Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel
Switzerland

HSBC Global Asset Management
8 Canada Square
London
E14 5HQ

Dear Sirs,

We are writing to you with HSBC Global Asset Management's public comment on the Financial Stability Board's "Strengthening Oversight and Regulation of Shadow Banking - An Integrated Overview of Policy Recommendations" consultation report. Our letter is a detailed description of our proposals for MMF reform and how they compare to those proposed by IOSCO in its "Policy recommendations for money market funds – Final report".

We would appreciate the opportunity to discuss our views on MMF reform with the relevant people at the FSB. Please contact us if you have any questions regarding our submission.

Yours sincerely,

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HSBC Global Asset Management's Money Market Fund ("MMF") business

HSBC Global Asset Management manages over USD 65bn in money market funds ("MMFs") and segregated money market mandates. We manage MMFs in 16 different jurisdictions and in 12 different currencies.

We have a unique perspective on the MMF industry due to the breadth of markets we offer MMFs and the fact that we are the only manager who has meaningful scale in the three largest markets for MMFs (US 2a-7 market, "international" market Dublin / Luxembourg and the French domestic market). We manage both Constant Net Asset Value ("CNAV") funds and Variable Net Asset Value ("VNAV"), adopting the same investment policies and investment process across our range of MMFs.

In summary, we recommend:

Liquidity reforms
- MMFs should be required to maintain 10% / 30% of their assets in instruments maturing overnight/within one week;
- MMFs should be required to manage shareholder concentration within a target range of [5-10%]

Redemption management reforms
- MMFs should be empowered to impose a liquidity fee on redeeming shareholders, if deemed necessary to ensure fair treatment of redeeming and remaining investors;
- MMFs should be able to limit repurchases on any trading day to 10% of the shares in issue;
- MMFs should be permitted to meet an investor's redemption request by distributing a pro-rata share of the assets of the fund rather than by returning cash to the investor i.e. an in-specie redemption

Structural reforms
- Sponsors should be prohibited from supporting their MMFs; and
- MMFs should be prohibited from being rated

HSBC Global Asset Management's principles when considering the need for further MMF reform

We fully support the enhancements made to regulation 2a-7 in the US and the creation of a short-term MMF definition in Europe. Both sets of regulation have reduced the risk that investors in MMFs "run" and made them better able to operate during a period of market stress. The new MMF definitions in Europe also provide clarity for investors and therefore enhance investor protection.

In our opinion there are additional reforms to MMFs that should be made to further enhance their ability to operate normally during a period of market stress. Our reform proposals are based on achieving the following objectives:

1. Provide MMFs with a greater ability to meet redemptions
2. Create a disincentive for investors to redeem

3. Remove any existing ambiguity of risk ownership
4. Reduce systemic risk created by MMF ratings

It is important that any MMF reform adopted is proportional to the issue being addressed. It must be remembered that whilst the challenges that the MMF industry has had to meet over the last 5 years have been very significant, the fact remains that there has only been one systemic liquidity event in the MMF industry since they were created over 40 years ago.

Any reform mechanisms adopted to address regulators concern of systemic liquidity risk in MMFs must also maintain MMFs in a form that remains attractive to investors to buy and for providers of MMFs to produce. If these objectives are not met then investors will no longer have access to a product that provides them with a solution to manage credit risk through diversification in an efficient manner. Investors in MMFs have a legitimate need for this product and continue to require access to it.

HSBC Global Asset Management's MMF reform proposals

Based on the objectives set out above, we propose the following reforms that will further improve MMFs ability to meet redemptions, create a disincentive to redeem to manage "run" risk, remove any ambiguity of risk ownership and remove systemic risk associated with MMF ratings. We believe these improvements meet regulators objectives whilst maintaining the viability of MMFs both for investors and producers of MMFs.

Liquidity reforms

Some of the mechanisms we propose are already included in regulation in some jurisdictions or are at least common practice in the industry.

- **Minimum liquidity requirements** – All MMF regulation should state the minimum amount of liquidity funds are required to maintain overnight and within one week. Both US 2a-7 regulation and IMMFAs Code of Practice were updated post the credit crisis to state these minimums. In addition, many MMF providers' internal investment guidelines stipulate minimum liquidity requirements that a fund is required to maintain. We believe requiring funds to hold minimum levels of natural liquidity (i.e. minimise the probability that asset sales are required to meet liquidity needs) will heighten MMFs ability to meet redemptions whilst minimising the impact of significant emergency asset sales on the broader financial system. We recommend that IOSCO follows the liquidity requirements stipulated in the SEC's rule 2a-7 of a minimum 10% of liquid assets maturing overnight and 30% of liquid assets within five business days.

- **A client concentration policy** – Current MMF regulation, MMF industry self regulation and most MMF providers internal investment guidelines focus on the liquidity of the assets in a fund with insufficient focus on a funds "liability" to its investors. Prudent liquidity risk management should also place controls on individual client and industry concentrations in a fund. This is to avoid a small number of individual investors, and investors from one, or a small number of industries, dominating the ownership of a fund. High client and/or industry concentration can place liquidity pressure on a fund if these investors were to redeem within a short timeframe.

Designing prescriptive regulation in this area is challenging and therefore we propose that regulation requires the Board of Directors of a fund (or its equivalent) to have a client concentration policy. The policy should set limits on individual client and industry concentrations. The policy must be more prescriptive than a simple "know your client" type policy. For example, the policy should set a target client concentration of 5%. The policy would need to set out how the MMF handles issues such as omnibus accounts and internal assets when calculating client concentrations.

