, I discuss the economic and legal development of money market funds in the United States, the specific financial dynamics that precipitated the breaking of the buck in the Reserve Primary Fund, and the broader ramifications of that failure upon credit and capital markets in the United States.

In Part II, I analyze the new rules and rationales adopted by the SEC in the wake of the financial crisis, particularly those amending maturity and liquidity requirements, endorsing the continued use of credit rating agencies, and retaining the use of a fixed NAV in money market funds. Specifically, I examine the degree to which these rules will – or will not – effectively address the recent problems in this area and protect against future dysfunction in money market funds.

In Part III, I propose and critique an array of possible solutions informed by economic and legal theoretical frameworks to address

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<sup>31</sup> See generally Christian A. Johnson, *Justice and the Administrative State: The FDIC and the Superior Bank Failure*, 36 LOY. U. CHI. L.J. 483 (2005).

<sup>32</sup> See Press Release, U.S. Treasury, *supra* note \_\_\_ (announcing the guaranty of money market funds by the U.S. Treasury and the Federal Reserve).

<sup>33</sup> See generally Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183 (2009).

specific issues within money market funds as well as their broader economic impact, including the imposition of a floating NAV, the use of a dual-tier investment structure for retail and institutional investors, and the establishment of some system of obligatory public, mutual, or private deposit insurance.

### I. THE GROWTH & REGULATION OF MONEY MARKET FUNDS

In four short decades, the assets managed by money market funds in the United States have soared from nothing to more than three trillion dollars.<sup>34</sup> Today nearly forty cents of every dollar that Americans invest in mutual funds flow into a money market fund.<sup>35</sup> The story of this astonishing success turns on two critical developments involving regulatory interventions: one that limited the investment returns of the greatest competitor of money market funds: bank savings accounts; another that liberated money market funds to emulate the appearance of those bank savings accounts.<sup>36</sup> As soon as investors believed that they could receive higher performance without sacrificing safety, they redirected huge amounts of their savings away from bank accounts and into money market funds.<sup>37</sup> But when the financial crisis exposed the structural vulnerabilities of money market funds in 2008 and reminded the market that these funds are far riskier than bank accounts, investors immediately redeemed hundreds of billions of dollars.<sup>38</sup> Thus the remarkable success – and recent suspicion – of money market funds has long been closely entwined with their regulatory and economic structure.<sup>39</sup>

#### A. Mutual Funds & Floating NAVs

Less than forty years ago, in 1971, a privately held investment advisory company named The Reserve brought to market a new

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<sup>34</sup> See ICI FACT BOOK at 146.

<sup>35</sup> See *id.* at 30.

<sup>36</sup> See generally Daniel E. Levin, *Breaking the Buck: The End for Money Market Mutual Funds as We Know Them*, 28 REV. BANKING & FIN. L. 747 (2009).

<sup>37</sup> See TAMAR FRANKEL & CLIFFORD KIRSCH, INVESTMENT MANAGEMENT REGULATION 463 (3d ed. 2005).

<sup>38</sup> See Diana B. Henriques, *The Buck Broke; So How To Retool Money Funds?*, N.Y. TIMES, Oct. 11, 2009, at 13.

<sup>39</sup> For an excellent overview of the financial literature studying the economic dynamics and performance of money market funds over the past four decades, see Baklanova, *supra* note \_\_.

mutual fund called the Primary Fund.<sup>40</sup> The investment strategy of this novel investment – the nation’s first money market fund – concentrated on the extremely conservative end of the investing spectrum: the fund invested only in securities offered by the United States government or the largest and safest corporate issuers, and only in those securities that offered very short-term maturities. For investors who wished to avoid perils of equity investments and longer-term debt offerings or the unpredictability of a volatile stock market, a fund such as this could serve as a relatively safe haven while still providing positive, albeit modest returns. This simple idea would win almost universal appeal amongst both retail and institutional investors, as soon as money market funds could modify their pricing mechanism.<sup>41</sup>

As do all mutual funds and indeed most collective investment vehicles, a money market fund gathers assets by persuading investors to invest cash in the fund through the purchase of shares in fund. The fund’s investment advisor then uses this collective pool of cash to assemble an investment portfolio by purchasing securities offered by other companies or governments. To the extent the advisor makes wise investment decisions, the fund’s portfolio will grow in value and thus generate a beneficial return for all the fund’s shareholders.<sup>42</sup> Although an investor could, of course, bypass the services of a fund and its advisor by directly acquiring a similar portfolio of underlying securities, millions of American individuals and institutions choose to pay funds – or, more precisely, those funds’ advisors – billions of dollars each year<sup>43</sup> to serve as intermediaries to manage twelve trillion dollars in mutual fund holdings.<sup>44</sup> In return, these investors

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<sup>40</sup> See Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 33-6870, 55 Fed. Reg. 30239 (1990).

<sup>41</sup> See Timothy Q. Cook & Jeremy G. Duffield, *Money Market Mutual Funds and Other Short-Term Investment Pools*, in INSTRUMENTS OF THE MONEY MARKET 156, 164-165 (Timothy Q. Cook & Robert K. Laroche eds., 7<sup>th</sup> ed. 1993).

<sup>42</sup> Note that any growth in assets under management that accrue merely as a function of new investors joining a fund does not increase returns to existing shareholders. Indeed, this phenomenon generally benefits only the fund sponsor. See Birdthistle, *supra* note \_\_\_\_.

<sup>43</sup> See Baklanova, *supra* note \_\_\_, at 5, n.6 (discussing the array and magnitude of fees associated with the management and operation of money market funds).

<sup>44</sup> See ICI FACT BOOK, *supra* note \_\_\_ (reporting total mutual fund assets

gain access to the advisors' investment expertise, instant financial diversification, and the ready ability to redeem their investments for cash.<sup>45</sup>

### *1. Mark-to-Market Accounting*

The Investment Company Act of 1940<sup>46</sup> and rules promulgated thereunder by the SEC<sup>47</sup> govern the general operation of money market funds and, indeed, all registered investment companies (as mutual funds are statutorily defined).<sup>48</sup> This body of law provides specific guidance on the accounting method that advisors must use for calculating the price that every shareholder pays for his or her shares in a mutual fund, known as the fund's net asset value (NAV). The standard accounting system for mutual funds – set forth in Section 2(a)(41) of the Company Act<sup>49</sup> in conjunction with rules 2a-4<sup>50</sup> and 22c-1<sup>51</sup> – is known as “mark-to-market accounting.”<sup>52</sup> Mark-to-market accounting requires that the value of a mutual fund's portfolio reflect the regular fluctuations in the value of a fund's underlying securities, thereby causing the fund's NAV also to oscillate – or to float.<sup>53</sup>

Specifically, mark-to-market accounting requires that a fund's advisor value the fund's portfolio securities using market quotations when the fund's NAV is calculated at the close of business each day.<sup>54</sup> To illustrate a simple example, picture a fund whose entire portfolio consists only of shares in ExxonMobil. At the close of business, the advisor would multiply the closing value of the

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under management of more than \$12 trillion in 2009).

<sup>45</sup> Worldwide holdings in money market funds reached a peak of \$5.8 trillion in 2009. See *Worldwide Mutual Fund Assets and Flow*, INVESTMENT COMPANY INSTITUTE, Oct. 31, 2009.

<sup>46</sup> Investment Company Act of 1940, 15 U.S.C. § 80b-2(a)(41).

<sup>47</sup> 17 C.F.R. § 275.2a-7, 22c-1 (2005).

<sup>48</sup> More specifically, money market funds are “open-end management investment companies registered under the Investment Company Act and regulated under rule 2a-7 under the Act.” Proposing release at Fed Reg 32688.

<sup>49</sup> Cite

<sup>50</sup> Investment Company Act, 17 C.F.R. § 270.2a-7 (2008) (Rule 2a-7).

<sup>51</sup> Investment Company Act, 17 C.F.R. § 270.22c-1 (2008) (Rule 22c-1).

<sup>52</sup> See Proposing Release, *supra* note \_\_ (describing the rules and requirements for using the “mark-to-market” accounting method.)

<sup>53</sup> See *id.*

<sup>54</sup> See Birdthistle, *supra* note \_\_ (describing the use of “forward-pricing” in mutual funds, which results in the calculation of a price only once a day, rather than constantly as with an exchange-traded financial product.)

