charles SCHWAB

January 17, 2013

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

RE: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003)

Members of the Financial Stability Oversight Council:

Charles Schwab Investment Management, Inc. ("Schwab")[1] appreciates the opportunity to provide comments on the November 2012 "Proposed Recommendations Regarding Money Market Mutual Fund Reform," issued by the Financial Stability Oversight Council (the "Council")[2].

Schwab is one of the largest managers of money market fund assets in the United States, with 3.3 million money market fund accounts and $167.9 billion in assets under management as of December 31, 2012. Approximately 85% of those assets are in sweep funds, with the balance in purchased funds. Sweep accounts automatically invest idle cash balances while providing investors with convenience, liquidity and yield. They also allow for clients to use their cash to implement intra-day trades in their investment and retirement accounts. Schwab's money market fund offerings predominantly appeal to, and are used by, individual retail investors who use money market funds to help manage their cash. It is from that perspective that we offer these comments.

Overview

Schwab has been an active participant in the debate over money market fund regulation since 2009. We were supportive of the 2010 amendments to Rule 2a-7, the rule that governs the funds, which we believe substantially strengthened money market funds, made them more transparent to investors, and reduced the risk of runs. We have continued to participate in the debate about whether additional reforms are needed, submitting multiple comment letters to both national and international regulatory bodies.[3] In these letters, and in other venues, Schwab has expressed

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[1] Founded in 1989, Charles Schwab Investment Management, Inc., (CSIM) a subsidiary of The Charles Schwab Corporation, is one of the United States' largest asset management companies, with more than $219 billion in assets under management as of December 31, 2012. It is among the United States' largest money market fund managers and is the third-largest provider of retail index funds. In addition to managing Schwab proprietary funds, CSIM provides oversight for the institutional-style, sub-advised Laudus Fund family. CSIM currently manages 73 mutual funds, 23 of which are actively-managed funds, in addition to two separate account model portfolios, and 15 exchange-traded fund offerings.

[2] "Proposed Recommendations Regarding Money Market Fund Reform." 77 Fed. Reg. 69455. November 19, 2012.

[3] See for example comment letter from Marie Chandoha, president, Charles Schwab Investment Management, April 6, 2012, available at http://www.sec.gov/comments/4-619/4619-161.pdf and Ms. Chandoha's comment letter to the

significant concerns with many of the reform proposals that have been put on the table, including requiring money market funds to float their net asset values (NAV), requiring the funds to have a capital buffer, and requiring funds to impose redemption restrictions on investors. These proposals, particularly if applied broadly across all types of funds, would have a devastating effect on the money market fund industry, render an enormously popular product much less appealing to individual investors and exacerbate systemic risk.

In recent weeks, however, our position on the issue of a floating NAV has evolved. We continue to believe that a blanket shift of the entire money market fund industry from a stable NAV product to a floating NAV product would imperil the industry, deprive individual investors of a critically important cash management option, disrupt the larger economy, and potentially destabilize the financial system itself. But a more targeted approach, one that applies a floating NAV to the types of money market funds most susceptible to runs and the types of investors most likely to trigger runs, is an option worth considering. As articulated in a November 23, 2012, op-ed piece in *The Wall Street Journal* by Charles Schwab Corporation's Chief Executive Officer, Walter Bettinger, we believe that requiring prime money market funds that cater to institutional investors to float their net asset values is an approach that merits consideration as a possible solution to the regulatory impasse.

This letter has three major components. First, Schwab offers its perspective on the process by which the Council has inserted itself into the money market fund reform debate, and urges the Council to allow the Securities and Exchange Commission ("SEC") to continue with its own regulatory process before the Council considers taking any further action. Second, Schwab addresses its concerns with each of the three recommendations put forward by the Council. And finally, Schwab is pleased to offer a detailed explanation of our "modified floating NAV proposal," an alternative reform measure that was first outlined by Mr. Bettinger. We believe such a solution could address the concerns of regulators by targeting reform at the sector of the money market fund industry most likely to initiate a potentially destabilizing run, but do so without wreaking havoc on a $2.7 trillion product that is enormously popular with individual investors and plays a critically important role in the financial system and in the broader economy. We discuss the mechanics of such a solution in the hopes that the SEC will consider this more reasonable alternative prior to issuing a final rule.

Concerns with FSOC Process

Schwab believes strongly that the SEC is the proper authority for the promulgation of rules related to money market funds. The Council acknowledges this in its recommendations, noting that "the SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risks that MMFs present to the economy."[4] Yet the Council, by issuing the Proposed Recommendations, demonstrates a lack of confidence in the agency of jurisdiction to address the issue, despite the fact that the SEC continues to be actively engaged on this topic.

