January 25, 2013

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

Re: President’s Working Group Report on Money Market Fund Reform; Rel. No. IC-29497; File No. 4-619; Comment submitted on the Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket No. FSOC-2012-0003); Alternative One: Floating Net Asset Value

Dear Ms. Murphy:

Enclosed is a copy of comments we submitted today on behalf of our client, Federated Investors, Inc., to the Financial Stability Oversight Council (the “Council”) on the Council’s recently issued Proposed Recommendations Regarding Money Market Mutual Fund Reform; specifically, “Alternative One: Floating Net Asset Value.” We ask that our comments be made a part of the Commission’s record.

Sincerely,

John D. Hawke, Jr.
January 25, 2013

The Honorable Timothy Geithner
Chairman, Financial Stability Oversight Council
C/o Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003); Alternative One: Floating Net Asset Value

Dear Secretary Geithner:

We are writing on behalf of our client, Federated Investors, Inc., and its subsidiaries (“Federated”), to provide comments in response to the Financial Stability Oversight Council’s (the “Council’s”) recently issued Proposed Recommendations Regarding Money Market Mutual Fund Reform (“Proposed Recommendations” or “Release”); specifically, “Alternative One: Floating Net Asset Value.” The Release would require money market mutual funds (“MMFs”) to have a floating net asset value (“NAV”) per share, and would also require MMFs to initially re-price their shares to $100.00 each. In conjunction with this alternative, the Release also proposes to rescind Securities and Exchange Commission (SEC) Rules 22e-3 and 17a-9, which were adopted as part of the SEC’s 2010 reforms responding to the financial crisis.

As discussed in greater detail in our letter of December 17, 2012, we believe the Council has arbitrarily and improperly invoked its Dodd-Frank Section 120 authority, in an attempt to pressure the SEC to move forward on proposals that a majority of its commissioners found unsupported by data or economic analysis and potentially risky to the financial system. The Council ignored the overwhelming public comments in the SEC docket raising substantial concerns about the very proposals the Council put forward.

in its Release. We do not believe Congress intended the Section 120 process to be used arbitrarily and in disregard of agency processes, in circumstances where an agency is continuing to grapple with a regulatory issue under its direct jurisdiction, simply because, in this case, the agency’s former chair could not muster the votes for proposals that clearly would be ineffective in achieving their primary purpose, would introduce more risk to the system, and would impose significant costs to issuers and investors.

We, nonetheless, appreciate the opportunity to provide comments and, again, call to the Council’s attention the significant flaws in the proposed reforms, which should have been abundantly clear from the comment letters, reports and surveys compiled in the SEC’s docket and available to the Council before it issued its Release.

As discussed in the enclosed paper, the Council should not recommend that the SEC adopt the proposal described in Alternative One, for the following reasons:

(1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating “runs.” There is no data to support this proposition and, indeed, the data show just the opposite.

(2) The floating NAV proposal is based on an unproven notion of “first-mover advantage,” the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.

(3) A stable NAV does not create an arbitrage opportunity for MMF shareholders.

(4) The elimination of the stable NAV is wholly unnecessary to address the perceptions of investors, who know and understand that MMFs are investments that are “not FDIC insured” and “may lose value.”

(5) A floating NAV would not reflect a measurably more “accurate” valuation of MMF shares than the amortized cost accounting method currently used by MMFs.

(6) A floating NAV, with a mandated $100.00 initial share price, would not be “consistent with the requirements that apply to all other mutual funds” but rather would be arbitrary and punitive, and would destroy MMFs as a product.

(7) A floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate MMFs as a viable cash management tool by destroying their principal liquidity function.
A floating NAV, for the sake of showing minute variations in value that cancel out over time, also would impose significant operational, accounting and tax burdens on users of MMFs and destroy their utility.

A floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

A floating NAV, because of the operational burdens, costs, and other impediments, would substantially shrink the assets of MMFs.

A floating NAV would therefore contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.

A floating NAV would force current MMF users to less regulated and less transparent products.

A floating NAV would accelerate the flow of assets to “Too Big to Fail” banks, further concentrating risk in that sector.

The Council’s proposal to rescind Rules 22e-3 and 17a-9 would remove important 2010 reforms designed to protect investors.

Instead of focusing on the floating NAV, regulators should consider how MMF’s enhanced liquidity has proved to be effective in absorbing heavy redemption requests, and how it has improved the characteristics of the marketplace from 2008.

We urge all members of the Council to review the comments submitted in response to its Release and to give careful thought to the issues discussed in the attached paper as well as those raised by other commenters. We further urge the Council to withdraw its Release.

Sincerely,

John D. Hawke, Jr.

Enclosure
cc: Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
Elisse B. Walter, Chairman of the U.S. Securities and Exchange Commission
Thomas J. Curry, Comptroller of the Currency
S. Roy Woodall, Jr., Independent Member with Insurance Expertise
John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions
John Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Michael McRaith, Director of the Federal Insurance Office
Eric Froman, Office of the General Counsel, Department of the Treasury
Amias Gerety, Deputy Assistant Secretary for the Financial Stability Oversight Council
Sharon Haeger, Office of the General Counsel, Department of the Treasury
Mary Miller, Under Secretary of the Treasury for Domestic Finance
Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission
Troy A. Paredes, Commissioner, U.S. Securities and Exchange Commission
Daniel M. Gallagher, Commissioner, U.S. Securities and Exchange Commission
Diane Blizzard, Deputy Director, Division of Investment Management, U.S. Securities and Exchange Commission
Norman B. Champ, Director, Division of Investment Management, U.S. Securities and Exchange Commission
David W. Grim, Deputy Director, Division of Investment Management, U.S. Securities and Exchange Commission
Craig Lewis, Director and Chief Economist, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission
Penelope Saltzman, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission
Proposal for a Floating NAV for Money Market Mutual Funds: Ineffective in Protecting Against Runs in a Crisis; Harmful to Investors and the Economy

Comment Submitted for Docket No. FSOC-2012-0003

January 25, 2013

Prepared by Arnold & Porter LLP on behalf of Federated Investors, Inc.
Proposal for a Floating NAV for Money Market Mutual Funds: Ineffective in Protecting Against Runs in a Crisis; Harmful to Investors and the Economy

We are submitting this paper on behalf of our client, Federated Investors, Inc., and its subsidiaries ("Federated"). Federated has served since 1974 as an investment adviser to money market mutual funds ("MMFs").

This paper responds to the release issued by the Financial Stability Oversight Council ("Council") requesting comment on Proposed Recommendations Regarding Money Market Mutual Fund Reform ("Release"); specifically, "Alternative One: Floating Net Asset Value." Under this alternative, money market mutual funds ("MMFs") would be required to have a floating net asset value ("NAV") per share and would not be allowed to use amortized cost accounting and/or penny rounding to maintain a stable NAV. The Release states that the value of MMFs' shares "would not be fixed at $1.00 and would reflect the actual market value of the underlying portfolio holdings, consistent with the requirements that apply to all other mutual funds." The Release describes this alternative as requiring that MMFs re-price their shares to $100.00 per share (or initially sell them at that price), in order to be "more sensitive to fluctuations" in the value of the portfolio's underlying securities. The Release proposes a potential transition period of up to five years, in which the Securities and Exchange Commission ("SEC") would prohibit new share purchases in grandfathered stable NAV funds after a pre-determined date, and any new share purchases would have to be made in floating NAV funds.

While all of the restrictions of Rule 2a-7 would remain, the Release proposes to rescind two existing SEC rules, adopted as part of the SEC’s 2010 reforms responding to the financial crisis. The first is Rule 22e-3, which currently allows an MMF board to suspend redemptions.

1 Federated has thirty-nine years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated’s Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.


3 Release at 69466.

4 Id.

5 Id. The requirement for MMFs to price their shares at $100.00 per share is not “consistent with the requirements that apply to all other mutual funds.” This issue is addressed extensively in a Letter from Stephen Keen to the Council. Letter from Stephen A. Keen to Financial Stability Oversight Council (Nov. 26, 2012), http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0004. No current law or regulation requires an investment company under the Investment Company Act of 1940 to offer its shares at a particular price.
and begin an orderly liquidation if the fund has broken or is about to break the buck. The Release rationalizes that a floating NAV diminishes the need for MMF sponsors or boards to suspend redemptions or otherwise intervene upon share price declines. The second is Rule 17a-9, which allows affiliates of an MMF to purchase portfolio securities from an MMF, which the Release says “typically” is used to support an MMF’s stable price per share. The Release rationalizes that since a floating NAV fund is designed to fluctuate in value, allowing this type of support would be unnecessary.

The Release describes the benefits of this proposal as (1) reducing the perception that shareholders do not bear any risk of loss in an MMF; (2) making MMFs operate like other mutual funds, showing day-to-day fluctuations; (3) removing uncertainty or confusion regarding who bears the risk of loss in an MMF; and (4) reducing “first-mover advantage.” The Release acknowledges, however, that a floating NAV “would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future . . . .” In short, a floating NAV will not remove the risk of “runs.” It also acknowledges, but does not size or attempt to address, significant tax, accounting, and operational costs that would result from the proposal.

In its perfunctory statement of the benefits and costs associated with a floating NAV, the Council largely ignores the extensive record of public comments in the SEC’s docket on this subject. As these comments explain, the stability, diversification, and high credit quality of MMFs over the years has enabled millions of individuals, businesses, nonprofits, and state and local governments to invest significant portions of their liquid assets in these funds – with total

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6 Release at 69466. See 17 C.F.R. § 270.22e-3.
7 Release at 69466.
8 Id. See 17 C.F.R. § 270.17a-9.
9 Release at 69466.
10 Id. at 69466-67.
11 Id. at 69467.
12 Id.
13 These comments were filed over a three-year period in response to the SEC’s 2009 proposed rule on Money Market Fund Reform, the SEC’s request for comment on the 2010 Report of the President’s Working Group on MMF Reform Options, and the public statements made by former SEC Chairman Mary Schapiro in which she outlined what she believed a further formal proposed rule would include. Unless otherwise stated, all letters cited in this paper were filed in response to the SEC’s Request for Comment on the President's Working Group Report on Money Market Fund Reform, File No. 4-619, http://www.sec.gov/comments/4-619/4-619.shtml (letters dated 2010 or later) or the SEC’s Request for Comment on a Proposed Rule: Money Market Fund Reform, File No. S7-11-09, http://www.sec.gov/comments/s7-11-09/s71109.shtml (letters dated 2009).
shareholder balances today exceeding $2.7 trillion. Individual investors rely upon the convenience of the one dollar per share pricing, which is why investors throughout the U.S. have opposed proposals to require MMFs to “float” their NAV. As the AARP has stated, “the requirement of floating net asset values would radically and detrimentally alter the role and function of money market funds, discourage the use of money market funds for individual investors, and disrupt the financial market landscape for investors.”

In addition, many institutional users of MMFs – corporations, state and local governments, and trustees, cannot (by law or investment guidelines) or will not (because of cost, operational, tax, or accounting considerations) use a floating NAV MMF. Indeed, the one dollar per share pricing is critical to the utility of MMFs for a variety of applications involving automated accounting and settlement systems and is incorporated into many automated systems and the interfaces used in these systems.

Although the Release contains several footnote references to isolated letters and surveys in the SEC’s comment file, the vast majority of comments were not referenced in the Release and apparently not considered by the Council. The hundreds of individually distinct public comment letters in the SEC’s docket contained substantial research, data, reports, surveys and other analyses developed over a period of almost two years. Commenters put forward data and research regarding the adverse impact of requiring MMFs to adopt a floating NAV; they also argued strongly that, based on their analysis of the data, the proposal not only would fail to prevent or reduce the risk of runs in a crisis, it in fact could precipitate runs and increase systemic risk. The Federal Reserve Bank of New York (“FRBNY”) in a recent report highlighted these same concerns, as did the President’s Working Group on Financial Markets...
in its 2010 report on MMFs (“PWG Report”). As stated above, in its own Release, the Council itself acknowledges that “while a floating NAV would remove the ability of a shareholder to redeem shares at $1.00 when the market value is less than $1.00, it would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future, consistent with the incentive that exists today for other types of mutual funds.”

Moreover, although the Release states the transition period would “reduce potential disruptions and facilitate the transition to a floating NAV for investors and issuers,” this contention wholly ignores the asset flows of the MMF industry. MMF investors use MMFs as cash management accounts. Given that 50% or more of the assets held in MMFs may turn over in under a month, the structure of the transition period ensures that most users will have very little time to adjust to the floating NAV. As a result, MMF users will rapidly feel the effects of

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continue to pose systemic risks if assets migrate to other, less regulated, less transparent stable-NAV products (such as offshore MMFs and some private liquidity funds). Alternatively, if institutional investors move cash to banks, the banking system might experience a large increase in uninsured, ‘hot money’ deposits. . . . [A] floating NAV might lead to a steep decline in investor demand for MMF shares and a migration of assets to less regulated vehicles that continue to offer stable NAVs. Moreover, even if MMFs with floating NAVs remain sizable, they might continue to be vulnerable to runs, since investors in distressed funds still would have strong incentives to redeem.” Patrick E. McCabe, et al., The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds, Federal Reserve Bank of New York Staff Study No. 564 at 6, 54 (July 2012), http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf (“FRBNY Staff Report”). Astonishingly, while acknowledging that a floating NAV cannot be relied upon to address the potential for MMF runs, and further noting the potential for significant adverse economic consequences if such a proposal were adopted, the FRBNY Staff Report nonetheless suggested that regulators could give investors a choice between two types of MMFs: floating NAV funds alongside others that would have stable NAVs but be required to maintain minimum balances subject to subordination. Id. at 54. This provides no choice for investors; floating NAV funds are available today, and investors who need the stability and liquidity of MMFs have rejected them.

19 The 2010 report warned that adopting a floating NAV would make MMFs a less desirable or even useless product for certain kinds of investors, the redemptions from which may cause deleterious and unintended consequences for a variety of users and credit markets as a whole. The report also said that the very shift to a floating NAV could cause major disruptions: “MMFs are the dominant providers of some types of credit, such as commercial paper and short-term municipal debt, so a significant contraction of MMFs might cause particular difficulties for borrowers who rely on these instruments for financing. If the contraction were abrupt, redemptions might cause severe disruptions for MMFs, the markets for the instruments the funds hold, and borrowers who tap those markets.” Report of the President’s Working Group on Financial Markets: Money Market Fund Reform Options at 21 (Oct. 2010), http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf (“PWG Report”).

20 Release at 69467.

21 Id. at 69466.

22 Professor David W. Blackwell, Professor Kenneth R. Troske, and Professor Drew B. Winters, Money Market Funds Since the 2010 Regulatory Reforms: More Liquidity, Increased Transparency, and Lower Credit Risk at 44 (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf (tracking

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the burdens associated with the shift to a floating NAV, and the change itself is likely to bring about dislocations in short-term credit markets and the broader economy.

As discussed in more detail below, the Council should not propose that the SEC require a floating NAV for MMFs for the following reasons:

(1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating “runs.” There is no data to support this proposition and, indeed, the data show just the opposite.

(2) The floating NAV proposal is based on an unproven notion of “first-mover advantage,” the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.

(3) A stable NAV does not create an arbitrage opportunity for MMF shareholders.

(4) The elimination of the stable NAV is wholly unnecessary to address the perceptions of investors, who know and understand that MMFs are investments that are “not FDIC insured” and “may lose value.”

(5) A floating NAV would not reflect a measurably more “accurate” valuation of MMF shares than the amortized cost accounting method currently used by MMFs.

(6) A floating NAV, with a mandated $100.00 initial share price, would not be “consistent with the requirements that apply to all other mutual funds” but rather would be arbitrary and punitive, and would destroy MMFs as a product.

(7) A floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate MMFs as a viable cash management tool by destroying their principal liquidity function.

(8) A floating NAV, for the sake of showing minute variations in value that cancel out over time, also would impose significant operational, accounting and tax burdens on users of MMFs and destroy their utility.

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redemptions in the five largest MMFs by month for 2011). Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012) (describing the various specialized uses of MMFs that require daily liquidity); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012) (supplying estimates of the amount of assets held for those specialized purposes).
A floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

A floating NAV, because of the operational burdens, costs, and other impediments, would substantially shrink the assets of MMFs.

A floating NAV would therefore contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.

A floating NAV would force current MMF users to less regulated and less transparent products.

A floating NAV would accelerate the flow of assets to “Too Big to Fail” banks, further concentrating risk in that sector.

The Council’s proposal to rescind Rules 22e-3 and 17a-9 would remove important 2010 reforms designed to protect investors.

Instead of focusing on the floating NAV, regulators should consider how MMF’s enhanced liquidity has proved to be effective in absorbing heavy redemption requests, and how it has improved the characteristics of the marketplace from 2008.

A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating “runs.” There is no data to support this proposition and, indeed, the data show just the opposite.