ExxonMobil share price by the number of the fund's ExxonMobil shares to determine the value of the fund's portfolio holdings. For fund investments that trade on public exchanges, such a computation is easily and instantaneously made.<sup>55</sup>

With securities for which no market quotation is readily available – such as illiquid investments in private companies, foreign markets, or other rarely traded sectors – the valuation process is somewhat more complicated. The fund's board of trustees must make a good faith determination of the portfolio securities' fair value, which it typically does in consultation with a third-party vendor that specializes in valuing such illiquid investments.<sup>56</sup>

The goal of the mark-to-market accounting system is to compute an accurate and timely value of the fund's portfolio.<sup>57</sup> If a fund fails to update the value of an outdated and illiquid holding, it will overvalue the total worth of its portfolio. Because advisors are compensated via fees calculated as a percentage of fund assets under their management, fund investors will overpay if a fund's portfolio is not valued accurately. A classic example of this kind of problem with fair valuation involves a fund's investment in a private company – for whose stock there is no publicly traded price or regular valuation event – which has lost much of its value but not been updated in the fund's overall NAV calculation. Consider, for instance, a start-up venture whose stock cost \$50 per share on January 1. If, one month later, the company were sued very credibly for patent infringement, the value of the company's stock would almost certainly have dropped well below \$50 per share, even if no publicly traded market reflected that decline. If mutual funds investing in that company did not then lower the value of their investments, they would in effect be overcharging their fund shareholders.<sup>58</sup> Mark-to-market accounting attempts to ensure that mutual funds are regularly reporting the most

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<sup>55</sup> See *id.*

<sup>56</sup> See, e.g., William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69 (2008) (analyzing situations in which funds have engaged in unfair valuations of their portfolios).

<sup>57</sup> See Proposing Release, *supra* note \_\_\_\_.

<sup>58</sup> See Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021 (2007).

accurate valuation of their portfolios, primarily to protect the fees that fund shareholders pay.<sup>59</sup>

In addition to holdings that are difficult to value, the calculation of NAV also must include other, easier computations. A fund's cash holdings, for instance, must also be counted, in addition to liabilities such as administrative expenses, legal fees, and the investment advisory fee, which must be subtracted. When the grand total is calculated, it is then divided by the total number of shares outstanding to calculate a price per each fund share.<sup>60</sup>

In the first few years of their existence, money market funds such as the Reserve Primary Fund used this mark-to-market accounting system and, accordingly, came with a floating NAV.<sup>61</sup>

## 2. *The Consequences of Redemption*

The pricing mechanism of mutual funds is relevant not only when investors purchase their shares but applies with even greater force when they choose to sell. Importantly, the fact that mutual fund NAVs float makes these funds, by definition, immune from that most devastating problem of financial selling: runs on the bank.<sup>62</sup> The disposition of mutual fund shares is unique in the capital markets because all mutual fund shareholders – including money market investors – redeem, rather than trade, their shares. That is to say, when a shareholder elects to exit a fund, he or she does not sell his shares on a stock exchange to some other willing investor. Instead, the shareholder puts the shares back to the mutual fund directly, which then pays the investor whatever the price of the NAV happens to be at the close of business that day. This redemption mechanism is not simply a technical trivium; it has enormous consequences for the entire governance and operational dynamics of mutual funds.<sup>63</sup>

By way of contrast, consider that shares in ordinary operating

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<sup>59</sup> See Birdthistle, *supra* note \_\_.

<sup>60</sup> See FRANKEL & KIRSCH, *supra* note \_\_.

<sup>61</sup> See Dale L. Domian & William Reichenstein, *Returns from Investing in Money Market Funds, 1990 to 1994*, 6 FIN. SVCS. REV. 169 (1997).

<sup>62</sup> See generally A.S. Pratt, *Presentment of Check During Run on Bank*, 49 BANKING L.J. 173 (1932).

<sup>63</sup> See ICI FACT BOOK, *supra* note \_\_.



companies trade between investors on a secondary stock exchange. Thus each investor buys or sells corporate shares for whatever price the market of supply and demand produces. None of these investors is guaranteed access to their actual monetary investment in the corporation. Ordinary corporations, unlike mutual funds, thus experience what is known as “capital lock-in.”<sup>64</sup> After initial investors commit their investment to the corporation through an initial public offering or other stock offering, the only ways in which capital may subsequently flow out of the corporation back to its investors are through dividends – which are authorized by the board of directors, not the shareholders – or liquidations upon the bankruptcy or dissolution of a corporation.<sup>65</sup> What a subsequent buyer of these shares is willing to pay thus turns largely upon what they believe the future prospects of a corporation are and how those prospects affect the net present value of shares today.<sup>66</sup> These trading dynamics, when coupled with the ability to sell corporate shares short and to separate economic and voting rights of shares, contribute to the creation of a market for corporate control with control premia.<sup>67</sup> Redemption at NAV, by contrast, virtually eliminates such governance mechanisms in mutual funds.

But in both corporations and mutual or money market funds, the fact that their prices or NAVs float immediately places all investors on notice that the value of their investment can rise or fall.<sup>68</sup> Indeed, each trading day of the year, the value of their investment will almost certainly rise or fall, either a few basis points or even multiple percentage points.<sup>69</sup> Thus the risk of loss – indeed, even of total loss – is a real and omnipresent feature of these investments.

### 3. *The Phenomenon of Runs*

Because of their floating prices, however, one risk that is not

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<sup>64</sup> See generally Lynn Stout, *On the Nature of Corporations*, 2006 U. ILL. L. REV. 253 (2005) (describing and discussing “capital lock-in”).

<sup>65</sup> See *id.*

<sup>66</sup> See *id.*

<sup>67</sup> See Anupam Chandar, *Corporate Law’s Distributive Design*, 118 YALE L.J. POCKET PART 82 (2008).

<sup>68</sup> See Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PENN. L. REV. 1263 (2009).

<sup>69</sup> See *id.*

present in either corporate or fund investment is that of a run. A run on a financial institution requires, as a prerequisite, some sort of promise by that institution of a guaranteed return to its counterparties.<sup>70</sup> A run then occurs when counterparties of the promising institution fear that the institution no longer holds assets sufficient to fulfill all its obligations.<sup>71</sup> In such a circumstance, the first parties to divest from the institution are the most likely to receive their entire deposit, while laggards may receive nothing at all.<sup>72</sup> The dynamics of this situation thus encourage counterparties to rush with as much haste as possible to withdraw their monies before the institution runs completely dry.<sup>73</sup> In a mutual fund, such a phenomenon is impossible because the fund never makes the initial promise to pay out anything more than each share's pro rata portion of the fund's total assets.<sup>74</sup>

If a fund's value were to drop by ten percent overnight, for example, the consequences would be identical whether one investor redeemed or every investor redeemed. Each investor in the fund would receive ninety percent of the original value. In an institution that guaranteed full payment, however, the dynamics would be quite different. The first ninety percent of investors to withdraw would receive one hundred percent of their deposits, while the last ten percent would receive nothing. Not wanting to be one of the latter, every investor will hurry to be one of the former, exacerbating the speed of the run.<sup>75</sup> When money market funds traded with floating NAVs, such runs were neither possible nor appeared to be so because most investors appreciated the fact that they were guaranteed nothing more than their portion of the fund's inconstant total. Once money market funds adopted fixed NAVs, however, most money market investors believed that their investment was not inconstant but steadfast. And thus was laid the foundation of the massive run on

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<sup>70</sup> See Richard McAdams, *Beyond the Prisoner's Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209 (2009) (discussing whether "bank runs represent a classic prisoner's dilemma").

<sup>71</sup> See *id.*

<sup>72</sup> See *id.*

<sup>73</sup> See *id.*

<sup>74</sup> See FRANKEL & KIRSCH, *supra* note \_\_.

<sup>75</sup> See McAdams, *supra* note \_\_.

money market funds during the 2008 financial crisis.<sup>76</sup>

### *B. Regulation Q & Limits on Interest in Bank Accounts*

Bank accounts are perhaps the archetypical example of financial instruments with fixed obligations. Unlike corporate securities and fund investments, bank accounts guarantee deposits with returns certain.<sup>77</sup> For investors seeking safety, banks are often the first option. Of course, most investors would wish that their deposits at least keep pace with inflation and do not merely remain static over time. To that end, banks offer savings accounts that guarantee more than just the safety of deposits.<sup>78</sup> Although the dangers of banks promising more interest than they can deliver are easy to imagine, the true vulnerability of banks vis-à-vis money market funds was quite the opposite: their failure to promise enough.

#### *1. Guaranteed Returns, Ratings & Insurance*

Banks offer certainty to their depositors through contractual guarantees to repay, not by abdicating the pricing process to market performance.<sup>79</sup> For so long as a bank remains solvent, the bank is contractually obliged to make all of its depositors whole. Poor performance of the market generally or of the bank's investments specifically has no legal bearing on the bank's obligations to its depositors.<sup>80</sup>

How does a bank fulfill its promise to honor deposits? Two options exist. The easiest would be for the bank simply to leave the depositors' money intact in a vault and not to touch it in any way. All funds would then be waiting for depositors whenever they wished to withdraw them. Of course, such a system is far from how banks operate. Instead, banks attempt to put their depositors' funds to work by lending or investing the money in search of a positive return. To the extent a bank makes a successful return on those investments – which can be done through very conservative and comparatively safe

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<sup>76</sup> See Henriques, *supra* note \_\_\_, at C9.

<sup>77</sup> See Levin, *supra* note \_\_\_.

<sup>78</sup> See Susan E.K. Christoffersen & David K. Musto, *Demand Curves and the Pricing of Money Management*, 15 REV. FIN. STUDIES 1499, 1524 (2002).