International Organization of Securities Commissions (IOSCO), May 28, 2012, available at http://www.sec.gov/comments/4-619/4619-187.pdf.

[4] Financial Stability Oversight Council, "Proposed Recommendations Regarding Money Market Mutual Fund Reform," November 2012, p. 15.

The SEC has been engaged in near-constant consideration of money market fund reform since the 2008 financial crisis, when one money market fund "broke the buck," or saw its net asset value fall below $1 per share, contributing to a run on money market funds generally. In the wake of the crisis, the SEC, in January 2010, approved a series of significant reforms to Rule 2a-7, which Schwab supported. At the time, SEC Chairman Mary Schapiro indicated that the reforms were "an important step — but just a first step — in our efforts to strengthen"[5] money market fund regulation. Since 2010, the SEC has been engaged in a process to determine what additional steps would be appropriate. That process has included a report of the President's Working Group on Financial Markets, of which the SEC is a member, that outlined numerous reform options and has, to date, received hundreds of public comments. The SEC also hosted a day-long roundtable on the subject in May 2011, and, again as the Council acknowledges, "engaged with stakeholders and regulators in an intensive effort to consider and refine various potential reform options."[6] Over the past year, there were numerous newspaper reports, as well as comments by the SEC Chairman,[7] outlining the details of the reform proposals under consideration at the agency. Those articles and comments indicated that the SEC was considering reform proposals that mirror almost exactly those subsequently put forward by the Council in the Proposed Recommendations. In August 2012, Chairman Schapiro announced that the majority of the SEC's commissioners were unwilling to support issuing for public comment her reform proposal, and she asked the Council to take up the issue.

Since then, however, it is clear that the regulatory process at the SEC has continued. Shortly after the Chairman's statement, Commissioners Troy A. Paredes and Daniel M. Gallagher issued a joint statement in which they did not say that they were opposed to reform, but rather that they wanted more research to be completed to make a better informed decision. They noted, "The truth is that we have carefully considered many alternatives, including the Chairman's preferred alternatives of a 'floating NAV' and a capital buffer coupled with a holdback restriction, and we are convinced that the Commission can do better."[8] They specifically asked the SEC staff to answer a series of questions regarding the causes of investor redemptions of money market fund shares during the 2008 crisis, the efficacy of reforms to Rule 2a-7 that were put in place in 2010, and how funds would have performed during the 2008 financial crisis had the 2010 reforms been in place.

Similarly, Commissioner Luis Aguilar issued a statement in August 2012 that emphasized that he was not opposed to reform per se, but that he also thought more study needed to be done to determine whether reform was needed and how that reform should be directed. In his statement, Aguilar said,

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[5] Chairman Mary L. Schapiro, "Statement on Money Market Funds Before the Open Commission Meeting," January 27, 2010, available at http://sec.gov/news/speech/2010/spch012710mls-mmf.htm.
[6] 77 Fed. Reg., 69459.
[7] E.g., Chairman Mary L. Schapiro, "Remarks at the Practising Law Institute's SEC Speaks," February 24, 2012, available at http://www.sec.gov/news/speech/2012/spch022412mls.htm and Chairman Schapiro, "Testimony on Perspectives on Money Market Mutual Fund Reform," Senate Committee Banking, Housing and Urban Affairs, June 21, 2012, available at http://www.sec.gov/news/testimony/2012/ts062112mls.htm
[8] Commissioner Daniel M. Gallagher and Commissioner Troy A. Paredes, "Statement on the Regulation of Money Market Funds," August 28, 2012, available at http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm.

> I am, and continue to be, supportive of the Commission putting forward a thoughtful and deliberative concept release that asks serious and probing questions about the cash management industry as a whole to diagnose its frailties and assess where reforms are required. This release should include all pooled cash management mechanisms so that the Commission is knowledgeable about how trillions of dollars are managed and understands how this money is able to move from the regulated, transparent money market fund market to the opaque, unregulated markets.[9]

In late November 2012, two months after the Chairman of the Council first indicated that the Council would issue recommendations regarding money market fund reform, the SEC staff issued a response of nearly 100 pages to the questions of Commissioners Gallagher, Paredes and Aguilar. Among other things, the response includes the first published analysis by the regulator of the impact of the 2010 amendments to Rule 2a-7 on the resiliency of money market funds. The response also provides analysis of the alternatives to money market funds, including bank deposits, time deposits, offshore funds, enhanced cash funds, ultra-short bond funds, collective investment funds, short-term investment funds, and others. The report notes that shifting money fund assets to one of these alternatives "may create additional operational costs or complexities, and they may impose redemption restrictions or other limitations on liquidity."[10] The report also observes that shifting money market fund assets to bank deposits "would increase reliance on FDIC deposit insurance and increase the size of the banking sector, which raises additional concerns about the concentration of risk in the economy."[11]

With the benefit of this additional information, the SEC staff is reportedly working on a revised proposal for consideration by the commissioners. Given that all signs point to another attempt by the regulatory agency of jurisdiction to promulgate a rule in 2013, we believe that the Council should not consider any further action on money market fund reform until such time as the SEC has completed its ongoing work.