As stated above, the Release acknowledges that a floating NAV for MMFs would not achieve the regulatory goal of eliminating a shareholder’s incentive to redeem in a crisis. Although the primary justification for moving to a floating NAV is to reduce the “susceptibility” of the funds to runs, the Council offers no empirical evidence to support this view. Indeed, the evidence suggests just the opposite, a point made in numerous letters in the SEC’s comment file, borne out in the experience of floating NAV funds during the crisis, and acknowledged by the

23 Release at 69467. See also FRBNY Staff Report at 54; Professor David W. Blackwell, Professor Kenneth R. Troske, and Professor Drew B. Winters, Money Market Funds Since the 2010 Regulatory Reforms: More Liquidity, Increased Transparency, and Lower Credit Risk (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf (citing recent scholarly papers on MMF regulation confirming that a floating NAV will not stop runs); Hal Scott, Interconnectedness and Contagion, Committee on Capital Markets Regulation at 224 (Nov. 20, 2012), http://www.capmktscrg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf ( “[A] floating NAV does not address the risk of contagion among MMMF investors.”).
Council in the Release. As Professors Jill Fisch, of the University of Pennsylvania Law School, and Eric Roiter, of the Boston University School of Law, have written:

Ultra-short bond funds are a near equivalent to money market funds but for the fact that they maintain a floating NAV. While their share of assets pales in comparison to MMFs, ultra-short bond funds faced waves of redemptions comparable in respective magnitude to what MMFs faced. Indeed, contractions of ultra-short bond funds likely exacerbated the freeze in the short term credit markets. By the end of 2008, assets in these funds were 60% below their peak level in 2007. In Europe, both types of money market funds – those with stable NAVs and those with floating NAVs – have co-existed for years. Floating NAV money market funds suffered substantial redemptions during the credit crisis in 2008, leading more than a dozen of them to suspend redemptions temporarily and four of them to close altogether. French floating NAV money market funds lost about 40% of their assets during a three month period in the summer of 2007.

Fidelity Investments also has pointed out the lack of “empirical evidence to support the belief that in a period of market turmoil, funds with [Variable] NAVs would be at lower risk of significant redemptions from shareholders. In fact, during the financial crisis, VNAV funds in Europe experienced redemption pressures similar to [Constant] NAV funds.”

A recent paper by three finance and economics professors that surveyed recent scholarly papers on MMF regulation stated, “All of the papers point out problems with the [floating] NAV proposal,” and emphasized that “MMFs reporting floating NAVs can still experience runs.”

24 See Letter from Invesco to IOSCO, filed with SEC (May 25, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Dec. 15, 2011) (filed with the SEC); Letter from Fisch & Roiter to SEC (Dec. 2, 2011); Letter from Jacksonville Chamber to SEC (Jan. 31, 2011); Letter from Cincinnati Chamber to SEC (Jan. 13, 2011); Letter from ICI to SEC (Jan. 10, 2011); Letter from The Dreyfus Corporation to SEC (Jan. 10, 2011); Letter from Crane Data LLC to SEC (Jan. 10, 2011); Letter from Wells Fargo Funds Management to SEC (Jan. 10, 2011); Letter from T. Rowe Price to SEC (Jan. 10, 2011); Letter from Institutional Money Market Funds Association to SEC (Jan. 10, 2011); Letter from Vanguard to SEC (Jan. 10, 2011); Letter from Invesco Advisors to SEC (Jan. 10, 2011); Letter from SIFMA to SEC (Jan. 10, 2011); Letter from Fidelity to SEC (Jan. 10, 2011); Letter from European Fund and Asset Management Association to SEC (Jan. 10, 2011); Release at n.72 (acknowledging data submitted by commenters).


As Professor Hal Scott further explained, requiring MMFs to adopt a floating NAV would not change the characteristics of the product itself: “MMMFs would still provide the same degree of maturity and liquidity transformation. A floating NAV does not reduce the underlying risk of MMMF investments, including interest rate risk, credit risk and liquidity risk.”

One investment adviser warned that the shift to a floating NAV “could precipitate a destabilizing flood of preemptive withdrawals by investors seeking to guarantee the return of their principal. This would bring about the very result that the measure was intended to prevent in the first place: a run on funds triggering a liquidity crisis and potentially destabilizing financial markets through widespread, forced sales of portfolio holdings.” If investor confusion is a concern and investor protection is a regulatory goal, to promote the idea to investors that a floating NAV MMF is more safe and less run-prone is itself misleading.

Although the Council presumes to revive the regulatory process after the former SEC Chairman’s unsuccessful attempt to garner sufficient votes for an SEC staff proposal to require, among other regulations, a floating NAV for MMFs, the Council, like the SEC, fails to offer any data to suggest that adopting a floating NAV would achieve the regulatory goal of reducing the risk of runs. The Council also fails to address the significant body of evidence to the contrary. As a result, the criticism of the SEC staff’s proposal by SEC Commissioners Gallagher and Paredes applies equally to the Council’s Release: “[T]he necessary analysis has not been conducted to demonstrate that a floating NAV . . . would be effective in crisis.” Further, the Commissioners pointed to the “predominant incentive of investors in a crisis to flee risk and move to safety,” stating,

As for the floating NAV proposal, even if there is no stable $1.00 NAV – i.e., even if, by definition, there is no “buck” to break – investors will still have an incentive to flee from risk during a crisis period such as 2008, because investors who redeem sooner rather than later during a period of financial distress will get out at a higher valuation.


29 Letter from Invesco Advisors to SEC (Jan. 10, 2011). Accord PWG Report at 22 (“MMFs’ transition from stable to floating NAVs might itself be systemically risky. For example, if shareholders perceive a risk that a fund that is maintaining a $1 NAV under current rules has a market-based shadow NAV of less than $1, these investors may redeem shares preemptively to avoid potential losses when MMFs switch to floating NAVs. Shareholders who cannot tolerate floating NAVs probably also would redeem in advance. If large enough, redemptions could force some funds to sell assets and could make concerns about losses self-fulfilling.”).


31 Id.
Even if the Council recommends that the SEC require MMFs to float their NAVs, the SEC will need to provide data concerning the benefits of such a change – namely, whether the change would reduce the likelihood of MMF runs, versus the costs of such a change, including its impact on competition, efficiency, and capital formation. If the SEC does not “support its predictive judgments” with respect to the impact of a floating NAV, which to date it has been unable to do, it may find itself yet again on the losing end of another rule challenge.32

(2) The floating NAV proposal is based on an unproven notion of “first-mover advantage,” the theoretical risk of which is more appropriately addressed through the operation of existing SEC rules and MMF board authority.

The Council in its Release relies heavily on a theory that MMFs are susceptible to a so-called “first-mover advantage” in which investors have an incentive “to redeem their shares at the first indication of any perceived threat to an MMF’s value or liquidity.”33 This has happened only once in history, when the Reserve Fund failed to suspend redemptions after the bankruptcy of Lehman Brothers. According to the Release, “Because MMFs lack any explicit capacity to absorb losses in their portfolio holdings without depressing the market-based value of their shares, even a small threat to an MMF can start a run. In effect, first movers have a free option to put their investment back to the fund by redeeming shares at the customary stable share price of $1.00, rather than at a price that reflects the reduced market value of the securities held by the MMF.”34 Indeed, addressing the purported dangers associated with the “first-mover advantage” concept is a foundation of each of the three proposals in the Release. But the Council’s armchair theorizing about a “first-mover advantage” is flatly contradicted by the recent report by the SEC’s Division of Risk, Strategy, and Financial Innovation (RiskFin Report), as well as the requirements of Rule 2a-7 itself, which the Council ignores.

As the RiskFin Report has pointed out, a fund’s amortized cost valuation “closely tracks” the fund’s shadow price.35 In many cases, the two are identical. In the absence of a credit event

32 Business Roundtable v. SEC, 647 F.3d 1144, 1149 (D.C. Cir. 2011).
33 Release at 69456.
34 Id. The Release also states that “[r]ounding obscures the daily movements in the value of an MMF’s portfolio and fosters an expectation that MMF share prices will not fluctuate. Importantly, rounding also exacerbates investors’ incentives to run when there is risk that prices will fluctuate. When an MMF that has experienced a small loss satisfies redemption requests at the rounded $1.00 share price, the fund effectively subsidizes these redemptions by concentrating the loss among the remaining shareholders.” Id. at 69461.
involving one or more of an MMF’s assets (such as a downgrade or default) which would disrupt this close tracking, there is simply not enough of variation between the amortized cost NAV and the fund’s shadow price to create the incentive the Council now claims exists.

Moreover, Rule 2a-7 places a number of detailed remedial obligations on the board of an MMF whenever a credit event occurs. These obligations are designed to prevent the first-mover advantage from developing. In the event that a portfolio security is downgraded, Rule 2a-7 requires an MMF’s board to “reassess promptly whether such security continues to present minimal credit risks and [to] cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders” unless the fund is able to dispose of the security (or is matures) within five days of the event.\textsuperscript{36} In the event of a default, the fund must dispose of the security “as soon as practicable consistent with achieving an orderly disposition” unless the board finds that disposal would not be in the best interest of the fund.\textsuperscript{37} Rule 2a-7 also requires prompt notice to the SEC if securities accounting for 1/2 of 1 percent or more of an MMF’s total assets default (other than an immaterial default unrelated to the issuer’s financial condition) or the securities become subject to certain events of insolvency.\textsuperscript{38} In its notice, the board must state the actions the MMF intends to take in response to such event.

An MMF is only permitted to price its shares at $1.00 using the amortized cost method “so long as the board of directors believes that it fairly reflects the market-based net asset value per share.”\textsuperscript{39} If the board believes any deviation from MMF’s amortized cost price per share “may result in material dilution or other unfair results to investors or existing shareholders,” the board is required to cause the fund to take action to eliminate or reduce the effect of the dilution or unfair results.\textsuperscript{40} Further, Rule 2a-7 provides that in the event that the extent of an MMF’s deviation from the mark-to-market NAV exceeds ½ of 1 percent, the board must “promptly consider what action, if any, should be initiated . . . .”\textsuperscript{41} In other words, in the event of a material credit event involving one or more of its portfolio securities, the fund would be required to go off amortized cost for the affected portfolio securities and value its shares based on the current NAV (as defined under SEC rules) as other mutual funds do. If immediate recognition of the credit

Footnote continued from previous page and fair valuation of portfolio instruments where market quotations are not available. This is discussed in greater detail in section 5 of this paper.

\textsuperscript{36} 15 C.F.R. § 270.2a-7(c)(7)(i)(A).
\textsuperscript{37} 15 C.F.R. § 270.2a-7(c)(7)(ii).
\textsuperscript{38} 15 C.F.R. § 270.2a-7(c)(7)(iii).
\textsuperscript{39} 15 C.F.R. § 270.2a-7(c)(1).
\textsuperscript{40} 15 C.F.R. § 270.2a-7(c)(8)(ii)(C).
\textsuperscript{41} 15 C.F.R. § 270.2a-7(c)(8)(ii)(B).
problem causes the MMF to break the buck, a redeeming shareholder would receive the current NAV for each share redeemed, rather than $1.00. That shareholder would not be receiving the benefit of $1.00 per share by redeeming before other shareholders. Unless the fund board and its pricing service fail to do their jobs in pricing fund shares, there is no “first-mover advantage.”

In addition to the above requirements, Rule 22e-3 currently gives an MMF board significant authority to intervene to protect investors, by suspending redemptions and beginning an orderly liquidation if an MMF has broken or is about to break the buck. The rule, adopted as part of the SEC’s 2010 reforms, is designed to prevent investor panic and prevent the type of run that could potentially reward first movers, by assuring that the board has the authority to suspend redemptions in order to treat all investors fairly in a liquidation. The rule is designed to address the potential for runs regardless of their cause – whether liquidity-driven (such as the 2008 crisis), credit-driven, or interest-rate driven. The Council, however, proposes to rescind Rule 22e-3, rationalizing that a floating NAV diminishes the need for MMF sponsors or boards to suspend redemptions or otherwise intervene upon share price declines except under the most extreme market circumstances. But, as discussed earlier in this paper, the Council itself admits that a floating NAV would fail to remove the risk of runs in a crisis; experts and experience from the past financial crisis confirm this as well. Thus, the Release not only ignores and fails to acknowledge the multitude of SEC requirements designed to assure that MMF boards take appropriate action to treat all investors equally and fairly, it recommends rescinding a key 2010 reform that addresses exactly the type of “run risk” the Council states it wishes to prevent.

(3) A stable NAV does not create an arbitrage opportunity for MMF shareholders.

It has been suggested that the use of a stable NAV creates an opportunity for shareholders to profit through “arbitrage” of the difference between the “shadow NAV” and $1.00 per share price. There is no way to profit, however, from purchasing MMF shares at $1.00 per share and redeeming at $1.00 per share. MMF shares are not offered for sale at below $1.00 per share. There is no opportunity to buy below $1.00 per share and sell at a higher price. There is no market for short-selling MMF shares. Indeed, there is no secondary market for sales of MMF at all – they can only be disposed of by redeeming the shares from the MMF, and the price is the fund’s NAV.

42 17 C.F.R. § 270.22e-3.

43 Of course, in addition to an MMF board’s authority to suspend redemptions in the event of a liquidity-driven crisis, the SEC’s 2010 amendments focused extensively on enhancing the resiliency of MMFs by strengthening the liquidity of MMF portfolios. Rule 2a-7’s liquidity requirements are discussed in detail in Section 15 of this paper.

44 Release at 69466. Of course, an MMF could still seek an order from the SEC permitting the fund to suspend redemptions and liquidate.
At most, under the theories espoused in the Release, an investor in an MMF might in rare cases avoid a potential loss on the investment by getting out ahead of other investors before a price decline. In the past, MMF shareholders would have had only two chances to have “profited” by avoiding a loss on MMF shares. The first such instance was in connection with the closure of the Community Bankers U.S. Government Fund, which in 1994 repaid its investors 96 cents on the dollar. The second was the Reserve Primary Fund, which was forced to liquidate in September 2008 as a result of a run triggered by Lehman’s bankruptcy and the fund’s holdings of Lehman commercial paper. The Reserve Primary Fund has returned to shareholders more than 99 cents on the dollar. In order to have gained the “benefit” from these events, MMF shareholders would have had to invest in several hundred MMFs over a period of forty years. Moreover, the “profit” from those transaction would not have been making money, but avoiding a loss of nine tenths of one cent per share in one case, and four cents per share in the other. It is hard to understand what would motivate an investor to purchase shares in an MMF to seek out this “arbitrage opportunity” to, at best, not lose money.

Thus, the proposition that an investor could profit from arbitraging a stable value MMF, when the investor transacts in and out of the fund at one dollar per share, is meritless. Given that many MMFs are now voluntarily publishing their shadow prices on a daily basis, the SEC will have the opportunity to assess this theoretical “arbitrage” possibility.

(4) The elimination of the stable NAV is wholly unnecessary to address the perceptions of investors, who know and understand that MMFs are investments that are “not FDIC insured” and “may lose value.”

If requiring MMFs to adopt a floating NAV will not achieve its regulatory purpose and may even precipitate runs, what then is the point of requiring a floating NAV in the first instance? The Release suggests that the goal may be to remove uncertainty as to who bears the risk of loss in an MMF. According to the Release, MMF investors have the “perception that shareholders do not bear any risk of loss when they invest in an MMF.”45 Requiring a floating NAV “would make gains and losses on MMF investments a regular occurrence,” “would accustom investors to changes in the value of their MMF shares,” and would “reinforce the principle that investors, not fund sponsors or taxpayers, are expected to bear the pro rata risk of loss in MMFs, as they do with other investment vehicles.”46 The Release further suggests that although MMF prospectuses are required to disclose to investors that their shares may lose value, past support by fund sponsors “may have obscured some investors’ appreciation of MMF risks

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45 Id.
46 Id. at 69466-67.
and caused some investors to assume that MMF sponsors will absorb any losses, even though sponsors are under no obligation to do so.  

The Release’s commentary on the misperceptions of investors follows former SEC Chairman Schapiro’s numerous statements to the same effect. Former Chairman Schapiro stated that MMF investors “don’t appreciate that these are investments, these are not cash instruments, they’re investments and when they break the buck, the impetus to run is enormous.” She said that a floating NAV would “reinforce what money market funds are – an investment product” and would “cause shareholders to become accustomed to fluctuations in the funds’ share prices, and thus less likely to redeem en masse if they fear a loss is imminent, as they do today.” She further commented, “The stable $1.00 share price has fostered an expectation of safety, although money market funds are subject to credit, interest-rate and liquidity risk. . . . As a result, when a fund breaks the dollar, investors lose confidence and rush to redeem.”

To be clear, not only are MMFs uninsured, Congress in 2009 specifically prohibited the Department of the Treasury from using the Exchange Stabilization Fund to support a program to guarantee MMF shareholders, as it did in the financial crisis in 2008. MMF investors neither rely upon a government guarantee nor do they seek it. Indeed, perhaps the strongest evidence of this fact is that in the midst of the financial crisis, MMF investors poured a net $170 billion in uninsured investments back into prime MMFs at the end of 2008. At that time, it was

47 Id. at 69462.


49 Chairman Mary L. Schapiro, Remarks at SIFMA’s 2011 Annual Meeting (Nov. 7, 2011).


abundantly clear to investors that an MMF could break the buck. It was also clear that MMF shares purchased after September 19, 2008 were not covered by the Treasury guarantee program.