<sup>79</sup> See Levin, *supra* note \_\_\_.

<sup>80</sup> See *id.*

investments – the bank can both preserve the integrity of its accountholders’ deposits and make a profit for itself.<sup>81</sup> Very often, banks do earn successful returns. Indeed, with savings accounts, banks will go further by promising not simply to return one hundred percent of deposits but to supplement that amount by an additional rate of interest.

Of course, the greater the magnitude of return a bank promises its depositors, the riskier its use of the depositors’ funds may become.<sup>82</sup> To generate modest returns, a bank could lend funds only to lenders with outstanding credit scores, large equity cushions, and strong collateral guarantees. This sort of lending is precisely what occurs when a bank “buys” or “invests” in a Treasury bill – the bank is lending its depositors’ money to the United States government, the institution with the strongest credit and collateral in the world, currently.<sup>83</sup> Of course, the safer and stronger the borrower, the less the borrower will pay to borrow money, so the return on Treasury bills is relatively low. To increase returns, a bank could lend to large private institutions such as publicly traded corporations, which do not wield the full faith and credit of a sovereign power but have historically boasted of excellent creditworthiness.<sup>84</sup> Because these corporations do not have the strength of the United States government, they must entice lenders by offering higher rates of interest. For banks seeking a return, the trade-off between risk and return is clear. As they seek higher interest rates for their depositors, and higher profits for themselves, they must lend funds to borrowers with higher risks.<sup>85</sup>

Assessing the risk of borrowers is thus a primary concern of the credit markets.<sup>86</sup> A bank might perform extensive due diligence on each potential counterparty to assess its credit risk, but such a process would be expensive, time-consuming, and duplicative. Instead, institutions called Nationally Recognized Statistical Rating

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<sup>81</sup> See Christoffersen & Muston, *supra* note \_\_\_\_.

<sup>82</sup> See NOCERA, *supra* note \_\_\_\_.

<sup>83</sup> See *id.*

<sup>84</sup> See FINK, *supra* note \_\_\_\_.

<sup>85</sup> See Levin, *supra* note \_\_\_\_.

<sup>86</sup> See generally NIALL FERGUSON, *THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD* (2009).

Organizations<sup>87</sup> – better known as credit ratings agencies, such as Standard & Poor’s, Moody’s, and Fitch<sup>88</sup> – serve as informational intermediaries by evaluating the creditworthiness of most major borrowers in the markets and assigning them grades that are readily interpreted by borrowers.<sup>89</sup> A bank, and indeed any lender, can thus conform the degree of risk and reward it is willing to pursue by lending only to institutions with certain credit ratings.<sup>90</sup> Extremely conservative institutions highly concerned with the safety of their investments, such as banks, may permit loans only to governments or corporate issuers with the highest ratings.<sup>91</sup>

Notwithstanding a conservative investment approach with scrupulous reliance upon independent ratings, a bank’s loan may still fail of course. If a borrower defaults or goes bankrupt, the bank’s loan may quickly become worthless. The bank may then have insufficient assets to honor its contractual guarantees to depositors. As we have seen, these are the circumstances that could very easily spark a run on the bank.<sup>92</sup>

Because of this risk – and hard-learned lessons – bank accounts are now insured against loss by the Federal Deposit Insurance Corporation, an independent government agency created by the Congress to “maintain stability and public confidence in the U.S. financial system by insuring deposits in banks.”<sup>93</sup> The FDIC insures each depositor up to at least \$250,000 per institution.<sup>94</sup> Not only does this facility reimburse significant potential losses, its presence forestalls runs on banks.<sup>95</sup> Because deposits are guaranteed, individual deposits have no need or incentive to sprint to withdraw their funds in the event of a bank failure. The FDIC has worked remarkably well at both preserving deposits and preventing runs.<sup>96</sup>

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<sup>87</sup> See Proposing Release, *supra* note \_\_\_\_.

<sup>88</sup> See *id.*

<sup>89</sup> See Partnoy, *supra* note \_\_\_\_.

<sup>90</sup> See *id.*

<sup>91</sup> See *id.*

<sup>92</sup> See MCDONALD, *supra* note \_\_\_\_.

<sup>93</sup> FEDERAL DEPOSIT INSURANCE CORPORATION, *available at* <http://www.fdic.gov>.

<sup>94</sup> See *id.*

<sup>95</sup> See *id.*

<sup>96</sup> See Johnson, *supra* note \_\_\_\_.

Of course, no insurance comes without a premium, and every penny paid to insure a bank account comes directly out of the potential interest returns on that account.

## 2. *The Rise & Demise of Regulation Q*

But deposit insurance has not been the only source of friction to drag the returns of bank accounts lower than comparable investments without insurance and premia. The most important historical limitation on the interest rates of bank accounts was a regulatory restriction: Regulation Q.<sup>97</sup> For more than half a century, from 1933 until 1986, Regulation Q imposed a ceiling on the rates that banks could pay on savings deposits.<sup>98</sup>

Through the Banking Acts of 1933 and 1935, Congress enacted Regulation Q to authorize the Federal Reserve to set the permissible rates of interest that banks would be allowed to pay their customers.<sup>99</sup> These price ceilings had multiple purposes: “to encourage country banks to lend more in their local communities rather than hold balances with larger banks in financial centers”<sup>100</sup>; to improve liquidity in the banking system; and “to increase bank profits by limiting the competition for deposits” because “competition for deposits not only reduced bank profits by raising interest expenses, but also might cause banks to acquire riskier assets with higher expected returns in attempts to limit the erosion of their profits.”<sup>101</sup>

In the 1970s, policymakers wielded Regulation Q to impose ceiling rates that rested below market rates of interest, a decision with quick and powerful consequences.<sup>102</sup> Throughout the late 1960s and all of the 1970s, the ceiling rate under Regulation Q never rose above six percent. During the same period, however, the three-month Treasury bill offered interest rates almost always significantly higher,

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<sup>97</sup> See generally R. Alton Gilbert, *Requiem for Regulation Q: What It Did and Why It Passed Away*, Feb. 1986, FED. RES. BANK OF ST. LOUIS REV. 22 (1986).

<sup>98</sup> See *id.* at 22-25.

<sup>99</sup> See *id.*

<sup>100</sup> *Id.* at 22.

<sup>101</sup> *Id.* at 24.

<sup>102</sup> See Joseph A. DiNuzzo, *The Depository Institutions Deregulation Committee: Did It Achieve the Goal?*, 101 BANKING L.J. 100 (1984).

even spiking above fourteen percent.<sup>103</sup> Investors seeking returns could do far better by investing their money outside rather than inside bank accounts.<sup>104</sup> Predictably, investors eagerly sought out investment vehicles that were not limited by Regulation Q.<sup>105</sup> The newly introduced Primary Reserve Fund and its ilk were just such investments.

### *C. Money Market Funds & Fixed NAVs*

As we have seen, money market funds in their earliest incarnations – like all other mutual funds – featured a floating NAV that differed markedly from the fixed return of bank accounts.<sup>106</sup> But throughout the 1970s, sponsors of mutual funds petitioned the SEC for, and received, exemptions to use an alternative to the mark-to-market accounting technique.<sup>107</sup> By using a method known as amortized-cost accounting,<sup>108</sup> money market funds could maintain a stable NAV that looks much more like a bank deposit, thus dramatically closing the gap in appearances between the two instruments. This change occurred just as Regulation Q was keeping bank interest rates far lower than market interest rates. Thus by looking like a bank account yet offering far higher yields, money market funds became tremendously popular.<sup>109</sup>

#### *1. Amortized-Cost Accounting*

In its June 2009 release proposing new regulations for money market funds, the SEC describes the operation and consequences of amortized cost method of valuation as follows:

Under the amortized cost method, portfolio securities are valued at cost plus any amortization of premium or accumulation of discount (“amortized cost”). The basic premise underlying money market funds’ use of the amortized

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<sup>103</sup> See Gilbert, *supra* note \_\_\_\_.

<sup>104</sup> See Kenneth T. Rosen & Larry Katz, *Money Market Mutual Funds: An Experiment in Ad Hoc Deregulation*, 36 J. FIN. 1015 (1983).

<sup>105</sup> See ICI FACT BOOK, *supra* note \_\_\_\_.

<sup>106</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>107</sup> See Kauko Karlo, *The Demand for Money Market Funds*, 14 BANK OF FINLAND RESEARCH DISCUSSION PAPERS (2005).

<sup>108</sup> See Proposing Release, *supra* note \_\_\_\_.

<sup>109</sup> See Levin, *supra* note \_\_\_\_; ICI FACT BOOK, *supra* note \_\_\_\_.

cost method of valuation is that high-quality, short-term debt securities held until maturity will eventually return to the amortized cost value, regardless of any current disparity between the amortized cost value and market value, and would not ordinarily be expected to fluctuate significantly in value.<sup>110</sup>

Therefore, in exchange for promising to invest only in “high-quality, short-term debt securities,”<sup>111</sup> the SEC permitted money market funds to use this method of accounting. Indeed, after numerous fund sponsors made identical petitions and promises, the SEC amended Rule 2a-7 to permit all money market funds to use this method.<sup>112</sup> As a consequence, all money market funds gained the ability to maintain a stable NAV of \$1.00 per share.<sup>113</sup> In effect, they now look extremely similar to bank accounts.