Concerns With Council's Proposed Recommendations

Schwab continues to believe that the three proposals put forward by the Council, if applied broadly to all types of money market funds and all types of investors, would have a devastating effect on the product and a significant impact on the capital markets and the broader economy.

In our view, the Proposed Recommendations suffer generally from inadequate analysis as to their impact on the industry, individual investors, companies, municipalities and other users of the product, as well as the capital markets and economy. While the Council makes some attempt to assess these costs, it acknowledges quite openly that "there are substantial uncertainties around the estimates of costs to long-term economic growth."[12] More robust analysis is needed to determine where cash investments would flow and the impact that movement would have on

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[9] Commissioner Luis A. Aguilar, "Statement Regarding Money Market Funds," August 23, 2012, available at http://www.sec.gov/news/speech/2012/spch082312laa.htm.

[10] SEC Division of Risk, Strategy and Financial Innovation, "Response to Questions Posed by Commissioners Aguilar, Paredes and Gallagher," November 30, 2012, p. 43. Available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

[11] Response, p. 45.

[12] 77 Fed. Reg. at 69482.

investors and institutions that use the funds for cash management purposes, as well as the capital markets and financial stability. As the Council points out, to the degree that some of the alternative cash-management vehicles to which money market fund assets might flow "are themselves vulnerable to runs and are also interconnected with other parts of the financial system, the benefits to long-term economic growth that result…could be reduced."[13] Given that $2.7 trillion currently is invested in money market funds, we believe proposals of this magnitude must be evaluated closely to avoid an inadvertent destabilization of the financial markets.

Alternative One: Floating Net Asset Value

Imposing a floating net asset value solution across all money market funds would be a fundamental change to a product upon which individual investors have come to rely for four decades. A broad requirement that all funds float their NAVs would lead to a flight to less regulated products or to banks. This, in turn, would increase demand deposit insurance requirements at recipient banks, increase bank capital obligations, and, ultimately, increase systemic risk by concentrating assets in a small number of very large, very complex institutions. An across-the-board floating NAV proposal would also severely limit the cash management options available to individual investors and to the thousands of businesses, non-profit organizations, educational institutions, municipalities and states that rely on the short-term markets to fund operations. Finally, while the Council acknowledges the problematic tax and accounting implications of a floating NAV fund, we believe this is a threshold question. Solving the tax and accounting uncertainties is a pre-requisite for considering a floating NAV under any circumstances.

For these reasons, we oppose a broadly-applied floating NAV as regulatory overreach. However, as we describe in detail below, requiring certain types of funds with particular investor characteristics to have a floating NAV is an idea we support.

Alternatives Two and Three: NAV Buffer with and without Minimum Balance at Risk

Alternatives Two and Three both feature a NAV buffer, a concept to which we strongly object. Our most significant concern is that they represent a move from the regulation of money market funds as securities products to the regulation of money market funds as bank-like products. For too long, money market funds have been labeled part of the "shadow banking" world. Nothing could be further from the truth. ***Money market funds are not banks***. Rather, they offer an alternative to bank products and, indeed, provide a number of advantages. The Charles Schwab Corporation also has a bank, and offers a variety of bank products. Individual investors like having a variety of options for managing their cash. Many of our clients use both bank products and money market funds. They are well aware of the differences between bank products and securities products and fully cognizant of the fact that money market funds do not participate in the FDIC insurance program. They appreciate the additional transparency afforded by money market funds, especially in light of the recent expiration of the Transaction Account Guarantee (TAG) program, which provided unlimited FDIC insurance for amounts in excess of $250,000.00

[13] 77 Fed. Reg. at 69482.

