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September 17, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Submitted electronically via rule-comments@sec.gov

RE: SEC Proposal Regarding Money Market Mutual Fund Reform, File Number S7-03-13, Release No. IC-30551 (the "Proposal")

Dear Ms. Murphy:

We appreciate the opportunity to provide our comments to the Securities and Exchange Commission (the "Commission" or "SEC") on the thoughtful alternatives for money market mutual fund reform set forth in the Proposal.[1] Vanguard [2] is an SEC-registered investment adviser that has managed money market mutual funds ("MMFs") since 1981. On behalf of our shareholders, who currently invest approximately $205 billion in our MMFs, we welcome the opportunity to work with the Commission to strengthen the money market industry for the benefit and further protection of investors.

Over the past five years, Vanguard has been actively involved in researching and evaluating potential MMF reform options. We were strong proponents of the SEC's amendments to Rule 2a-7 that were implemented in 2010. We believe these changes positioned many MMFs to be self-provisioning for liquidity, thereby reducing the likelihood that a future systemic market disruption would impede the ability of the funds to satisfy shareholder redemptions. We believe regulators could do more to strengthen money markets for investors and have previously expressed our support for solutions that were narrowly tailored to the funds most likely to experience destabilizing redemptions.[3] We encouraged regulators to seek a reform solution that would continue to allow investors, particularly retail investors, the discretion to choose MMFs for their cash management needs.[4]

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[1] Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36834 (June 19, 2013) available at http://www.gpo.gov/fdsys/pkg/FR-2013-06-19/pdf/2013-13687.pdf.

[2] Vanguard offers more than 160 U.S. mutual funds with aggregate assets of approximately $2.2 trillion.

[3] *See* Vanguard comment letter to the Financial Stability Oversight Council, dated January 15, 2013 (the "FSOC Letter").

[4] Id. We note that prime MMFs also serve important investor needs beyond cash management. Many investors use prime MMFs as (i) a diversifier in a portfolio of equity and fixed income securities, (ii) a safe harbor in times of stock and bond market volatility, and (iii) an emergency fund to help pay for unexpected expenses.

As the financial crisis of 2008 demonstrated, institutional prime MMFs have an increased risk of experiencing disruptive shareholder redemptions, which can impair a fund's liquidity and its ability to maintain a stable NAV. The primary reason for this increased risk is the composition of an institutional prime MMF's shareholder base. An institutional prime MMF is likely to have a concentrated shareholder base of professional investors who own a significant portion of the fund. When these shareholders redeem their shares at the same time, a fund's liquidity can be severely impaired and its ability to maintain a stable NAV may be compromised.

We believe the SEC's Proposal appropriately identifies institutional prime MMFs as the funds most likely to contribute to widespread financial market stress, as these funds have proven to be more susceptible to significant redemptions.[5] The Proposal also acknowledges that retail prime MMFs did not experience disruptive redemptions during the financial crisis of 2008 and, therefore, recommends that such funds retain the stable NAV.[6] This finding is consistent with our experience in managing retail MMFs over the past 32 years—retail investors do not cause MMFs to experience sudden and disruptive redemptions. For these reasons, Vanguard encourages the Commission to adopt a floating NAV for institutional prime MMFs ("Option I").

Part I of this letter provides a summary of our comments. Part II discusses our detailed comments on the proposed structural reforms for MMFs. Part III provides the reasons to exclude municipal (tax-exempt) MMFs from further structural reforms. Part IV discusses our general support for many of the proposed disclosure and diversification reforms for MMFs, but cautions against certain changes that would not be in the best interest of investors.

I. Executive Summary

We have summarized our key points below, each of which is discussed in greater detail in Parts II-IV of this letter:

1. **We support Option I to require floating NAVs for institutional prime MMFs and stable NAVs for retail prime MMFs.** Option I provides an appropriate balance between targeting the funds that are most likely to experience disruptive redemptions and preserving prime MMFs for the retail investor. In our experience, the stable NAV is a very highly valued feature for those retail investors who continue to invest in retail MMFs to manage their cash, pay their bills, and diversify their portfolios, despite negligible yields.

2. **We believe that the daily redemption limit for investors in a stable NAV prime MMF should be raised from $1 million to $3 million.** If the daily redemption limit is not raised, we believe certain exceptions would be necessary to make the $1 million daily redemption limit less disruptive to ordinary retail shareholder activity. Regardless of the dollar limit on redemptions, however, we believe redemptions in retirement plan accounts and other tax-deferred savings accounts should be deemed "retail" activity.

3. **We urge the SEC to treat municipal MMFs like government and Treasury MMFs and exclude such funds from further structural reforms.** We believe that the Proposal correctly concludes that government and Treasury MMFs do not require structural reforms. These funds are unlikely to have disruptive redemptions that could contribute to wider financial stress, given the higher credit quality and liquidity of the securities held by these funds. We believe the Proposal mistakenly concludes, however, that municipal MMFs warrant the same reforms as prime MMFs, without any evidence that such funds have a history of destabilizing, widespread redemptions. We believe the Proposal is

[5] *See* Appendix A-1 (showing largest 25 prime institutional funds' change in net assets from September 9-23, 2008).
[6] *See* 78 Fed Reg. at 36844 & 36856.

significantly flawed for its failure to show how shareholder activity in municipal MMFs may result in disruptive redemptions that impair a fund's liquidity, or transmit systemic risk.

4. **We do not support the combination of Option I with the additional structural reforms of liquidity fees and redemption gates ("Option II"), nor do we support having both structural reforms available.** We believe combined structural reforms are unnecessary for the SEC to achieve its objective of preventing disruptive redemptions and could serve to make MMFs an unattractive cash management vehicle for investors, particularly those who hold MMFs in a retirement plan or other tax-deferred savings account. We believe having both structural reforms available may be confusing for investors and could promote regulatory arbitrage.

5. **We largely support the proposed disclosure and diversification reforms; however, we strongly oppose the proposal to eliminate a fund's ability to hold up to 25% of its assets in securities subject to a guarantee or demand feature from a single institution (the "25% basket").** We support disclosure of a fund's liquidity levels and market-value NAV, which can help investors better understand the liquidity and stability of their MMFs. We also support the proposal to require fund advisors to aggregate exposures to affiliated credit sources, as it is consistent with the spirit of Rule 2a-7's diversification requirements. We oppose, however, eliminating the 25% basket, which can be useful for municipal MMFs as it provides the flexibility to obtain greater exposure to a strong credit source in times when high credit quality may be scarce. Eliminating such flexibility would be an SEC mandate for funds to hold lower-quality securities.

II. Comments on Proposed Structural Reforms for MMFs

A. The SEC Should Adopt Option I and Float the NAV for Institutional Prime Funds.

Vanguard supports the structural reforms set forth in the Proposal as Option I. Over the past five years, we have consistently advocated for the retail investor to continue to have access to a stable NAV prime MMF.[7] We expressed concerns that requiring retail MMFs to move to a floating NAV would destroy the utility of the product for the millions of retail investors who choose to use MMFs for their cash management and savings needs[8] and do not have access to the same cash management products as institutional investors. The floating NAV, if forced upon all MMF asset classes or all prime MMFs, would have had draconian consequences for investors, the financial markets, issuers, and the MMF industry. We had significant reservations that retail investors, without access to a stable NAV MMF, would have only bank accounts for their cash management needs. This lack of choice would result in lower earnings on cash, and ironically, serve to further concentrate systemic risk in the banking industry. We believed, and continue to believe, that our investors deserve better.

1. Option I provides an appropriate balance between preventing disruptive redemptions and preserving prime MMFs for the retail investor.