The similarity to bank accounts was heightened by money market funds’ adoption of several additional bank-like features. First, money market funds adopted a penny-rounding method of pricing, in which “the current net asset value per share is rounded to the nearest one percent” when calculating NAV for the “purposes of distribution, redemption and repurchase.”<sup>114</sup> Once the price of money market funds was thus stabilized, other features that rely upon predictability became common, including “check-writing privileges, exchange privileges, and near-immediate liquidity.”<sup>115</sup>

Once money market funds began to enjoy success, the resemblance to bank accounts was made complete by the banks themselves.<sup>116</sup> Seeing their customers flee bank accounts for the higher returns of money market funds, banks fought back first by lobbying for the elimination of Regulation Q and then by offering something they called “money market deposit accounts.”<sup>117</sup> The name was simply a marketing tactic. This kind of bank account had no “relationship to the money market other than via the name of its

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<sup>110</sup> Proposing Release, *supra* note \_\_\_\_.

<sup>111</sup> *Id.*

<sup>112</sup> *See id.*

<sup>113</sup> *See id.*

<sup>114</sup> *Id.* at 10, n. 23.

<sup>115</sup> *Id.*

<sup>116</sup> *See* Levin, *supra* note \_\_\_\_.

<sup>117</sup> *Id.*



nemesis, the money market mutual fund.”<sup>118</sup> Instead, it was simply “a deposit account product designed to make consumers believe that it was the same as the money market mutual funds that those consumers had come to love.”<sup>119</sup> But increasing the level of confusion did not help banks – money market funds continued to grow, and investors increasingly grew to assume they possessed bank-like security.<sup>120</sup> Indeed, with the two similarly named instruments now competing head-to-head, the money market mutual funds would always win because they did not carry insurance and thus did not deduct insurance premia from their returns. Compared to an FDIC-insured instrument, like money market deposit accounts, they would always bring greater returns – as well as greater risk.

## 2. *The Growth of Money Market Funds*

The fact that money market funds quickly took on the appearance bank accounts, while offering far higher rates of return – because they were not restricted by Regulation Q and not insured – triggered tremendous growth in these investments.<sup>121</sup> From before 1971, when they contained no money whatsoever, until their peak in 2008, money market funds accumulated almost \$4 trillion in assets under management.<sup>122</sup> During that time, they grew from no funds to more than one thousand at their peak in 1999.<sup>123</sup>

Currently, more than 750 money market funds are registered with the SEC – in aggregate, they hold more than \$3.2 trillion, which represents approximately 39 percent of all assets invested in the entire mutual fund industry.<sup>124</sup> The money market field has also specialized, and now features prime funds, government funds, and tax-exempt funds.<sup>125</sup> Prime funds typically hold an assortment of “taxable short-term obligations issued by corporations and banks, as well as repurchase agreements and asset backed commercial paper

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<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *See* ICI FACT BOOK, *supra* note \_\_\_\_.

<sup>121</sup> *See id.*

<sup>122</sup> *See id.*

<sup>123</sup> *See id.*

<sup>124</sup> *See id.*; Proposing Release, *supra* note \_\_\_\_.

<sup>125</sup> *See* Proposing Release, *supra* note \_\_\_\_.

secured by pools of assets.”<sup>126</sup> Government funds “principally hold obligations of the U.S. Government, including obligations of the U.S. Treasury and federal agencies and instrumentalities, as well as repurchase agreements collateralized by Government securities.”<sup>127</sup> Investing in the private sector is generally riskier than investing in government securities, so prime funds usually offer a higher rate of return, while government funds offer greater safety. Tax-exempt funds “primarily hold obligations of state and local governments and their instrumentalities, and pay interest that is generally exempt from federal income taxes.”<sup>128</sup>

One major development in recent years concerns the nature of the shareholders who purchase shares in money market funds. Initially, money market funds sought investment from individuals; today, institutional investors – such as corporations, hedge funds, pension funds, and governmental entities – use money market funds to “outsource” their cash management operations, and now own approximately 66 percent of assets in these funds.<sup>129</sup>

But the impact of money market funds is not confined to the internal dynamics of funds and their investors. This enormous investment pool also interacts importantly with the broader money and credit markets, where these funds use their \$3 trillion to buy and sell short-term investments.<sup>130</sup> Those external affairs of money market funds played a significant role in the financial crisis of 2008.<sup>131</sup>

#### *D. Breaking the Buck & Financial Crisis*

Stresses in the U.S. financial system that had built up throughout 2008 reached a critical point in mid-September of that year when Lehman Brothers Holdings Inc. declared bankruptcy.<sup>132</sup> The bankruptcy of Lehman Brothers caused the Reserve Primary Fund first to break its buck and then to experience a run by its

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<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> *See id.*

<sup>130</sup> *See id.*

<sup>131</sup> *See* PAULSON, *supra* note \_\_.

<sup>132</sup> *See* McDONALD, *supra* note \_\_.

shareholders.<sup>133</sup> The Primary Fund held \$63 billion in assets under management, of which it had invested \$785 million – or more than 1.2 percent of its portfolio – in commercial paper issued by Lehman Brothers.<sup>134</sup> When Lehman Brothers went bankrupt, the value of its commercial plummeted to zero. Thus the Primary Fund instantly lost \$785 million in value, dropping its NAV per share from \$1.00 to less than \$0.988.<sup>135</sup>

Although that loss may not appear substantial, when applied to large investment holdings, shareholders stood to lose hundreds of millions of dollars that they had assumed were rock solid. More importantly, the loss triggered a run on the fund that threatened to impose far greater losses on the last investors remaining in the fund.<sup>136</sup> When large institutional investors learned that the Primary Fund was writing down its Lehman holdings to zero, they immediately attempted to redeem their shares.<sup>137</sup> If the Reserve honored its commitment to these shareholders, it would have had to pay the departing institutional investors \$1.00 for every redeemed share. For each investor who left the fund with fully intact redemptions, the \$785 million loss would grow into an ever-increasing percentage of loss for the stragglers. Just as in a classic bank run, the first depositors out the door might exit with their entire holdings until the bank's reserves are exhausted, at which point remaining depositors receive nothing.<sup>138</sup> To avoid this outcome, smaller investors in the fund sued to enjoin all redemptions until a federal court could oversee an orderly liquidation of the entire fund on a pro-rata basis.<sup>139</sup>

In addition to these internal dynamics between the money market fund, its sponsor, and its investors, the failure of the Primary Fund dramatically illustrated the interdependence of money market funds and the capital markets. When shareholders in the fund first

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<sup>133</sup> See Mamudi & Johnson, *supra* note \_\_\_\_.

<sup>134</sup> See Press Release, The Reserve, *supra* note \_\_\_\_.

<sup>135</sup> See Henriques, *supra* note \_\_\_\_.

<sup>136</sup> See *id.*

<sup>137</sup> See *id.*

<sup>138</sup> See Andrew B. Lyon, *Money Market Funds and Shareholder Dilution*, 39 J. FIN. 1011, 1020 (1984).

<sup>139</sup> See Henriques, *supra* note \_\_\_\_.

demanded redemptions, the Primary Fund quickly paid out its available cash to satisfy those requests. Once all of the fund's cash was gone, the only way the fund could satisfy additional redemptions was to sell portfolio holdings. Just as with widespread margin calls in a bear market, the fund's rapid sale of its holdings further depressed the market valuations of those securities. As shareholders in other money market funds witnessed the collapse of Lehman Brothers' commercial paper, the potential bankruptcy of similar financial borrowers, the run on the Primary Fund, and the downward pressure on prices by rapid liquidations in the credit markets, they too sought redemptions and thus precipitated runs on other money market funds.

Of course, money market funds had suffered losses in their portfolios previously – the collapse of Lehman Brothers paper was dramatic but certainly not the first time an investment held by money market fund had unexpectedly declined in value. Indeed, once – though only once – previously, a money market fund had broken its buck. But well over a dozen times previously, losses in a money market fund's portfolio had threatened to break the buck.<sup>140</sup> In each of those other cases, however, the investment advisor managing the fund had itself stepped in to prevent the buck from breaking.<sup>141</sup> To do so, the advisor or one of its affiliates paid full price for whatever holding in the fund's portfolio had fallen in value and was threatening the integrity of the fund's price.<sup>142</sup> Thus, the fund would be made whole, the advisor would absorb the loss, and the fund shareholders might never know the difference. Of course, for an advisor to absorb these losses, it must have sufficient resources to do so. Many fund advisors are affiliates of major financial institutions, with large pools of capital at their disposal, and have proven capable of engineering these internal bailouts. The Reserve, however, is a much smaller operation. And, in the case of its Lehman Brothers losses, it simply did not have the financial wherewithal to pump \$785 million into the fund.<sup>143</sup>

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<sup>140</sup> See Mamudi, *supra* note \_\_\_\_.