As discussed below, institutional investors are clearly aware of the risks of investing in MMFs, and, according to surveys of retail investors, the vast majority of these users also are well aware of these risks. The Release offers no data to support its statements that investors may be confused or uncertain regarding the nature of MMFs, and offers no rebuttal to the survey data and individual letters that fill the SEC’s comment file stating the opposite.

It’s not appropriate for regulators to treat investors “like children.” In a hearing before the Senate Committee on Banking, Housing, and Urban Affairs, the Treasurer of the State of Maryland responded to former Chairman Schapiro:

[O]n behalf of many of the investors . . . [w]e do read the prospectus and we know it’s an investment. It’s not a savings account. And the reforms of 2010 and the experience of 2008 I think has brought that home very clearly. So I think this treating us sort of like children is really not appropriate.

The National Association of State and Local Treasurers made similar comments in a letter filed with the SEC, stating that it “does not accept the statement that investors believe that money market funds are ‘risk free cash equivalents.’ On the contrary, NAST believes that investors realize that money market funds have an inherent risk, albeit a small one.” An investor, in a comment letter to the SEC, stated, “I think you underestimate American's abilities to comprehend the investment risks that they're taking. And those of us that do understand the risks should not have to suffer poorer investments options . . . .” These views are borne out in surveys of retail investors. For example, Fidelity Investments, after conducting a survey of its retail customers, reported that 75% of retail investors surveyed understood that MMFs are not guaranteed by a government entity. Only 11% of those surveyed believed MMF were guaranteed, while 14% were unsure.

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56 Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010) (internal citations omitted).
58 Letter from Fidelity Investments to SEC (Feb. 3, 2012).
In addition to surveys of retail investors, which tell us a great deal, the vast majority of MMF investors are institutional investors, and it simply is not credible to assert they do not understand the nature of MMFs, including the nature of sponsor support. MMFs clearly disclose that they are “Not FDIC Insured” and “May Lose Value.” The variable “shadow” price of each MMF and each individual instrument in the fund is reported monthly to the SEC, which makes it publicly available on its website, clearly reflecting the fluctuations (however minute) in the underlying valuation of each MMF.

Neither the Council in its Release nor the SEC has provided survey or other data supporting the view that investors believe there is “implicit” support for MMFs or that they are unaware of the small fluctuations in underlying market value of MMF shares. Moreover, while taking the position that investors may misperceive the risks of MMFs, the Council fails to address the results of Fidelity’s extensive survey of retail investors demonstrating that a large majority of retail investors understand that MMFs are unguaranteed investment products. Oddly, the Release cites that very survey for other purposes in the Release. Without data of their own, and without responding to evidence to the contrary, the Council’s and the SEC’s statements regarding investor perceptions are “mere speculation.”

(5) A floating NAV would not reflect a measurably more “accurate” valuation of MMF shares than the amortized cost accounting method currently used by MMFs.

In its Release, the Council states that after requiring MMFs to adopt a floating NAV “the value of MMFs’ shares would reflect the market value of the underlying portfolio holdings, consistent with the valuation requirements that apply to all other mutual funds under the Investment Company Act.” The Release echoes earlier statements to the same effect by former Chairman Schapiro and Treasury Secretary Timothy Geithner. These statements suggest a

59 15 U.S.C. § 80a-34. See also 17 C.F.R. § 270.34b–1; 17 C.F.R. § 230.482 (requiring all MMF advertisements to include the following statement: “An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.”).

60 MMFs, in turn, provide links from their websites to the portfolio information presented on the SEC’s website.

61 Release at n.80.

62 Business Roundtable v. SEC, 647 F.3d 1144, 1150 (D.C. Cir. 2011).

63 Release at 69466.


65 In his letter of September 27, Treasury Secretary Timothy Geithner argued that a floating NAV would “allow the value of investors’ shares to track more closely the values of the underlying instruments held by MMFs and eliminate the significance of share price variation in the future.” Letter from Timothy F. Geithner, Secretary of the

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view among regulators that, if MMFs redeemed shareholders securities at a floating or variable NAV, that price would be a truer indication of the MMF’s “mark-to-market” value.

_The Myth of “Marking-to-Market” to Arrive at a Floating NAV._ What is left out of these statements by regulators – perhaps because they may not be familiar with the nature of the instruments held in MMF portfolios – is that there are no daily reported prices for many of the instruments held in a prime MMF portfolio.66 Because of their short-term nature, money market instruments generally are purchased and held to maturity (which is the general basis under GAAP67 for the use of amortized cost accounting used by MMFs to value portfolio assets). In a lengthy analysis of the performance of stable and floating NAV funds, Professors Fisch and Roiter point out that “[v]ery short-term money market instruments like commercial paper or bank CDs ordinarily lack readily available market prices.”68

Commercial paper and other instruments for which there are no readily available market prices are priced based on their “fair valuation” – a reasonable estimate of the price at which the instrument could be sold in a current trade. Thus, these valuations are not necessarily “mark-to-market” prices. An MMF’s board, like the board of any mutual fund, in valuing the fund’s portfolio assets, must use the market value for securities or other assets for which market quotations are readily available, and with respect to other securities and assets, must use their “fair value as determined in good faith by the board of directors.”69 As Professors Fisch and Roiter point out, the SEC has provided extensive guidance on the issue.70 But the SEC also has long acknowledged that there is no single “correct” fair value and, that “The same security held in the portfolios of different funds can be given different fair value prices at any one time, all of which can be reasonable estimates meeting the statutory standard.”71

In practice, MMFs have elaborate and rigorous procedures to obtain valuations for their portfolio assets and to measure deviations between the MMF’s amortized cost price per share

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Treasury, to Members of the Financial Stability Oversight Council (Sept. 27, 2012),

66 Of course, for government MMFs, there are ample market prices for Treasuries and agency securities.

67 Accounting for Certain Investments in Debt and Equity Securities, Statement of Fin. Accounting Standards No. 115, § 7 (Fin. Accounting Standards Bd. 1993). See also the discussion of amortized cost as applied to MMFs in Professor Dennis R. Beresford, Amortized Cost is “Fair” for Money Market Funds (Fall 2012),


69 17 C.F.R. § 270.2a-4.

70 Letter from Fisch & Roiter to SEC at n.22-23 (Dec. 2, 2011).

71 Id. at 6.
and the “current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions),” SEC rules require that they do this. Virtually all MMFs engage independent pricing services to get to a high degree of comfort that the valuations identified by these services for each instrument held in portfolio appropriately “reflects current market conditions,” and MMF internal valuation experts closely monitor any deviations from the valuations obtained using amortized cost accounting. Where there are variations, depending upon internal thresholds that may be reached, MMF procedures generally require involvement of internal valuation committees and in some circumstances the board.

But, these pricing services normally do not identify “mark-to-market” prices, due to the fact that many of the instruments held in a prime MMF portfolio do not have reported trading prices on any given day. For those instruments that do not trade on a daily basis, these services generally use what is known as “matrix” pricing: the pricing service compares each individual instrument within the portfolio to a homogenous set of instruments in the market (e.g., because they have similar ratings, interest rates, maturities) and derives a valuation that it believes reflects current market conditions based upon similar instruments that have traded that day. While matrix pricing is mechanistic and may be an “appropriate substitute” where there is no mark-to-market price, different pricing services may arrive at very minute differences in prices for a portfolio asset, depending upon how they bucket it and the market prices used as reference points. Moreover, each MMF board has the ultimate responsibility to assure that valuation methods used (whether by a pricing service or otherwise) are appropriate. It is this valuation method that MMFs use to arrive at a “shadow price” to compare against the amortized cost valuations. It is an important benchmark, but it is, like amortized cost valuation, a type of fair valuation and is not “mark-to-market.” Indeed, as discussed further below, because the valuations derived under this method are often identical to, or very similar to, valuations derived using amortized cost, amortized cost is a more efficient and reliable means of pricing MMF portfolio assets.

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72 17 C.F.R. § 270.2a-7(c)(8)(ii)(A).

73 Fair Value Measurement, Accounting Standards Update Topic 820-10-55-3C (Fin. Accounting Standards Bd. May 2011) (“Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities.”).

74 These calculations and comparisons are done periodically as determined by the fund’s board of directors, generally weekly if required by rating agencies, or every two weeks. Calculations should be more frequent in volatile market conditions.

75 The same general approach has been adopted by the Financial Industry Regulatory Authority (“FINRA”), and approved by the SEC, as the standard for broker-dealers to price debt securities when there is no active trading market.” FINRA Rule IM-2440-2; Securities Exchange Act Release No. 55638 (Apr. 16, 2007), 77 Fed. Reg. 20150 (April 23, 2007).
**A Distinction Without a Difference.** Day to day, the shadow price of an MMF – however it is determined – deviates from the $1.00 per share arrived at through amortized cost accounting by only miniscule amounts, if at all. The Investment Company Institute (“ICI”), has produced several studies detailing this point. According to its analysis of MMF prices maintained even prior to the 2010 reforms, “Data from a sample of taxable money market funds covering one-quarter of U.S. taxable money market fund assets show that the average per-share market values for prime money market funds varied between $1.002 and $0.998 during the decade from 2000 to 2010.”

An analysis of more recent data submitted by the ICI to Congress demonstrates that the remarkable stability of MMF prices has continued under the 2010 reforms:

[U]sing publicly available data from Form N-MFP reports that require money market funds to disclose their underlying mark-to-market share price, without using amortized cost pricing, ICI calculated changes in prime fund share prices on a monthly basis for January 2011 to March 2012. Nearly all (96 percent) of the prime money market funds had an average absolute monthly change in their mark-to-market share prices of 1 basis point [(one hundredth of one penny per share)] or less and all had an average absolute monthly change of less than 2 basis points.

As these data demonstrate, the stable NAV using amortized cost closely tracks the shadow price (the “floating” value) using other methods of valuation. They are usually identical (even before rounding the NAV to the nearest cent) and only occasionally deviate from one another by plus or minus a few one-hundredths of a cent. To put this in perspective, a deviation of a hundredth of one percent is equal to $.10 on a thousand dollars worth of MMF shares. Unless the MMF is suddenly liquidated, even that small price deviation is not translated into actual losses, because the underlying portfolio investments mature in short order and are repaid at par, which returns the shadow price to $1 per share. Due to the very high levels of liquid assets that MMFs are required to hold under amended Rule 2a-7, it is now even less likely that an MMF would need to sell portfolio assets before maturity to raise cash and recover less than par value. The enhanced liquidity requirements of amended Rule 2a-7 further support the

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76 Letter from ICI to SEC (Feb. 16, 2012).

77 *Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 112th Cong. at 29-30 (Jun. 21, 2012) (testimony of Paul Schott Stevens, President, Investment Company Institute), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc731899c0 (citing the publicly available data from the Form N-MFPs MMFs are required to file each month with the SEC).

economic validity of using amortized cost – they ensure that absent a credit event, no “first-mover advantage” will materialize.

At least two financial regulators represented on the Council recently have published statements acknowledging the effectiveness of amortized cost in tracking the shadow price using other methods of valuation. First, in the RiskFin Report the SEC staff analyzed the distribution of MMF shadow prices between 1994 and 2012 based on data from N-SAR filings. Except for two brief periods, Figure 16 of the Division’s report shows 95% of MMFs continuously maintained shadow NAVs of $0.999 or greater. The two exceptions are the first half of 1994, when the Federal Reserve unexpectedly implemented a series of significant interest rate hikes, and the height of the financial crisis in September 2008. Neither of these events caused the shadow NAVs of these funds to fall below $0.998.79

Second, when permitting bank short-term investment funds to use amortized cost accounting and round share prices to nearest cent, the Comptroller of the Currency concluded, “[B]ecause . . . investments are limited to shorter-term assets and those assets generally are held to maturity, differences between the amortized cost and mark-to-market value of the assets will be rare, absent atypical market conditions or an impaired asset.”80

(6) A floating NAV, with a mandated $100.00 initial share price, would not be “consistent with the requirements that apply to all other mutual funds” but rather would be arbitrary and punitive, and would destroy MMFs as a product.

In its Release, the Council suggests that its proposal to require MMFs to float their NAVs and mark portfolio assets to market is “consistent with the requirements that apply to all other mutual funds.”81 But the Council also recommends that MMFs re-price their shares to an initial $100.00 per share “to be more sensitive to fluctuations in the value of the portfolio’s underlying securities than under a $1.00 per share price.”82 The latter is certainly not consistent with the requirements that apply to other mutual funds.83 In fact, no current law or regulation requires an investment company under the Investment Company Act of 1940 to offer its shares at a


81 Release at 69466.

82 Id.

particular price. Other investment companies that value their shares at $10.00 do so by market custom, not as required by law or regulation. Rather, removing the pricing exemption provided by Rule 2a-7 would require MMFs to comply with Accounting Series Release No. 219, which states only that MMFs must calculate “current net asset value per share with an accuracy of one-tenth of one percent . . . .”

Although stating in its Release that its proposal would require MMFs to price shares in the same way other mutual funds do, the Council is in fact holding MMFs to an arbitrarily more stringent pricing standard than other types of funds. In fact, MMF shares fluctuate so little that the Council has had to concoct an abnormally high $100.00 share price in order to show movement in the NAVs of the funds. To what end? What purpose is served, given that investors are already aware of the potential for fluctuations in MMF’s underlying NAVs? The only result of this arbitrary requirement would be to drive investors to alternative cash management products that are not burdened with an arbitrary pricing standard and do not impose on investors the tax, accounting, and operational burdens described below.

(7) A Floating NAV, for the sake of showing minute variations in value that cancel out over time, would eliminate MMFs as a viable cash management tool by destroying their principal liquidity function.

Nearly every commenter who filed a letter with the SEC opposing the floating NAV wrote that forcing MMFs to abandon the stable NAV would eliminate the MMF as a viable cash management tool by destroying its principal liquidity function. These commenters include both users and issuers, state and local government officials, local and regional chambers of commerce, asset managers, and the industry groups that represent them. Many users, both institutional and individual, stated that MMFs, because of their stable NAV feature, are essential to their cash management strategies.

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As a group of 14 local, state, and national public agency associations explained, MMFs “are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked.”86 While similarly extolling the benefits of stable NAV funds, the New Hampshire College & University Council warned of the adverse consequences of requiring MMFs to shift to a floating NAV:

These funds have consistently proven to be a safe, efficient, and effective cash management tool. Requiring a floating NAV would have negative implications for the utilization of money market mutual funds, as investors would be forced to seek alternative products that are less regulated and provide less diversification. To that end, we are concerned a floating NAV would effectively eliminate money market mutual funds as a viable investment tool for public and private higher education institutions.87

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The Council in its Release acknowledges that a wide range of entities use MMFs “for a variety of cash management and investment purposes,” and that certain types of users “may be unwilling or unable to conduct their cash management through an investment vehicle that does not offer a stable value.”88 The Council states that removing the stable NAV of MMFs “would be a significant change for a multi-trillion dollar industry in which the stable $1.00 share price has been a core feature” that “may reduce overall investor demand for MMFs, which would diminish the funds’ capacity to invest in the short-term securities of financial institutions, businesses, and governments, possibly impacting their costs of funding.” But, the Release simply claims “the ultimate long-term reaction to such a change is difficult to predict with any precision.”89 It then declines to make any attempt to size the impact of eliminating MMFs as a cash management tool on the MMF users or long-term economic growth.

(8) A Floating NAV, for the sake of showing minute variations in value that cancel out over time, also would impose significant operational, accounting and tax burdens on users of MMFs and destroy their utility.

Although the Release acknowledges certain “operational costs,” “accounting impacts,” and “tax considerations” associated with requiring MMFs to adopt a floating NAV, the Council does so with little analysis and does not attempt to size their impact on users.90 Further, the Council does not address the potential consequences of the migration of assets away from MMFs once they no longer exhibit the key features of operational, tax and accounting simplicity and efficiency. Given that these changes will make MMFs a substantially less attractive and more cumbersome product compared to other cash management alternatives, a shift of assets away from MMFs and into other cash management products is a likely outcome of the Council’s proposal.91 The Council’s failure to address these consequences in the Release is a significant oversight.