We support the SEC's proposal to impose a floating NAV on institutional prime MMFs and retain the stable NAV for retail prime MMFs. Option I offers a workable solution that strikes an appropriate

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[7] *See* Vanguard letter to the SEC, dated August 19, 2009 (the "2009 SEC Letter") (cautioning that MMF reforms must not be so drastic as to force retail investors into different, less regulated products); Vanguard letter to the SEC, dated January 10, 2011 (discussing concerns that a floating NAV would preclude the small retail investor from having a cash management alternative to the traditional bank account).

[8] *See* 2009 SEC Letter (noting that the $1.00 NAV offers tax, accounting, and record keeping simplicity and that a shift to a floating NAV would require significant and expensive changes for both funds and investors); FSOC Letter (arguing that retail investors would have no choice but to resort to a bank account for their cash management needs).

balance between preventing disruptive redemptions, yet retaining the product's key features for some asset classes (like government and Treasury MMFs) and the retail investor. We believe that the impact of this structural reform will produce the right result for those concerned with systemic risk matters and for those who seek choice for their cash and investment management needs.

We note that those who oppose the floating NAV will argue it will not prevent investors from redeeming their MMF shares. We agree. Even bond funds, which have fluctuating NAVs, can and do experience heavy redemptions. The reason the floating NAV would mitigate the risk of disruptive shareholder redemptions in institutional prime MMFs is that the process of moving from a stable NAV to a floating NAV will force the shareholders of these funds, which tend to be concentrated with professional investors who cannot withstand any share price movement, into different investment vehicles. The investors who remain will have a greater tolerance for loss, making them less likely to flee at the first sign of stress. So long as the transition period is managed appropriately, with sufficient lead time to permit investor redemptions to occur in an orderly fashion, investors with no risk tolerance will be able to choose a more appropriate way to invest their cash. Since Treasury and government MMFs will be permitted to retain the stable NAV, institutional investors can choose one of these funds for cash that requires a stable NAV. Likewise, they may choose to invest in a bank product or manage their cash internally. We expect that this structural reform will result in a smaller institutional prime MMF industry, and will potentially decrease demand for prime assets. We do not believe the costs associated with this contraction outweigh the benefits derived from addressing institutional prime MMFs' ability to exacerbate financial market stress.[9]

2. <u>Option I appropriately differentiates between retail and institutional MMFs</u>.

We support Option I because we believe it provides a relatively straightforward way to distinguish between retail and institutional MMFs, a distinction we believe is necessary given the different shareholder base, redemption behavior, and portfolio management activities in these two types of funds. As the SEC knows, the MMF industry has struggled for many years to come up with a workable definition of "institutional" and "retail." The difficulty stems from the fact that there is no one metric that precisely differentiates between all institutional and retail MMFs. In the past, we have proposed an account balance test.[10] Others have proposed a shareholder concentration approach.[11] The SEC in its 2009 proposal for MMF reform suggested that each fund board could determine whether a fund was intended to be sold to "institutional" investors.[12] Each approach has its costs and benefits, and each approach is imperfect. The SEC has decided to propose a definition of "retail" that is not based on investor type. The Proposal suggests a dollar-capped daily redemption limit, which would apply to all investors (individuals, large corporations, small businesses, endowments, foundations, etc.) in a stable NAV prime MMF. This approach is also imperfect, as it will restrict the liquidity of the product for some investors and will be costly and complicated for fund sponsors and intermediaries to implement. Notwithstanding these facts, we believe the overall benefit that retail investors will derive by having a stable NAV prime MMF will, over the long term, outweigh the occasional inconvenience of delayed liquidity and the implementation and compliance costs associated with this reform measure. For this reason, we generally support the SEC's proposed approach to define a "retail" fund as one that imposes a dollar-capped daily redemption limit.

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[9] We, too, are willing to adopt significant structural reforms to our MMFs, two of which would qualify as "institutional" under Option I because they may be purchased only by other Vanguard funds. These two MMFs would be required to convert to a floating NAV.

[10] *See* FSOC Letter (stating that regulators could distinguish between retail and institutional prime MMFs based on account balances).

[11] *See* Letter, dated January 17, 2013, from Charles Schwab Investment Management to FSOC (stating that regulators could distinguish between retail and institutional prime MMFs based on the extent of investor concentration in the fund).

[12] *See Money Market Fund Reform,* SEC Release No. IC-28807 (June 30, 2009) at 62.

3. Option I is better for the long-term viability of MMFs in retirement plan accounts and IRAs, and such accounts should be deemed "retail" regardless of daily redemption activity.

We support Option I because, upon further consideration and analysis, we believe this option is better than Option II for the long-term viability of MMFs in retirement plan accounts and other tax-deferred savings accounts. Option I is simpler to communicate to employer retirement plan sponsors and retirement plan participants and easier for intermediaries to administer. Option I also appropriately reflects the fact that individual retirement plan participants invest for the long term and do not focus on short-term changes in the perceived market risk of certain funds. In contrast, Option II would require enormous systems modifications by intermediaries to enable them to implement or remove liquidity fees or redemption gates on extremely short notice and could result in unpredictable delays in payments to beneficial owners like retirement plan participants in connection with legally required distributions or distributions taken to meet financial hardship. This is a possibility many employer plan sponsors are unlikely to accept. In light of these concerns, we believe Option I to be a preferable approach for retirement plan accounts.

With respect to retirement plan and individual retirement accounts ("IRAs"), however, we urge the SEC to amend the retail definition to deem all such activity as "retail" in nature, regardless of whether daily withdrawals initiated by any individual beneficial owner are above or below $1 million. In our experience, the risk of disruptive redemptions posed by retirement plan or IRA investors is particularly low, and the cost of implementing a daily redemption limit (or, when interacting with intermediaries, monitoring such a limit) is high. Retirement plan participants invest with long-term goals, and do not tend to react quickly to market trends or perceived changes in market risk. Further, it is unusual for retirement participants or IRA investors to accumulate amounts approaching $1 million in a single retirement account investment. Reviewing calendar year 2012 transactions in detail, we find that only a minuscule number would have been prevented if Option I, as proposed, were applicable. Specifically, only 0.13%, or 397 redemptions out of approximately 300,000 prime MMF redemptions effected for retirement plan participants with accounts maintained on our recordkeeping system exceeded $1 million. Further, a significant percentage – 74% – of these transactions resulted from activity other than discretionary participant-directed investment elections.[13] In other words, only 0.0335%, or 103 of the 300,000 prime redemptions effected for retirement plan accounts were both over $1 million and the result of discretionary participant investment elections. While the restrictions proposed by Option I will affect a very small number of retirement plan transactions, the required programming, negotiations, education and monitoring will be burdensome and costly for retirement plan record keepers and fund managers, particularly in light of the minimal risk of disruptive MMF redemptions posed by retirement plan participants and IRA investors.

Moreover, if unaltered, Option I could have detrimental consequences for retirement plans and participants and may cause plan sponsors to seek alternative cash equivalents for retirement plans. For example, plan sponsors have a fiduciary obligation to prudently select and monitor service providers and investment options offered to retirement plan participants.[14] If any participant holds more than $1 million in a prime MMF at the time of a plan-wide liquidation or transfer, these plan changes would be complicated and delayed. Further, common participant transactions, like distributions or rollovers upon retirement, could also be delayed for some participants due to the proposed daily redemption limit. Without changes to Option I, the complications for plan operations, participant communications, and participant transactions are likely to cause plan sponsors operating under strict fiduciary obligations to seek alternative cash management investments. These alternatives may not offer plan participants the same regulatory protections provided by MMFs.

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[13] Nearly half of all prime redemptions over $1 million effected for retirement plan accounts resulted from plan-sponsor directed transactions, like conversions to new record keepers, and approximately a quarter resulted from participant transactions other than implementation of investment decisions, like distributions or rollovers of a full plan account balance to an IRA. See further discussion of such participant activity in Part II.A.4(a) of this letter.

