MEMORANDUM
To: Money Market Reform Proposal File
From: Rachel Mincin, Associate Chief Accountant, Office of the Chief Accountant
Date: September 4, 2013
Re: Meeting with Representatives from the Financial Services Roundtable

September 4, 2013, Lona Nallengara, Chief of Staff, Paul Beswick, Chief Accountant, Office of the Chief Accountant, Shelly Luisi, Rachel Mincin and Jeffrey Schaeffer of the Office of the Chief Accountant and Sarah ten Siethoff, Jamie Eichen, Megan Monroe of the Division of Investment Management met with representatives from the Financial Services Roundtable ("FSR"), including Joseph J. Barry Senior Vice President—Regulatory and Industry Affairs at State Street, Michael Barkman, Partner at Ernst & Young, Steven E. Buller, Managing Director at BlackRock, Ann Cavanaugh, Managing Director at BlackRock, Rajan Chari, Partner at Deloitte LLP, Stephanie Dorsey, Treasurer at Fidelity Funds, Robert Dura, Law Clerk at Debevoise & Plimpton LLP, James F. Febeo, Jr. Senior Vice President, Head of Regulatory Affairs, Public Affairs and Policy Group at Fidelity Investments, Kathryn Fulton, Managing Director at BlackRock, John Garrison, Law Clerk at FSR, Christopher R. May, Partner at PricewaterhouseCoopers LLP, Sean P. Newth, Senior Vice President— Finance at State Street, Felicia Smith, Regulatory Counsel at FSR, Scott E. Talbott, Senior Vice President of Public Policy at FSR and Elaine Yue Wu, Law Clerk at FSR. The representatives discussed the Commission's proposal on money market fund reform and the attached slides.

Meetings with Staff of the Office of the Chief Accountant of the SEC and Staff of the FASB

September 4 and 6, 2013

Background

The accounting profession has recognized the unique attributes of accounting for MMFs for over 40 years.

The Reserve Fund, established in 1971, was the first MMF. The Industry Audit Guide on Audits of Investment Companies was first issued by the AICPA in 1973, which later became SOP 77-1. It did not cover use of amortized cost.

The first authoritative guidance for MMFs came in May 1973 with issuance of ASR 219 (IC-9786), which indicated that it would be appropriate for MMFs to determine FV of a debt portfolio on an amortized cost basis, provided securities had remaining maturities of 60 days or less, and it provided a materiality standard of $0.01 per share on a $10.00 NAV.

In July 1983 the SEC finalized Rule 2a-7, “Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds).” The SEC limited weighted average maturity of MMF portfolios to 120 days (lowered to 90 days in February 1991) and maximum maturity of all investments to one year.

The FASB formally approved issuance of the Audit Guide in November 1986, which referred to Rule 2a-7.

FASB considered the maturity, credit quality, diversification, and liquidity requirements of MMFs in determining that amortized cost approximates market value.

Denny Beresford, Chairman of the FASB when SFAS 95, *Statement of Cash Flows*, was enacted, echoed FASB’s conclusion in a 2012 release titled *Amortized Cost is “Fair” for Money Market Funds*.

IFRIC Guidance

The International Financial Reporting Interpretation Committee's (IFRIC) mission is to interpret the application of International Accounting Standards and International Financial Reporting Standards.

In March 2009, the IFRIC staff opined that MMFs which operate under a specific regulatory regime (e.g., Rule 2a-7 of the Investment Company Act of 1940) should meet the definition of cash equivalents.

The IFIRC staff documented their opinion that "…units that don't have a maturity date, but that are readily convertible into an amount of cash that is known at inception are subject to an insignificant risk of future changes in value. They thus meet the critical criteria in IAS 7 and can be considered 'in substance' cash equivalents in accordance with paragraph 7 [of IAS 7]."

Background – SFAS 95, *Statement of Cash Flows*

SFAS 95 was issued November 1987.

Paragraph 9 of SFAS 95 listed examples of cash equivalents, such as treasury bills, commercial paper and money market funds. It further stated that cash purchases and sales of those investments generally are part of the enterprise's cash management activities rather than part of its operating, investing, and financing activities.

Paragraph 53 stated that in developing SFAS 95, the Board noted that the objective of cash management programs generally is to earn interest on temporarily idle funds rather than to put capital at risk in the hope of benefiting from favorable price changes that may result from changes in interest rates or other factors. MMFs were, and still are, principally a tool for cash management and not for investment return.

Paragraph 8, now ASC 305-10-20, defines cash equivalents:

"Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

- **a. Readily convertible to known amounts of cash**
- **b. So near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.**

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations)."

Convertible to known amounts of cash

The FASB concluded that amortized cost for MMFs approximates fair value. By including MMFs in the definition of cash equivalents, it recognized that MMFs *materially* equal cash.

Concepts Statement No. 8, "*Conceptual Framework for Financial Reporting*," Chapter 3, "*Qualitative Characteristics of Useful Financial Information*," defines materiality as: "Information is material if omitting or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."

Staff Accounting Bulletins No. 99 and 108 specify that materiality cannot be reduced to a numerical measure, but must include qualitative considerations. As Mr. Beresford observed in his 2012 article, "It is reasonable to assume that amounts that are less than the 1/2 of 1% of net asset value threshold at which directors must take action to address a difference between fair value and amortized cost would not be considered material by most parties."

The SEC Staff communicated materiality expectations in 1994 when they defined whether, and how, a NAV error should be corrected based on $0.01 per share and ½ of 1% criteria.