88 Release at 69457, 69468.
89 Id. at 69468.
90 Id. at 69467-68.
91 Letter from Jonathan R. Macey to Financial Stability Oversight Council (Nov. 27, 2012), http://www.regulations.gov/#/documentDetail;D=FSOC-2012-0003-0010 (“A stable $1.00 NAV provides convenience and simplicity to investors and managers alike, boosting MMFs’ efficiency with regard to tax, accounting, and recordkeeping. Unlike other mutual funds, MMFs are used primarily as a cash management tool, which means that large transactions flow through them every day. Without a stable NAV, many investors will bolt for other cash management entities in order to minimize tax, accounting, and recordkeeping burdens.”) (Macey 2012).
Users would lose key operational features only available with a stable NAV fund. A number of features MMFs currently offer would not be possible with a floating NAV. As the investment advisor Invesco stated, “a stable share price simplifies cash management policies for investors and has made it possible for broker-dealers to make available to clients a wide range of features including ATM access, check writing, and ACH and Fedwire transfers. These features are generally provided only for accounts with a stable NAV.”92 For example, according to ICI, MMFs “typically offer retail investors same-day settlement on shares redeemed via ‘wire transfers’ (where redemption proceeds are wired to an investor’s bank account via fedwire), whereas bond funds typically offer only next day settlement for wire transfers.”93

If MMFs are required to float their NAV, all of these systems would have to undergo significant retooling of accounting, trading, and settlement systems to accommodate the possibility of a minute change in a fund’s NAV. That cost, according to many commenters, would be substantial.94 Cachematrix, a software provider of online institutional trading systems for banks and financial institutions, stated,

[A]n entire industry has programmed accounting, trading and settlement systems based on a stable share price. The cost for each bank to retool their sub-accounting systems to accommodate a fluctuating NAV could be in the millions of dollars. This does not take into account the costs that each bank would then pass on to the thousands of corporations that use money market trading systems.95

As an example, the stable share price of MMFs currently simplifies corporate treasury operations. Treasurers know the $1.00 NAV in advance, and, as Vanguard pointed out, that amount often is hard-coded into companies’ accounting and cash-tracking systems. Treasurers can then use an MMF to fund transactions over the course of the day.96 Bank sweep account systems with an option to invest in MMFs often do the same.97 As the American Bankers Association described the effect of the floating NAV on these operations,

92 Letter from Invesco to SEC (Sept. 4, 2009).
93 Letter from ICI to SEC (May 25, 2012).
94 Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letter from Association for Financial Professionals and 13 other organizations to SEC (Apr. 4, 2012); Letter from John D. Hawke, Jr. to SEC (Mar. 19, 2012); Letter from ICI to SEC (Feb. 16, 2012); Letter from Cachematrix to SEC (Dec. 12, 2011); Letter from Invesco to SEC (Sept. 4, 2009).
95 Letter from Cachematrix to SEC (Dec. 12, 2011).
97 Id.
If the NAV floats, service providers would need to request that shares be redeemed prior to the close of the market (when the fund is priced), but the number of shares needed to be redeemed to fund the transaction would be uncertain. Estimating the number of shares needed to be redeemed will result in an end-of-day excess or shortfall. This leads to a potentially significant difficulty in calculating the end-of-day values. By contrast, a stable NAV provides certainty for funding the day’s transactions. Similarly, municipal bond issuers who, under their indentures, are required to maintain reserves at a specified level can be assured that they will not have to advance cash to satisfy that reserve level because funds invested in MMFs will not fluctuate.\footnote{Letter from American Bankers Association to SEC (Jan. 10, 2011). See also Letter from American Bankers Association to SEC (Sept. 8, 2009).}

In the case of same-day settlement by floating NAV MMFs, retooling would require major changes to the way pricing services and the Fedwire system operate, and ultimately may not be feasible. The Release points to a single floating NAV fund that offers same-day settlement of wire transfers, suggesting that MMFs need only “modify systems” to allow same-day settlement of redemption transactions. In fact, this change would require, among other things, a substantial overhaul of operations by third party pricing services. The earliest the pricing services will transmit valuations for money market instruments is after 4 p.m. EST. Currently, pricing services gather valuation information from market participants throughout the morning and early afternoon of each trading day to establish valuations as of 3 p.m. EST. The services then input this information into their valuation system and quality check the results, a process which itself takes over an hour. There is no guarantee that pricing services would be able to collapse this day-long process to a fraction of the time to accommodate the demand for intra-day pricing of money market instruments. Further, it should be noted that it took several years to convince pricing services to provide valuations as of the close of the New York Stock Exchange (in addition to 3 p.m. valuations), so pricing services may resist efforts to add more valuation times.

Additionally, in the absence of more frequent valuation to permit a fund to pay redemptions, a floating NAV MMF would be forced to send all wire transfer redemptions late in the afternoon, towards the close of the Fedwire, rather than throughout the day. This would impede the efforts of wire transfer recipients attempting to rewire redemption proceeds, and could greatly increase the volume of late day transfers over the Fedwire system, potentially beyond the system’s capabilities. Having a single NAV calculation per day in a floating NAV fund would significantly inhibit investors’ access to cash and would further decrease the utility of MMFs overall.
A range of business functions would require costly overhaul. A floating NAV would disrupt numerous business applications that run on automated accounting and settlement systems designed for same-day settlement and rely upon a stable NAV. The effect on business and public accounting processes would be far-reaching and at a minimum would include: trust accounting systems at bank trust departments; corporate payroll processing, corporate and institutional operating cash balances; federal, state and local government cash balances; municipal bond trustee cash management systems; consumer receivable securitization cash processing; escrow processing; custody cash balances and investment manager cash balances; 401(k) and 403(b) employee benefit plan processing; broker-dealer and futures dealer customer cash balances; and cash management type accounts at banks and broker-dealers. These processes would all have to undergo significant and costly retooling in the absence of stable NAV MMFs. As discussed in Arnold & Porter’s March 19, 2012 letter to the SEC, these specialized uses likely account for well over half of total MMF assets.

A floating NAV would create an additional accounting burden for users. With a stable $1.00 NAV, MMFs currently qualify as “cash equivalents” under accounting standards. Because the NAV is fixed at $1.00 per share (absent an event that drives the fund’s shadow price below $0.995 or above $1.005), there is no need for investors to recognize gains or losses for financial accounting purposes. With a floating NAV, different accounting standards would apply. Users would be required to reclassify their holdings of MMFs, likely as Available-for-Sale securities, which must be held at fair value. The ICI explained the consequences of this accounting treatment of floating NAV MMFs:

99 The impact on these specialized uses is discussed in detail in the Appendix.

100 Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012).


102 See Accounting for Certain Investments in Debt and Equity Securities, Statement on Fin. Accounting Standards No. 115 (Fin. Accounting Standards Bd. 1993).
Accounting standards setters aren’t likely to grant cash-equivalent status to floating-value money market funds, which means institutions would have to track and reflect any fluctuations in shares’ values on their books. Individuals and many institutional investors would have to regard every money market fund transaction as a potentially taxable event, and funds would have to build reporting systems to track gains and losses in the pennies. In short, the fact that money market funds could float means that investors, funds, and intermediaries have to be prepared that they will float. Changing the nature of these funds from stable to floating would force funds and investors to adapt, build new accounting systems, and overhaul their cash management—whether the funds' value actually fluctuates or not. The result would be heavy costs.\(^{103}\)

The ICI described the consequences specifically for corporate users as follows:

Corporate treasurers would also have to track the costs of their shares and determine how to match purchases and redemptions for purposes of calculating gains and losses for accounting and tax purposes. Moreover, under the new treatment, companies could not enter and reconcile cash transactions nor calculate the precise amount of operating cash on hand until the money market fund’s NAV became known at the end of the day, creating additional disincentives for corporations to use money market funds for cash management purposes.\(^{104}\)

Over two thousand users have written to the SEC to warn that the floating NAV would create an “accounting nightmare” for them as well.\(^{105}\)

\textbf{A floating NAV would create an additional tax burden for users.} The stable NAV currently allows an MMF to distribute all returns to shareholders as income, which greatly reduces tax and accounting burdens for both retail and institutional investors. As several commenters have explained,\(^{106}\) the stable NAV also relieves investors of having to consider the timing of purchases and sales of shares of MMFs, as they must with variable NAV funds, to

\(^{103}\) Letter from ICI to SEC (Apr. 13, 2012).


ensure compliance with the so-called “wash sale rule.”\textsuperscript{107} MMFs transactions currently do not implicate the rule due to the funds’ stable NAV.

As these commenters point out, if MMFs were forced to adopt a floating NAV, investors would need to track the amount and timing of all purchases and sales, capital gains and losses, and share cost basis to ensure compliance with the rule. Investors already face these burdens in connection with investments in long-term mutual funds, but most investors do not trade in and out of long-term mutual funds with the same frequency as many do with MMFs. Moreover, as the ICI explained, often the investments in long-term mutual funds are made within tax-advantaged accounts (\textit{e.g.}, 401(k) plans), where such issues do not arise.\textsuperscript{108} Thus, if MMFs had a floating NAV, and all share sales become tax-reportable events, the result would be to magnify greatly the tax and recordkeeping burdens of investors who use their MMFs for daily cash management purposes, all for the purpose of tracking fluctuations amounting to fractions of a cent.\textsuperscript{109}

To its credit, the Release does appear to acknowledge the tax burden a floating NAV MMF would place on all MMF users.\textsuperscript{110} The Release recognizes that

because each redemption could produce a gain or loss for the shareholder, it would be necessary to determine for every redemption—(i) which share was redeemed, (ii) the tax basis (generally, the acquisition cost) of that share, and (iii) whether the holding period of that share was long term or short term. In addition, if a shareholder purchases shares in an MMF within thirty days before or after a redemption, the Tax Code’s “wash sale” rules would limit the extent to which the shareholder could deduct any loss realized on the redemption.\textsuperscript{111}

\textsuperscript{107} Under this IRS rule, investors are prohibited from recognizing a loss on the sale of a security if they purchase a replacement security within the next 30 days (or for that matter, if the investor has purchased a replacement security in the 30 days prior to the sale that triggers the loss). Instead, the loss is added to the basis of the replacement security. The holding period for the sold stock is also added to the holding period of the replacement stock. 26 C.F.R. § 1.1091–1.

\textsuperscript{108} Letter from ICI to SEC (Jan. 10, 2011).

\textsuperscript{109} Multiple commenters warned that a floating NAV would cause each MMF sale a tax-reportable event. Letter from Donald Brundrett to SEC (Mar. 24, 2012); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letter from SunGard Global Network to SEC (Mar. 16, 2012); Letter from Washington State Treasurer to SEC (Nov. 15, 2011); Letter from Financial Services Institute to SEC (Jan. 10, 2011); Letter from FSC Securities Corporation to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from Wells Fargo Funds Management to SEC (Jan. 10, 2011); Letter from Treasury Strategies to SEC (Jan. 10, 2011); Letter from Royal Alliance Associates to SEC (Jan. 7, 2011); Letter from Letter from SagePoint Financial to SEC (Jan. 7, 2011). See also PWG Report at 21 (noting the “loss of accounting convenience and tax efficiencies” resulting from the move to a floating NAV).

\textsuperscript{110} Release at 69467.

\textsuperscript{111} \textit{Id.}
The Council purports to dismiss the burden this altered tax treatment would place on users by suggesting that the Treasury Department and the IRS “will consider” various forms of administrative relief for MMF users and sponsors.\textsuperscript{112} It does not include any proposals to recommend such relief to the Treasury Department, and certainly the Council makes no guarantee that any such relief will be forthcoming. Congress surely created a multi-agency council to coordinate such proposed reforms more efficiently than the Council has in the Release.

(9) A Floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using MMFs.

Many commenters warned that a floating NAV would preclude certain investors, who are permitted to invest only in stable NAV funds, from investing in MMFs.\textsuperscript{113} The Council in its Release succinctly states the problem:

Some MMF investors may be unwilling or unable to conduct their cash management through an investment vehicle that does not offer a stable value. Some institutional investors may be prohibited by board approved guidelines or firm policies from conducting cash management using MMFs that do not have a stable NAV and may be unwilling to change these policies. Other investors, such as some state and local governments, may be subject to statutory or regulatory requirements that permit them to invest certain assets only in funds that seek to maintain a stable net asset value.\textsuperscript{114}

\textsuperscript{112} Id.

\textsuperscript{113} Letter from Denver Metro Chamber to SEC (July 20, 2012); Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Indiana County Treasurers Association to SEC (Apr. 25, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letters from ICI to SEC (Apr. 19, 2012 and Jan. 10, 2011); Letter from Association for Financial Professionals and 13 other organizations; Letter from Metropolitan Mayors Caucus to SEC (Mar. 28, 2012); Letter from 14 National, State and Local Entities to SEC (Mar. 8, 2012); Letter from Texas Association of Business to SEC (Feb. 27, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with the SEC (Dec. 15, 2011); Letter from Fisch & Roiter to SEC (Dec. 2, 2011); Letter from the Financial Services Roundtable to SEC (Jun. 30, 2011); Letter from Colorado County Treasurers’ Association to SEC (Jun. 21, 2011); Letter from Jacksonville Chamber to SEC (Jan. 31, 2011); Letter from Greater Boston Chamber of Commerce to SEC (Jan. 28, 2011); Letter from Texas Municipal League to SEC (Jan. 21, 2011); Letter from 12 National, State and Local Entities to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from FSC Securities Corporation to SEC (Jan. 10, 2011); Letter from Royal Alliance Associates to SEC (Jan. 7, 2011); Letter from SagePoint Financial to SEC (Jan. 7, 2011); Letter from Port of Houston Authority to SEC (Jan. 6, 2011); Letter from Tom Welch to SEC (Dec. 26, 2010).

\textsuperscript{114} Release at 69468. See also Letter from American Bankers Association to Financial Stability Oversight Council (Jan. 18, 2013), http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0062 (“Although MMFs are now popular with both retail and institutional investors alike, trust departments in banks of all sizes still make large
Undertaking to size the potential disruption to institutional investors (who include Fortune 500 corporations, states, localities, and major fund managers), Treasury Strategies, a treasury management consulting firm, found that 33% of corporate, government, and other institutional users surveyed currently are subject to investment policies, laws, or other restrictions prohibiting them from investing in floating NAV products.115

A joint letter from twelve national, state and local entities, including the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, and the U.S. Conference of Mayors, elaborated on the potential disruption:

[M]any governments have specific policies that mandate stable values, and money market funds are to be used for their short-term investments due to the fixed NAV. MMMFs are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked. If the SEC were to adopt a floating NAV for MMMFs, the organizations [co-signing this letter] expect that many, if not all, of their members would divest a significant percentage of their MMMFs . . . .116

(10) A Floating NAV, because of the operational burdens, costs, and other impediments, would substantially shrink the assets of MMFs.

The impact of the burdens, costs and other impediments of a floating NAV in shrinking the assets of MMFs is borne out in surveys of users:

- Fidelity Investments, the largest MMF manager in the United States, surveyed both its institutional and retail MMF investors. Of retail investors surveyed, 74% stated a preference to keep the stable NAV, and 47% said they would decrease or discontinue use investments in MMFs to meet their fiduciary obligation to make trust assets productive. . . . It is highly likely that bank trust departments will no longer invest in MMFs if they are not able to maintain a stable NAV.”); PWG Report at 21.

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of MMFs if they adopted a floating NAV. Of institutional investors surveyed, 89% stated a preference to keep the stable NAV, while 57% said they would decrease or discontinue use of MMFs if they adopted a floating NAV.117

- In a wide ranging survey of institutional MMF users commissioned by the ICI, Treasury Strategies found that forcing MMFs to adopt floating NAVs would drive a large portion of current users out of the MMF market. Of the more than 200 corporate, government, and other institutional users of MMFs surveyed, 79% said they would decrease or stop using MMFs if the fund had a floating NAV. Of that number, 44% said they would stop using MMFs entirely, and a full 72% said they would decrease use by more than half.118

Alarmingly, Treasury Strategies estimated that as 61% of the MMF assets currently held by corporate, government and institutional investors would flow out of MMFs if the funds were required to adopt a floating NAV.119 Despite the potential for large scale redemptions upon the adoption of a floating NAV for MMFs, which in some cases will be a legal or prudential requirement, the Council notes only that it “may take time for investors and short-term funding markets to adjust to such a change, and the ultimate long-term reaction to such a change is difficult to predict with any precision.”120

(11) A Floating NAV would therefore contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.