[14] ERISA § 404(a)(1)(B); 29 CFR § 2550.404c-1(d)(2)(iv).

4. The daily redemption limit should be modified to better reflect potentially disruptive investor behavior.

Notwithstanding our overall support for Option I[15], we would like to provide the Commission with some additional considerations regarding the daily redemption limit. The concept of a daily redemption limit attempts to achieve the right result: slow down redemption activity to prevent a fund's liquidity from being depleted. One of the significant drawbacks about the approach, however, is that it will prohibit transactions that regularly occur above the $1 million level but do not impair a fund's liquidity. Our comments on this matter are informed by our experience managing MMFs over the past three decades.

For example, the $1 million daily redemption limit is particularly concerning to our municipal MMF investors.[16] The SEC's Proposal would impact daily redemption activity of the very shareholders who help provide scale to the MMFs. This scale helps to lower the funds' expense ratios, and benefits all shareholders in the fund. We are concerned that a $1 million daily redemption limit on tax-exempt MMFs could cause the largest fund investors, who are individuals and not institutions, to leave altogether. In a recent survey of Vanguard's largest tax-exempt MMF shareholders, 67% of responders were very concerned about the $1 million daily limit and indicated they were more likely to seek an investment alternative as a result of such a restriction.

There are several common examples of redemptions that could cause an investor in a retail MMF to exceed the $1 million daily redemption limit. Small businesses could require amounts in excess of the daily limit to meet payroll or fund business operations. High net worth individuals could have a need to redeem more than $1 million to pay for state and federal income taxes or real estate taxes. These withdrawals are not being made in reaction to market events, but rather, to comply with a federal, state, or local tax law. Investors should be able to satisfy their tax obligations without being limited by the daily redemption limit. Likewise, investors sometimes make large purchases of real estate, particularly in states with high costs of living, such as New York and California. Investors are highly unlikely to flee a MMF to make a real estate purchase, as most real estate purchases require significant lead time. There are also cases where trust and estate settlements may involve payments in excess of $1 million to heirs or to settle outstanding debts. Trust and estate trustees are highly unlikely to engage in preemptive runs given the length of time required to administer a trust or settle an estate. These trustees will often liquidate equity and other securities holdings and purchase shares of a MMF to make necessary distributions to creditors, taxing authorities, and heirs. Finally, there are situations when a MMF account must be re-registered. Account re-registrations are common and are not indicative of a run because cash does not leave the fund. Account re-registrations occur, for example, when an investor inherits an account, such as an IRA. These account re-registrations are book-entry "redemptions" and "repurchases" of the same funds held under the former registration. An investor who holds a MMF and has an account re-registration should not be limited by the $1 million (or any) daily redemption limit.

Based upon our experience, we believe the Commission could reasonably raise the daily redemption limit to $3 million to permit such retail shareholder activity and continue to effectively exclude institutional assets from retail MMFs. Importantly, this higher limit would not meaningfully threaten to deplete a fund of its liquidity. Raising the limit to $3 million would be a more cost-efficient

[15] We believe a dollar-capped daily redemption limit is an acceptable way to distinguish between retail and institutional MMFs. We would, however, encourage the SEC to consider other ways to define retail MMFs that may be just as effective at preventing disruptive redemptions, but are less complicated and less costly to implement.
[16] For the reasons set forth in Part III of this letter, we do not believe municipal MMFs need to adopt structural reforms. If the SEC does not exempt these funds from daily redemption limits, we are particularly concerned that the proposed daily redemption limit will be problematic for these funds.

way to implement the daily redemption limit, without impairing a fund's liquidity or imposing the costly systems changes required to implement several of the accommodations described below.

If the Commission determines not to raise the daily redemption limit, we believe the following accommodations would be necessary to make the $1 million daily redemption limit more workable. We believe each of the examples provided below represents activity that occurs regularly by retail investors in MMFs and is not indicative of disruptive redemptions.

a) Retirement Plan and Individual Retirement Account Transactions.

In the absence of a categorical characterization of retirement plan account and IRA transactions as retail, we encourage the SEC to modify application of the proposed daily redemption limit in Option I to exclude redemptions initiated by plan sponsors or resulting from certain retirement investor transactions, like plan distributions and rollovers. These activities typically require significant advance planning, do not cause widespread market dislocations, and are not indicative of disruptive redemptions.

With respect to plan sponsor-initiated activity,[17] such transactions often result from plan-wide changes requiring significant advance review by plan fiduciaries and advance notice to plan participants.[18] Service providers also typically require advance notice to implement such plan-wide changes, due to the operational requirements of recordkeeping systems. This advance planning and the fiduciary liability that commonly accompanies such plan activity makes it extremely unlikely that plan sponsors would implement plan changes resulting in MMF redemptions solely as a result of perceived changes in the market risk of a particular MMF. Advance notice also makes these redemptions easier for MMFs to manage, because they can manage MMF liquidity to anticipate upcoming plan-wide transactions.

With respect to retirement plan investor activity,[19] many common transactions resulting in MMF redemptions are disconnected from the investor's views of the risk or perceived risk of the MMF. For example, distributions or rollovers from retirement accounts typically result in complete liquidations of all account holdings, but result from job termination or retirement decisions rather than investment decisions. Indeed, such activity is restricted by the provisions of the retirement plan and applicable law.[20] Similarly, due to recordkeeping systems requirements, participants invested in plan brokerage accounts generally must deposit assets in the plan's MMF, from which assets are then directed to investments participants select through the brokerage window. Under these circumstances, participants are motivated by personal financial needs and plan, legal, and recordkeeping systems requirements, and redemptions resulting from such activity (regardless of amount) should not be considered indicative of disruptive redemptions.

With respect to intermediary transactions generally, we urge the SEC to further simplify operations for all accounts by confirming that intermediaries are not required to aggregate beneficial

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[17] Plan sponsor-initiated activity could include, for example, changes in a plan's investment line-up, share class changes, plan terminations, plan service provider changes, changes in a default investment option or re-enrollment of plan participants into a default investment, changes in model portfolio investments at the plan level, and transactions in plan forfeiture accounts (used to pay plan expenses and fund participant benefits).

[18] See, e.g., 29 CFR § 2550.404a-5(c)(1)(ii) (30-90 days notice required before any changes in the investment line-up of a participant-directed retirement plan); 29 CFR § 2520.101-3(b)(2)(i) (30 days notice required before any "blackout" period, which is a period of more than three business days during which participants may not direct investments – typically resulting from plan activity like changes in record keepers).

[19] Retirement plan investor activity could include, for example, MMF redemptions resulting from distributions, rollovers, plan brokerage window activity, or periodic changes in investments resulting from rebalancing or changes in investment allocation generated by managed account programs.