Money market funds are investment products that offer a number of critical differences to bank products:

- *Capital Ratio:* Banks in most jurisdictions are required to have a capital ratio of less than 10%. Regulators around the world have been negotiating for years to increase the requirements, under the basic notion that strong capital requirements are a good thing. Money market funds, on the other hand, have capital ratios of 100%.
- *Leverage:* Money market funds are not in the business of leveraging their holdings. They have no liabilities, only assets. Banks, on the other hand, leverage the vast majority of their deposits, lending money to people and businesses.
- *Liquidity Requirements:* Money market funds have strict liquidity requirements. Under the amendments to Rule 2a-7 adopted in 2010, 10% of a prime fund's assets must be liquid within one day, and 30% of all funds' assets must be liquid within one week. At Schwab, the real-life liquidity of our funds often exceeds those requirements. Banks do not have such stringent requirements.
- *Weighted Average Maturity:* The weighted average maturity (WAM) of investments held in a money market fund must be 60 days or less, and most money market funds have WAMs that are significantly less than that. Not only are banks under no such requirements, but banks are in the business of lending money in situations, such as the 30-year mortgage, where the asset will not mature for many years.
- *Weighted Average Life:* In addition, the introduction of Weighted Average Life (WAL) limitations, also a component of the 2010 amendments to Rule 2a-7, restrict the maximum weighted average life maturity of a fund's investments to 120 days. The effect of this restriction limits the ability of a fund to invest in long-term floating rate securities.
- *Transparency:* One of the most important differences between money market funds and banks is the transparency provided by money market funds. Money market funds are required to report their holdings, net asset value and other information on a monthly basis to the SEC, which makes that information publicly available on a 60-day lag. Indeed, in recent days, several major fund companies, including Schwab, have announced plans to begin reporting their funds' per-share market value on a daily basis. In addition, funds are now required to share their holdings with the public by posting that information on the fund's website within 5 business days of the end of each month. Banks are not required to disclose their holdings.
- *Money Market Funds put the client first:* All mutual funds covered by the Investment Company Act of 1940 must segregate client assets and invest those assets for the sole benefit of the client. This is not true for banks that use client deposits to make loans and other investments on their own behalf.

For these reasons, bank-like regulation for money market funds is inappropriate. Money market funds are investment products and should be regulated as such. Companies offering money market funds are required, via a robust disclosure regime, to be fully transparent with investors that the funds have risk and are not guaranteed by the government. We urge regulators to reject bank-like reforms.

Furthermore, Alternative Two combines two ideas that we firmly oppose. In addition to our concerns about NAV buffers, we also have strong objections to the concept of a Minimum Balance at Risk, which we believe to be simply unworkable for individual investors.

The vast majority of Schwab's money market fund assets, approximately 85%, are housed in sweep funds, which offer automatic investment of cash balances while retaining flexibility for investors to use these funds on an intra-day basis Indeed, many of Schwab's money market fund clients utilize the convenience and liquidity features of these money market funds to pay bills, get cash from ATMs, write checks and facilitate the buying and selling of investments in their investment and retirement portfolios. Their balances often change on a daily or even an intraday basis. The implementation of a minimum balance at risk proposal would destroy the convenience and flexibility that is a hallmark of the product. Investors would not be able to withdraw all their money at once and would likely be confused as to how much of their money would be available for withdrawal at any given time. Indeed, a shareholder could have multiple tranches of 3 percent of their assets held up in the 30-day window described in the Proposed Recommendations. Individual investors in this context present almost no run risk at all, yet significant portions of their assets would be unavailable. It would be nearly impossible for these investors to use such a product to manage their cash in any efficient or reasonable way. It is not clear to us that any individual investor would want to use money market funds with these restrictions in place. In addition, it is not clear to us that holding back a certain percentage of a client's funds would reduce run risk. Therefore, we recommend the Council withdraw this alternative.

The third option outlined in the Proposed Recommendations is to require funds to retain a buffer equivalent to 3 percent of assets in the fund. As stated above, we object to this approach because it rests on an assumption that money market funds are bank-like products that warrant bank-like regulation. But we also have other objections to the proposal. First, a buffer will not prevent a run – the stated goal of the Council's reform recommendations. Rather, it simply addresses how a fund would handle a credit event. Second, the cost of building up a buffer will necessarily have a negative impact on the yield of the fund, rendering it less attractive as a reform option. Third, investors in a fund while it is building up its buffer will be adversely impacted as compared to investors who enter the fund after the buffer is in place. Fourth, all of the mechanisms for building a buffer outlined in the Proposed Recommendations are flawed, untested, and likely to be operationally challenging. We have a real question, for example, as to whether there is even a viable market for the type of subordinated shares outlined in the Proposed Recommendations.

<u>Schwab Alternative Proposal: Modified Floating NAV</u>

During much of the last three years, Schwab has argued that the 2010 amendments to Rule 2a-7 were an appropriate and sufficient response to the 2008 financial crisis. The 2010 amendments significantly strengthened the regulatory framework for money market funds. Since 2010, money market funds have shown their resiliency in the face of a variety of challenging market conditions, including the US debt ceiling crisis of 2011 and the ongoing EuroZone crisis. No fund has broken the buck, and all funds have shown stability and strength. Schwab continues to believe fundamentally that the 2010 reforms are working.