Redemption management reforms

- **Limit the total number of shares repurchased on any trading day** – Regulation should allow MMFs to limit the total number of shares that a fund is required to repurchase on any trading day to 10% of the shares in issue. If enacted, the limitation will be applied pro-rata so that all shareholders redeeming on a particular business day realise the same proportion of their shares. The balance of shares not repurchased will be carried over to the next business until all redemption requests have been met. This mechanism provides an extended period in which a fund can manage the redemption requests. In some jurisdictions this type of mechanism is allowed by regulation and many MMFs in those jurisdictions have language in their prospectus allowing the Board of Directors (or its equivalent) to enact this mechanism.

- **In-specie redemptions** – MMF regulation should allow a MMF to meet an investor's redemption request by distributing a pro-rata share of the assets of the fund rather than by returning cash to the investor i.e. a in-specie redemption. The benefit for the fund is that it is not required to use its immediate access liquidity, or to sell its more liquid assets, to meet a large redemption request. Due to the potential difficulty for some investors in MMFs to receive a share of the assets in the fund a minimum redemption size should be set so that redemptions are only provided in-specie for "large" redemptions. However, a MMF should have the ability to process any redemption request in-specie if the fund and the shareholder both agree to it and it is in the interest of all shareholders. Due to the complexity of operating this mechanism in practice, the Board of Directors of the fund (or its equivalent) should be required to maintain a policy on the handling of in-specie redemptions.

Create a disincentive to redeem to manage "run" risk

We believe a trigger-based liquidity fee would be a powerful mechanism for strengthening MMFs during a financial crisis. In particular, a liquidity fee would:

- Ensure the fair treatment of redeeming and remaining investors;
- Disincentivise redemptions; and
- Reinforce the 'investment fund'-like nature of MMFs.

What should 'trigger' the imposition of a liquidity fee?
We believe the 'acid test' for imposing a liquidity fee depends on whether redeeming investors are causing a disadvantage to remaining investors. After all, a MMF - like any other investment fund - is supposed to mutualise risk-taking amongst its investors; if redeeming investors are causing a disadvantage to remaining investors

then, to that extent, risk-taking has been de-mutualised; imposing a liquidity fee in those circumstances would re-mutualise risk-taking; that would be appropriate, because it would be consistent with the prospectus investors had signed-up to.

Since investment fund boards have a fiduciary obligation to treat investors fairly, we believe it should be left to the board of MMF to decide when to trigger the imposition of a liquidity fee[1]. This would be consistent with the power many European boards already have to impose a dilution levy (which is economically equivalent to a liquidity fee) if they believe an investor is market-timing a fund.

However, some commentators have suggested that a fund board may be too commercially conflicted to decide whether to impose a liquidity fee. They have therefore argued that a liquidity fee should be triggered by a 'rules-based' event.

In that case, we believe the most appropriate rules-based trigger event would be if the 'shadow price' of a CNAV fund fell to 0.9975, or the price of a VNAV fell by 25bps in one week (see our paper "Liquidity fees; a proposal to reform money market funds" for further information).

We acknowledge other possible rules-based trigger events, but are concerned they might result in liquidity fees being inappropriately imposed. For example;

- If a liquidity fee was triggered when a fund's overnight/one week liquidity fell below [5%/15%], but there was no substantial lack of liquidity in secondary markets or material deviation in mid-value of the MMF, then redeeming shareholders would not be causing any particular disadvantage to remaining shareholders and it would not be appropriate to impose a liquidity fee; or
- If a fee was triggered when a fund experienced net redemptions of more than [25%] in one week, but there was no substantial lack of liquidity in secondary markets or material deviation in mid-value of the MMF, then redeeming shareholders would not be causing any particular disadvantage to remaining shareholders and it would not be appropriate to impose a liquidity fee; or
- If a fee was triggered when *another* fund in the industry broke the buck, but that was an isolated incident which did not cause contagion to other funds or issuers (a la Community Bankers in 1994), then it would not be appropriate to impose a liquidity fee.

Some commentators have objected that a trigger-based liquidity fee would cause investors to seek to redeem prior to the imposition of the fee. We disagree with this argument, which misunderstands the cause of investor redemptions. As noted by IMMFA:

> *"…in September 2008 a series of headline events (e.g. relating to Fannie Mae and Freddie Mac, Merrill Lynch, American International Group, Washington Mutual Group, Bank of Ireland, Allied Irish Bank, Lloyds etc) caused investors to lose confidence in the solvency of the financial system as a whole, and the banking system in particular. 'Prime' MMFs invest substantially all of their assets in deposits and securities issued by banks and other short-term issuers. US institutional investors therefore redeemed because they were worried about losses that prime MMFs might be exposed to, i.e. they redeemed from US prime*

[1] The classic account of bank runs ("Bank Runs, Deposit Insurance, and Liquidity", Diamond and Dybvig, Journal of Political Economy, June 1983) notes that: "…the demand deposit contract satisfies a *sequential service constraint*, which specifies that a bank's payoff to any agent can depend only on the agent's place in line and not on future information about agents later in line." This compares starkly with the fiduciary obligation of the board of an investment fund to treat all investors fairly. *In extremis*, the board of an investment fund might enforce that obligation by gating the fund, or by imposing a liquidity fee, as described above.