[20] Plans generally restrict distributions to certain circumstances like job termination or retirement, death, disability, or attainment of a particular age. The Internal Revenue Code also imposes penalties on certain distribution activity, including most distributions before age 59½. Internal Revenue Code § 72(t).

owner activity in different accounts when applying any retail MMF daily redemption limit.[21] Intermediary systems are not typically designed to aggregate beneficial owner activity across multiple accounts, such as multiple retirement plans maintained by separate employers with a single record keeper. In a similar context, for example, retirement plan participants—not intermediaries—are directed to monitor application of contribution limits imposed by the Internal Revenue Code across multiple plans, even where accounts may be maintained by a single record keeper. Because intermediary systems are not designed to aggregate beneficial owner activity, the cost of implementing any steps to monitor such restrictions would be very high. The MMF redemption activity that could be subject to limits as a result of such aggregation, however, is extremely low. Intermediaries should not be required to attempt this aggregation, and MMFs should not be required to attempt to monitor intermediary compliance with any such requirement.

b) Check writing

Investors who write a check in excess of $1 million, or who write multiple checks in an aggregate amount that exceeds $1 million, are not engaging in disruptive redemptions. The uncertainty around when a check might clear makes this activity a very inefficient way to limit exposure to a MMF under stress. For this reason, we would encourage the SEC to exempt check-writing activity from the $1 million daily redemption limit.

c) Advance Notice

Investors who provide MMFs with advance notice of their intention to redeem in excess of a $1 million daily limit should be permitted to exceed the limit. When an investor is able to provide advance notice of a redemption, the investor is not attempting to flee the fund. Advance notice can help portfolio managers better position portfolios to address these redemptions. The advance notice exception would allow investors to notify their MMFs of an upcoming tax bill, real estate purchase or trust and estate settlement activity that could require a redemption in excess of a $1 million daily limit. Without guardrails, however, the advance notice exception to the daily redemption limit could enable abusive and opportunistic behavior. For this reason, we would support a maximum dollar limit of $3-5 million. Advisors should be able to determine the means through which advance notice may be provided, but options could include e-mail or telephone. Finally, we believe one business day would suffice for advance notice.

The complexity and costs associated with systems programming for the accommodations mentioned above, as well as for the floating NAV and $1 million daily redemption limit are substantial. We believe the efforts could take up to three years and our conservative estimates put the initiative between $35-50M. These are not costs we take lightly, but we are willing to make this investment to further strengthen MMFs and to ensure that these funds remain an available investment option for the millions of retail investors who use the funds for their cash and investment management needs.

B. The SEC Should Not Combine Options I and II

We urge the Commission not to adopt a final rule that would combine the structural reforms outlined in the Proposal on retail MMFs. With respect to retail MMFs, a combined structural reform would require the funds to impose a $1 million daily redemption restriction, coupled with liquidity fees and gates. For the reasons stated in Part II.A of this letter, liquidity fees and gates would be largely unworkable in retirement plan accounts. Imposing both structural reforms would effectively eliminate a

[21] 78 Fed. Reg. at 36861 & n.224 (proposing that retail MMFs must have policies and procedures requiring reasonable efforts by intermediaries to aggregate multiple accounts held by a single beneficial owner with the intermediary when applying the daily redemption limit).

stable NAV prime MMF for thousands of individuals seeking to diversify and reduce risk in their retirement account portfolios. In addition, we believe a daily redemption limit is an effective way to stem redemptions from a retail MMF. Imposing additional structural reforms could unnecessarily drive investors away from these funds and would require funds to incur additional implementation and compliance costs associated with the liquidity fees and gates.

C. The SEC Should Permit Only One Structure Between The Two Options

We are aware that the SEC could adopt a hybrid approach that would allow prime MMFs to be structured either as floating NAV funds or as stable NAV funds with liquidity fees and gates. We believe having both structural options available at the fund sponsor's preference may be confusing for investors and could promote regulatory arbitrage. We also believe that one of the key strengths of Option I is that it creates an important distinction in the industry between institutional and retail MMFs. This distinction is warranted given the different shareholder base, redemption activity, and portfolio management techniques used by these funds. The distinction would be lost if a fund self-selects as a floating NAV fund or a fees and gates fund. We urge the Commission to adopt Option I and hold fund companies to a standardized structure that will be simple for investors to understand, and protective of the future strength and reputation of the money market fund industry.

III. Municipal MMFs Do Not Impose Systemic Risk and Should be Excluded from Structural Reforms

We believe municipal MMFs should be excluded from structural reforms because these funds (i) do not impose or contribute to systemic risk; (ii) have very high levels of weekly liquidity; and (iii) hold securities that are less likely than prime MMFs to suffer loss of principal. We discuss each of these reasons in more detail below.

A. Tax-exempt MMFs do not impose or contribute to systemic risk.

Tax-exempt MMFs currently invest approximately $268 billion in short-term municipal securities, representing about 10% of all MMF assets.[22] If the SEC were to impose Option I on the prime MMF industry, the SEC will have impacted $1.4 trillion of MMF assets through some type of significant structural reform measure. It is simply not plausible that 10% of the industry's assets could cause, or meaningfully contribute to, financial market stress once structural reforms have been imposed on prime MMFs. Since the purpose of this second round of MMF reform is intended to mitigate systemic risk concerns,[23] we believe tax-exempt money market funds should be excluded from structural reforms.

In addition to the size of this industry being too small to shake the financial system, it is worth noting that the municipal market has less issuer concentration than the prime market. Latest figures indicate that the municipal market has approximately 60,000 issuers while the prime market has about 130 issuers. The largest municipal issuer, the state of California, has approximately $80 billion in outstanding debt, of which approximately 4% is issued as commercial paper and variable-rate demand notes.[24] Even if all of the short-term debt issued by California were held by tax-exempt MMFs (which is

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[22] *See* Investment Company Institute, "Money Market Mutual Fund Assets," dated August 15, 2013 at http://www.ici.org/research/stats/mmf/mm_08_15_13.

[23] 77 Fed.Reg.69455 (November 19, 2012); Financial Stability Oversight Council, "Proposed Recommendations Regarding Money Market Mutual Fund Reform" (2012) available at http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

[24] Source: California State Treasurer's office, as of August 31, 2013, adjusted for the September bond issue.

not the case), such debt would comprise just 1.2% of all tax-exempt MMF assets. The municipal market simply does not have the issuer concentration that is characteristic of the prime industry.

The short-term municipal market also has a strong track record of repaying its obligations. Nonetheless, much attention has been paid recently to various municipal bankruptcies, such as Vallejo and Stockton, California; Harrisburg, Pennsylvania; Central Falls, Rhode Island; Detroit, Michigan; and Jefferson County, Alabama. Notwithstanding these bankruptcies, municipal MMFs did not experience disruptive redemptions, nor did such bankruptcies produce "contagion" effects in the prime market. In fact, we are unaware of any instance when a credit deterioration in one municipal issuer caused credit deterioration in other municipal or corporate issuers in systemic proportions. Municipal issuers simply do not transmit systemic risk.

This point is underscored by the fact that shareholder redemption activity experienced by tax-exempt MMFs during the 2008 financial crisis was not similar to the shareholder activity experienced by most prime MMFs. As Appendix A-1 illustrates, the top 25 institutional prime MMFs experienced, on average, a decline in net assets of 10% from September 9-16, 2008. During the following week, the same top 25 institutional prime MMFs experienced an average net asset decline of 24%. During the same two-week period, the 10 largest tax-exempt MMFs experienced an average decline in net assets of 1.3% and 3.6%, respectively.[25] The tax-exempt MMF industry's relatively small size, diversified municipal issuer base, and history of maintaining stable assets in times of severe financial market stress are reasons why these funds do not impose or contribute to systemic risk.

B. Tax-exempt MMFs have very high levels of weekly liquidity.

Unlike prime MMFs, tax-exempt MMFs maintain significant levels of weekly liquidity. Typically, national tax-exempt MMFs hold approximately 80% of fund assets in securities that are payable in seven days or less,[26] while state tax-exempt funds hold approximately 75% of assets in the same type of securities. While prime funds generally hold 30% of assets in weekly securities, tax-exempt MMFs have more than twice this amount in weekly liquidity. Such highly liquid assets allow these funds to withstand exceptionally high levels of shareholder redemptions, for the reasons explained in Part III.C below, even if a large number of redemptions should occur in a day.

C. Municipal weekly securities are structured differently than prime MMF securities and are less likely to suffer loss of principal.