In the face of ongoing regulatory pressure for further action, however, Schwab has given serious consideration to whether there is an alternative that would address the concerns of regulators and enhance investor confidence in money market funds without rendering the product unusable. In doing so, Schwab has focused on what we believe to be the key goal of the regulatory process: mitigating, to the greatest extent possible, the risk of a destabilizing run on a money market fund.

On July 21, 2012, in testimony before the Senate Committee on Banking, Housing and Urban Affairs, then-SEC Chairman Mary Schapiro succinctly described the risk of a run in a money market mutual fund:

> …(e)arly redeemers tend to be institutional investors with substantial amounts at stake who can commit resources to watch their investments carefully and who have access to technology to redeem quickly. This can provide an advantage over retail investors who are not able to monitor the fund's portfolio as closely. As a consequence, a run on a fund will result in a wealth transfer from retail investors (including small businesses) to institutional investors.[14]

Schwab agrees with the perspective that what limited risk there is of a run in a money market fund lies with institutional investors, and, as one of the leading providers of money market funds to retail investors, has worked hard to determine if a solution is possible that addresses this reality. Therefore, a core element of our proposal is that there should be a distinction made between institutional investors in a prime money market fund and retail investors in a prime money market fund. However, such a distinction is inherently difficult to make. As the Council observes in its Proposed Recommendations, "investors in MMFs fall into two categories: (i) Individual, or "retail" investors; and (ii) institutional investors, such as corporations, bank trust departments, pension funds, securities lending operations, and state and local governments."[15] But a footnote observes that "at times, these two categories may overlap." The challenge for reform proposals to date has been finding a way to draw a line between institutional and retail investors in a way that targets reform appropriately. In our proposal, we believe we have drawn a line that addresses the behavior of the largest investors, who are the ones most likely to increase run risk.

Our alternative proposal dovetails with the Council's observation that "it may be optimal to offer both floating NAV funds and stable NAV funds with enhanced protections and to allow investors to determine which they prefer."[16] It is the last part of the Council's statement that we disagree with, however. It is Schwab's belief that few investors of any type would voluntarily choose a floating NAV fund over a stable NAV fund. Our alternative proposal allows investors to remain in a prime stable NAV fund if they own a sufficiently small percentage of the fund and thus pose minimal risk to the fund. But it takes the decision out of the hands of shareholders who own a larger percentage of the fund. Shareholders would not be permitted to own more than 0.1% of a prime stable NAV fund. We think this option strikes the balance for which a regulator should strive: leaving the decision about which type of fund to invest in up to the investor in most

[14] Testimony, June 21, 2012.
[15] 77 Fed. Reg. at 69457.
[16] 77 Ref. Reg. at 69465.

circumstances, but dictating in which type of fund an investor can invest when the shareholder's concentration in the fund poses a measurable risk to the stability of the fund.

Below, we outline the five key elements of our proposal, followed by a discussion of the individual elements and how we arrived at them:

1. **Distinguish Between Fund Types:** "Non-prime" funds – Treasury, Government and Municipal money market funds – should be permitted to retain their stable $1 per share pricing and be open to any investor.

Comments: Schwab believes that the first step in any reform proposal should be to acknowledge that different types of funds have different risks associated with them. While all money market funds are securities products that can lose value, the risk in Treasury Money Market Funds and Government Money Market Funds is minimal. The Council acknowledges the lack of risk with Treasury Funds in its Proposed Recommendations, noting that "Treasury MMFs are unlikely to suffer credit events; tend to experience net inflows, rather than net redemptions, in times of stress; and may be more likely to maintain a stable value during times of market stress, when Treasury securities generally maintain their value."[17] Moreover, the Council exempts Treasury funds from the proposed requirements in its Alternative Two and Alternative Three,[18] another indication that the Council shares our view that Treasury Funds do not need further regulation. There may be slightly higher risk in Municipal money market funds, but these funds tend to be more liquid than most prime funds[19]. The SEC may want to consider additional disclosure and diversification requirements on these types of funds.

2. Investor Diversification: In order to be designated a "Prime Constant NAV Money Market Fund," and thus be permitted to offer stable $1 per share pricing, no single shareholder should be allowed to make an initial purchase greater than 0.1% of the total assets of the fund, and an existing investor who exceeds this percentage through additional purchases of fund shares or through a change in the fund's total assets should be subject to the measures outlined below. Percent ownership would be calculated by the fund on a daily basis.