Dozens of commenters stated that forcing MMFs to adopt a floating NAV, thereby eliminating or reducing the utility of MMFs for many users, would contract the market for, and raise the costs of, short-term public and private debt financing.121 Some of these commenters

117 Letter from Fidelity Investments to SEC (Feb. 3, 2012).
119 Id.
120 Release at 69468.
121 Letter from 33 Members of Congress to SEC (May 1, 2012), http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658511.pdf (“Letter from 33 Members of Congress to SEC”). This letter, from 33 Members of the House of Representatives, is particularly significant in light of the experiences of its various signatories, all of whom served as officials of state or local governments and in the letter express their views of the importance of MMFs to such entities. The following Members of Congress signed the letter: Congressman Richard E. Neal (D-MA), Congressman Tom Reed (R-NY), Congressman James P. Moran (D-VA), Congressman Frank C. Guinta (R-NH), Congressman Gerald E. Connolly (D-VA), Congressman David Schweikert (R-AZ), Congressman Michael E. Capuano (D-MA), Congressman Steve Chabot (R-OH), Congressman Gary Peters (D-MI), Congressman Aaron Schock (R-IL), Congressman Jim Himes (D-CT), Congressman Phil Roe, MD (R-TN), Congressman David Cicilline (D-RI), Congressman Mike Coffman (R-CO), Congressman Henry
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Cuellar (D-TX), Congresswoman Lynn Jenkins (R-KS), Congressman John Carney (D-DE), Congresswoman Cynthia Lummis (R-WY), Congressman Brian Higgins (D-NY), Congressman James B. Renacci (R-OH), Congressman Martin Heinrich (D-NM), Congressman Adam Kinzinger (R-IL), Congressman Albio Sires (D-NJ), Congressman Kenny Marchant (R-TX), Congressman Bill Pascrell (D-NJ), Congressman Steve Stivers (R-OH), Congressman John Larson (D-CT), Congressman Bill Posey (R-FL), Congressman Sam Farr (D-CA), Congressman Jeff Fortenberry (R-NE), Congressman Todd Rokita (R-IN), Congressman Mike Fitzpatrick (D-PA), and Congressman Mike Kelly (R-PA). See also Letter from Michael B. Hancock, Mayor of Denver, to SEC (July 25, 2012); Letter from Stephanie Rawlings-Blake, Mayor of Baltimore, to SEC (July 20, 2012); Letter from Louisiana Retailers Association to SEC (July 19, 2012); Letter from Utah Association of Counties to SEC (June 27, 2012); Letter from New York State Association of Counties to SEC (June 20, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (April 24, 2012); Letter from Association for Financial Professionals and 13 other organizations to SEC (April 4, 2012); Letter from Mutual Fund Directors Forum to SEC (March 29, 2012); Letter from Metropolitan Mayors Caucus to SEC (March 28, 2012); Letter from Indiana Chamber to SEC (March 20, 2012); Letter from 14 National, State and Local Entities to SEC (March 8, 2012); Letter from Texas Association of Business to SEC (February 27, 2012); Letter from Northern Kentucky Chamber of Commerce to SEC (January 20, 2012); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council, filed with SEC (December 15, 2011); Letter from New Jersey Association of Counties (July 11, 2011); Letter from the Financial Services Roundtable to SEC (June 30, 2011); Letters from Utah League of Cities and Towns to SEC (May 10, 2012 and January 11, 2011); Letter from Greater Albuquerque Chamber of Commerce to SEC (February 7, 2011); Letter from New Jersey Business & Industry Association to SEC (February 7, 2011); Letter from Florida Department of Financial Services to SEC (February 3, 2011); Letter from Jacksonville Chamber to SEC (January 31, 2011); Letter from Greater Raleigh Chamber to SEC (January 31, 2011); Letter from Association of Commerce and Industry, New Mexico to SEC (January 31, 2011); Letter from Providence Chamber of Commerce to SEC (January 31, 2011); Letter from Greater Durham Chamber of Commerce to SEC (January 31, 2011); Letter from New Mexico Association of Counties to SEC (January 28, 2011); Letter from Greater Boston Chamber of Commerce to SEC (January 28, 2011); Letter from Florida Chamber of Commerce to SEC (January 28, 2011); Letter from Rhode Island Economic Development Corporation to SEC (January 26, 2011); Letter from North Carolina Chamber of Commerce to SEC (January 25, 2011); Letter from American Association of State Colleges and Universities to SEC (January 21, 2011); Letter from Texas Municipal League to SEC (January 21, 2011); Letter from New Jersey Chamber of Commerce (January 18, 2011); Letter from Northern Rhode Island Chamber of Commerce to SEC (January 15, 2011); Letter from New York Business Council to SEC (January 14, 2011); Letter from the Mayor of Salt Lake City, Utah to SEC (January 13, 2011); Letter from Cincinnati Chamber to SEC (January 13, 2011); Letter from J.P. Morgan Asset Management to SEC (January 10, 2011); Letter from Kentucky State Treasurer to SEC (January 10, 2011); Letter from 12 National, State and Local Entities to SEC (January 10, 2011); Letter from Agilent Technologies, Inc., Air Products & Chemicals, Inc., Association for Financial Professionals, The Boeing Company, Cadence Design Systems, CVS Caremark Corporation, Devon Energy, Dominion Resources, Inc., Eastman Chemical Company, Eli Lilly & Company, Financial Executives International's Committee on Corporate Treasury, FMC Corporation, Institutional Cash Distributors, Kentucky Chamber of Commerce, Kraft Foods Global, Inc., National Association of Corporate Treasurers, New Hampshire Business and Industry Association, Nissan North America Inc., Pacific Gas and Electric Company, Safeway Inc., Weatherford International, Ltd., U.S. Chamber of Commerce to SEC (January 10, 2011) (Letter from 22 Issuers and Associations); Letter from FSC Securities Corporation to SEC (January 10, 2011); Letter from SIFMA to SEC (January 10, 2011); Letter from Associated Industries of Florida to SEC (January 10, 2011); Letter from Invesco Advisors to SEC (January 10, 2011); Letter from Fidelity Investments to SEC (January 10, 2011); Letter from Kentucky Chamber of Commerce to SEC (January 10, 2011); Letter from Dallas Regional Chamber to SEC (January 10, 2011); Letter from Professor Jonathan Macey to SEC (January 8, 2011); Letter from Royal Alliance Associates to SEC (January 7, 2011); Letter from SagePoint Financial to SEC (January 7, 2011); Letter from Cincinnati/Northern Kentucky International Airport to SEC (January 7, 2011); Letter from Port of Houston Authority to SEC (January 6, 2011); Letter from National Association of State and Local Treasurers to SEC (December 21, 2010).
noted that MMFs hold almost 40% of outstanding commercial paper, roughly two-thirds of short-term state and local government debt, and significant portions of outstanding short-term Treasury and federal agency securities.122 In addition, corporate and other institutional investors may also decide to invest directly in money market instruments, thus concentrating their risk and necessitating an increase in in-house expertise.

A letter co-signed by 22 diverse companies and organizations, representing a broad range of industries and entities that rely on MMFs to support their capital raising and investment needs by purchasing their commercial paper, warned that:

American business will lose one of its most important sources of short-term funding if money market funds are forced to abandon their stable per-share value, whether directly or indirectly . . . . With such a change, the expected flight of investors from these funds will severely impair the ability of companies to raise capital in the U.S. and undermine efforts to strengthen the American economy.

. . .

There are no immediate substitutes for money market funds in this financing role. Bank lending cannot fill this funding gap unless banks raise substantial new capital. Unregulated private pools might see an opportunity to expand, but encouraging investors to migrate to these vehicles hardly seems consistent with efforts to reduce risk, increase transparency, and ensure greater market stability. Mandating a floating NAV would make short-term financing for American business less efficient and far more costly, ensuring a severe setback for an economy emerging from recession.123

A letter signed by 33 Members of Congress who are all former state and local officials further stated, “Any reduction in demand for money market funds would reduce demand for the securities issued by state and local governments and purchased by Money Funds. As a result, states and municipalities would be deprived of a critical funding source and would be faced with increasing debt issuance costs.”124 The PWG Report acknowledged that a floating NAV “might

122 This data originally appeared in the PWG Report at 7.
124 Letter from 33 Members of Congress to SEC (May 1, 2012).
reduce investor demand for MMFs and thus diminish their capacity to supply credit to businesses, financial institutions, state and local governments, and other borrowers who obtain financing in short-term debt markets.¹²⁵ Fidelity Investments estimated that for municipal issuers, the amount of annual interest paid by these entities to fund their operations would increase by billions of dollars if MMFs ceased to be significant purchasers, and that the federal government similarly would have to pay billions more in annual interest to finance its short-term debt.¹²⁶

Further, a range of MMF users and industry participants have warned that the very process of switching to a floating NAV would destabilize the short-term credit markets¹²⁷ and create volatility.¹²⁸ The Council even acknowledges this point in the Release, stating that it “may take time for investors and short-term credit funding markets to adjust” to a floating NAV, and that “if the transition to the new regulatory regime prompted investors to redeem suddenly and substantially, the transition itself could create financial instability.” The Council then reasons that “[a] longer transition period and the grandfathering of existing fund shareholdings are designed to lessen this risk.”¹²⁹ But as discussed above, more than 50% of the assets held in MMFs are likely to turnover in as little as a month.¹³⁰ As a result, a transition period structured as the Council recommends will prove ineffectual in stopping the sudden and substantial redemption of MMF assets that may occur should MMFs be required to adopt a floating NAV.

Given the body of evidence submitted by commenters on this issue,¹³¹ and the fact that the Council cites the importance of MMFs to short-term credit markets no less than a dozen

¹²⁵ PWG Report at 21.
¹²⁶ Letter from Fidelity Investments to SEC (Jan. 10, 2011).
¹²⁷ Letter from Cachematrix to SEC (Dec. 12, 2011); Letter from ICI to SEC (Jan. 10, 2011); Letter from National Association of State and Local Treasurers to SEC (Dec. 21, 2010); Letter from Invesco to SEC (Sept. 4, 2009).
¹²⁸ See, e.g., Letter from American Association of State Colleges and Universities to SEC (Jan. 21, 2011); Letter from ICI to SEC (Jan. 10, 2011).
¹²⁹ Release at 69468.
¹³⁰ Professor David W. Blackwell, Professor Kenneth R. Troske, and Professor Drew B. Winters, Money Market Funds Since the 2010 Regulatory Reforms: More Liquidity, Increased Transparency, and Lower Credit Risk at 44 (Fall 2012), http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf (tracking redemptions in the five largest MMFs by month for 2011). Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Feb. 24, 2012) (describing the various specialized uses of MMFs that require daily liquidity); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Mar. 19, 2012) (supplying estimates of the amount of assets held for those specialized purposes).
¹³¹ The Release briefly acknowledges but does not attempt to size these concerns. Release at 69468, n.81 (“Moving to a floating NAV may cause the MMF industry’s AUM to contract . . . which would diminish the funds’ capacity to invest in the short-term securities of financial institutions, businesses, and governments, possible impacting their costs of funding. . . . In addition, if the transition to the new regulatory regime prompted investors to redeem suddenly and substantially, the transition itself could create financial instability.”).
times throughout the Release, the Council’s failure to credibly account for these impacts is astonishing. The Council, in addition to statutory requirements compelling it to consider the costs to long-term economic growth,132 is subject to executive orders by the current and former administrations to undertake rigorous cost-benefit analyses when engaging in major regulatory actions.133 Any recommendations to the SEC also must account for the SEC’s own statutory requirements to consider efficiency, competition, and capital formation.134 The Council not only has failed to assess the costs, it has no compelling data suggesting any benefits from forcing MMFs to move to a floating NAV. In fact, it has no evidence at all other than speculation regarding the misperceptions of the nature of MMFs as an investment product, which has been refuted by survey information.135

(12) A floating NAV would force current MMF users to less regulated and less transparent products.

Commenters, including current and former state and local government officials, warned that forcing MMFs to move to a floating NAV would leave resource-strapped public treasurers without the safely managed investment option of MMFs.136 One group of fourteen national, state

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and local entities, representing thousands of municipalities, agencies, and officials throughout the U.S. warned that if the SEC required MMFs to float their NAVs, it would force many of their members to look at “competing products that could be more susceptible to market conditions, more difficult to account for and manage, and may pose market risk. That would contrast sharply with the SEC’s goals, particularly since many of those competing products don’t provide investors with the same transparency and comprehensive regulatory protections as MMMFs.”

Numerous additional commenters warned that a floating NAV for MMFs would motivate investors to shift assets to riskier or unregulated cash-management vehicles once MMFs no longer meet the liquidity requirements of institutional and retail investors using MMFs for their short-term cash management needs. A survey of recent scholarship by three finance and economics professors found that many criticized the adoption of the floating NAV as likely to “push many–particularly institutional investors–to move their money into less regulated sectors of the market.” The Kentucky Chamber of Commerce, representing over 2,000 businesses and 250,000 workers, noted that a regulatory change that would drive investors to less-regulated

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137 Letter from 14 National and Local Entities to SEC (Mar. 8, 2012).


funds “is hardly consistent with efforts to reduce risk, increase market transparency and ensure
greater market stability.” The PWG Report stated the problem as follows:

[E]limination of MMFs’ stable NAVs may cause investors to shift assets to stable
NAV substitutes that are vulnerable to runs but subject to less regulation than
MMFs. In particular, many institutional investors might move assets to less
regulated or unregulated cash management vehicles, such as offshore MMFs,
enhanced cash funds, and other stable value vehicles that hold portfolios similar
to those of MMFs but are not subject to the [Investment Company Act’s]
restrictions on MMFs.

Despite the overwhelming number of MMF users who have expressed to the regulators,
either through surveys, coalitions, or individual letters, that they would not, or could not, invest
in a floating NAV product, the Council acknowledges this point in only the most cursory
fashion, and fails entirely to assess the harmful impact of this flow of funds out of MMFs and
into alternative investment products on the broader economy. Regulators need to weigh fully
whether the speculative benefits of the floating NAV proposal, as well as the other MMF reform
proposals under consideration, are worth the cost of dramatically shrinking the MMF industry
and directing investor funds to institutions and products that are less transparent and generate
potentially higher systemic risks.

(13) A floating NAV would accelerate the flow of assets to “Too Big to Fail” banks,
further concentrating risk in that sector.

The stability, diversification, transparency, high credit quality, and mandatory liquidity
levels of MMFs have established MMFs as a more conservative investment than other fixed
income alternatives, and far more efficient for an investor than attempting to manage an
individual portfolio of bonds. As Professor Jonathan Macey points out, these key features,
coupled with a stable NAV achieved through the amortized cost method, have enabled MMFs to
serve as a viable investment alternative to bank deposits. Even bank regulators acknowledge
that, for large balances in excess of FDIC deposit insurance limits, MMFs are safer than bank
deposits, which represent undiversified and unsecured exposures to a bank.

140 Letter from Northern Kentucky Chamber of Commerce to SEC (Jan. 20, 2012).
141 PWG Report at 21-22.
142 Release at 69468.
143 Macey 2012 at 41.
144 Federal Reserve Bank of New York Staff Report, The Minimum Balance at Risk: A Proposal to Mitigate the
Systemic Risks Posed by Money Market Funds at 52 (July 2012),
http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf (“Even bank deposits have safety
The operational, accounting, tax, and legal implications associated with requiring the adoption of a floating NAV would mean that a substantial portion of current MMF users would not, or could not, continue to use the product. Those assets which do not flow to less-regulated, less-transparent cash management alternatives would likely flow to banks, exacerbating the banks’ need for capital and concentrating risks in that sector.\textsuperscript{145} The Mutual Fund Directors Forum warned, “[A] shift of significant amounts of cash to the banking system may have unintended and unpredictable consequences,” and stated “[A]ny increase in the systemic risk resulting from the flow of money to other investment vehicles is important and should be considered by the Commission before proposing or adopting further significant changes to the manner in which money market funds are regulated.”\textsuperscript{146} Regulators have noted that a broad shift of institutional cash to the banking system could lead to a large increase in uninsured, “hot money” deposits.\textsuperscript{147}

Over 75\% of deposit growth in 2011 that was caused by unlimited deposit insurance of demand deposit accounts flowed into the ten largest banks.\textsuperscript{148} The ten largest U.S. banks represent 65\% of banking assets and 75\% of U.S. GDP.\textsuperscript{149} Institutional investors hold approximately two-thirds of MMF shares. If two-thirds of MMF balances move into the banking system and 75\% of that flows into the ten largest banks, that would increase the size of the ten largest banks by $1.3 trillion to 74\% of U.S. banking assets and 84\% of U.S. GDP.

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disadvantages for large institutional investors whose cash holdings typically exceed by orders of magnitude the caps on deposit insurance coverage; for these investors, deposits are effectively large, unsecured exposures to a bank. MMF shares—which represent claims on diversified, transparent, tightly regulated portfolios—would continue to offer important safety advantages relative to bank deposits [even if the regulatory structure of MMF were altered].”) (FRBNY Staff Report).


\textsuperscript{146} Letter from Mutual Fund Directors Forum to SEC (Mar. 29, 2012). In their analysis of the performance of stable and floating NAV funds, Fisch and Roiter pointed out that “[e]liminating MMFs as an alternative to bank deposits means greater concentration of risk in the one sector of our financial system that history has indisputably shown to be most prone to systemic risk, the banks.” Letter from Fisch & Roiter to SEC (Dec. 2, 2011).

\textsuperscript{147} FRBNY Staff Report at 6.

\textsuperscript{148} FDIC Press Release, Insured Institutions Earned $35.3 Billion in The Third Quarter of 2011 (Nov. 22, 2011); FDIC Quarterly Banking Profile, Vol. 3, No. 1, at 4 (Dec. 31, 2008) (noting that total deposits increased by $307.9 billion (3.5\%) in the fourth quarter of 2008, the largest increase in ten years), http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP.

Further, much of the financing currently provided by MMFs will be forced onto bank balance sheets or into entities that are structured and regulated like banks. One large asset manager questioned whether banks could perform the funding role that MMFs currently do, stating, “It is our belief that banks have neither the infrastructure nor the profit incentive based on minimum leverage capital requirements to provide short-term funding to the economy in the way that money market funds do through the purchase of commercial paper and other short-term debt instruments.”

The inevitable consequence of this approach is the further substantial growth of the largest systemically important financial institutions and the further expansion of the federal government safety net of deposit insurance, government lending, and periodic bail-outs by taxpayers that is required to maintain them. The failure of any of these banks would be catastrophic to the economy and our financial system. MMF shares, on the other hand, are not insured by the federal government. In the two instances (in forty years) where an MMF broke a buck, investors lost a small amount of money but taxpayers were not on the hook. Increasing the size of the federal safety net was not the purpose of Dodd-Frank, the express purpose of which was to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts,” and yet that would be the most likely result of the use of Title I of Dodd-Frank to shrink or eliminate MMFs.

(14) The Council’s proposal to rescind Rules 22e-3 and 17a-9 would remove important 2010 reforms designed to protect investors.