Unlike most prime MMF securities, where the securities have interest rates that reset monthly, quarterly or yearly, tax-exempt securities held by MMFs typically reset their interest rates on a weekly basis, coupled with a corresponding put feature provided by a bank or financial institution. This distinction creates a very important difference in how "distressed" municipal MMF securities trade in the secondary market. The weekly reset feature common to most tax-exempt MMF securities allows the security to accurately reflect the interest rate that sufficiently compensates the investor for the risk associated with holding that security for another seven days. In the event a MMF determines that a weekly security no longer presents minimal credit risk, the fund can sell that security into the market at an interest rate that reflects the then-current risk associated with holding the security. The timeliness of the interest rate reset function allows the fund to sell the security <u>at par</u> (i.e., full payment of principal and interest), upon seven days notice, via a designated remarketing agent to other interested buyers, including but not limited to tax-exempt and taxable bond funds, which have an appetite for such product at adjusted market levels. The ability to resell weekly securities at par allows a fund to raise liquidity quickly in

[25] *See* Appendix A-3.

[26] *See* Appendix B (showing weekly liquidity levels held in the Vanguard Tax-Exempt Money Market Fund from January, 2008 through July, 2013).

response to shareholder redemptions, even if such redemptions were concentrated on one day. Rarely do the banks or financial institutions that provide the put feature need to step in to provide liquidity to weekly tax-exempt securities. When they do, the banks are paid an exceptionally high interest rate by the issuers for as long as the bank needs to hold the securities on its books. This exceptionally high rate is designed to incent the issuer to restructure its securities, thereby taking them off the books of the banks or financial institutions.[27]

"Distressed" prime MMF securities are unlikely to trade at par in the secondary market. These securities, with longer interest reset periods, do not have a way to adjust interest paid by the issuer to the investor to compensate for the issuer's deteriorating credit condition. As a result, when a prime MMF tries to sell a distressed security, it may have to take a loss in principal to provide the purchaser of the distressed security with a yield that more accurately compensates for the weaker credit.

The SEC's Proposal also discusses how tax-exempt MMFs can have exposure to some of the same financial firms as prime MMFs,[28] and is the primary reason why municipal MMFs are cited as having the hypothetical potential to contribute to systemic risk. This concern is overstated and should be balanced against the facts. Prime funds typically hold taxable securities, such as commercial paper, issued by banks or other financial institutions. When the credit quality of the issuer deteriorates, these funds are directly exposed to that issuer. The exposure can only be removed by selling the security—the issuer cannot be replaced. The sale of such security, when market conditions are dire, is likely to occur at a loss for the reasons previously stated in the paragraph above.

While it is true that weekly securities, such as variable rate demand notes and tender option bonds, often will have banks or other financial firms provide credit enhancements or liquidity agreements, these banks and financial firms are not the issuers of the securities. The issuers of tax-exempt weekly securities are one of the 60,000 state, municipal, or other tax-exempt entities that comprise the municipal market. A municipal MMF's exposure to a bank or financial firm providing credit enhancement or liquidity is ancillary. Under normal circumstances, the credit enhancement or liquidity agreement is in place to improve the overall credit quality or liquidity of the tax-exempt MMF security. In the event that a credit enhancement or liquidity arrangement no longer improves a security's credit quality or liquidity, the municipal issuer has the ability, and is often incented, to substitute or remove the credit enhancer or liquidity bank without financial loss to the MMF.[29]

IV. <u>Comments on Proposed Disclosure, Diversification, and Portfolio Management Changes for MMFs</u>

A. Disclosure

We generally support the Commission's proposals to improve awareness among investors of the stability and liquidity of their MMFs. For this reason, we support disclosure of a fund's daily and weekly liquidity levels, and we would support disclosure of a fund's market-value NAV. We suggest that the requirement to provide six-month historical information on the market-value NAV and liquidity levels be effective on a rolling basis after the effective date of the final rule. Given that public reporting of the market-value NAV has not been a requirement for MMFs in the past, fund companies may not have all of the historical data necessary to provide this information immediately upon effectiveness of the rule.

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[27] We note that weekly municipal securities are also accepted as collateral at the Federal Reserve Bank's discount window.

[28] *See* 77 Fed. Reg. 69463 (Nov. 19, 2012); Financial Stability Oversight Council, "Proposed Recommendations Regarding Money Market Mutual Fund Reform" (2012).

[29] Since 2008, we have also observed an increase in municipal issuers providing self-liquidity for their securities.

We do not, however, support the proposal to require web disclosure of net cash flows on a daily basis. One-day cash flows do not provide helpful information to investors and could be misinterpreted. For example, a retirement plan sponsor notifies its fund advisor of an anticipated large redemption well in advance, as is typical when a retirement plan changes its underlying investment options. This large redemption could cause the fund to be in a large net-outflow position for one day. The fund, however, would be well prepared to accommodate the redemption, with no impact on its overall ability to maintain adequate levels of liquidity. The disclosure of the one-day net outflow could be misinterpreted by fund shareholders as indicative of a problem within the fund. Disclosure of a fund's daily net cash flows does not improve an investor's ability to make prudent decisions about his or her investment in a MMF. Disclosure of a fund's daily and weekly liquidity levels is a far more helpful data point for investors to use.

We support the Commission's proposal to require advisors to include SAI disclosure to inform investors of past support an advisor may have provided to its MMFs and to file new Form N-CR with the Commission. We do not believe, however, that financial support should include instances where an advisor is providing a fee waiver. Fee waivers are indicative of today's low interest rate environment, and are not indicative of credit or liquidity stress in a MMF. Including fee waivers as a form of financial support could cause investors to draw incorrect assumptions about the stability and liquidity of their funds. We encourage the SEC to clarify that fee waivers are not intended to be included in the definition of "financial support." In addition, we do not believe that all instances of an advisor, or its affiliates, purchasing shares of its MMFs should qualify as "financial support." Many investment advisors have MMFs that are only used by the advisors' other mutual funds. In these cases, purchasing shares of the affiliated MMF is a daily event, and is not indicative of the advisor providing financial support to the fund to rescue a distressed security or to provide additional liquidity. We ask the Commission to clarify that these purchases of MMF shares do not constitute "financial support," and would not require the advisor to file Form N-CR or make the corresponding SAI disclosures.

With respect to the new information that is proposed to be included on Form N-MFP, we oppose the new security-level disclosure described in items C.17 and C.25 of the form. This information, to be reported on a lot basis, would include the purchase/sale price, purchase/sale date, yield at purchase/sale, among other data points. Compiling this information every month for all of the securities in our MMFs would be extremely burdensome and expensive. The Proposal explains that this additional information would be beneficial, as it would allow for price discovery. We believe this detailed level of portfolio information would also allow for a less desirable outcome—free riding. Such detailed information about MMF portfolios would allow professional investors to mirror the portfolio management techniques of our investment management team, thereby reducing the value we are able to provide to our investors. We believe that price discovery is important for the overall health of our financial markets, but if the Commission is truly concerned about price discovery in fixed income securities, we believe there are more appropriate ways it can achieve this goal. We also note that the requirement to have two security identifiers (i.e., a CUSIP and an ISIN or CIK) for each security reported on Form N-MFP would not be possible for municipal securities, where multiple security identifiers are simply not available. We request that the proposal be revised to allow advisors to continue to report their MMF securities using only one identifier.

