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FCIC memo of staff interview with the Investment Company Institute

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MEMORANDUM FOR THE RECORD

Event: Meeting with Members of the Investment Company Institute

Type of Event: At 11 a.m. on Friday, meeting at ICI's offices

Date of Event: March 5, 2010

Participants - Non-Commission:

Paul Stevens, President & CEO – Investment Company Institute, Karrie McMillan, General Counsel – Investment Company Institute, Brian Reid Chief Economist – Investment Company Institute, Jane Heinrichs, Sr. Associate Counsel – Investment Company Institute, Jack Brennan, Former Chairman of Vanguard (via phone)

Participants - Commission:

Tom Krebs (via phone), Troy Burrus, Mina Simhai, Jay Lerner, and Desi Duncker

MFR Prepared by: Mina Simhai

Date of MFR: March 11, 2010

Summary of the Interview or Submission:

This is not a transcript of the meeting and should not be quoted as such

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At 11 a.m. on Friday, March 5, 2010 the FCIC and ICI staff listed above met at ICI's offices to discuss repo markets, commercial paper markets, and the role of money market mutual funds.

MMF and "Shadow Banking"

ICI does not think of money market funds ("MMF") as part of the shadow banking system. ICI believes MMF is different from other parts of the shadow banking system because MMF are not leveraged. Also, according to ICI, it is not true that MMF are unregulated – they are regulated by the Investment Company Act, and the amendments to Rule 2a7 will make MMF more transparent.

Key Changes to Rule 2a7

According to ICI, key changes to Rule 2a7 in response to the problems of 2008 include the following:

- Mandatory liquidity requirements.
- Shortening required maturity. Before it was 120 days, now its 60 days. This should reduce volatility and make it more likely credit requirements can be met.
- Know your investor requirements.
- Stress testing.
- Ability of the board of directors of a MMF to suspend redemptions if the fund is about to break the buck. This would allow a fund to be closed and liquidated without a run on the fund. All the shareholders would be treated the same.

Reserve Primary Fund ("RPF")

ICI advised that the RPF invested heavily in high-yield commercial paper and other higher yield assets because they were trying to increase their asset base. This was done because RPF planned to sell its management agreement, and it would be able to get a better price if the fund had a larger asset base. RPF seemed to be betting that the government would bail out Lehman, like it did Bear Stearns.

According to the ICI, the RPF experienced a run of redemptions, and in order to satisfy them it had to do a fire-sale of its assets, which exacerbated already difficult market conditions.

Commercial Paper Market after Lehman, Freddie, Fannie and Merrill Lynch Difficulties; Government Assistance

ICI advised that after the events of September 2008 the commercial paper ("CP") markets froze. Even GE had trouble rolling its commercial paper. GE had to raise expensive capital from Berkshire Hathaway. Also, it relied more heavily on the deposit market by growing its Utah banks. There was a strong flight to quality, and many investors chose to hold T-bills rather CP. This drove T-bills to have a negative yield. The flight to quality was exacerbated because markets relied so heavily on short term credit.

According to ICI, raising capital became much more expensive. Companies were forced to raise capital through financing mechanisms that were more permanent than CP, and they also diversified their funding sources.

ICI stated that investors were asking MMF whether certain companies were in their portfolios. The market concerns about certain companies drove the government to put programs in place (including a program that benefitted Tier 1 Commercial Paper issuers) that gave MMF comfort that these companies were solvent. ICI believed the facilities the Fed put in place were necessary and worked. ICI also thought that we came very close to an abyss.

According to ICI, Primary Dealers stopped guaranteeing they would buy CP if there was no buyer. Without this backstop, CP froze up.

After Lehman fell Merrill Lynch CP traded at a 20% discount.

<u>Tier 2 Commercial Paper</u>

Mr. Brennan advised that Vanguard never own Tier 2 Commercial Paper. ICI indicated many of its members did not own Tier 2 Commercial Paper and, by law, the most a MMF could hold is 5%, so ICI is not very involved in the Tier 2 Commercial Paper market.

<u>Failure of Bear Stearns</u>

ICI stated the root cause of Bear Stearns' failure was (1) sub-prime mortgages, (2) supervision of investment banks generally, including their capital structure and funding strategies, and (3) a lack of confidence and trust. The policy judgments on leverage and Bear's funding strategy, which relied heavily on overnight funding, also contributed to Bear's failure.

ICI compared the loss of liquidity Bear and other banks experienced to water evaporating from a dish. Banks stopped lending to each other as evidenced by the increase in LIBOR rates.

<u>Repo; Tri-Party Clearing Banks</u>

According to the ICI, the tri-party clearing banks rely on outdated models and platforms. Every repo (even term) is unwound every day. This meant that JP Morgan, as clearing bank, could not monitor counterparties and their collateral effectively. When repo counterparties pulled away from Bear, JP Morgan was left holding the bag.

According to ICI MMF are concerned about counterparty risk, and they do not just look to the collateral. This is because they owe it to their investors to do this risk determination.

Additional comments from ICI on repo include the following:

- In term repos, the collateral changes often.
- When Drexel failed it was slow enough that counterparties had already pulled back from the repo market.
- <u>Lehman</u>: When Lehman went down they had a lot of repo outstanding. The Primary Dealer Credit Facility was in place so the Fed helped unwind Lehman repos. Lehman was still able to find counterparties willing to do repos with it.
- Mechanics for foreclosing on collateral are not very good.

- Bankruptcy: Repos are not subject to automatic stay provisions in a bankruptcy, so counterparties can get collateral right away. However, MMF are not allowed to directly own much of the collateral that is pledged in repos. Taken together, a bankruptcy of a major repo counterparty could lead to many MMF trying to sell assets at the same time, which could depress prices. Also, foreclosure may result in a MMF holding "odd-lots", which are securities in volumes that are too small to sell to a typical institutional investor. A mechanism for an orderly liquidation is needed.
- Margins: Margins are not published publically, so it is difficult to say whether they changed during or as a result of the financial crisis, but ICI does believe they increased during the crisis and now. Margins on MBS probably went up 50% and margins on T-bills and agency bonds probably went up from 102 to 110.
- ICI members do not typically do bi-lateral repo.

General Comments

According to ICI MMF can hold Euro issuances. These tend to be higher quality issuances and this is a very important market.

LIBOR rates during the crisis are a good way to tell the story of banks distrusting each other. ICI has LIBOR rates.

The Fed has National Monetary Reports from 1912 that may be instructive.

Municipal Markets

According to ICI, the Tender Option Bond market is currently about $100 billion, down from its peak of $200 billion. The securities are split into 2 tranches, 1 long term and the other short term. Hedge funds typically buy the long positions. MMF buy put options.

Next Steps

1. Ask ICI (Brian Reid) for comments on repo questionnaire. ICI also said they would be happy to get the questionnaire out to their members.

2. ICI indicated they were willing to put us in touch with Tier 1 CP issuers.

3. Take ICI (Brian Reid) up on their offer to introduce us to the Tri-Party Working Group staff.

4. Take Brian Reid up on his offer to share a copy the power point presentation he has on Tender Option Bonds/synthetic short term obligations.

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