<sup>141</sup> See *id.*

<sup>142</sup> See Proposing Release, *supra* note \_\_\_\_.

<sup>143</sup> See *id.*

Immediately after the Primary Fund broke its buck, investors redeemed approximately \$300 billion from other prime funds.<sup>144</sup> Bracing themselves for runs on their own funds, other advisors of money market funds retained their cash positions rather than continue to invest as normal in money market securities.<sup>145</sup> The complete cessation of new investment short-term debt instruments consequently caused the money market to “seize[] up” and thus “impair[ed] access to credit in short-term private debt markets.”<sup>146</sup> That is to say, the nation’s large operating companies immediately lost access to huge sources of loans that they used continually to manage their daily operations.

To halt the spread of this credit debacle across the broader economy, the United States government announced massive and immediate measures. On September 19, 2008, the Treasury and the Federal Reserve announced a Temporary Guarantee Program for Money Market Funds, “an unprecedented market intervention by the federal government in order to stabilize and provide liquidity to the short-term markets” by insuring each of the country’s money market funds against losses of up to \$50 billion per fund.<sup>147</sup>

Quiet money market funds no longer bored their investors into a sound sleep, as the head of the Reserve, Bruce Bent, had previously suggested.<sup>148</sup> Their failures had precipitated a potentially calamitous failure of the U.S. economy and demanded massive and unprecedented government intervention.

## II. A CRITIQUE OF THE NEW REGULATIONS & RATIONALES

Almost a year and a half after the breaking of the Primary Fund’s buck and its collateral damage, the SEC has just finalized new rules that attempt to grapple with these failures of money market funds.<sup>149</sup> While the Federal Reserve and the Treasury Department wielded both the funds and authority to play more immediate and

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<sup>144</sup> *See id.*

<sup>145</sup> *See id.*

<sup>146</sup> *Id.*

<sup>147</sup> Diana B. Henriques, *Battered Money Funds to Find Relief*, N.Y. TIMES, Oct. 11, 2008, at B8.

<sup>148</sup> *See* Norris, *supra* note 1.

<sup>149</sup> *See* Final Rule, *supra* note \_\_.

prominent roles in addressing the financial crisis, the SEC's reaction to those events is only now becoming clear through its more deliberate regulatory response. But the SEC's new revisions to Rule 2a-7 – which tinker with permissible portfolio holdings, continue the use of discredited ratings agencies, and retain the fixed NAV<sup>150</sup> – is a deeply disappointing response to money market funds specifically and to the crisis more generally.

The SEC's new approach conveys a conception of financial regulation remarkably inconsistent with widely accepted economic and legal theory. While neoclassical economic theory counsels regulators to remain detached as to the merit of specific investments,<sup>151</sup> and behavioral theory permits the privileging of certain, socially optimal investments,<sup>152</sup> the SEC has chosen an altogether different path. The SEC has instead extended a policy of providing a regulatory subsidy to one specific investment vehicle, money market funds, at the expense of others. That is, rather than establishing a neutral ground on which bank deposits, short-term bond funds, and other investment compete evenly against one another, the SEC has picked a winner by tilting the field towards money market funds, which have just demonstrated their weaknesses and vulnerability.

#### *A. Shorter Maturity & Greater Liquidity*

The most serious technical deficiency of the SEC's new rules is their mistaken view of the ways in which money market funds interact with the broader credit markets.<sup>153</sup> This misapprehension is manifest in the SEC's new requirements that the composition of portfolios in money market funds consist of investments of shorter maturity and greater liquidity.<sup>154</sup> Generally speaking, investments with shorter maturity and greater liquidity carry less risk to the investors who hold them but, as Professor Jeffrey Gordon illuminates, the SEC's new rules actually increase risk to the broader financial

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<sup>150</sup> *See id.*

<sup>151</sup> *See, e.g.,* POSNER, *supra* note \_\_.

<sup>152</sup> *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 104 (2008).

<sup>153</sup> *See* Final Rule, *supra* note \_\_.

<sup>154</sup> *See id.*

system.<sup>155</sup> Inasmuch as investors in even the broken Reserve Fund lost only a percent or two of their holdings,<sup>156</sup> the systemic effects of the broken buck are arguably far more important.

In its revisions to Rule 2a-7, the SEC has reduced the average weighted maturity of permissible money market investments from ninety days to sixty days.<sup>157</sup> Similarly, the weighted average life of these permissible investments is now limited to 120 days.<sup>158</sup> The SEC argues that these shorter time horizons decreases a fund's exposure to interest rate risk, decreases the amplification of credit and interest rate spreads on a fund, and reduces liquidity risk because a greater percentage of a fund's investments will mature on a daily or weekly basis.<sup>159</sup> While these arguments are relatively uncontroversial, they apply only to the internal dynamics of funds. That is, they are intended to protect money market funds from the dangers of external investments.

But, as Gordon argues,<sup>160</sup> the SEC's attempt to limit risks within money market funds "adds systemic risk to financial intermediation by heightening the pressure on short-term money markets," a "flaw" that is "fundamental and requires a rethinking of the general [money market fund] framework."<sup>161</sup>

The premise of the SEC's tightening of portfolio requirements in money market funds rests upon the SEC's earlier decision to permit fixed NAVs. That is, in order to ensure that funds with fixed NAVs never experience precipitous or dramatic declines in their portfolios – a step necessary to ensure that these funds do not experience runs like the one in 2008 – the SEC has elected to place substantive constraints on what these funds can invest in.<sup>162</sup> And if short maturities are relatively riskless, the thinking appears to go, then even shorter maturities must be even more so. But the relatively minor improvement in the quantum of risk experienced by fund

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<sup>155</sup> See Gordon Letter, *supra* note \_\_, at 2-10.

<sup>156</sup> See Proposing Release, *supra* note \_\_.

<sup>157</sup> See Final Rule, *supra* note \_\_.

<sup>158</sup> See *id.*

<sup>159</sup> See *id.*

<sup>160</sup> Gordon Letter, *supra* note \_\_, at 2-10.

<sup>161</sup> Gordon Letter, *supra* note \_\_, at 2-4.

<sup>162</sup> Final Release, *supra* note \_\_.

investors when the maturity is reduced from 90 to 60 days is vastly outweighed by the comparatively major increase in the systemic risk.

As Gordon notes, “by shortening maturities the SEC proposal [now rule] will increase rather than reduce the fragility of these markets because it makes it easier for MMFs to ‘run’ at a time of financial distress.”<sup>163</sup>

Gordon’s argument becomes clearer when one considers the counterparties to money market funds. Money market funds buy short-term debt – that is, they lend money to the issuers of that debt – from corporations who need funds to pay for daily operations such as payroll and trade vendors.<sup>164</sup> Any solvent corporation could, of course, choose not to borrow money for these purposes. A large enterprise such as General Electric, for example, could simply ensure that it maintained a cash reserve large enough to cover daily or weekly expenditures. But in order to do so, General Electric would need to pay very close attention to its cash flow and, to avoid miscalculating, would need to include a conservative buffer of more cash than it ever actually needed.<sup>165</sup> Putting resources into carefully and conservatively managing cash flow necessarily depletes resources that could be used to expand General Electric’s more profitable enterprises.<sup>166</sup> Perhaps it cannot build a new and efficient plant because those funds would deplete cash reserves too much, so the company moves forward with outdated facilities. If, instead, General Electric could simply borrow at short notice whatever funds it needed to cover daily outlays, and then repay those loans right away, the corporation could operate far more leanly and efficiently.<sup>167</sup> And, given the overall size and soundness of its operations, the corporation could certainly obtain an extremely short-term loan for very low prices. This process, in essence, drives much of the money market.<sup>168</sup>

But now imagine that the new SEC’s rules go into effect. If every money market fund now reduces the maturity of its holdings

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<sup>163</sup> Gordon Letter, *supra* note \_\_\_, at 2-4.

<sup>164</sup> *See* STIGUM & CRESCENZI, *supra* note \_\_\_.

<sup>165</sup> *See id.*

<sup>166</sup> *See id.*

<sup>167</sup> *See id.*

<sup>168</sup> *See id.*



from 90 days to 60 days, borrowers such as General Electric will have that much less time to repay its loans. Normally, this abbreviated should not be a problem for a company like General Electric. But at moments of great stress in the economy – such as we experienced recently – all corporations may experience cash-flow strains.<sup>169</sup> If those companies now have less, not more time to repay their loans, the chances of default will necessarily increase.

One or two defaults does not necessarily pose a serious threat. But as we saw with Lehman Brothers in 2008,<sup>170</sup> even a single default can trigger market-wide problems if large investors react precipitously. If all money market loans have shorter maturities, then any defaults will come faster and more quickly – precisely the sort of cascade that will accelerate and exacerbate widespread panics.

The SEC should be seeking to increase the potential time for greater reflection and intervention in future moments of financial stress. But these new maturity requirements do the opposite. In essence, the SEC appears to have purchased a minor reduction in risk to the shareholders of money market funds with a major increase in risk to the entire system.