With respect to the SEC's proposal to require new Form N-CR and Form N-MFP data to be reported on a fund's website, we request that fund companies be permitted to satisfy this requirement through the use of web links. Re-formatting the data required to be filed on these forms to be website compatible would be extremely time consuming and expensive. Investors who are interested in the data provided on Form N-MFP may already obtain the information through the SEC's website. Providing a link to each fund's filing on the SEC's website would be a simple and cost-effective way to direct those investors to the forms. We also understand that some investors have an interest in obtaining such detailed fund information quickly, and for this reason, Vanguard supports making Form N-MFP publicly available 10 business days after filing with the SEC. The proposal to make such information publicly available immediately upon filing does not serve the best interest of investors. A small delay in the public availability of this information will ensure that advisors have an opportunity to correct reporting errors that sometimes arise when completing this form.

Finally, if the SEC requires fund companies to make all of the proposed disclosures, the nine-month implementation period proposed is simply not long enough. We would request that the disclosure implementation period be extended to 18 months.

B. Diversification

The Proposal would require MMFs to aggregate exposures to affiliated credit sources for purposes of complying with Rule 2a-7's issuer diversification limits. We support this aggregation requirement, as it reflects our current practice of how we test for issuer diversification. We believe aggregating exposures to affiliated entities is a more accurate way to test a fund's issuer diversification, and it reduces the risk that any one fund becomes too heavily exposed to credit sources that are likely to be highly correlated in their ability to perform on the fund's securities.

We also support the proposal to have funds diversify against ABS sponsors, with one important caveat for tender option bonds ("TOBs"). Many fund companies purchase ABS securities and rely on the ABS sponsor to purchase the security if it should default or become illiquid. This is because many ABS securities do not have committed liquidity providers or credit enhancers. The proposed requirement would codify this practice, effectively and appropriately limiting a fund's exposure to ABS sponsors. TOBs, however, differ from other ABS in that TOB structures always have dedicated liquidity providers and frequently have credit enhancement, neither of which may be provided by the TOB sponsor. Rule 2a-7 requires that a MMF diversify against the liquidity provider and credit enhancer (to the extent a fund relies on such entities to make the TOB certificates 2a-7 eligible). Where the TOB sponsor has no role in providing credit enhancement or liquidity to the TOB certificates, diversification against the TOB sponsor is unnecessary.

C. Portfolio Management Changes

1. <u>Municipal MMFs Should Not be Required to Hold 10% of Assets in Daily Liquidity</u>.

The Proposal requests comments on whether municipal MMFs should be required to hold 10% of fund assets in securities that are payable within one day. The Proposal explains that some tax-exempt MMFs already hold 10% in daily liquidity, and making this a requirement could better position the funds to withstand significant redemptions that may occur within a day. Vanguard does not support a daily liquidity requirement for tax-exempt MMFs. Given the high levels of weekly liquidity held by these funds,[30] coupled with the low levels of shareholder redemptions that occurred during the most tumultuous market crisis since the Great Depression, we do not believe such a requirement is necessary for investor protection.[31] In addition, such a requirement could cause a fund to hold lower credit quality securities to satisfy the requirement. The availability of variable rate demand notes in a daily reset mode is inconsistent at best. At a minimum, if tax-exempt MMFs were required to hold 10% in daily liquidity, there will be instances where some funds, particularly state tax-exempt funds, would be forced to find alternatives. These alternatives are unattractive and include options such as purchasing out of state

[30] For the reasons discussed in Part III.C above, the interest rate reset mechanism on weekly securities allows these securities to reprice every seven days at par, which allows a fund to readily sell these securities to raise liquidity to pay for redemptions.

[31] *See* Appendix C illustrating the Vanguard Tax-Exempt Money Market Fund's daily cash flow volatility from July, 2008 through December, 2008.

municipal bonds, the interest on which may not qualify for the investor's state tax exemption[32], purchasing Treasury securities (not federally tax-exempt), and/or increasing the potential for additional costs associated with holding bank cash balances. We understand the SEC has stated that, based on a particular point in time, many tax-exempt funds already appear to maintain high levels of daily liquidity. We would argue that in order to maintain a 10% level of daily liquidity at all times, a fund would need to maintain even higher levels of these instruments in order to meet redemptions, or to fund any immediate investment opportunities fundamental to the daily cash management process. For these reasons, we oppose the 10% daily liquidity requirement for municipal MMFs.

2. <u>Rule 2a-7 Should Retain the 25% Basket</u>.

The Proposal contemplates removing some of the current flexibility under Rule 2a-7, which permits fund managers to have up to 25% of fund assets subject to guarantees or demand features from a single institution. The SEC states that the proposed change will limit the extent to which a money market fund can become exposed to any one guarantor or demand feature provider. We urge the Commission to retain the 25% basket. The 25% basket is particularly useful for tax-exempt MMFs, as it provides the flexibility to obtain greater exposure to a strong credit source in times when the availability of guarantors and demand feature providers with high credit quality may be scarce. Eliminating such flexibility could subject investors to heightened credit risk in a fund, which might increase a fund's likelihood of experiencing a credit event. The 25% basket has not been the reason funds have experienced credit events in the past, and we ask that the Commission retain the provision for use by MMFs when many high quality credits are not available.

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We commend the Commission for its thoughtful Proposal, and we appreciate the opportunity to provide our thoughts and concerns on this very important issue. If you have any questions about Vanguard's comments or would like any additional information, please contact Laura Merianos, Principal, at (610) 669-2627.