MMFs because they no longer believed a diversified investment in the financial system was an effective way of managing credit risk. The majority of their redemption proceeds were used to subscribe to US Treasury MMFs (which invest in US Treasury bills). In other words, and contrary to much commentary, there wasn't a 'run' from US MMFs per se: rather investors sought to avoid losses by 'switching' their exposure from the banking system to the US government; there was a classic 'flight to quality'. The flight came to an end when the Federal Reserve's Temporary Guarantee Programme effectively made prime MMFs 'as good as' treasury MMFs and made further switching unnecessary

In other words: a loss of confidence in the banking system may cause a 'flight to quality' by some investors, including switching between prime and Treasury MMFs. A liquidity fee would be imposed *as a consequence of* investors' loss of confidence/flight to quality. It could not, therefore, be the cause of investors loss of confidence/flight to quality.

How should a liquidity fee be calculated?
If the test for imposing a liquidity fee depends on whether redeeming investors are causing a material disadvantage to remaining investors, then it follows the fee should be calculated as that amount required re-mutualise risk taking. Therefore:

- In the case of a CNAV fund, the fee would be the amount required to equalise the mid-value ('shadow price') of a MMF's portfolio before and after any redemption, assuming the sale of a 'horizontal slice' of the fund's portfolio to meet the redemption payment.
- In the case of a VNAV fund, the fee would be the difference between an investor's actual redemption proceeds and the proceeds that would have arisen if the fund had been bid-priced, and assuming the sale of a horizontal slice of the fund's portfolio.

A liquidity fee so calculated should also be acceptable to investors, because it can be rationalized in terms of investor protection[2]. (When we've presented the case for a liquidity fee in these terms to our investors, they have generally been receptive.)

How would a liquidity fee disincentivise redemptions?
We believe a liquidity fee imposed in these circumstances and calculated in this manner would disincentivise redemptions. This is helpful because redemptions can otherwise, in a self-fulfilling fashion, end up causing redeeming investors to disadvantage remaining investors. Consider the 'decision pair' facing an investor in a prime MMF which, during a financial crisis, had decided to impose a liquidity fee on redeeming investors in order to protect remaining investors. An investor could either:

- Remain in the prime MMF, in which case the investor would bear the remote chance of a loss if one of the fund's assets defaults; or
- Redeem from the prime MMF, in which case the investor would bear the irrecoverable cost of the liquidity fee, and subscribe the net proceeds into a Treasury MMF.

Faced with these options, we believe a risk averse investor would be more likely to remain in the prime MMF than to redeem. Our belief is supported by research in

[2] By contrast, a 'punitive' liquidity fee (i.e. that imposed a cost on a redeeming investor in excess of the amount required to equalise remaining investors) would represent a transfer of capital from redeeming to remaining investors. This w ould be inequitable, and w e do believe investors would be prepared to invest in a MMF on that basis.

behavioural finance which observes that, when having to decide between with two negative choices ('bad choices') people tend to prefer *possible losses* over *sure losses*, even when the amount of the possible loss is significantly higher than the sure loss, i.e. an investor would tend to prefer the loss in the event of a default (a possible loss/a gamble) over a liquidity fee (a sure loss).

Consistent with this, and as noted in our earlier paper, there is anecdotal evidence in support of the disincentivising effect of a liquidity fee:

- In November 2007 redemptions were suspended from Florida's Local Government Investment Pool following redemptions from the MMF and a fall in assets from USD27b to USD15b. Subsequently the MMF was restructured with the fund split into two with a fixed liquidity fee of 2% charged on the fund that was created to hold the less liquid assets.
- In 2008, liquidity fees were applied to a suite of international enhanced cash funds. The funds in question were variably priced enhanced cash money market funds. But, accounting differences aside, we understand the funds applied a variable charge based on the estimated bid price of the assets.

Structural reforms

- Prohibition of sponsor support of MMFs - MMFs are an investment product where the risks and rewards belong to its investors. The investor's risks of ownership of a MMF are clearly stated in its prospectus and in its marketing materials. There is no legal basis for an investor in a MMF to transfer the downside risk of ownership to a fund's sponsor (unless it can be proved the sponsor has been negligent in its responsibilities).

However, a level of ambiguity about who owns the risk when investing in a MMF has developed amongst some investors. This ambiguity has developed due to the sponsor support of MMFs that has taken place prior to, and during, the credit crisis. Some investors have been encouraged to *expect* sponsors to support their MMFs. Such expectations cannot be enforced, since managers are under no obligation to support their funds, and consequently leads some investors to misunderstand and misprice the risks they are subject to. The mispricing of risk created by sponsor support should be addressed. The ambiguity of risk ownership is also exacerbated by Fitch Ratings decision to bake an assumption of a fund sponsor's willingness and ability to support their MMFs into their rating methodology for MMFs.

There is an incentive for both fund sponsors and, arguably, regulators to maintain a level of ambiguity of risk ownership in a MMF. We believe any ambiguity of risk ownership must be removed so risk is correctly priced. We therefore propose a prohibition on MMF sponsors providing support to their MMFs. This will make clear to all investors that they are buying an investment product and own the risks and rewards of that investment. A prohibition on sponsor support would also address the comments that have been made that MMF sponsors must have "skin in the game" to ensure they are encouraged to manage risk and not to focus on higher returns. Prohibiting support of MMFs will remove any risk to the sponsor / parent that the provision of support can create.