#### *B. The Continued Use of Credit Ratings Agencies*

One of the truly curious decisions of the SEC in response to all that has occurred in the past two years is its continued endorsement of the credit ratings agencies.<sup>171</sup> In its newest rules, the SEC continues to limit a money market fund's investments only to securities that have been rated – and rated highly – by Nationally Recognized Statistical Rating Organizations (NRSROs).<sup>172</sup> If there is widespread consensus upon the profound failure of any single component of the U.S. financial system during the recent crisis, it is with these ratings agencies that continued to assign their highest ratings to securitized bundles of ultimately worthless subprime mortgages. Yet when regulations require the use of such agencies, these agencies will continue to operate and, assuredly, to continue to

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<sup>169</sup> See PAULSON, *supra* note \_\_\_\_.

<sup>170</sup> See McDONALD, *supra* note \_\_\_\_.

<sup>171</sup> See Final Rule, *supra* note \_\_\_\_.

<sup>172</sup> See *id.*

mislead investors with false assurances as to the safety of investments. Rather than attempting to swaddle the dangers of money market investments, the SEC should be doing all it can to inform investors that the risks of these funds are real and potentially expensive. No regulation – by the SEC or any other financial regulator – should continue to rely on these privileged and wayward NRSROs.

The SEC argues for the continued use of these agencies as a “screen on credit quality.”<sup>173</sup> But the SEC has also been quick to emphasize that the advisors of money market funds are legally obliged to “perform an independent credit analysis of every security purchased.”<sup>174</sup>

In light of this requirement of an independent credit analysis by the fund’s sponsor, the continued use of the agencies remains truly perplexing. As Professor Frank Partnoy and many others have argued, the credit agencies suffer from serious and irredeemable capture.<sup>175</sup> That is, agencies rate only the securities of issuers who pay them for that service. Naturally, issuers who seek high ratings will migrate their business to agencies that offer favorable ratings, leading to systemic grade inflation.<sup>176</sup>

These artificially high ratings are worse than useless because, with the regulatory imprimatur of the SEC, they falsely assure investors that investments are stronger and safer than they truly are. Having no such assurance might prompt investors – or their intermediaries – to conduct their own due diligence or at least to exercise caution.<sup>177</sup> But hearing that a security has a AAA rating may coax investors into transactions that are, in fact, far more perilous.

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<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> See, e.g., Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111 (2009); Frank Partnoy, *Historical Perspectives on the Financial Crisis: Ivar Kreuger, The Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets*, 26 YALE J. ON REG. 431 (2009); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999).

<sup>176</sup> See Partnoy, *Siskel & Ebert*, *supra* note \_\_\_\_.

<sup>177</sup> See *id.*

Dissenting SEC Commissioner Kathleen Casey noted that the SEC's use of "ratings have long acted as a crutch rather than a safeguard for many investors, creating a false sense of comfort and protection and effectively encouraging their use as a substitute for due diligence – not only on the part of funds and investors, but regulators as well."<sup>178</sup>

As with the foregoing maturity requirements, the SEC's reliance upon ratings agencies whose abysmal performance has been widely condemned *increase* rather than decrease the likelihood of future runs on money market funds and consequential failures of the credit markets.

### *C. The Retention of a Fixed NAV*

A false sense of security is perhaps the single largest problem with money market funds today. These funds convey an artificial impression that they are as safe as bank accounts, when recent events so clearly demonstrate that they are not. This sense of security is certainly exacerbated by the continued use of ratings agencies, but the chief culprit in propagating this impression is the fixed NAV because it so closely resembles the fixed obligations of a bank account. Yet in its newest rulemaking, the SEC has missed an ideal opportunity to return to the floating NAV that money market funds originally used.<sup>179</sup>

The SEC justifies its continued permission for fixed NAVs by pointing out that investors enjoy tax and accounting advantages through this mechanism.<sup>180</sup> But even if that claim were true, it would be so only because of regulatory largesse, not because of any inherent design innovation. Indeed, it would beg the question of why these funds, and not all funds, should be allowed to enjoy such preferential treatment. Or, the related query, why should not all funds – regardless of their pricing structure – be granted equal tax and accounting treatment? The SEC is, in effect, granting a regulatory

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<sup>178</sup> Speech by SEC Commissioner Kathleen Casey, *Statement on Money Market Funds Before the Open Commission Meeting*, Jan. 27, 2010, available at <http://www.sec.gov/news/speech/2010.htm>.

<sup>179</sup> See Final Rule, *supra* note \_\_.

<sup>180</sup> See Proposing Release, *supra* note \_\_.

subsidy to one specific kind of investment over others.

Both the SEC and the fund industry argue that, through disclosure, fund investors are disabused of the notion that money market funds are guaranteed.<sup>181</sup> Indeed, they claim that all investors in these funds are acutely aware that their investments are subject to loss. But nowhere in the SEC's copious rulemaking materials is any empirical evidence produced to that effect. When one considers the history of the growth of these funds, one sees a consistent and concerted attempt by fund sponsors to make money market funds appear as similar as possible to bank accounts. For the industry now to claim that investors never bought their ruse is cheeky at best and deceptive at worst.

#### *D. The Relevance of the Primary Fund's Failure*

Even if one were to view the rationales and arguments supporting the SEC's new rules in the light most favorable to the SEC, the failure of the Reserve Primary Fund ineffably alters the calculus for these funds. Whatever investors and the capital markets may have once thought about money market funds was altered fundamentally by the events of late 2008. When the U.S. government stepped in to guarantee these funds against failure, it crystallized the suspicion that money market funds are, in fact, insured against loss. But perhaps the only thing worse than operating without insurance is having insurance for which no one pays. That scenario is always the prelude to moral hazard and future failures.<sup>182</sup>

If a financial instrument operates with a fixed return, it must either arrange a mechanism for guaranteeing that return or be prepared to suffer runs at the first suspicion that the return may no longer be fixed.<sup>183</sup> But money market funds attempted to have the best of both worlds: a fixed return without the costs of a guarantee. In retrospect, the industry argues that it never claimed to offer a fixed return. Again, proponents argue, disclosure documents clearly state

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<sup>181</sup> See, e.g., *id.*

<sup>182</sup> See, e.g., David S. Miller, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988).

<sup>183</sup> See FRANKEL & KIRSCH, *supra* note \_\_\_\_.

that money market funds are not insured and at risk.<sup>184</sup> The events of 2008, however, demonstrate that the financial authorities simply cannot afford to allow this enormous sector of the economy to fail.<sup>185</sup>

All investors now know that money market funds will not be allowed to fail. But if these funds continue to operate without paying insurance to cover their returns, future problems will be more likely than before. Individual fund sponsors can now make riskier investments in higher yielding securities, either to capture market share or to increase profits, all while knowing that if they overreach and their funds fail, the government is standing by as an insurer. But a basic premise of all insurance is that those who take the risks must be the ones to internalize the costs of the insurance. When individuals do not pay for their own mistakes, moral hazard abounds.

Thus, even if the SEC's rationales were compelling in a vacuum, they are no longer so. The SEC must now address the very real sense of an implicit guarantee that greatly increases the moral hazard and systemic risk associated with these funds.

### III. NEW SOLUTIONS FOR MONEY MARKET FUNDS

The SEC could quickly remediate the perils of moral hazard and systemic risk in money market funds and credit markets simply by reducing the level of obfuscation in its current approach. By adopting the lessons of neoclassical,<sup>186</sup> behavioral,<sup>187</sup> or prudential regulation, the agency could quickly encode a new set of rules to bring greater transparency to this vital and once-ignored sector of the economy. Two simple but fundamental changes could accomplish a great deal of this work: either a return to the floating NAV; or the adoption of an insurance facility to guarantee deposits in money market funds.

#### *A. Neoclassical Economics & a Floating NAV*

Neoclassical law and economics emphasizes the primacy of market forces in achieving optimal social welfare. As Professors

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<sup>184</sup> See Proposing Release, *supra* note \_\_.

<sup>185</sup> See PAULSON, *supra* note \_\_.

<sup>186</sup> See, e.g., EASTERBROOK, *supra* note \_\_.

<sup>187</sup> See THALER & SUNSTEIN, *supra* note \_\_.

Gilson and Kraakman argued in their seminal article, the efficient capital market hypothesis – and its reliance on a market for information – “is now *the* context in which serious discussion of the regulation of financial markets takes place.”<sup>188</sup> Neoclassical theory promotes a disclosure-based approach to financial regulation, positing that through a sufficiently competitive market for information, investors and their agents will quickly and effectively process risk and price in the capital markets.<sup>189</sup> Ostensibly following this theoretical framework, the SEC itself states publicly that “[o]nly through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.”<sup>190</sup>

But the SEC’s approach toward the regulation of money market funds is fundamentally in conflict with transparency. Indeed, the SEC’s rules have done much to obscure the true risks associated with money market funds by abetting the efforts by fund sponsors to make their funds resemble bank accounts. Were the pricing mechanism of these funds to revert to their original floating status, all fund investors would be reminded daily – even without digging into formal disclosure documents – of the possible losses from their investments.