All cash equivalent investments, including commercial paper, bankers' acceptances, certificates of deposit, repurchase agreements and short-term municipal securities, carry some measure of risk that the amount invested will not be returned due to credit risk, and some investments due to foreign currency risk.

The current parameters set forth for Rule 2a-7 MMFs, which are mirrored by many (if not most) non-registered MMFs, serve to ensure that MMF investments are convertible to a known amount of cash, within the standards of materiality contemplated by both the FASB and the SEC.

In many respects, MMFs provide less risk than a direct investment in commercial paper maturing in three months or less, given diversification, short duration and credit quality.

Pricing a MMF at four decimal places (i.e., $1.0000) is not expected to change in any material respect the amount received by an investor.

Given materiality, it is reasonable to consider a MMF investment a cash equivalent if it is [probable] [more likely than not] that the fund will have a net asset value that is greater than 99.5% of the original investment.

Highly Liquid Investments

A mutual fund is essentially a pass-through vehicle, with the characteristics of the underlying investments. The underlying investments of a MMF are highly liquid and readily convertible to cash.

The SEC established parameters in 2010 that require a taxable MMF to maintain 10% of total assets in daily liquidity assets[1] and for all funds to maintain 30% of assets in weekly liquid assets[2], to meet redemptions and to help ensure that a fund is able to redeem at $1.00 per share. Substantially all MMF assets must be rated the equivalent of A1 or P1, which helps ensure both liquidity and that amortized cost will approximate fair value.

The SEC also established additional maturity and diversification requirements (see Appendix 1).

[1] Daily liquid assets constitute cash, Treasury securities, or securities that mature or are subject to a demand feature that is exercisable and payable within one business day.

[2] Weekly liquid assets constitute cash, Treasury securities, discounted notes issued by federal agencies and instrumentalities with remaining maturities of 60 days or less, or securities that mature or are subject to a demand feature that is exercisable and payable within five business days.

Readily Convertible…Without Prior Notice or Penalty

Footnote 1 to SFAS 95 specified that "*Cash* also includes other kinds of accounts that have the same general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty." It did not require that all cash equivalents have the *exact same* attributes as cash (e.g., cash equivalents may be subject to a settlement process and timetable).

Generally, most cash equivalents settle within one day, although most investment securities are subject to a regular-way settlement period of three days (five business days when SFAS 95 was released).

"Readily convertible" may be subject to different expectations, which may vary depending on the global market on which investments settle.

MMFs do not require advance notice to withdraw funds. However, under the SEC's proposed amendments, if weekly liquid assets fall below 15% of total assets, either a liquidity fee (currently proposed at 2%) must be assessed on all redemptions or the board may temporarily suspend redemptions for a limited period of time. (A lower liquidity fee might still achieve the same objective and lower the barrier to MMFs not being deemed cash equivalents.)

In the event of a market dislocation, the redemption suspension could be short, for a period of seven days (historic regular-way settlement) or longer, or open-ended.

To the extent a redemption fee arrangement is triggered, that portion of the MMF investment may not be considered by some investors as a cash equivalent, even though they may not intend to redeem their investment.

Business Considerations

Many investment guidelines refer to cash and cash equivalents. If MMFs do not qualify as cash and cash equivalents, some investors would be prohibited from investing in such funds without amending their guidelines.

Given the characteristics of MMFs, users of financial statements likely would consider a MMF with a floating NAV or a redemption restriction as a cash equivalent.

Enabling investors to continue to classify MMFs, including those with a floating NAV or a redemption restriction, as a cash equivalent, would help ensure the viability of this key component of the capital markets.

A financial crisis may be for a short duration, so providing fund sponsors with flexibility in determining the amount of the redemption fee and the duration of any redemption “gates” would help tailor a solution most beneficial to MMF shareholders.

Strawman Definition of Cash Equivalent

Strawman Definition of Cash Equivalent:

Investments in money market funds meet the definition of a cash equivalent unless it is [probable][more likely than not] that the fund will:

a. **restrict redemptions for more than [X] days; or**

b. **have a net asset value that is less than 99.5% of the original investment.**

To the extent a fee would be imposed upon redemptions [and the investor expects to pay the fee], the amount equal to the potential fee would not be considered a cash equivalent.

Appendix 1 – Summary Rule 2a-7 Requirements (post 2010 Reforms)

Liquidity

Daily Portfolio Liquidity of 10% — can include cash, US Treasuries and securities that can be sold in one day (municipal funds are not subject to the daily limit)

Weekly Portfolio Liquidity of 30% — weekly assets and agency discount notes of 60 days maturity or less

Maturity

Individual securities can have a maximum maturity of 397 days

The weighted average maturity (WAM) cannot exceed 60 days and can be calculated using the reset date of a floating rate security

The weighted average life (WAL) or spread WAM cannot exceed 120 days. The WAL is calculated by using the final maturity of a floating rate security, not the reset date

Credit and Diversification

Maximum first tier issuer concentration of 5% of portfolio assets

Maximum second tier issuer concentration limit of 3% of portfolio with additional restrictions of 0.5% per single issuer and a final maturity not exceeding 45 days

Fully collateralized repurchase agreements can only be used for look-through purposes if comprising cash items or government securities

Illiquid securities can only comprise 5% of portfolio assets where defined as any security that can’t typically be sold at a figure close to its fund value within 7 business days