Sponsor support can take a number of different forms depending on whether the issue seeking to be addressed is credit or liquidity related. If the sponsor is looking to reduce the volatility of the NAV due to an outright credit loss or a mark-to-market loss, a capital support agreement, buying an asset out of the fund at above market prices or a capital injection could be used. If a fund is experiencing liquidity challenges, the sponsor or an affiliate could purchase shares in the fund to inject liquidity. In all these cases it involves the sponsor or an affiliate entering into a transaction or agreement with the fund. Regulators are therefore able to prohibit sponsor support by prohibiting sponsor of affiliate transactions and agreements with its MMFs. In the US, the Securities and Exchange Commission ("SEC") has to approve all transactions between the sponsor or an affiliate and the fund. Whilst the SEC does not prohibit sponsor support it has been a successful mechanism for it to monitor the use of sponsor support in the US MMF industry.

- Prohibition of the use of MMF ratings - The use of MMF ratings has grown significantly over the last 15 years as fund sponsors and CRAs have promoted the benefits of a MMF rating. The level of adoption has been most significant in markets where a regulatory definition of a MMF did not exist. For example, MMF ratings have been of particular benefit to investors in the EU where, until recently, there was no pan-European regulatory definition of a MMF, and investors had to rely on national definitions which often imposed relatively weak constraints on credit, market or liquidity risk.

Investors value MMF ratings as they provide additional risk constraints and oversight by the CRAs. This is understandable in an environment where any regulatory oversight is deemed insufficient and/or there is limited transparency to investors of the assets held by MMFs. Both these issues have been addressed post the crisis and, arguably, the need for a MMF rating has been significantly reduced. We have had discussions on this subject with a number of investors in our MMFs who have confirmed that robust regulation and heightened transparency create a credible alternative to a MMF rating.

Whilst there are some benefits to MMFs being rated, there are also significant systemic risks:

Firstly, with the banking sector long-term ratings predominately in the single-A rating category, the probability of a MMF rating being placed on review for downgrade or downgraded has increased significantly. As many investors' treasury policies stipulate a MMF must be triple-A rated, we are concerned that downgrade action by a CRA will lead to significant redemption activity. Indeed, a UK domiciled MMF complex whose MMF ratings were recently placed on review for downgrade by Fitch Ratings experienced redemptions of almost 50% of the assets under management of its sterling MMF within the space of one week. In this instance the fund manager was able to meet the redemptions. If this had not been possible, or the downgrade had impacted a larger number of funds, or one of the larger fund complexes, the impact on the money markets could have been systemic.

Secondly, and as a consequence of the above, there is enormous pressure on MMFs to maintain their ratings. Those ratings depend on MMFs satisfying CRAs' ratings criteria, which manage credit risk with reference to the ratings of the funds' underlying issuers. If an issuer is put on ratings watch or downgraded, then it may not longer be an eligible investment for a rated MMF, notwithstanding the fund's own assessment of credit worthiness. This is significant: issuer ratings are supposed to be mere opinions; but if CRAs rate both funds and issuers, then they change from being opinions to being soft forms of regulation. Indeed, as pressure is brought to bear on CRAs to behave 'consistently', they have less latitude even to permit rated downgraded assets from rolling-off, and instead require MMFs to make forced sales in order to maintain the fund rating.

Thirdly, there is a lack of understanding amongst investors on MMF ratings. Investors appear to assume that the ratings of different CRAs are interchangeable, whereas in fact they are increasingly diverse. Broadly speaking, Standard & Poor's rating relates to credit risk; Moody's to credit and liquidity risk; and Fitch's to credit and liquidity risk, and to an assessment of the likelihood of sponsor support. Investors also appear to assume the highest MMF ratings can be 'read across' to a long-term triple-A rating. That is understandable given the symbology the CRAs have used: AAAm in the case of Standard & Poor's; Aaa-mf in the case of Moody's; and AAAmmf in the case of Fitch. The suffix (m, mf, mmf) is intended to distinguish the rating as a MMF rating, and not a long term rating, but that subtlety seems to be lost of most investors who instead prefer to focus on the prefix (AAA). This lack of knowledge creates a systemic risk as MMF investors may not understand the risk of the investment they are making.

The broadening and strengthening of regulation of MMFs and increased transparency to investors on the investments made by MMFs reduces the need for a fund rating. Coupled with the significant risks created by MMFs being rated, we propose that MMFs are prohibited from being rated. This will require a period of time before implementation to allow investors in MMFs to update their treasury policies and for fund sponsors to provide additional transparency to investors to provide a credible alternative to a MMF rating.

HSBC Global Asset Management's position on MMF reform compared with IOSCO's fifteen recommendations for reform of MMFs

HSBC Global Asset Management supports many of the reforms for MMFs that IOSCO has proposed. At the same time, there are significant differences of opinion on two particular recommendations. The table below notes the position of HSBC Global Asset Management the fifteen reform recommendations from IOSCO and, where possible, if HSBC Global Asset Management has already implemented the reform.

IOSCO No.	IOSCO recommendation	HSBC's position	Implemented by HSBC?
1	Money market funds should be explicitly defined in CIS regulation	Supports	**N/A**
2	Specific limitations should apply to the types of assets in which MMFs may invest and the risks they may take	Supports	**Y** (more conservative WAL limit of 90 days applied for our MMFs)
3	Regulators should closely monitor the development and use of other vehicles similar to money market funds	Supports in principal	**N/A**
4	Money market funds should comply with the general principle of fair value when valuing the securities held in their portfolios. Amortized cost method should only be used in limited circumstances	Disagrees	**N**
5	MMF valuation practices should be reviewed by a third party as part of their periodic reviews of the funds accounts	Supports	**Y**
6	Money market funds should establish sound policies and procedures to know their investors	Supports	**Y** (a target maximum of 5% of NAV per investor)
7	Money market funds should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales	Supports	**Y** (a "liquidity ladder" that stipulates minimum liquidity levels in maturity buckets from overnight to 397 days)
8	Money market funds should periodically conduct appropriate stress testing	Supports	**Y** (weekly stress testing performed)
9	Money market funds should have tools in place to deal with exceptional market conditions and substantial redemptions pressures	Supports	**Y** (redemption gates, in-specie redemptions in legal documentation Liquidity fees will be implemented where regulation allows)
10	MMFs that offer a stable NAV should be subject to measures designed to reduce the specific risks	Disagrees	**N**