### *1. Transparency*

The SEC appears to accept the industry’s contention that statements in official prospectuses and Statements of Additional Information effectively convey to all money market fund investors the claim that their fund investments are perpetually at risk.<sup>191</sup> Yet a great deal of scholarly work has demonstrated the very real limitations of financial disclosure.<sup>192</sup> Few investors read these

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<sup>188</sup> Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1989).

<sup>189</sup> *See id.*

<sup>190</sup> Securities and Exchange Commission, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, available at <http://www.sec.gov/about/whatwedo.shtml>.

<sup>191</sup> *See* Proposing Release, *supra* note \_\_\_\_.

<sup>192</sup> *See, e.g.*, James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 923 (2005) (explaining why, under current disclosure practices, investors cannot be expected to make rational choices).

documents; fewer still process the meaning of them.<sup>193</sup>

These limitations would be true even if the money market fund industry had not spent a great deal of effort attempting to override these disclosures. Although all fund sponsors file their legally required disclaimers, they wink at those statements of risk through the enormous promotional effort they put into far more visible intimations of stability in these funds. Money market funds are regularly referred to as “cash or cash equivalent,”<sup>194</sup> they are furnished with check-writing and ATM privileges, and they are provided with the all-important fixed price.

Indeed, the success of the industry’s efforts to assure investors of the stability of money market funds became most clear in the panic of 2008. Even though the Primary Fund stood to lose then than two percent of its value, the breaking of its buck represented a profound violation of trust – investors ran for the exits immediately.<sup>195</sup> If they had believed that their investments were truly at risk, that their assets might fluctuate a few pennies up or down on any given day, then they certainly would not have panicked.

But if we assume that only a minority of investors misunderstood how money market funds operate, should financial regulations accommodate the foolish or the wise? That is, the industry might argue that they filed their required disclosure announcing that money market fund investments are at risk, and that anyone who failed to believe them is a fool, and that regulating for bad customers makes bad law. While such an approach might be reasonable for sophisticated financial sectors, in which counterparties possess equal bargaining power and information, it makes little sense for an inherently retail product.<sup>196</sup> But what about the presence of institutional investors in this sector – won’t they protect the interests of individual investors? While sophisticated players do often discipline a market to the benefit of all participants, in this scenario,

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<sup>193</sup> *See id.*

<sup>194</sup> *See* FRANKEL & KIRSCH, *supra* note \_\_\_\_.

<sup>195</sup> *See* Mamudi & Johnson, *supra* note \_\_\_\_.

<sup>196</sup> *See generally* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61 (2010).

retail and institutional investors often invest in separate money market funds.<sup>197</sup> Thus in the absence of regulation that reasonably accounts for the ability – and inability – of retail investors, problems will assuredly occur.

Yet proponents of these rules might contend that no change is needed here. Money market funds have broken the buck only twice in their history and, both times, investors stood to lose only pennies on the dollar.<sup>198</sup> Such rare and minimal risks, so the argument might go, simply do not warrant significant changes to an industry. This argument glosses over two problems: first, without changes, the frequency of future mishaps is much higher today than before the 2008 meltdown; second, the relatively minor losses to fund shareholders completely omits the massive and profound losses that would have accrued in the capital markets, if the federal government not intervened.

Each of these counterarguments rests on the implicit and remarkable assumption that the market will perform better if investors are offered less transparency and furnished with an inaccurate view of these funds. Yet decades of financial theory and empirical studies demonstrates the opposite: that with greater transparency comes healthier, more efficient, and more effective markets.<sup>199</sup> If the SEC emphasized the perils of these funds to investors, many investors may still choose to invest in them (albeit fully cognizant of the risks), while others may choose less risky, less rewarding alternatives, such as bank accounts. Without a regulatory thumb on the scale, the market could provide a better picture of the price and risk of these securities, and investors would not live in an artificial cocoon.

## 2. *Equalizing Regulatory Benefits & Burdens*

With a simple step, the SEC could level the competitive field both between money market funds and all other mutual funds and between money market funds and bank accounts. Simply by reverting to the regulatory framework that the SEC maintained during the early years of money market funds – in which they, like all mutual funds,

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<sup>197</sup> *See id.*

<sup>198</sup> *See supra*, text accompanying notes \_\_\_-\_\_\_.

<sup>199</sup> *See* Gilson & Kraakman, *supra* note \_\_\_.



were required to use a floating NAV<sup>200</sup> – several specific and systemic foibles of this investment could be policed with robust market mechanisms.

If the SEC repealed the use of amortized cost accounting – which it could do with a straightforward amendment of Rule 2a-7<sup>201</sup> – money market funds would then be obliged to use mark-to-market accounting. Inasmuch as most investment advisors who sponsor money market funds also oversee large mutual fund complexes, the industry could quickly adopt this technical alteration. The price of money market funds would then begin to float and, shortly thereafter, investors in those funds would see their daily NAVs oscillate between a few pennies above and below the \$1.00 price. This fluctuation would communicate far more effectively than any prospectus disclosure the fact that these funds carry the risk of loss and thereby forestall any future runs on the industry.

If a money market fund experienced the collapse of one its investments, as the Primary Fund did with its Lehman Brothers holdings,<sup>202</sup> the price of that fund would drop a few pennies lower than usual, but investors would not be alarmed at the breaking of any sort of promise. But even if investors did exit the fund, they would not trigger a run because a floating NAV is, by definition, immune to such phenomena.

Certain investors, however, may greatly value the stability of the \$1.00 price in money market funds, and a floating NAV would eliminate this feature. For any investor who demands the predictability of fixed balance – in order to write checks or simply to plan future activities – a financial product already exists: the bank account. Similarly, bank accounts will accommodate those investors with more conservative investment profiles.

But bank accounts offer lower yields than money market funds.<sup>203</sup> Certainly, that is true – primarily because bank accounts must pay insurance on their deposits to the FDIC. In essence, money

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<sup>200</sup> See Levin, *supra* note \_\_\_\_.

<sup>201</sup> See *id.*

<sup>202</sup> See Henriques, *supra* note \_\_\_\_.

<sup>203</sup> See ICI FACT BOOK, *supra* note \_\_\_\_.

market funds have received free insurance, with disastrous results and equally dire prospects in the absence of revisions. Money market funds, their investors, and their sponsors have all enjoyed higher yields by transferring the risk of their investments to the American taxpayers. Both the equities of that structure, as well as its promotion of moral hazard, require its termination.

For those money market investors who do prioritize a higher yield and will not be satisfied with bank accounts, several products already exist for this taste: short-term bond funds. Short-term bond funds hold investments extremely similar to those in money market funds, but are structured as classic mutual funds, and thus already have floating NAVs. They carry a higher yield than bank accounts, and reflect more accurate risks for those rewards. In the absence of the SEC's regulatory subsidy, money market funds must reflect price and risk that are true reflections of the prevailing market rate.

The industry argues that investors will move offshore to riskier and unregulated products.<sup>204</sup> But that supposition prompts two replies: unlikely and so what? Unlike hedge fund investors, about whom the "offshore" argument is commonly deployed, money market investors are not seeking outsized returns, privacy, or investment expertise. These investments are straightforward, plain-vanilla offerings – bank accounts and short-term bond funds already offer extremely approximate services in the United States.

Fund sponsors contend that the market has already spoken by pouring more than \$3 trillion into these funds.<sup>205</sup> But this argument ignores the enormous regulatory thumb on the scale – investors have chosen a product whose price is artificially low because of governmental intervention. Corn syrup is also highly popular in the United States but to attribute that fact to superior performance rather than massive government subsidy is woefully unsophisticated, or disingenuous.<sup>206</sup> Asking customers to purchase bank accounts or short-term bond funds, as may befit their preference for risk and

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<sup>204</sup> See Proposing Release, *supra* note \_\_\_\_.

<sup>205</sup> See *id.*

<sup>206</sup> See Daniel Sokol, *Limiting Anticompetitive Interventions that Benefit Special Interests*, 17 GEO. MASON L. REV. 119 (2009).

yield, is simply a regulatory-neutral position that defers to market forces.

The market for short-term paper will be largely unaffected, inasmuch as bank accounts and short-term bond funds will replace fixed-rate money market funds as purchasers in accordance with the migration of investors. Corporate issuers of commercial paper will not care whether Bank of America's savings funds or Bank of America's money market funds are lending them money. Any temporary disruption to these channels will be replaced quickly with buyers already operating within the system. In short, money market funds have enjoyed thirty years of regulatory largesse, whose elimination effectively rectifies an old but growing threat.

### *B. Behavioral Economics & the Selection of Winners*

The work of Cass Sunstein and Richard Thaler emphasizes some of the shortcomings in neoclassical economic theory.<sup>207</sup> The market is deficient in processing information, they argue, because of biases, distractions, and shortcomings in so many market participants.<sup>208</sup> Rather than leaving all decisions to a completely unregulated agora, therefore, regulators should be prepared to offer "libertarian paternalism" in the form of choice architecture.<sup>209</sup> That is, without actually restricting the choices of market participants, regulators may still privilege certain options over others.