As discussed in Section 2 of this paper, the Release recommends the rescission of SEC Rule 22e-3, which currently grants MMF boards the authority to suspend redemptions and begin an orderly liquidation of an MMF has broken or is about to break the buck. This rule, adopted

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152 Accord Letters from Fidelity Investments to IOSCO, filed with SEC (May 30, 2012); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from Invesco to SEC (Jan. 10, 2011); Letter from Professor Jonathan Macey to SEC (Jan. 8, 2011). The SEC staff acknowledged this point. Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 45 (Nov. 30, 2012), http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf (“The shift to bank deposits would increase reliance on FDIC deposit insurance and increase the size of the banking sector, which raises additional concerns about the concentration of risk in the economy.”).

153 Preamble to Dodd-Frank.

154 17 C.F.R. § 270.22e-3.
as part of the SEC’s 2010 amendments, gives boards an important tool to assure equitable
treatment of investors, and enables MMF boards to avert a run that could potentially reward first
movers.

The Council in its Release also proposes to eliminate Rule 17a-9, which currently permits
MMF affiliates to purchase portfolio securities from an MMF. The SEC has strongly supported
this rule in the past as an important investor protection. The Council recommends rescission of
the rule based on its assumption that a floating NAV makes it unnecessary.\(^{155}\)

While the issue of past incidences of MMF sponsor support has recently emerged as a
central argument for imposing new limitations on MMFs,\(^{156}\) sponsor support is not a new issue.
Indeed, not only has the SEC acknowledged the value of sponsor support to MMF shareholders
in the past, the SEC has twice amended its MMF rules to facilitate sponsor support of MMFs.
The first was in 1996, when the SEC adopted Rule 17a-9 to permit MMF sponsors to buy
portfolio securities from their MMFs, subject to certain conditions.\(^{157}\) In response to
commenters who opposed the new rule based on concerns that investors might rely upon the
sponsor support to buy out troubled securities, thus guaranteeing a stable NAV, the SEC
responded that it “believes that existing rules applicable to money funds already address this
concern by requiring money fund prospectuses and sales literature to disclose prominently that
there is no assurance or guarantee that a fund will be able to maintain a stable net asset value of
$1.00 per share.”\(^{158}\)

In 2010, when the SEC was well aware of the incidences of sponsor support during the
financial crisis, the SEC amended Rule 17a-9 to make it easier for MMF sponsors to buy
securities out of an MMF, without seeking an order from the SEC.\(^{159}\) Although the SEC
acknowledged that one commenter, Federated, “opposed the proposed amendment out of
concern that the expansion of the rule may exacerbate the unwarranted expectation of some
shareholders that advisers will take whatever steps are necessary to financially support the $1.00
share price”\(^{160}\) of their MMF, the SEC stated, “[W]e do not believe [the amendment] will
materially change shareholders’ perceptions about money market funds or the likelihood of

\(^{155}\) Release at 69466.

\(^{156}\) See Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Comm. on Banking,
Housing and Urban Affairs, 112th Cong. (June 21, 2012) (statement of Mary L. Schapiro, Chairman, SEC),
8f99c9f5fe9a.

\(^{157}\) Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 7275, Investment Company Act

\(^{158}\) Id. at 13974.


\(^{160}\) Id. at 10087.
sponsor support during times of market turmoil” and that “[t]he amendment simply extends the existing rule to types of transactions that historically have been permitted through no-action assurances obtained from the [SEC]’s staff because the staff believed they were in the best interest of the fund’s shareholders.”

The Release states that Council believes a floating NAV would not eliminate the risk of runs and would “reduce, though not eliminate” a so-called “first-mover advantage.” But, MMF board action to suspend redemptions under Rule 22e-3 does stop an MMF run and is specifically designed to benefit MMF shareholders by eliminating first-mover advantage. MMF sponsor actions, facilitated by Rule 17a-9, clearly benefit shareholders, particularly in those rare instances where sponsor support helps sustain a stable MMF NAV. The Council’s proposals to rescind these rules contain no elaboration or supporting data. The Council should not recommend rescinding these important reforms, less than three years after their adoption.

(15) Instead of focusing on the floating NAV, regulators should consider how MMF’s enhanced liquidity has proved to be effective in absorbing heavy redemption requests, and how it has improved the characteristics of the marketplace from 2008.

Any empirical analysis of the data and prior history shows that a variable NAV does not prevent or absorb runs. Imposing a variable NAV would not foster systemic stability, although it would produce the negative consequences that we have previously described. This is because a variable NAV (or a capital requirement or a minimum balance at risk standard) does not address the reasons that investors run in the first place. Investors run when they believe that it is likely that they must redeem their investments immediately in order to avoid losses, or to avoid having their investment trapped in illiquidity when they may need cash in the near term. If enough investors hold the same beliefs, their expectations can become self-fulfilling as selling drives down prices and buyers stay on the sidelines waiting for the market to bottom. This happened repeatedly during the subprime financial crisis (e.g., to SIVs, CDOs and auction rate securities).

Therefore, in order to promote systemic stability, regulators should focus on measures that would foster the rapid transformation of investments to cash holdings, and that would provide investors with confidence that MMFs will be able to meet redemption demands. Experience and economic analyses both confirm that what prevents a run – or resolves a run before it causes a panic – is liquidity. A 2006 analysis by Federal Deposit Insurance Corpo-

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161 Id.
162 Release at 69466-67.
163 The only other regulatory measure that has historically been shown to prevent runs, or to absorb runs that have started, is government deposit insurance. Although the Council’s release does not propose insurance for MMFs, we

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Corporation staff shows that it is insufficient liquidity, rather than capital, that is the best predictor of financial panics in the banking system. Likewise, a more recent study of German MMFs concluded that “[i]nvesting in less liquid assets . . . widens the narrow structure of money market funds and makes them vulnerable to runs. During the shortening of liquidity caused by the subprime crisis illiquid funds experienced runs, while more liquid funds functioned as a safe haven.”

Consistent with these studies, the experience of the subprime financial crisis showed that liquidity was an Achilles’ heel for many financial institutions, including certain MMFs. Before and during the subprime crisis, Rule 2a-7 did not establish specific minimum liquidity standards for MMFs, and disclosure of fund holdings was not as detailed. Thus, investors could not be sure that a given MMF would meet their liquidity requirements, and many sought immediate redemption in order to avoid future losses or a delayed access to cash.

In 2010, however, the SEC revised Rule 2a-7 by, among other things, establishing stringent liquidity standards for MMFs. Thus, each MMF is now required to have a minimum percentage of its assets in highly liquid securities so that it can meet reasonably foreseeable shareholder redemptions. Under new minimum daily liquidity requirements applicable to all taxable U.S. MMFs, at least 10 percent of the assets in the fund must be in cash, U.S. Treasury securities, or securities that convert into cash (e.g., mature) within one business day. In addition, under a new weekly requirement applicable to all MMFs, at least 30 percent of their assets must be in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within five business days. No more than 5 percent of a fund's portfolio may be “illiquid” (i.e., cannot be sold or disposed of within seven days at carrying value).

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note that government should promote competition in the financial system, and not foreclose the ability of investors to choose different alternatives for their cash holdings.


166 Rule 2a-7(c)(5); see Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

167 Rule 2a-7(c)(5)(ii), (a)(8); 17 C.F.R. §§ 270.(c)(5)(ii), (a)(8).

168 Rule 2a-7(c)(5)(iii), (a)(32); 17 C.F.R. §§ 270.(c)(5)(iii), (a)(32).

169 Rule 2a-7(c)(5)(i); 17 C.F.R. § 270.(c)(5)(i). To offer some perspective, these liquidity standards are far more stringent than those that apply to banks. In brief, MMFs may invest in debt instruments in which a national bank may invest, including prime commercial paper, bank deposits, short-term U.S. government securities, and short-term municipal government securities. 12 U.S.C. 24 (Seventh), 12 C.F.R. Part 1. However, they may not invest in less liquid instruments.

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Finally, depending upon the volatility of the fund’s cash flows (in particular shareholder redemptions), a fund may be required to maintain greater liquidity than would be required by the specific daily and weekly minimum liquidity requirements of Rule 2a-7. Thus, the 2010 reforms also require MMFs to conduct assessments of their shareholders’ anticipated redemptions, and to gauge the liquidity risks posed by individual shareholders or types of shareholders. Thus, as a practical matter, MMFs hold even more liquidity than regulations specify.

The 2010 amendments to Rule 2a-7 have had multiple stabilizing effects on individual MMFs and on the financial markets in general. First, the high level of liquidity in individual MMFs allows them to absorb and stop nascent runs. When investors who request a redemption are quickly paid in full, no redemption queue forms, and investors do not panic and suddenly demand to redeem shares at once. Second, when an MMF has liquidity available from normal portfolio maturities to meet redemptions, it does not need to sell portfolio assets prior to maturity to raise liquidity. This, in turn, protects the MMF from having to incur losses from sales of performing notes into an illiquid money market, and protects the money market from becoming locked up with large amounts of paper being sold.

An analysis prepared by Fidelity Investments demonstrates how the post-crisis amendments to Rule 2a-7 have made MMFs so resilient that they cannot be said to present systemic risk. Fidelity examined how various hypothetical scenarios in which interest rates rose suddenly and investors abruptly redeemed shares would affect the NAV of a typical institutional prime money market fund. The analysis showed that even “an instantaneous rise in interest rates of 200 basis points, as well as a simultaneous shareholder redemption of 50% of outstanding shares,” would not cause the MMF to “break the buck.” By comparison, “in 2008, it took four weeks for the three-month LIBOR rate to rise by 200 basis points. Moreover, shareholder redemptions in the week following the [Lehman] bankruptcy totaled approximately 30% of institutional prime MMF assets.”

Also, as noted above, MMFs hold more liquidity than the amounts specifically prescribed by Rule 2a-7 because they must assess and respond to the liquidity needs of their investors. Thus, in the RiskFin Report the SEC staff stated, “Today, the typical prime fund holds over one quarter of its portfolio in DLA [daily liquid assets] and nearly one half of its portfolio in WLA [weekly liquid assets].”

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liquid, longer-term and more risky investments that national banks may own, such as medium and long-term government or corporate debt and most types of loans (e.g., mortgages and consumer loans).


172 Id.

173 Id.
According to Fidelity, as of January 2012, MMFs held in excess of $1 trillion in 7-day liquid assets out of $2.6 trillion in total assets.175 This is many times the amount required to satisfy shareholder redemptions during the September 2008 crisis ($310 billion) and the June through August 2011 period of the European debt crisis and U.S. debt ceiling debate ($172 billion).176 Fidelity stated, “The large liquidity cushions now required by Rule 2a-7 have mitigated risk without imposing exceedingly costly unintended consequences.”177 Because the 2010 reforms are working to lessen the incentive to run and now require funds to have sufficient levels of liquidity to meet shareholder redemptions during periods of market stress, Fidelity concluded that additional reforms are unnecessary.

Their enhanced liquidity also allowed MMFs to handle large amounts of redemption requests in a time of extreme volatility in world markets — caused by fear of major sovereign defaults and the potential for related contagion — during the 2011 European debt crisis and federal debt ceiling impasse without disruptions. As of June 22, 2011, “prime” MMFs held about $1.6 trillion in assets, requiring daily liquid assets under Rule 2a-7 of at least $160 billion and weekly liquid assets of at least $480 billion. From June 22 to June 29, 2011, following reports of exposures to European banks and Greek debt, about $48 billion was redeemed from prime MMFs.178 Under Rule 2a-7’s minimum standards, prime MMFs had about ten times the weekly liquidity needed to cover actual withdrawals in this period.

As of late July 2011, taxable MMFs (MMFs other than municipal securities MMFs) held approximately $2.3 trillion in assets.179 In the last week of July 2011, when negotiations over the federal debt-ceiling reached an impasse, almost $120 billion in share value was redeemed from taxable MMFs.180 In the week ending August 3, net outflows from taxable MMFs totaled $69 billion, apparently due to concerns about the U.S. debt ceiling negotiations and Eurozone debt.181 Thus, under Rule 2a-7’s minimum requirements, taxable MMFs held weekly liquid assets of at least 5.7 times the amounts redeemed in late July and 10 times the amounts redeemed in early August. In fact, the minimum daily liquid asset requirement would have been more than sufficient to cover the heaviest week of withdrawals.

175 Letter from Fidelity Investments to SEC (Mar. 1, 2012).
176 Id.
177 Id.
179 Id.
From the end of May until August 3, 2011, investors redeemed over 10% of their prime (taxable non-government) MMF investments, totaling over $169 billion in redemptions. The RiskFin Report notes that “[s]ome prime funds had redemptions of almost 20 percent of their assets in each of June, July, and August 2011, and one fund lost 23 percent of its assets during that period . . . .” Much of the redemption activity was in short bursts around the key events of each financial episode. Yet no MMF “broke the buck,” faltered or was unable to meet redemption requests. Finally, as of March 2012, MMFs held 7-day cash liquidity of approximately $1.1 trillion, an amount seven times the largest outstanding borrowing by banks from the Federal Reserve under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility in 2008, and multiples of the amounts needed to meet redemptions in September 2008.

The enhanced liquidity of MMFs has had a clear and positive effect on financial stability. It is therefore disappointing that the Council has not analyzed the present liquidity of MMFs and the impact of that liquidity on the current financial market. In support of its Proposed Recommendations, the Council’s Release only notes that in 2008, some MMFs experienced levels of redemption requests in excess of the new daily or weekly minimum liquidity requirements. Yet this misses the point that in 2012, regulatory reforms have fundamentally altered the marketplace. Along with liquidity standards, the SEC has imposed stricter credit quality, diversification, portfolio maturity and disclosure requirements on MMFs. As a result, investors are better able to monitor fund portfolios, MMFs are able to redeem more shares without resorting to forced asset sales, and the likelihood of an MMF breaking the buck has been reduced substantially.

**Conclusion.** Forcing MMFs to adopt a floating NAV would do substantial damage to an investment product that has proved useful for over 30 million shareholders. It would eliminate MMFs as a viable cash management tool for a substantial portion of MMF investors who rely on

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182 Id.


184 See also Fidelity Investments, A Look at Regulatory Reform for Money Market Mutual Funds: Studying the Impact of the 2010 Changes (Mar. 1, 2012) (“The amount of liquidity currently held in MMFs is many times larger than the temporary government support provided during the 2008 financial crisis. Moreover, current liquidity far exceeds the amounts redeemed from MMFs during either of the two most recent identifiable episodes of market crisis: (1) $172 billion within an eight week period from June 2011 to August 2011 in the wake of the European debt crisis and U.S. debt ceiling debate; and (2) $310 billion in the week following the Lehman bankruptcy in September 2008”).

185 Release at 69464-65.
MMFs for a variety of specialized uses. Many of these investors would be prohibited from using a floating NAV MMF, and would place substantial tax, accounting, and operational burdens on the investors who could continue to use the product. These burdens would result in a dramatic shrinkage in MMFs. The consequences to both short-term credit markets could be substantial and remain largely unanalyzed by the Council. Further, this would cause investors to move liquidity balances elsewhere: to “Too Big to Fail” banks that are more risky and less efficient and require massive federal government support to stay afloat; to individually-managed investment accounts for the largest investor entities to invest directly in commercial paper, bank notes and other money market instruments; or to bank-sponsored short-term investment funds, hedge funds and offshore investment vehicles that are less transparent, less regulated, less efficient and result in the same “roll-over risk” for issuers in the money markets that the Council apparently wants to ameliorate through its plan to change the structure of MMFs.186

The justifications the Council provides for its proposed recommendation in the Release – stopping runs, reducing a “first-mover advantage,” and removing uncertainty or confusion regarding who bears the risk of loss in an MMF – are speculative and unsupported by data. Indeed, each is contradicted by substantial research, data, reports, surveys and other analyses submitted by commenters to the SEC. The Council’s recommendation to require MMFs to adopt a floating NAV should not be proposed or adopted.

Appendix

Impact on Specialized Systems That Use MMFs to Hold Temporary Liquidity Balances

The MMF business developed during a period in which a wide range of businesses moved from archaic manual systems to automated systems for processing the posting and settlement of various types of transactions. As a result, use of stable value MMFs to hold short-term liquidity was incorporated into many of the accounting systems and the automated interfaces used in these systems. Examples, which are discussed in more detail below, include trust accounting systems at bank trust departments, corporate payroll processing, corporate and institutional operating cash balances, federal, state and local government cash balances, municipal bond trustee cash management systems, consumer receivable securitization cash processing, escrow processing, custody cash balances and investment manager cash balances, 401(k) and 403(b) employee benefit plan processing, broker-dealer and futures dealer customer cash balances, and cash management type accounts at banks and broker-dealers.

The systems changes that have been implemented in many different businesses over the past four decades have greatly reduced (i) the time required to post and settle transactions, (ii) the personnel required to post and settle transactions (and thus the overhead costs associated with those functions), (iii) the errors associated with posting and settling those transactions, (iv) the “fails” involved in settling those transactions, (v) the size and length of time outstanding of the “float,” “due to,” and “due from” balances tied up in processing of transactions, and (vi) the counterparty default risk associated with transactions between and among companies. These changes have had the net result over the past four decades of reducing risk and increasing the efficiency of many business activities and greatly reducing the amount of funding required for businesses to conduct transaction processing.