	associated with their stable NAV feature and to internalize the costs arising from these risks. Regulators should require, where workable, a conversion to floating/ variable NAV. Alternatively, safeguards should be introduced to reinforce stable NAV MMFs' resilience and ability to face significant		
11	MMF regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoid any mechanistic reliance on external ratings	Supports	**Y** (A team of over 30 credit analysts support the liquidity business)
12	CRA supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money market funds	Supports	**Y** (As noted above we support the prohibition of fund level ratings for MMFs)
13	MMF documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal	Supports	**Y**
14	MMFs' disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress	Supports	**Y**
15	When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repos by money market funds, taking into account the outcome of current work on repo markets	No policy formulated by regulators yet	**N/A**

As can be seen from the statement of our position on MMF reform and our support of the majority of IOSCO recommendations we are not in the "do nothing" camp. In a number of areas we had already adopted many of IOSCO's recommendations in our investment policies for our MMFs. This followed a full review of our investment policies for MMFs in 2009 and which have since been further enhanced. In a number of areas, most importantly in relation to sponsor support and the use of fund level ratings, we go recommend more stringent reforms.

However, we do not support the IOSCO recommendation for MMFs to revert, where workable, to a variable / floating NAV or adopt safeguards in order to retain the use of a CNAV and amortised cost accounting; or, that MMFs should comply with the general principle of fair value when valuing the securities held in their portfolios.

HSBC Global Asset Management's position on IOSCO's Recommendation 10 – converting to floating / variable NAV

Constant Net Asset Value ("CNAV") and Variable Net Asset Value ("VNAV") debate

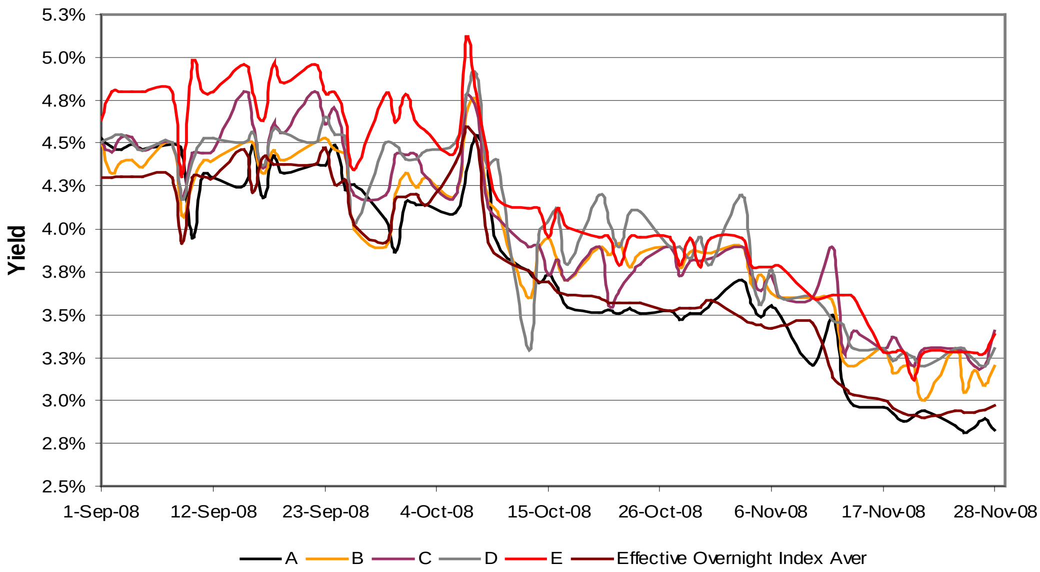
Since the start of the debate on MMF reform, it has regularly been punctuated by opinions being expressed on the relative risk to the financial system of CNAV and VNAV MMFs. In the IOSCO consultation report alone this issue is referenced in four different sections of the report. It has also been discussed in the President's Working Group's report on MMF reform and in public comment by the Autorite des Marches Financiers.

A number of senior figures in the regulatory world have commented that CNAV MMFs pose greater systemic risk than VNAV MMFs. They therefore recommend that CNAV funds should be required to adopt a variable net asset value. Their opinion is based on a theory that CNAV funds foster investors' expectations that the funds are risk free as they "promise" to preserve investors' capital and liquidity. The theory continues that switching to a variable net asset value would make gains and losses a regular occurrence which would alter investor expectations and make clear that MMFs are not risk free. In turn, investors would become less prone to "run" in the face of even modest losses.

Whilst an interesting theory, it does not appear to stack up in practice when the behaviour of investors in CNAV and VNAV funds during the credit crisis is analysed.

Since the most developed market for VNAV funds is in France, we have looked at the share prices of six of the largest French VNAV 'monétaire' funds (as at June 2007) over a ten year period (from January 1999 to September 2009). Since these funds only offer accumulating shares, we assessed the variability of their share price by looking at the daily yield of the fund; a negative yield implies that the day's accumulation of income was more than offset by a mark-to-market loss.