As an excellent example of behavioral theory applied to financial regulation, consider the Pension Reform Act of 2006.<sup>210</sup> Prior to that law, any proceeds employees saved in their retirement accounts that they did not allocate to a specific investment were required, by law, to be held as cash.<sup>211</sup> In many cases, the obliviousness or busyness of employees would result in retirement assets languishing well below levels necessary for healthy savings.<sup>212</sup>

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<sup>207</sup> THALER & SUNSTEIN, *supra* note \_\_\_\_.

<sup>208</sup> *See id.*

<sup>209</sup> *Id.*

<sup>210</sup> *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219, 120 Stat. 780 (2006).

<sup>211</sup> *See* Birdthistle, *supra* note \_\_\_\_.

<sup>212</sup> *See, e.g.,* James J. Choi, *For Better or For Worse: Default Effects and 401(k) Savings Behavior*, in PERSPECTIVES IN THE ECONOMICS OF AGING 81-121

The reform act permitted retirement administrators to direct unallocated investments into conservative, passively managed, broadly diversified mutual funds instead. In both scenarios, employees could easily change the allocation of their investments. The behavioral approach, however, took account of shortcomings in the laissez-faire approach and simply altered the default setting, which has resulted in far higher savings rates for plan participants.<sup>213</sup>

In the context of money market funds, one might argue that behavioral economy theory might justify the SEC's behavior even if neoclassical theory does not. If, for instance, one could argue that the SEC has surveyed the available options and simply privileged money market funds for their optimal combination of safety, yield, and convenience. Indeed, the argument might proceed, requiring a floating NAV might exacerbate future runs because investors might panic sooner if they see a fund's value declining or because the "true" price of short-term debt becomes highly unreliable during moments of market stress.

But, again, investors simply cannot trigger a run on any financial portfolio that promises only to pay them a pro rata portion of whatever the portfolio holds. Runs occur when investors are promised more than a pro rata portion, and thus have an incentive to be the first to withdraw their portions before the corpus is exhausted.<sup>214</sup> More importantly, the SEC has not simply placed an existing financial option at the top of a menu of choices, it has through rulemaking affirmatively altered the nature of investment options by giving one an advantage that could not exist without regulatory intervention.

### *C. Prudential Regulation & Mandatory Insurance*

Even in financial systems that purport to be capitalist and laissez-faire, regulation plays a role.<sup>215</sup> Indeed, in the United States, earnest debates about financial oversight do not seriously contemplate either a truly unregulated system or a truly controlled system – the

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(David Wise ed. 2004).

<sup>213</sup> *See id.*

<sup>214</sup> *See supra*, text accompanying notes \_\_\_ - \_\_\_.

<sup>215</sup> *See, e.g.*, Mohammad H. Fadel, *RIBA, Efficiency, and Prudential Regulation: Preliminary Thoughts*, 25 WIS. INT'L L.J. 655 (2008).

debate is largely one of degree. Prudential, or merit, regulation therefore always plays a role.<sup>216</sup> One of the few truly celebrated examples of financial merit regulation is the success of the FDIC's record of insuring bank accounts. If the SEC declines to require money market funds to use a floating NAV, then it should adopt some equivalent system of insurance.

With every financial instrument, some party must be prepared to absorb the loss of unfortunate market events. A floating NAV places the risk of that loss on investors in a fund. A fixed NAV requires that some other party do so. Indeed, a fixed price always carries an assurance, express or implied, that someone will make customers whole if investments fail. In the events involving the Primary Fund, the federal government placed billions of public dollars at risk to avoid collapse. In bank accounts, the FDIC do so – but only after being paid to do so by depositors through their banks. A few variations on this insurance scheme might be equally useful in the context of money market funds.

### *1. The Existing, Unspoken Insurance Regime*

The first option would be to continue with the current regime. Currently, money market funds offer the strong suggestion to investors that their investments are stable, safe, and secure. When that assurance proved false, as it did in the Reserve Fund, the federal government guaranteed depositors against loss.<sup>217</sup> That is, the government offered implicit insurance for money market funds without charging specific insurance premia to any of the participants – investors, funds, sponsors, lenders – in this system.<sup>218</sup>

As we have seen, insurance that is given to parties who do not pay for it simply cultivates serious moral hazard and, if left in place, provides every incentive for participants to increase the risk of their activities greatly. Investors have every incentive to put their money into money market funds offering the very highest yield, while funds and sponsors have every incentive to choose investments with the highest degree of risk and reward. If these decisions turn out to be

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<sup>216</sup> *See id.*

<sup>217</sup> *See* Press Release, U.S. Treasury, *supra* note \_\_.

<sup>218</sup> *See id.*

poor ones, the loss will be born by all U.S. taxpayers.

Such a system, needless to say, will greatly exacerbate not mitigate the future likelihood of runs on money market funds and systemic risk in the capital markets. In light of the equally problematic rules shortening maturities in money market funds, the status quo is untenable.

## 2. *Self-Insurance*

A second alternative would be to require the sponsors and advisors of money market funds to insure their funds themselves.<sup>219</sup> Such a system has been in place informally for several decades. With two very notable exceptions, in all previous instances in which fund have threatened to break their buck, their investment advisors provided self-insurance to the fund's investors.<sup>220</sup>

That is, the advisors or their affiliates intervened to purchase at full value portfolio securities whose values had declined precipitously and threatened to break the buck. In essence, the advisors paid money out of their own pockets to insure the loss and to make fund investors whole. The advisors paid for this insurance through the premia of previous profits they had made from managing the funds.

In many respects, this system most perfectly aligns the interests and risks of money market funds – if the people most directly responsible for managing the funds are also the people who stand to lose the most from mistakes, they will take the optimal degree of care in running the funds. The limitations, however, are clearly visible in cases such as the Primary Fund.<sup>221</sup> Whenever the advisor simply does not have sufficient capital to buoy its own fund, the fund will fail and the system will face collateral risks. Thus a broader insurance pool is necessary to address the true amount of risk in these funds.

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<sup>219</sup> See, e.g., Timothy Stolfus Jost, *The Massachusetts Health Plan: Public Insurance for the Poor, Private Insurance for the Wealthy, Self-Insurance for the Rest?*, 55 U. KAN. L. REV. 1091 (2007).

<sup>220</sup> See Mamudi, *supra* note \_\_\_\_.

<sup>221</sup> See Henriques, *supra* note \_\_\_\_.

### 3. *Collective Insurance*

A third option would be to follow the example of the banking industry of collective insurance.<sup>222</sup> Money market funds could either mutually or governmentally insure their risk across the entire industry by having all funds pay into a common pool that would rescue any fund that failed. Of course, all funds would have to pay insurance premia, the cost of which would in turn be passed through to all investors in those funds. That additional cost would naturally reduce the yield for all funds, but only by the true cost of securing these investments.<sup>223</sup>

The current system is cheaper, but only because none of the industry's constituents is paying for their actual risk. Inasmuch as different funds operate with different risk profiles, so too could the premia be risk-adjusted,<sup>224</sup> so that the actual costs of investing with a guaranteed return are internalized with the most accurate allocation possible. Insurance certainly will not prevent future investment failures but, as the FDIC has demonstrated, it can protect both investors individually and the capital markets more systemically.

#### CONCLUSION

The shattering of the buck in the Reserve Primary Fund dramatically demonstrated two suspected but unspoken fears about what were once considered the economy's safest and surest investments. Contrary to the industry's decade-long attempt to conflate money market funds with bank accounts, the global markets witnesses precisely how great the risk that funds do carry, not just to themselves and their investors but also to the broader credit and capital markets. When the Primary Fund stumbled, investors fled what they feared were Potemkin bank accounts, and the capital markets seized.<sup>225</sup>

Notwithstanding this graphic lesson, the SEC's regulatory response has been disappointingly incoherent and ineffective.

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<sup>222</sup> See Johnson, *supra* note \_\_\_\_.

<sup>223</sup> See FDIC, *supra* note \_\_\_\_.

<sup>224</sup> See Gordon Letter, *supra* note \_\_\_\_, at 2-10 (discussing possible ways to adjust fund insurance payments for their respective risk profiles).

<sup>225</sup> See PAULSON, *supra* note \_\_\_\_.

Shunning the principles and guidance of widely accepted legal economic theories, the SEC adopted instead not just an unlikely set of risk-reduction measures but an ineffectual one. By shortening the permissible maturities of money market funds, the SEC has actually increased the likely velocity and impact of future runs without making any effort to address the newly heightened peril of moral hazard.

Neoclassical and behavioral economic theories proffer two alternative approaches that would eliminate the regulatory subsidy of these investments and increase the health of the capital markets. By either replacing fixed NAVs with floating ones or, instead, requiring the industry to adopt insurance to cover their fixed obligations, the SEC might have increased the transparency and long-term health of a cornerstone of the U.S. economy.