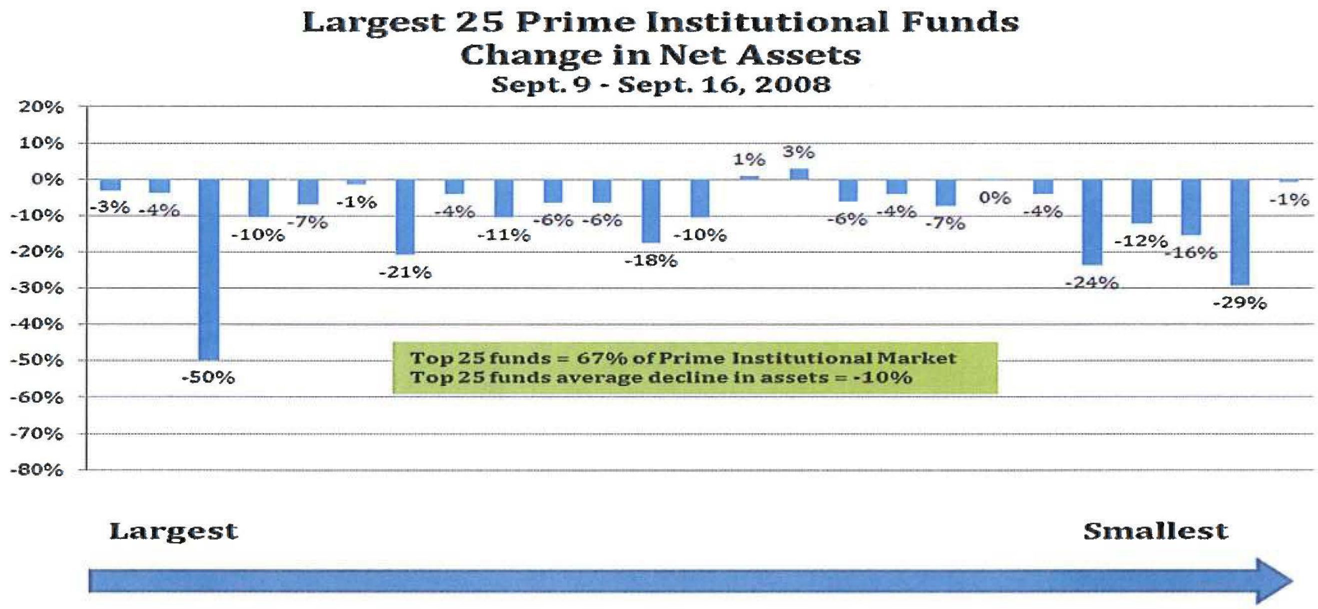
Sincerely,

F. William McNabb III
Chairman and Chief Executive Officer
Vanguard

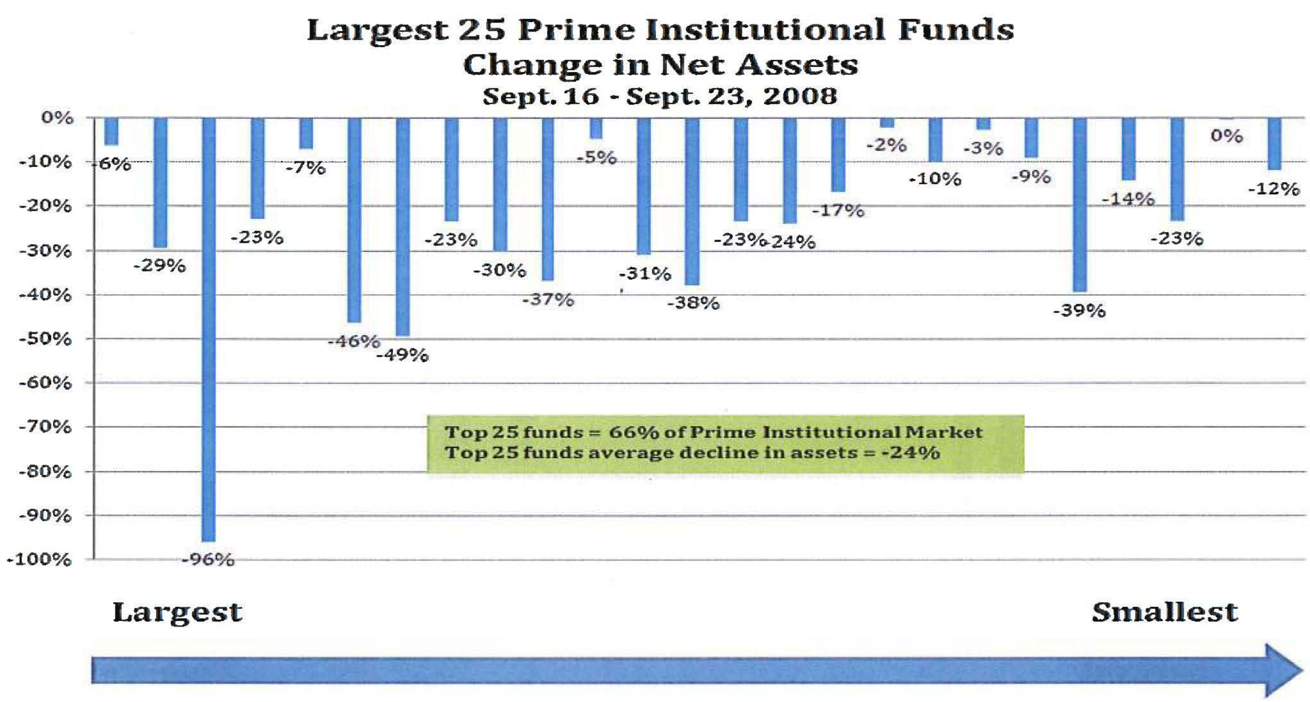
cc: The Honorable Mary Jo White
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Michael S. Piwowar
The Honorable Kara M. Stein
Norm Champ, Director
Division of Investment Management

[32] For many of the investors who choose a state tax-exempt fund over a national tax-exempt fund, it is the exemption from state taxes that is the primary driver for the investment decision.