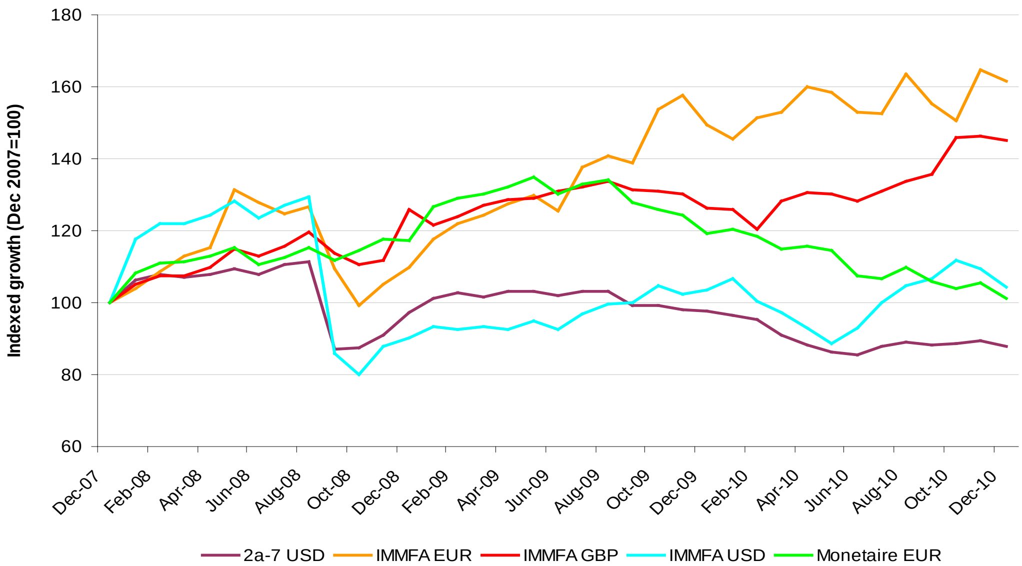
In the case of five of those six funds, at *no point* during the ten year period did they post a negative yield, i.e. daily mark-to-market losses were never substantial enough to cause the price of the funds to fall. This includes the period between September and November 2008 illustrated below, when markets were significantly dislocated. In other words, from an investor's perspective, these funds behaved much the same as if they were CNAV.



Source: Bloomberg

We also compared MMF flows between 2008 and 2010 to assess whether CNAV funds demonstrated larger and more sudden redemptions than VNAV funds. For the purpose of our analysis, CNAV funds comprised: 2a-7 prime funds; IMMFA USD funds; IMMFA EUR funds; and IMMFA GBP funds. VNAV funds comprised French monétaire funds. We found that in 2008, run risk appears to be correlated by currency rather than by pricing mechanism: USD denominated MMFs suffered runs, whereas EUR and GBP denominated MMFs funds did not.

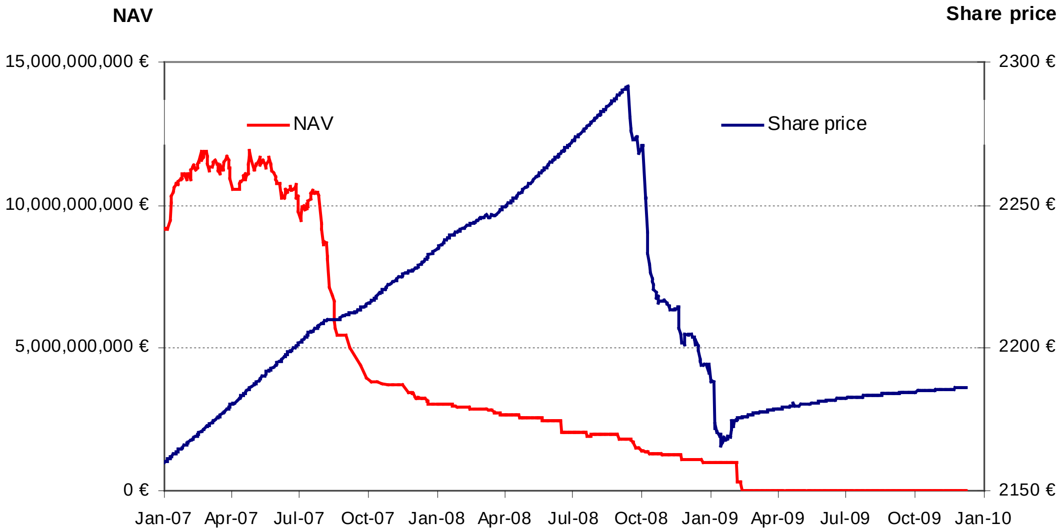
MMF indexed asset growth 2007-2010



Source: iMoneynet, Europerformance

Furthermore, neither did we find that investors are more sanguine to losses in VNAV than CNAV MMFs.

Of the six French VNAV monétaire funds we surveyed, one did post a negative yield in September 2008. Investors largely redeemed from that fund in the year before the decline in its share price, and what few shareholders remained in the fund redeemed after the decline in its share price. Either way, this fund clearly experienced a run notwithstanding that it was a VNAV fund.



Source: Bloomberg

In conclusion, we cannot find any evidence for the argument that there are substantial differences between CNAV and VNAV funds, which cause CNAV funds to be more prone to run risk than VNAV funds.

If one ignores the evidence that the accounting methodology a fund follows has no influence on the probability of an investor redeeming during a period of market stress, requiring CNAV MMFs to switch to VNAV is likely to significantly shrinking the buyer base for these funds. This will remove a valuable outsourcing option for providers of liquidity to manage credit risk.