Many of these systems have as a key element the use of MMFs to hold short-term liquidity in connection with settlement of the transactions. The features of MMFs that are ideal for holding temporary balances in these systems include (1) stable $1 per-share value during the time the transaction is being processed to allow certainty of the day of the exact dollar amounts that are being processed between different counterparty accounting systems so that the amount due and the amount paid do not diverge even by a few cents during the time in which the transaction is being processed, (2) same-day settlement capability (T+0 processing) which is possible only because of the use of amortized cost by MMFs, (3) high credit quality and underlying portfolio issuer diversification which reduces risk of insolvency during the time the transaction is being processed, and (4) operation within a highly-automated secure computer environment that allows for 24/7 no downtime interfaces with accounting and data processing systems of all parties to the transactions.
The use of amortized cost and the resulting stable NAV are crucial features of MMFs that allow them to work with automated processing systems. Amortized cost allows the use of a stable $1 per-share pricing by MMFs. The valuation method accretes one additional day’s worth of imputed interest on each portfolio asset each day using factors and information known in advance. This means that, absent a material credit event during the day that drops NAV below 99.5 cents per share, at 6:00 a.m., the system operators know what a share will be worth at 6:00 p.m. It will be priced at exactly $1.00 per share. If MMFs were required to use continuously floating NAV, the exact price of a share as of the close of the day would not be known until after the markets close that day. Floating NAV funds must determine the purchase or redemption price of a share using the market-closing prices of the portfolio securities that are not known until the next close of markets after that purchase or redemption order is placed.\textsuperscript{187}

In other words, if MMFs used a floating NAV, the system operator would not know until 4:00 p.m. whether a share would be worth $1.00001 or $0.99999 at the end of the day. When the automated system learned in the morning that it must purchase or liquidate MMF shares to process a payment of say, $10,000,000 that afternoon, and placed that order, it would not be clear at the time the order was placed exactly how many MMF shares would have to be liquidated to reach that exact amount. It might be a few cents more or less at the end of the day than anticipated. This few extra or short pennies would be a discrepancy that would need to be manually reconciled and the difference trued up before the transaction could be finished. Manual processing would mean more staffing requirement, more costs associated with staffing the function, and errors and delays in completing the process.

Furthermore, because the purchase and redemption price would not be known earlier, and the market-closing prices from after the purchase or redemption order was placed must be used to set the price for the purchase or redemption order, the settlement payment could not occur the same day the order is placed (T+0), but instead is made the next business day (T+1). This means one party to the transaction owes the other money for one more day (three if it is a weekend, four if a holiday weekend). Both parties would carry the unsettled transaction as an open position for one extra day and each party would be exposed for that time to the risk that its counterparty would default during the extra day, or that the bank holding the cash overnight (or over the weekend) would fail. For a bank involved in making a payment in anticipation of an incoming funds transfer as part of these processing systems, this change from same-day to next-day processing of MMF redemptions would turn intra-day overdrafts into overnight overdrafts, resulting in much greater default and funding risks to the bank. This extra day’s float would mean more risk in the system and a larger average float balance that each party must carry and finance.

The net result of a floating NAV would be to make MMFs not useful to hold the large, short-term cash balances used in these automated transaction processing systems across a wide

\textsuperscript{187} 17 C.F.R. §§ 270.2a-4, 270.22c-1.
variety of businesses and applications. A generation’s worth of work in automating settlement systems, shortening settlement times, and limiting counterparty risk would be undermined. At a minimum this would require systems to be re-programmed on a wide scale, involving substantial personnel, time and years to complete. This would be comparable in some ways to the Y-2K effort, although the effort would be concentrated at fewer firms, but more work required at each affected firm to redesign and reprogram their processing and accounting systems. Completion of the systems would take many years and hundreds of millions of dollars to complete across a wide range of businesses and applications for which stable value MMFs currently are used to hold short-term liquidity. Until these systems could be redesigned, reconfigured and rebuilt, processing of transactions would essentially be back to the manual processes that existed in the early 1970s.

If MMFs no longer provide a business solution for holding short-term cash balances for each of these various processing functions, something else would need to be used. The vehicles that formerly held these pending balances before MMFs filled this need included credit balances at the commercial counterparty (due to and due from amounts at a commercial company, or free credit balances at a broker), bank short-term investment funds, corporate variable amount notes, and bank deposits. These vehicles have fallen out of use for this purpose or might no longer be available, and each carries with it much greater and more concentrated default risks.

Examples of some of the transaction processing systems that use MMFs to hold short-term cash balances are set forth below, along with a description of how MMFs fill a business need of that particular system.

Bank Trust Accounting Systems. Bank trust departments are responsible for receiving, tracking, accounting for, holding in custody, investing, and paying out cash balances for large numbers of trust accounts. This cash includes balances from many different trust and fiduciary accounts. It represents cash received from the proceeds of sales of securities or other assets, dividends and interest on client investments, and new balances placed in trust. The cash is held briefly pending distribution to beneficial owners, payment of expenses and taxes on behalf of clients, and payments for purchases of securities and other assets for client fiduciary accounts. At any given time, the balance for any one client account may be very large or very small, but in the aggregate the trust department as a whole represents a very large, short-term cash balance. Trust departments have an obligation to keep trust assets productive, minimize the time cash balances remain uninvested, and seek a competitive return on cash balances consistent with prudent investment principles.188

Tracking, investing and accounting for these cash balances is a complex effort, due to the large numbers of fiduciary accounts which must be tracked, the many and varied inbound and outbound streams of cash, the need to plan and manage payments and distributions for the

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188 12 C.F.R. § 9.10.
various client accounts, tax considerations, the non-uniform provisions of the many different trust instruments that govern the requirements of each different account, and the complex and overlapping requirements of state and federal laws governing fiduciary accounts. Fiduciary laws in many jurisdictions designate certain types of assets as permitted investments for trusts and certain other fiduciary accounts. MMFs have been recognized as permitted fiduciary investments in many states. A change to the regulatory requirements for MMFs that precluded MMFs from using amortized cost or seeking to maintain a stable net asset value per share could lead state legislatures to amend fiduciary statutes to prohibit the continued use of MMFs to hold trust cash balances.

Among the many complexities of applicable fiduciary laws is a requirement in many jurisdictions to track and separately account for principal and income on each account, and requirements on diversification and in what assets a particular type of fiduciary account can be invested, as well as restrictions on conflicts of interest by the trustee bank.

Most bank trust departments operate on trust accounting systems provided by one of ten large national vendors. These automated, computer-based systems are designed to maintain records of client accounts, generate internal and external reports used by the trust department, as well as tax records and client statements, and interact with the investment and cash management programs of the bank on an automated basis.

In the past, trust departments generally held trust cash either on deposit with the commercial side of the bank, or in a “short term investment fund” maintained by the trust department. Both of these alternatives had significant operational problems. If placed on deposit with the commercial side of the bank, the fiduciary account deposit generally must be collateralized by high quality bonds,189 and must bear a competitive rate of interest.190 Depositing with the commercial side presents a conflict of interest that must be carefully managed and maintained only for a short period.191 This presents further complications under the reserve requirements of Regulation D, which require reserves to be placed by the bank with the Federal Reserve equal to 10% of a “demand deposit” portion of these cash balances.192 The combination of these factors makes it impractical in many cases for the commercial side of the bank to accept fiduciary deposits.

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191 Id.
192 12 C.F.R. § 204.
Short-term investment funds (or STIFs) present other challenges as a cash management vehicle for trust department cash. STIFs are a form of bank common trust fund invested in relatively short-term high quality debt instruments, and only certain types of bona fide fiduciary account balances from the bank that maintains the STIF and its affiliated banks can be placed in them. Revocable grantor trusts, investment management and custody accounts, IRA and pension and employee benefit plan assets cannot be placed with the other trust assets in a STIF due to requirements of the Investment Company Act exemption within which STIFs operate. Moreover, separate STIFs must be operated in order to segregate pension plan assets from assets in trust accounts. This results in a relatively small investable balance for each STIF (compared to MMFs) and therefore a substantial challenge in keeping the portfolio of the STIF fully invested in a diverse pool of high quality assets while matching the timing of cash flow requirements dictated by trust account investments in and redemptions from the STIF.

One of the first major uses of MMFs was to hold these trust department temporary cash balances. MMFs provided a useful solution to bank trust departments which allowed them to invest balances of fiduciary accounts for short periods of time in an asset permitted by state fiduciary laws and trust instruments, at a competitive yield in a liquid, diverse pool of high quality debt instruments. Because an MMF can accept investors from many different banks’ trust departments as well as other types of retail or institutional investors, an MMF can be much larger than a STIF and can accordingly achieve more portfolio diversification, better management of liquidity needs, and lower operating costs per dollar of assets, as compared to a STIF, and pay higher returns with less concentration of risk to trust accounts than a bank deposit. Use of amortized cost permits an MMF to anticipate NAV and share prices at the beginning of the day for the entire day (subject to the remote possibility that there will be an unexpected substantial credit event during the day that drops NAV below 99.5 cents per share), rather than needing to wait until after the close of the trading markets at 4 pm to know end-of-day NAV. This means the price of an MMF share can be anticipated at 6 am when the processing day begins.

Trust accounting systems interface with many different external systems on a daily basis. These include interfaces with systems of broker-dealer firms through which the trust department executes purchases and sales of securities for fiduciary accounts, systems providing notification of dividend and interest payments received through securities clearinghouses and payment agent banks, and systems for receiving and sending incoming and outbound payments through the

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194 Investment Company Act 3(c)(3) (exemption for bank common trust funds), 3(c)(11) (exemption for bank collective funds for pension and employee benefit plans); In the Matter of Commercial Bank and Marvin C. Abeene, SEC Rel. 33-7116 (Dec. 6, 1994).

banking system on behalf of fiduciary accounts. These electronic data communications generally involve a bilateral exchange of pending payment amounts stated in dollars and cents, which are followed subsequently by deliveries of those amounts.

In order to reduce errors and cash shortfalls, trust accounting systems typically post a debit to the cash position in the account immediately before or simultaneously with the placement of an order to purchase a security, which is transformed into a redemption order for shares of the MMF to generate cash to pay, the next day, for the security being purchased.196 These accounting systems require a predictable MMF NAV share value at the time the redemption order is placed for (i) the cash position to match the cash needed to settle the purchase order and (ii) the ending balance reflected as available in the MMF to be accurate for processing any other transactions in the customer account that day.

Predictability in the per share price of MMFs is critical to the operation of trust accounting systems, allowing them to be more fully automated (rather than relying on manual processes and the staffing costs, delays and errors associated with manual posting and processing of transactions and cash balances), allowing an exact sweep of cash balances to the penny, and permitting same day processing of cash payments. This permits same day (T+0) or next day (T+1) settlement of portfolio securities transactions for fiduciary accounts, which in turn reduces the amount of settlement cash, “due to” and “due from” “float” in the trust department and overnight overdrafts and out-of-balance trust accounts. This, in turn, means less counterparty risk and shorter time for client fiduciary assets to be less than fully invested.

Federated has been informed by the vendors of each of the major trust accounting systems that their systems are not designed to process cash balances using MMFs with a continuously floating NAV. Forcing MMFs to move to a continuously floating NAV would make MMFs incompatible with the major trust accounting systems. Until these trust accounting systems could be redesigned and reprogrammed either to accept a continuously floating NAV (assuming it could be done at all and trust departments would accept it) or use some other vehicle to hold cash balances, trust departments would essentially be forced to use more manual processing, returning them essentially to the 1970s.

**Corporate Payroll Processing.** Most companies pay their employees either twice per month or every two weeks. Generally, pay is disbursed to all employees on the same days. The pay is either distributed in a direct deposit to an account previously designated by the employee, or in a physical paycheck given to the employee. The aggregate amount of money involved in each payroll disbursement is very large. The bigger the company, and the larger its employee base, the larger is the aggregate amount of cash involved. The corporate treasury department manages its cash availability through a variety of short-term investments that are sufficiently

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liquid to address scheduled payments that must be made. Payroll is a very large and recurrent payment amount.

Pending distribution to employees, the cash must sit somewhere. Large companies commonly use third-party vendors to handle payroll processing, but employers are not eager to incur the credit risk of such vendors on payroll balances, even for a short period of time. For a given pay period, the aggregate payroll amount for a large company is many millions of dollars, well in excess of the standard $250,000 FDIC deposit insurance limits (which limits are only temporarily suspended on noninterest bearing demand deposits until year-end 2012). If the entire balance is placed on deposit at a bank, and the bank fails, the company is at risk of losing a large portion of the payroll balance in excess of $250,000. Companies with large payrolls are understandably anxious about limiting their loss exposure in the event of the insolvency of a bank. From the bank’s perspective, many banks are not eager to take on multi-million dollar deposit balances for periods of a few days each month, because there are costs involved with having those balances on the bank’s balance sheet and the bank is not able to profitably invest the cash for such a short period of time.

As an alternative, many large employers place cash pending distribution of payroll into MMFs, with an automated sweep into the payment system and vendor used by the employer. An MMF knows in advance, through communications with the employer and experience, how much money is coming in and out and when it will arrive and depart, and is able to profitably invest the proceeds through the MMF’s portfolio for a few days in short term instruments, carefully managing the cash position of the MMF with advance knowledge of the amounts and schedules of the payroll arrival and disbursement.

Key features that allow MMFs to work to hold short-term balances for corporate payrolls pending distribution include the use of amortized cost and a stable NAV of $1 per share, which allows for a predictable value of share prices throughout the day (rather than needing to wait for end-of-day market close prices to know share prices and processing of purchases and redemptions after 4:00 p.m.) and same-day processing of investments and redemptions of shares. The bank that is processing the payroll distributions makes payments as checks and other items are presented through the banking system, and is able to redeem shares of the MMF and receive payment on a same day basis and avoid an overnight overdraft. If MMFs were required to use a continuously floating NAV, purchases and redemptions would need to be processed on a next-day basis. This would require either (i) that large balances be redeemed and held as cash overnight or over a period of days as items are presented to the bank, creating an exposure by the employer to the credit risk of the bank for large amounts of money, or (ii) leaving the bank exposed to the risks associated with overnight overdrafts pending receipt of cash from the MMF or directly from the employer.

Moreover, if a continuously floating NAV is required for MMFs, on a multi-million dollar balance, the value of the MMF shares would move around a small amount, such that the payment sent by the employer and held in the MMF for a few days would be a few dollars over
or a few dollars short of the gross payroll amount each payroll period. This, in turn, would require more manual processing, creating more delays and errors, and significantly undermining the usefulness of MMFs to employers, banks and payroll processors.

**Corporate and Institutional Operating Cash Balances.** In addition to payroll balances, companies have other payments received, as well as incoming cash from operations, and closely manage those cash balances in order to meet their payment obligations as they occur. Large companies typically have a corporate treasury management function to handle the liquidity needs and short-term investment of the company’s assets.

The balances involved at a company at any given time can be very large. Due to low (or zero) interest rates on short-term corporate deposits and the risk of bank failure when balances are in excess of the $250,000 FDIC deposit insurance limits, leaving large amounts of cash on deposit at a bank is not a good alternative. Although the FDIC deposit insurance coverage on non-interest bearing demand deposits has been temporarily increased to an unlimited amount until December 31, 2012, that remains a short-term and not a highly attractive solution for corporate treasurers for holding large cash balances.¹⁹⁷

Traditionally, larger corporate treasury departments managed cash balances by holding separately managed portfolios of direct investments in commercial paper, treasury bills, and other high quality short-term debt instruments. Many corporate treasurers have found it more efficient to invest a portion of those short-term balances in MMFs. This allows for professional management at a lower cost of a diverse portfolio with greater liquidity than the company’s treasury desk could accomplish on its own. In this context, MMFs are an alternative to an individually-managed portfolio of securities.

Use of amortized cost accounting which has resulted in nearly all circumstances over the past 35 years in a stable NAV of $1 per share provides a simple means for MMF balances to be integrated into the internal accounting and cash management systems used in corporate treasury departments. Same day processing of MMF share purchases and redemptions, which is not possible with a floating NAV MMF, allows MMFs to be used more efficiently by corporate treasurers and permits a more automated interface among the internal accounting systems used by the corporate treasury department, the banks through which the company sends and receives payments, and the MMF’s transfer agent. This, in turn, reduces float in the system, overnight overdrafts by the corporation’s banks and the balances of the corporation with its banks in excess of FDIC deposit insurance limits.

¹⁹⁷ The statutory deadline was imposed by Section 343 of the DFA and is codified in 12 U.S.C. § 1821(a). As discussed below in Section II-D, further extension of unlimited deposit insurance would be inconsistent with the goal of reducing the size of the Federal safety net and would also further fuel the growth of the largest banks.
Federal, State, Local Government Cash Balances. Like businesses, governments have cash management needs. Many state, local and federal government bodies use MMFs as an efficient means to invest short term liquidity balances. Governments have payrolls to pay and operating cash balances to invest for short and medium periods of time. Government cash balances often are tied to tax payment cycles and expenditures tied to fiscal year budgets. Investment of the balances is subject to a myriad of state and local government requirements on investment of government assets, and in some cases to Internal Revenue Service requirements. These state and local laws commonly include lists of permitted investments that specifically authorize investments in MMFs, defined in terms of a fund that seeks to maintain a stable net asset value per share. A change to the regulatory requirements for MMFs that precluded MMFs from using amortized cost or seeking to maintain a stable net asset value per share would require many state and local government statutes to be amended by the state legislature to permit the continued use of MMFs by the state or local government.