Comments: In considering how to distinguish between "retail" and "institutional" money market funds, Schwab considered several options before settling on a measure of concentration as the key distinguishing characteristic. Other options considered included:

- *Investor Identification* – We considered first whether an investor who has a Social Security Number (SSN) could be considered a "retail" investor, while an investor with an Employer Identification Number (EIN) could be designated an "institutional" investor. But SSNs do not necessarily correlate to an actual person, and EINs do not necessarily correlate to a business. In addition, this would unfairly impact clients who invest through an adviser who aggregates accounts or through an employer-sponsored retirement plan. While this would be simple to implement, we concluded that it does not adequately

[17] 77 Fed. Reg. at 69471.
[18] 77 Fed. Reg. at 69469 and 69474, respectively.
[19] At Schwab, our Municipal Money Market Funds, on average, hold well more than 60% in weekly liquidity, far above the 30% required by rule.

address the risk of a run on a fund because a wealthy individual with an SSN could have a very large position in a fund and could spark a run by abruptly redeeming that position.

- *Dollar Threshold* – We also considered simply setting a dollar threshold for determining the dividing line between retail and institutional investors. This would be relatively simple to implement and very easy to communicate to investors. But an arbitrary amount would likely result in investors spreading their assets across many accounts or many funds to ensure that they were just under the threshold. The result would be a level of complexity for investors that may be unworkable, as investors could potentially have to monitor their investments across dozens of accounts.

  Moreover, determining the appropriate threshold proved very difficult. In the Proposed Recommendations, the Council suggests that shareholders with less than $100,000 in assets would not be subject to the Minimum Balance at Risk requirement in Alternative Two[20]. Using the $100,000 figure as the threshold for distinguishing a retail investor from an institutional investor, however, seems unreasonably low. At Schwab, the vast majority (81%) of all accountholders in Schwab Prime MMFs would be classified as "institutional," though few, if any, observers of the industry would suggest that an investor with $125,000 in a money market fund account is an "institutional" investor.

  But the real flaw in using a specific dollar figure as the dividing line between retail and institutional investors is that it does not address risk. In a large money market fund of $30 billion, an investor with $1 million represents 0.00003% of the assets in the fund. If that investor redeemed his shares in a day, the activity would have no measurable impact on the stability of the fund. Clearly, then, setting a dollar threshold is not an effective means of addressing the run risk in a fund.

After considering these options, Schwab settled on a percentage of assets under management threshold as the most effective way to address run risk in a fund, and thus distinguish between retail and institutional investors. The next step was to determine an appropriate percentage. Any level is admittedly arbitrary, but we chose 0.1% because we believe that concentration above that level represents a material risk to the fund. Under Rule 2a-7, prime money market funds are required to ensure that at least 10% of the fund's assets are convertible to cash within one day. Our proposal, then, would ensure that if the top 100 shareholders in a fund (each of whom holds just slightly under the 0.1% maximum percentage of ownership) all decided to redeem their entire position on the same day – an extremely unlikely scenario – the fund would be able to meet those redemptions without difficulty. The fact that most funds, including Schwab's, hold more than 10% in daily liquidity ensures that an even more extreme series of redemptions could be handled.

3. **Delayed Settlement:** As an additional mechanism to discourage large investors from investing in a Prime Constant NAV Money Market Fund, shareholders who exceed the 0.1% daily ownership threshold, due to their own inflows or due to a decline in the overall fund assets, would face a seven-day delayed settlement if they fail to reduce their share percentage

[20] 77 Fed. Reg. at 69469.

to below the threshold within five business days. The settlement delay would apply to the amount over the threshold.

a. At the end of the quarter in which the shareholder exceeded the ownership threshold, the shareholder's daily average ownership percentage would be calculated. If the average percentage is above the 0.1% threshold, the shareholder's assets would be liquidated or, if possible, transferred to an alternative fund, and the investor would be prohibited from repurchasing shares in the fund for a time to be determined by the regulators. A shareholder whose average percentage for the quarter is below the threshold would be eligible to remain in the fund and return to regular settlement procedures.
b. Funds would be required to include robust disclosure at the time of purchase that clearly informs investors that they will be subject to these restrictions if they exceed the ownership percentage.

Comments: The five-business day "cure" period is designed to address situations in which an investor unwittingly, or knowingly but temporarily, crosses the ownership percentage. There are numerous circumstances in which such a situation might occur. An investor who has just completed a major transaction, such as the sale of property or a business, may have a sudden large deposit into his or her money market fund, or have those funds swept into a money market fund, with the intention of soon thereafter diversifying. The five-day cure period allows an investor to make the necessary transactions to reduce his or her position in the fund in a reasonable amount of time. An investor could also cross the threshold through no activity of his or her own, but because other shareholders in the fund have reduced their positions, thus reducing the size of the overall fund. In these types of circumstances, we believe it is appropriate to give the investor the opportunity to reduce his or her position in the fund.