"First mover advantage"

The concept of "first mover advantage" is regularly referenced by regulators in reference to the systemic risk created by CNAV funds. The Institutional Money Market Fund Association ("IMMFA") has recently conducted a study titled "Money Market Funds, Bank Runs and the First-Mover Advantage"[3].

The IMMFA paper notes that thirty years of academic research on bank runs has concluded that the best protections against bank runs are retail *deposit insurance* or the *suspension of convertibility*. There are no arguments within the academic literature in favour of changing the terms of the demand deposit contract, from stable to variable value: it is quite remarkable that the preferred solution for MMFs is one without precedent in banking regulation.

It goes on to state that money market funds are different from banks in four fundamental respects. These differences concern their *legal form* but also, importantly, their *economic function*. Money market funds do not engage in fractional reserve banking and they do not perform liquidity creation. In a period of heightened systemic risk, the ability of money market funds to suspend the standard terms under which shareholders are able to redeem fund units for cash, is the mechanism most

[3] The full text of the paper can be found at

likely to eradicate the possibility of a first mover advantage and thereby to reduce the risk of a run. This means *liquidity fees* or *liquidity gates*.

In the absence of a credible deposit insurance policy for the money market fund industry, *suspension of convertibility should be the preferred option*: for regulators, for fund sponsors and for investors.

HSBC Global Asset Management supports the conclusions of the IMMFA paper and recommends consideration is given to it by the regulatory community.

IOSCO's suggested "safeguards" where switching to floating / variable NAV is not "workable"

HSBC is pleased that its liquidity fee proposal has been recognised by IOSCO as a credible tool to manage run risk in MMFs.

We have asessed the other "safeguards" highlighted in IOSCO's MMF reform recommendations such as a NAV buffer and hold back mechanism and others such as capital against our objectives of providing MMFs with a greater ability to meet redemptions, creating a disincentive for investors to redeem, removing any existing ambiguity of risk ownership, any reform to be proportional to the probability of a systemic liquidity event occurring in the MMF industry and for it to be practical to implement.

The table below summarises whether each reform proposal meets our objectives:

	Redemption criteria	**Risk ownership criteria**	**Viability / Practicality**
Capital	No	Potentially	No
NAV buffer	No	Potentially	Yes
Hold-back	No	Yes	No

We will now provide our reasoning for the conclusions above for each of the reform proposals.

Capital

It has been argued that investors redeem from MMFs in order to avoid losses; therefore it is proposed redemptions will be mitigated to the extent MMFs hold sufficient capital to offset losses. In that case, a significant amount of capital would be required, perhaps as much as 3-5% of the NAV of the fund.

We disagree with this proposal.

If the cost of capital was borne by the MMF manager, it would eliminate the profit margin – particularly in a low interest rate environment. If the cost of capital was borne by the MMF investor, it would eliminate the yield – particularly in a low interest rate environment. Either way, the proposal would fail to meet the viability criteria.

We note that well capitalized banks can still suffer runs, and so are doubtful that this proposal would meet the redemptions criteria. Incentives to remain do not work when investors have lost confidence in an investment.

Imposing capital on sponsors would send a strong signal to investors that MMFs should be regarded as 'bank like' products, whose sponsors are expected to backstop losses. In a sense, this would remove ambiguity around risk ownership; however, it would do so by fundamentally changing the economic nature of what was hitherto an investment product. And ambiguity would still remain to the extent MMFs remained regulated by the SEC as investment products.

Finally, this proposal raises an important practical question: in the current economic climate, does sufficient capital exist to capitalize a USD 5tn industry?

NAV buffer

Unlike capital, a NAV buffer is not intended to offset losses due to a credit event; rather, a NAV buffer is merely intended to offset the relatively small mark-to-market losses that arise during a financial crisis. In a future 2008-event, a NAV buffer would not prevent the Reserve from breaking-the-buck due to its losses on Lehman, but it would enable the rest of the MMF industry to absorb losses arising in the ensuing crisis, including losses arising as a consequence of selling assets to raise liquidity to meet redemption payments. Proponents of a NAV buffer have argued that it meets the redemptions criteria by, in effect, over collateralising MMFs and therefore incentivising investors to remain in the fund for fear they would lose the benefit of that over collateralization relative to any alternative investment option. To the extent that investors did redeem, the buffer would increase relative to the NAV to the benefit of remaining investors, and so the incentive to remain would grow still greater.

It is proposed that the NAV buffer should either be accumulated through the partially-retained earnings of a MMF, or contributed to a fund by its sponsor, or a combination of the above. It is further proposed that the buffer should be a relatively modest amount, representing perhaps 40-50bps of the NAV, and could be reduced further to the extent a MMF holds overnight paper (including Treasuries). By allowing the NAV buffer to scale in proportion to overnight paper, sponsors with insufficient resources to contribute to the buffer would not be excluded from operating MMFs, but would be required to manage them with more liquid assets.

We have a number of reservations about this proposal.

Regarding the redemption criteria, we do not think the NAV buffer would meaningfully incentivise investors to remain. In a 2008-event, we suspect the attractiveness of the NAV buffer would pale in comparison with the comfort provided to risk-averse investors by Treasuries. (Most redemptions in 2008 were made by institutional investors. If one considers the position of decision makers in those firms, it is hard to imagine they would be criticized for forfeiting the advantages of an over-collateralised prime MMF, and switching to Treasuries, particularly since the switch from the MMF would remain a free option.)