Although placing the funds on deposit at a bank is an alternative, government deposits frequently are required to be collateralized with high quality bonds, which make them expensive for the bank to hold. Another alternative is for the state or local government to attempt to manage a portfolio of direct investments in individual money market instruments, although this is a more expensive, higher risk and ultimately less liquid means of investing cash balances of state and local governments than investing in MMFs. An unintended consequence to a movement away from amortized cost and a stable value of $1 per share would be to diminish the ability of state and local governments to use MMFs and to force them into less liquid, more expensive, higher risk alternatives for investment of cash portfolios.

Municipal Bond Trustee Cash Management Systems. State and local governments raise money for general operations and for specific projects through the issuance of municipal bonds. Each bond issuance has an indenture with a bank as bond indenture trustee and payment agent to handle various aspects of the bonds’ issuance, payment of interest and ultimate retirement. Substantial cash balances flow through the bond trustee and paying agent bank, with which cash payment must be made on time every time pursuant to the contractual terms of the bonds to avoid default. In many cases, the credit quality and credit rating of the bond issuance is tied to a very carefully developed cash management program designed to assure that there will be cash available to make scheduled interest payments and sinking fund retirements of the bonds. The trust indenture of the bond, as well as state and local government laws and IRS requirements dictate certain aspects of how and into what types of assets the cash balances can be invested pending payment or distribution.

Leaving large amounts of cash on deposit at a bank results in a concentration of credit exposure that in some cases is not acceptable to bondholders. In addition, because the liquidity balances flow through the bond trustee and payment agent over relatively short periods of time, a bank may not be able to profitably invest the cash on a short term basis. As a result, MMFs are used in many cases to hold portions of the short term liquidity pending payment or distribution on scheduled dates.

Use of amortized cost accounting and a stable NAV of $1 dollar per share allows MMF balances to be integrated into the accounting systems used in the corporate trust department of the bank that serves as bond trustee. Same day processing of MMF share purchases and redemptions, which is not possible with a floating NAV MMF, allows MMFs to be used more efficiently by the bond trustee and payment agent. This, in turn, reduces float in the system, overnight overdrafts by the payment agent bank and the balances of the issuer with its bank in excess of FDIC deposit insurance limits.

A trust company president described the importance of MMFs with a stable NAV of $1 per share to the investment of cash amounts associated with municipal bonds as follows:

Until the advent of money market mutual funds, state and local government entities investing bond proceeds for infrastructure projects were extremely limited in scope to the manner in which bond proceeds could be invested. The work that we did collectively to have state statutes passed to allow a broader investment product array by utilizing money market funds as “permitted investments” has allowed for the minimization of market risk . . . .

If for some reason the maintenance of a stable $1.00 value by money market mutual funds is at risk, we will see a mass exodus of investors from the institutional side of the business, such as Reliance Trust Company. This exodus will expose all investors to increased processing costs, substantially greater risk and liability, limited choices of investment vehicles primarily because of statutory restrictions and far greater exposure to credit risk.200

Consumer Receivables Securitization Cash Processing. The structures used for issuance of mortgage-backed bonds and other securitizations of consumer receivables share some of the attributes and cash management needs of municipal revenue bonds, but the cash flows are far more complicated and less predictable. Many of the structures require an initial cash balance and additional retention, build-up and hold back of significant amounts of cash

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from payments received on the underlying consumer receivables as a “prefunded account” in order to assure timely payment of the senior tranches of the securitization. These cash hold-backs serve some of the same purposes as a back-stop letter of credit from a bank, which may also be in place in addition to the cash hold-back. The prefunded account reduces the likelihood of the need to draw on the letter of credit and the potential size of that draw. MMFs are used as a more efficient and lower risk alternative to direct investment by the indenture trustee of the prefunded balances in a portfolio of individual money market instruments.

MMFs are used in some cases to hold portions of these cash balances, for essentially the same reasons described above – MMFs limit counterparty risk exposure to any one bank, and the stable NAV permits same day processing of share redemptions and more convenient inclusion of balances in the complex accounting systems needed to track payments and disbursements in these securitization structures.

The permitted instruments into which cash balances can be invested generally are specified in the trust indenture and other governing documents of the structure and cannot readily be changed after the securitization structure is launched and its securities sold to investors. Changing the regulatory attributes of MMFs could compromise their role in holding short-term liquid assets in securitization structures.

**Escrow Processing.** Money is placed in escrow in connection with a variety of transactions ranging from the purchase of a home to corporate acquisitions. The basic purpose is similar -- to place a cash balance into the hands of an independent party to make a payment on a contractually specified amount when certain conditions are met. The amounts per customer may be a few thousand dollars for mortgage escrows to hold tax and insurance payments, or billions of dollars in a corporate M&A transaction. The funds may be held for a few hours, days or months. The amounts held by an escrow agent commonly exceed deposit insurance limits of $250,000. If pass-through deposit insurance treatment is not available, or if the amounts per ultimate beneficial owner exceed $250,000, allowing the escrow agent to place the escrow balance in a bank deposit may not be an acceptable risk to the parties. Escrow agreements commonly allow the parties to direct the escrow balances be held in shares of a designated MMF, as a way of limiting counterparty risk.

MMFs are useful for this purpose because they do not represent the credit risk of a single issuer, but instead represent a diversified pool of high-quality short term debt obligations of many underlying issuers. In addition, because the value of the shares do not fluctuate, the escrow agent can hold an amount representing exactly what must be paid if the conditions to completion are met and the escrow amounts paid out on settlement. For escrows on purchases of companies with many shareholders, the accounting systems needed to assure exactly the correct amounts are paid to the proper shareholders are complex. Similarly, escrow agents that process

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mortgage-related tax and insurance escrows use complex automated accounting systems that must track and account for a large number of consumer escrow accounts each with different balances and payment amounts.

The use of amortized cost permits the share price of an MMF to be anticipated in the morning (because the daily amortization factors are known for each portfolio security) for the day, rather than known only after the closing of the markets at 4:00 p.m. This permits a share price to be used at a stable dollar amount throughout the day by the automated accounting and payment processing systems used by escrow agents. Moreover, the use of amortized cost also permits same-day settlement of purchases and redemptions of MMF shares. These two features—a stable share price throughout the day and same-day settlement—are key to the utility of MMFs to hold temporary cash balances for escrow agents. If MMFs were required to use a continuously floating NAV, they would not be as useful to escrow agents, the escrow agents’ accounting systems would need to be redesigned and reprogrammed to accommodate a floating NAV, and payment cycles would be delayed by a day. If escrow agents continued to use MMFs at all, there would be one extra day to closing required, and that delay means one extra day of counterparty risk. In addition, the cash balance would likely need to sit in a bank account overnight, adding the risk of bank failure during that period.

**Custody Cash Balances and Investment Manager Cash Balances.** Banks serve as custodians for securities accounts of commercial and individual customers. Securities purchases and sales orders are placed by the customer (or its investment adviser)\(^2\) with a securities broker and the custodian bank is notified of the transaction. The custodian bank communicates settlement instructions with the broker-dealer. Custodial cash is commonly invested in MMF shares, in part because the cash balances commonly exceed the $250,000 FDIC deposit insurance limit. When it receives instructions to deliver cash to a broker-dealer to settle a transaction, the custodian bank redeems shares of the MMF. Same-day settlement of MMF shares (T+0) permits the cash to be available to settle the securities transactions the next day (T+1). With a continuously floating NAV, there would be an additional business day required to redeem MMF shares, which would move the settlement cycle for the securities transaction back one day (T+2).

**401(k) and 403(b) Employee Benefit Plan Processing.** Private employers over the past few decades have shifted from defined benefit retirement plans to defined contribution plans due to the high costs and potentially large unfunded liabilities associated with defined contribution plans. Two common and highly popular forms of participant-directed defined contribution plans are 401(k) and 403(b) plans, which draw their names from provisions of the Internal Revenue Code. Among the requirements applicable to these plans under the Department of Labor rules implementing the Employee Retirement Income Security Act (ERISA) are that, in order to limit the liability of plan trustees, a stable value option be included as part of the plan to hold cash.

\(^2\) See 17 C.F.R. § 275.206(4)-2 (customer accounts of registered investment advisers required to be held in custody of bank or broker-dealer).
contributions for which a participant has not yet provided investment instructions. MMFs are an investment option eligible to meet this requirement for up to 120 days.

In addition, cash balances in participant accounts must be segregated from the assets of the plan trustee and held during brief periods of time when a plan participant is changing the investment allocation of the participant’s account. MMFs serve this purpose within 401(k) and 403(b) plans.

The use of amortized cost and $1 per-share pricing at MMFs allows for same-day settlement, and allows the value of shares to be known throughout the day. If MMFs were required to use a continuously floating NAV, it might further delay the settlement of transactions and share prices could fluctuate very slightly and would not be known with certainty until after 4:00 p.m. each business day. This would limit the utility of MMFs for use with the automated accounting and processing systems used by vendors that provide 401(k) and 403(b) plans, and if MMFs continued to be used at all, would increase settlement times by at least one day, increase float in the system, require a process for reconciling and truing up order amounts to reflect small variations in the value of MMF balances and require a significant redesign and reprogramming of the accounting and processing systems used by 401(k) and 403(b) plans to accept a floating NAV MMF to hold temporary cash balances.

**Broker-Dealer and Futures Dealer Customer Cash Balances.** Customer accounts at securities broker-dealers carry cash balances that are used to make payments on amounts owed by the customer on purchases of securities. This cash belongs to the brokerage customer. Cash flows into the brokerage account through cash amounts added to the account by the customer, dividends and interest on investments held in the account, and from the proceeds of sales of securities.

If the brokerage customer’s cash balance is not invested in something, it sits as a “free credit balance” which is simply a “due to” amount owed to the customer by the brokerage firm. To protect customers against the risk of a failure of the broker-dealer firm (and ultimately the SIPC which guarantees customer cash balances up to $250,000 per account), the broker-dealer is required to hold bank deposits or certain types of securities in a segregated account for the exclusive benefit of its customers, in an amount at least equal to the net unencumbered amounts of customer “free credit balances.”

As an alternative to holding customer cash as free credit balance liabilities of the broker-dealer, brokerage firms normally provide a cash sweep program by which customer cash balances are “swept” into investments in shares of MMFs which are then owned by the customer but held in custody through the broker-dealer. Investment of the cash balances into MMF shares

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203 See 29 C.F.R. § 2550.404c-5 (Department of Labor Qualified Default Investment Alternative Regulations).

204 17 C.F.R. § 240.15c3-3.
segregates these customer assets from the assets of the broker-dealer and removes them from the balance sheet liabilities of the broker-dealer.

Because MMF redemptions settle same day (T+0), cash is available very quickly to pay for customer purchases of securities, or to receive incoming cash from the sale by the customer of a security. This same day cash availability is important to avoid customer “fails,” and to assure compliance with the margin rule requirements applicable to brokerage accounts which require cash availability in the account when a customer places an order in a customer cash account and margin collateral coverage in a customer margin account.205 In addition, the use of amortized cost and a stable NAV of $1 per share allows efficient processing of cash balances by the accounting system of the broker-dealer throughout the transaction processing cycle at a known and predictable amount, and communication with the accounting systems of the transfer agent of the MMF. This allows the use of MMFs as a means to hold cash balances within the automated accounting and transaction processing systems used by the broker-dealers, which in turn reduces settlement times, pending transaction float balances and fails, and the counterparty risk in the system.

Similarly, rules of the Commodity Futures Trading Commission (“CFTC”) require the segregation of customer cash balances at a futures firm used to pay for (and provide margin collateral for) futures transactions place by a customer.206 MMFs serve the same function at futures firms as they serve at securities broker-dealers -- hold customer cash balances, and to collateralize amounts due or potentially due on futures positions of the customer held through the futures firm. The CFTC reaffirmed the continued appropriateness of MMFs to hold customer liquidity balances in December 2011 after careful review and a lengthy rulemaking proceeding.207 The CFTC determined through this process that MMFs satisfy the statutory objective that “customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers . . . and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk.”208 as well as the Regulation 1.25 prudential standard that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”209

Broker-dealers and futures dealers are subject to regulatory requirements specifying the types of assets that the entity can own and the types of assets that can serve as collateral or be

205 See Regulation T, 12 C.F.R. Part 220. The margin rule treats MMFs shares essentially as the equivalent of cash for this purpose.
206 17 C.F.R. § 1.20.
208 Id. at 78776.
209 Id. (citing 17 C.F.R. § 1.25(b)).
used to invest client cash balances. Many of these regulatory provisions specifically include as a permitted investment MMF shares that seek to maintain a stable net asset value per share.\(^{210}\)

The ability of securities broker-dealers and futures commission merchants to shorten settlement times and reduce the systemic risks associated with unsettled transactions has been facilitated by the ability of MMFs to process purchases and redemptions of shares on a same day (T+0) basis, which in turn is only possible as a result of using the amortized cost method of accounting. Requiring MMFs to use a continuously floating NAV would require them to move to next-day settlement and lengthen settlement times of securities transactions by at least one day. The securities industry has spent the past 35 years shortening settlement times to in order to reduce systemic risk. Using MMFs to hold short-term cash balances in connection with the transaction settlement process has been an integral part of how that was accomplished. An unintended consequence of the movement of MMFs to a continuously floating NAV (or the elimination altogether of MMFs) would be longer securities transaction settlement cycles and an increase in systemic risk.

**Cash-Management Type Accounts at Banks and Broker-Dealers.** Brokerage firms and banks offer “cash management” type accounts that permit customers to access cash balances in their brokerage accounts by check or debit card. Millions of retail customers find these accounts to be convenient. Cash balances in these accounts are held either in MMFs or in brokered deposits at banks. Checks and debit cards are processed by a bank for the brokerage firm. The payments of these items are funded by cash received from redemptions of MMF shares held in the customer’s brokerage account. The bank runs nightly files of items presented for payment, which triggers a redemption of MMF shares. The bank advances payment on the items after confirming electronically MMF shares are being redeemed to repay the bank on the advance of Funds. The cash from the redemptions is then sent to the bank.

Processing the transactions is done on an automated basis, requiring a series of electronic data exchanges among the bank that issues the debit card and processes the checks, the brokerage firm that carries the customer’s brokerage account, and the transfer agent of the MMF which processes the redemption requests and forwards payment to the bank.

Use of amortized cost and stable value of $1 per share is crucial to processing these accounts because it permits same-day processing of MMF share redemptions. This allows the bank to limit its credit exposure and avoid overdrafts and “NSF” or “bounced” checks. Use of a predictable $1 per share value is also critical to the interface among the accounting systems. The systems are programmed to work on a stable value of $1 per share. A continuously floating NAV would result in transactions being a few pennies over or short each day, which would require manual processing of the transactions. In the alternative, if the accounting systems were

\(^{210}\) N.Y. Mercantile Exchange Letter to Mr. Richard Recker, Federated Securities Corp. (May 18, 2001); Options Clearing Corp. Memorandum to all Clearing Members (Feb. 18, 2005).
reprogrammed to address a continuously floating NAV by submitting the redemption request as a dollar amount rather than a number of MMF shares, the account balance remaining after an MMF share redemption is processed would be off by a few pennies per day, requiring inclusion of a larger buffer balance in the customer’s account to ensure a sufficient available cash balance to avoid fails and overdrafts in subsequent transactions by the customer in the account, and additional work by the customer to keep track of available balances in the account.

For debit cards, there is a two step-process notification and payment of items is separated by a few days. First, at point of sale, the merchant sends an electronic signal through the banking system that the customer is buying something at a certain price, and the available balance is confirmed and a hold placed on that balance at the MMF. A few hours or days later, the merchant submits the debits for payment through the banking system, which submits the items for payment to the bank that issued the debit card and, which makes the payments. The bank then sends a signal to redeem the MMF shares that are on hold, to repay the bank for the advance. If the MMF shares continuously floated up and down in price between the time when the hold was placed and the shares redeemed, the payments would be off a little bit each time, requiring manual processing. If same day settlement of MMF redemptions were not available, the bank would not be reimbursed on the same day that it advanced payment on the debit card items. Same-day cash would not be available to the entity “sourcing” the transaction. This would require cash funding flow changes throughout the funding chain and could require some participants in the process to carry an overnight overdraft until the cash arrives the next business day. Additionally, as entities authorizing debit/POS/ATM transactions based on an “Available Balance” data delivered to them by the transfer agent or brokerage platform, that balance could be slightly off as the shares representing that balance change based on end-of-day floating NAV pricing. Currently, these workflows and systems all assume a stable NAV of $1 per share throughout the chain of processing and same day processing of MMF share redemptions. Any change to that assumption will require a retooling of the workflow and cashflow timing to accommodate cash availability and delivery.

Banks offer a substantially similar product without the brokerage account. In the bank version, the bank offers a checking account with a debit card and ATM access, with balances above a set dollar minimum (which often is $0) swept into shares of an MMF. The bank pays items after they are presented and after verifying there are enough MMF shares owned by the Customer. The bank places an order to redeem MMF shares to repay the advance.