APPENDIX A-1



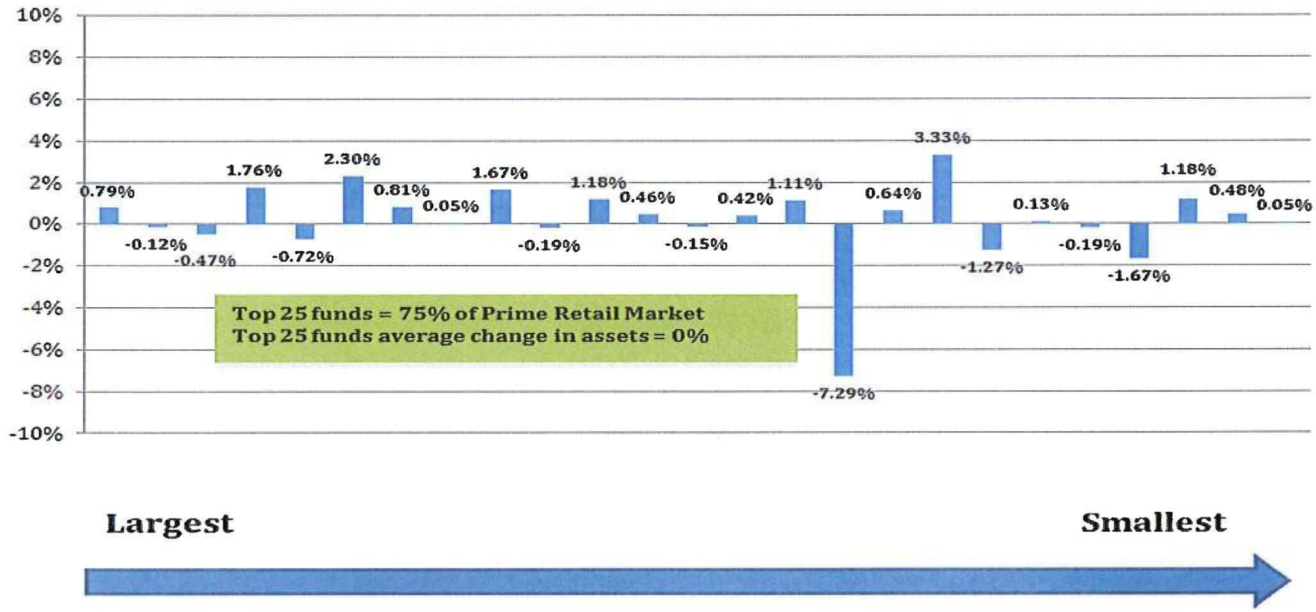
Source: iMoneyNet



Source: iMoneyNet

APPENDIX A-2

Largest 25 Prime Retail Funds
Change in Net Assets
Sept. 9 - Sept. 16, 2008

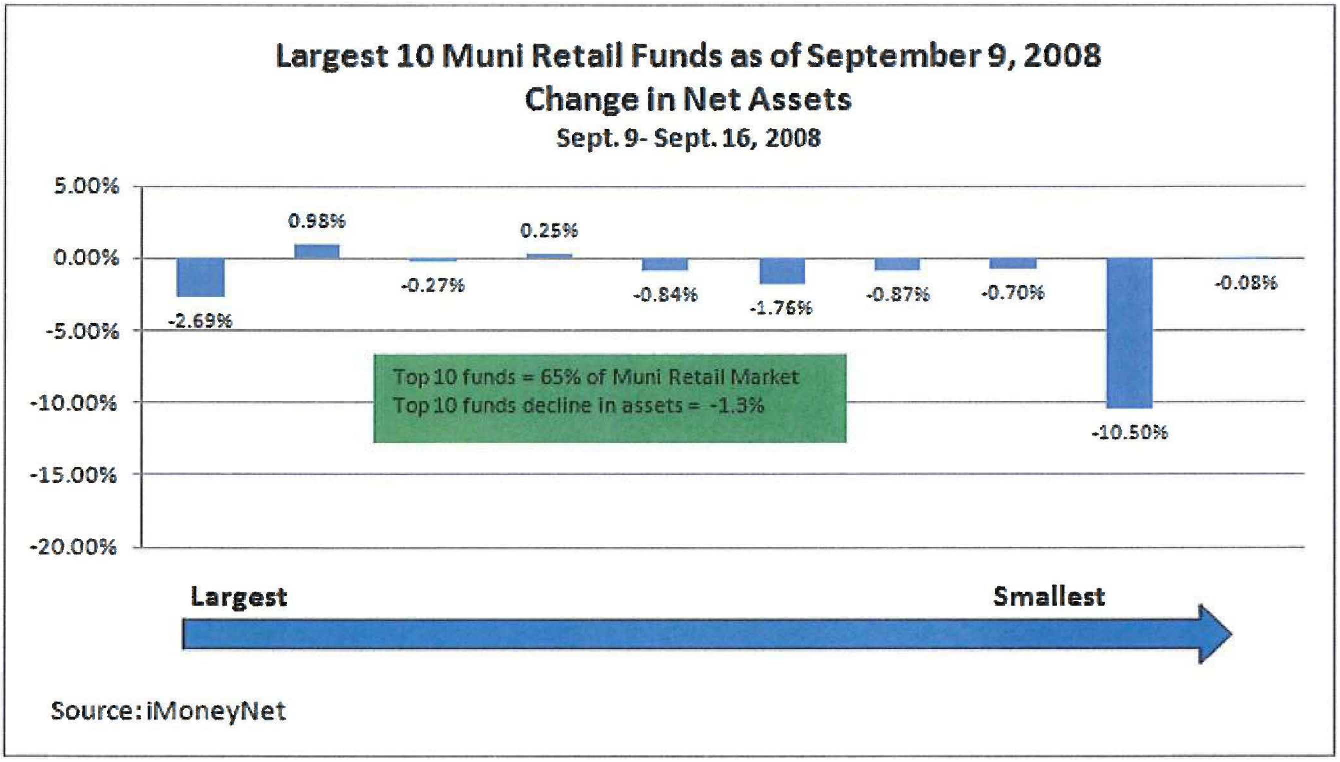


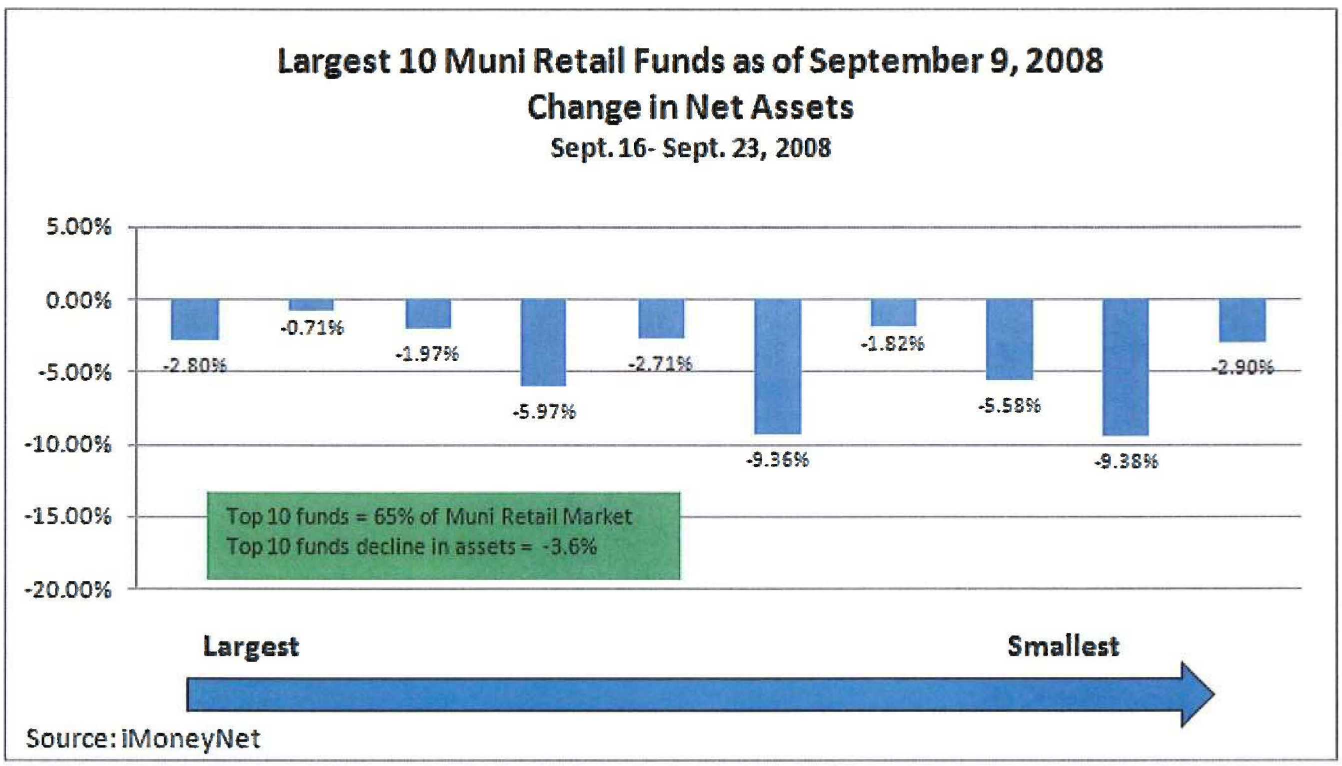
Source: iMoneyNet

Largest 25 Prime Retail Funds
Change in Net Assets
Sept. 16 - Sept. 23, 2008

Source: iMoneyNet

APPENDIX A-3





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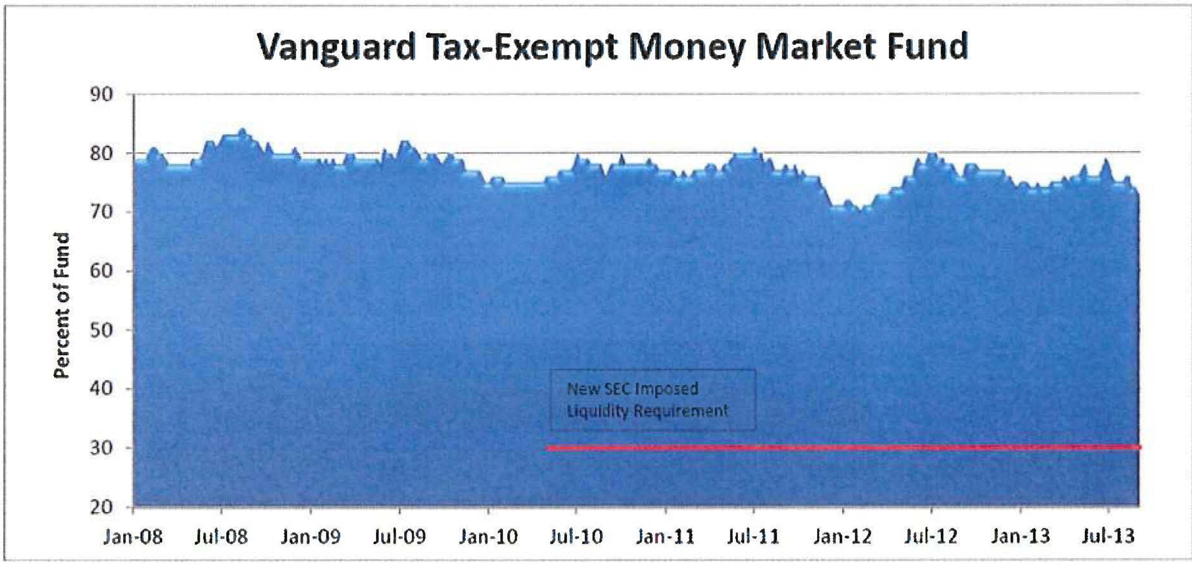
APPENDIX B



APPENDIX C