Regarding the risk ownership criteria, to the extent the NAV buffer is funded from retained earnings of the MMF then it would clearly meet the criteria, i.e. because the cost of accumulating the buffer would be attributed to investors and so reinforce MMFs as an investment product. However, to the extent it is funded by contributions from the sponsor then it would clearly fail to meet the criteria. Indeed, sponsor contributions to the NAV buffer are likely to be read by investors as evidence that sponsors will ‘stand behind’ their funds; and yet at 40-50bps the sponsor commitment would actually be very modest, i.e. a sponsor contributed NAV buffer would actually **deepen** the existing ambiguity of risk ownership.

Some commentators have suggested that sponsor contributions to a NAV buffer would cause them to have ‘skin in the game’, i.e. would cause greater financial alignment of interests of sponsors and investors, and cause sponsors to take less risk with investors' subscriptions.

We are uneasy with this argument. First, sponsors already have skin in the game, insofar as they receive fees from their MMFs, and would suffer reputational damage if they mismanaged those funds. Second, it seems possible that this proposal would result in a two-tier MMF industry, i.e. a top-tier comprising sponsors who have access to capital, and a bottom-tier comprising sponsors who do not have access to capital and whose funds therefore run with more liquidity and lower yields. In that case, the sponsors of bottom-tier MMFs seem likely to complain about the competitive consequences of a regulatory reform which causes them to lose market share to sponsors of top-tier MMFs.

Finally, and very importantly, we do not believe the mechanism is equitable as an "early" investor contributes and a "later" investor benefits thus compromising the key principle of an investment fund.

Hold-back

The 'hold back' or 'retention' reform proposal is designed to disincentivise investors from redeeming from MMFs during a period of market stress or heightened idiosyncratic risk on a specific fund. It is proposed that investors should be 'calmed' by holding-back, say, 3% of redemption proceeds within the fund for a period of 30 days. Once the 30 days have elapsed, the held-back amount should be paid to the redeeming investor, less any losses due to credit events that may have occurred during the period. This is intended to have two consequences:

We have a number of reservations about this proposal.

Regarding the redemption criteria, we do not think hold-back would meaningfully disincentivise redemptions. Consider the position of an investor who has concerns about the portfolio of a MMF:

- If he redeems from the fund, then 3% of his redemption remains invested in the portfolio, whereas 97% can be invested in liquid treasuries;
- If he remains in the fund, then 100% of his investment remains invested in the portfolio, all of which may become illiquid in the event the fund suffers mass redemptions following a credit event.

Faced with these options, we suspect the investor would choose to redeem.

Regarding the risk ownership criteria, we acknowledge that hold-back clearly assigns downside risk to the investor. (One could conceive of hold-back as a form of capital provided by redeeming shareholders.)

Regarding the viability criteria, we believe hold-back would fundamentally compromise the utility of MMFs to institutional investors. Specifically, hold-back would significantly complicate cash-flow forecasting, which is an essential requirement of corporate treasury. We have not surveyed our investors on this point, but could do so if required.

HSBC Global Asset Management's position on IOSCO Recommendation 4 – restricting the use of amortised cost accounting

The use of amortised cost accounting by MMFs has been another area of intense debate over the last couple of years. IMMFA has recently written a paper on this subject which expands its position on this subject[4]. We fully concur with IMMFA's findings.

The IMMFA paper recognises that MMF managers tend to *buy and hold* assets. A recent survey of fund administrators revealed that the average annual value of asset sales from MMFs in Europe amount to less than 0.5% of the value of maturities. In addition, MMFs tend to own assets that *do not have traded market prices*. The same survey suggested that between 90% and 100% of assets in MMFs are priced using "evaluated prices" rather than traded or quoted prices.

Therefore, since MMFs buy assets with the intention of holding them to maturity, and since most of these assets do not have accurate traded market prices, *amortised cost accounting is the most appropriate method* to value assets in a MMF. The use of amortised cost accounting is consistent with the accounting treatment of bank assets that are bought with the intention to be held to maturity: it is consistent with FRS39 and it is both true and fair.

The paper goes on to recognise that the use of constant NAV pricing for MMFs does lead to occasional frictional transfers of wealth between investors as they buy and sell shares. These transfers are not material in size; furthermore, these transfers *cannot be avoided by moving from constant to variable NAV pricing* for the fund because of the bid-offer spread for money market assets. The historical difference in value between constant NAV funds and their shadow (i.e. mark to market) price is very small. Data from the US shows the difference in value to average 0.002% between 2000 and 2010. Moving from amortised cost accounting to mark to market pricing *would have no material impact on the prices of MMFs*.

The paper concludes that using market pricing risks *importing market volatility into the MMF sector*. In a time of market stress, market prices often do not reflect the fair value of assets. If MMFs are forced to use depressed market prices they run the risk of triggering a redemption run, which in turn would lead to further assets sales and a downward spiral of asset prices.

Conclusion

HSBC Global Asset Management remains committed to working with regulators to identify reforms that will reduce the risk of runs in money market funds. We have identified seven reform proposals that will reduce the run risk in MMFs whilst preserving the value they bring to investors and the broader economy. We remain concerned that regulators continue to focus on differentiating between CNAV and VNAV funds and the use of amortisted cost accounting to address their concerns of run risk. We believe these issues are "red herrings" that will not reduce systemic risk in the financial system created by run risk in MMFs and will leave the financial system open to risk in the future.

[4] The full text of the paper can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2187818