After the five-day period has passed, however, any investor who remains over the 0.1% threshold would trigger a seven-day delayed settlement on the amount over the threshold. It is Schwab's view that this provision will be such a substantial disincentive to large investors that investing in a Prime Constant NAV Money Market Fund will be unappealing.

Finally, it struck us as unreasonable to ban immediately from a particular fund any investor who occasionally exceeds the 0.1% ownership percentage, particularly through no fault of his own. Thus, the final part of this proposal attempts to distinguish between the occasional violator of the threshold and the chronic violator. In our view, if an investor consistently remains above the 0.1% threshold, on average, for an entire quarter, he or she is violating the spirit of the proposal and should be excluded entirely from the fund. Such an investor would see his or her assets liquidated at the beginning of the next quarter or transferred, if possible, to a more appropriate fund, such as a Treasury Money Market Fund or a Prime Variable NAV Money Market Fund. Moreover, the investor would be prohibited from repurchasing shares of the fund for a period of time to be determined by the regulator. This provision is designed to ensure that neither the fund's stability, nor the retail investors in that fund, is threatened by a small number of large investors.

4. **Variable NAV Funds for Institutional Investors.** Any prime fund that allows a single shareholder to own more than 0.1% of the total assets of the fund would be designated a "Prime Variable NAV Money Market Fund." Such a fund must "float" its NAV and report

the share price at the end of each trading day. Necessary tax and accounting rules must be adjusted so as to ensure variable NAV money market funds are a viable investment option.

Comments: To meet the needs of institutional investors, fund companies could choose to offer a Prime Variable NAV Money Market Fund. Such a fund would float its NAV and report the share price at the end of each trading day, similar to other types of mutual funds. In the Proposed Recommendations, the Council, in Alternative One, lays out its perspective on how a floating NAV money market fund would work, and, generally, Schwab agrees with the Council's approach, with these comments and observations:

- We disagree with the proposal to reprice shares of a floating NAV to $100 and would recommend retaining the familiar per share price of $1. Changing the share price amounts to the government injecting by regulation artificial volatility into a securities product. The government's role should be to regulate the market, not manipulate the market.

- A critical element to making a Variable NAV Money Market Fund viable will be resolving the tax implications. Transactions in such a fund could result in thousands of *de minimis* gains and losses, a tax reporting burden so severe that it could by itself threaten the viability of such a fund. In the Proposed Recommendations, the Council does acknowledge that these issues will need to be resolved, and states that "the Treasury and the IRS have indicated to the Council that they will consider the extent to which expansion or modification of basis reporting could help shareholders deal with floating NAV MMFs."[21] The Proposed Recommendations also acknowledge that changes to wash sale rules would also be necessary. We wish to emphasize that a floating NAV money market fund is simply not a viable option without these changes. The Council should require that these issues be resolved before any rules related to variable NAV money market funds take effect.

- We note that the Proposed Recommendations suggest the Floating NAV as a possible requirement for all money market funds. We believe that an across-the-board switch of all money market funds to a floating NAV is an unreasonable proposal and strongly oppose it. Such a decision does not address run risk in a meaningful way; would devastate a $2.7 trillion industry; would lead to a flood of money to either less regulated or unregulated products or banks; and would, in and of itself, be a potentially systemically risky event. The proposal outlined in this letter represents a compromise approach, focused on requiring a floating NAV only for certain types of investors and funds. Our approach reduces the risk of runs in money market funds by changing the rules for the investors most likely to run in a crisis, not by fundamentally altering the industry itself.

5. **Increased Transparency for Retail Investors**: All Constant NAV funds would be required to disclose their shadow NAV to the SEC and the public on a more frequent basis.

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[21] 77 Fed. Reg,. at 69467.

Comments: Schwab has long supported additional reforms to Rule 2a-7 that improve transparency to investors. Under current requirements, money market funds must disclose their shadow NAV to the SEC and the public monthly, with a 60-day delay. We believe investors of all types would benefit from more frequent disclosure. On January 11, 2013, Schwab announced that it would begin posting the per-share market value for all of its domestic taxable and tax-free money market funds on a daily basis, beginning later in the first quarter of 2013. We believe the SEC should consider making this an industry-wide requirement.

Operational Considerations of Schwab's Modified Floating NAV proposal

Schwab has spent considerable time, energy and resources wrestling with the myriad operational challenges that our own proposal presents. Any of the solutions proposed, including our own, would require major systems overhauls across the industry, which would be expensive and time-consuming to implement. Should the SEC accept our proposal, we would urge ample time be granted for this work.

In addition to building the capability to segregate those shares held by an individual who exceeds the 0.1% ownership threshold and thus triggers the seven-day settlement requirement, fund companies would undoubtedly want to build a new monitoring capability designed to warn investors that they were approaching the threshold. It is our belief that considerable work would go into ensuring that no investor ever crossed the threshold. Prior to implementation, we would expect to identify those shareholders who are already over the threshold or whose past behavior indicates a likelihood to exceed the threshold, inform them of the upcoming regulatory changes, and advise them that an alternative fund (such as a Treasury money market fund that maintains a constant NAV, or a Variable NAV Prime fund) would be better suited to their needs.

Once the new rule was in effect, we would expect to create a monitoring system designed to identify clients at risk of exceeding the threshold and inform them proactively of their situation and the options available to them. For example, a fund could build a daily report that automatically notifies a shareholder that he or she has exceeded a lower threshold (for example, 0.075% ownership of the fund's assets) that puts the shareholder at an elevated risk for triggering the new rule. Such a system could also warn a shareholder prior to moving a large position into the fund that doing so would result in exceeding the threshold. These warnings could be set at any level and set of circumstances that the fund sponsor chooses. In a sweep environment, it should also be possible to build a "tiered sweep" system that sweeps cash into a prime fund up to some level just shy of the threshold, then automatically sweeps excess cash into an alternative fund (such as a Treasury fund).

We are also aware of specific concerns about how this proposal would work in an omnibus account environment, such as that of an employer-sponsored retirement savings plan. In a plan, a single omnibus account could represent the transactions of thousands of underlying plan participants. Should the plan exceed the ownership percentage threshold, fail to take action within the five-day period to get itself back under the ownership percentage threshold, and trigger the seven-day settlement, all plan participants who transacted that day would be impacted. We acknowledge that the communication and implementation responsibility to plan participants in such a situation, which would likely fall to the plan sponsor, would be challenging.

Practically speaking, it may be that omnibus accounts, unless they are far under the threshold, would find a Prime Constant NAV Money Market Fund an unworkable option. They would continue to have access to Treasury or Government money market funds at a constant NAV, or could opt to invest in a Prime Variable NAV fund.

Finally, we would note that our Modified Floating NAV proposal, as outlined above, remains a work in progress. We have begun soliciting input from others in the industry, which has been very valuable, and would welcome more. We would also welcome the opportunity for more detailed discussions with the SEC commissioners and staff to address questions, respond to scenarios we may not have addressed, and generally work collaboratively to make this proposal as effective and efficient as possible.

Conclusion

In its Proposed Recommendations, the Council specifically states that it "aims to address the activities and practices of MMFs that make them vulnerable to destabilizing runs."[22] We believe our proposal meets the Council's goal by greatly reducing the first-mover advantage in the Prime Variable NAV Fund and by removing from Prime Constant NAV funds the shareholders most likely to cause a destabilizing run. No solution can offer any guarantees – the very nature of any securities product is that it could lose value and shareholders could abruptly decide to mitigate their potential losses. The Council also notes that the same features that make money market funds vulnerable to runs make them appealing to investors.[23] In its zeal to prevent runs, the Council's proposed solutions render the product unappealing to retail investors. Our proposal succeeds in maintaining the important balance between stability and utility.

Thank you very much for the opportunity to offer our perspective on this important issue. We would be pleased to respond to questions or provide any additional information needed.

Sincerely,

Marie Chandoha
President, Charles Schwab Investment Management

cc : Elisse M. Walter, Chairman, Securities and Exchange Commission
Luis A. Aguilar, Securities and Exchange Commission
Daniel M. Gallagher, Securities and Exchange Commission
Troy A. Paredes, Securities and Exchange Commission

Timothy F. Geithner, Secretary of the Treasury and Chairman, Financial Stability Oversight Council
Ben S. Bernanke, Chairman, Federal Reserve System

[22] 77 Fed. Reg. at 69465.
[23] 77 Fed. Reg. at 69465.

Richard Cordray, Director, Consumer Financial Protection Bureau
Thomas Curry, Comptroller of the Currency
Edward DeMarco, Acting Director, Federal Housing Finance Authority
Gary Gensler, Chairman, Commodity Futures Trading Commission
Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
Debbie Matz, Chairman, National Credit Union Administration
S. Roy Woodall, Jr., Independent Member, Financial Stability Oversight Council
John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions
John Huff, Director, Missouri Department of Insurance, Financial Institutions and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Michael McRaith, Director, Federal Insurance Office

Mary J. Miller, Under Secretary for Domestic Finance, Department of the Treasury