INVESTMENT COMPANY INSTITUTE

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September 8, 2009

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

Re: Money Market Fund Reform (File Number S7-11-09)

Dear Ms. Murphy:

The Investment Company Institute[1] is pleased to express its overall strong support for the Securities and Exchange Commission's proposed amendments to Rule 2a-7 and other rules that affect money market funds under the Investment Company Act of 1940.[2] The amendments, which are similar to those recommended last March by the Institute's Money Market Working Group ("Working Group"),[3] are designed to better enable money market funds to withstand certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share.

The SEC and the industry have invested substantial time and resources in efforts to ensure the continued success of money market funds, products that are valued by investors and crucial to our

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $11.02 trillion and serve over 93 million shareholders.

[2] *See Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009) ("Release"), available on the SEC's website at http://sec.gov/rules/proposed/2009/ic-28807.pdf.

[3] A copy of the press release announcing the formation of the Working Group is available on the Institute's website at http://www.ici.org/mmfs/08_news_mm_group. *See generally* Report of the Money Market Working Group ("MMWG Report"), available on the Institute's website at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

economy. Pressures on money market funds have eased substantially since late 2008, reflecting the unprecedented steps taken by the federal government to buffer the money markets and strengthen financial institutions. Money market funds nevertheless continue to face considerable challenges. Owing to the monetary policy that the Federal Reserve is pursuing in order to bolster the economy, short-term interest rates, and thus yields on money market funds, remain very low. Indeed, yields remain so low that many advisers to these funds have had to offer significant fee waivers in order to ensure that yields on their funds do not fall below zero. In addition, demand for money market funds has weakened as investors, especially retail investors, have migrated to higher yielding alternatives, such as bank deposits. As a result, advisers are currently bearing a significant share of the costs of operating money market funds. Changes to money market fund regulation must take into account these continued challenges.

We are therefore especially pleased that, for the most part, the proposed enhancements to money market fund regulation are well balanced and not an overreaction to "tail events."[4] Indeed, we believe that, in general, the SEC's proposal should work well in prosperous times, as well as during periods of severe market instability or economic pressures. The SEC's proposed amendments, like the Working Group's recommendations, are designed to further strengthen an already resilient product. Specifically, the proposal would make improvements to money market fund regulation through explicit liquidity standards, stress testing, "know your customer" procedures, shorter portfolio maturities, improved credit quality, and more disclosure. The proposal also expands the circumstances under which affiliated persons can purchase money market fund portfolio securities. Further, in the event that a money market fund is unable to maintain a stable net asset value per share, the SEC's proposal authorizes a money market fund's board of directors to suspend redemptions in order to facilitate an orderly liquidation of the fund and ensure that all investors—regardless of who is first to the door—are treated fairly.

We thus offer our overall strong support for the proposal. We do, however, have a number of comments—including those opposing certain aspects of the SEC's proposal. We also comment on certain ideas not proposed, but raised for comment, that would make more fundamental changes in the SEC's regulation of money market funds that, if implemented, would not only undermine the improvements noted above but create new and potentially far greater risks than those the SEC is seeking to avoid.

In summary, our comments are as follows:

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[4] *See* Speech by SEC Commissioner Troy A. Paredes, Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference, Washington, DC (May 4, 2009) (encouraging lawmakers, including the SEC, to take a balanced approach to money market fund reform), available on the SEC's website at http://www.sec.gov/news/speech/2009/spch050409tap.htm.

**Risk-Limiting Conditions of Rule 2a-7**

- **Portfolio Liquidity:**

  - **Daily and Weekly Requirements:** We support adding explicit daily and weekly liquidity requirements; however, we strongly oppose different regulatory thresholds for money market funds depending on whether their investors are considered retail or institutional. Instead, we recommend the SEC follow the Working Group's recommendation (5 percent daily for taxable funds and 20 percent weekly for all funds), which provides a minimum liquidity "floor" that can be adjusted upwards based on an individual fund's liquidity needs.

  - **Illiquid Securities:** We do not support changing the SEC's current guidance that allows a money market fund to invest in illiquid securities up to 10 percent of its total assets.

- **Portfolio Quality:**

  - **Credit Ratings Requirement:** We do not support removing credit ratings from Rule 2a-7. The rule already prevents undue reliance on ratings and the elimination of credit ratings will decrease protection for investors and undermine investor confidence. Instead, we support requiring fund advisers (rather than the boards as the SEC has suggested) to designate and disclose three or more NRSROs that funds would look to for all purposes under Rule 2a-7.

  - **Second Tier Securities:** We support limiting money market fund purchases to first tier securities but suggest that the SEC follow the Working Group's recommendation that would continue to allow a fund to hold a first tier security that is downgraded to second tier after an adviser has purchased the security for the fund.

  - **Asset Backed Securities:** Given the Working Group's recommendations to improve the process by which money market funds select potential investments, we do not believe it is necessary for the SEC to make specific changes to Rule 2a-7 regarding asset backed securities.

- **Portfolio Maturity:**

  - **Weighted Average Maturity (WAM):** We do not support reducing the WAM limit to 60 days because it would constrain the ability of many money market funds to produce yields that cover their expenses, particularly during times of low interest rates. Instead, we suggest that a WAM of, for example, 75 days, as recommended by the Working Group, would reduce interest rate risk without significantly impairing portfolio flexibility during different market conditions.

  - **Weighted Average Life (WAL):** We support a WAL limitation of 120 days, which would limit the portion of a fund's portfolio that could be held in longer term variable- or floating-rate securities.

  - **Maturity Limit for Other Portfolio Securities:** In light of the proposed reduction in the WAM and the new WAL maturity test, we do not believe it necessary, and so do not support reducing the current maximum maturity of 397 days for individual non-government securities acquired by a money market fund.

- **Diversification:** We do not support further restricting the diversification limits of Rule 2a-7 relating to issuers and/or guarantors. In particular, the universe of institutions issuing or providing guarantees or liquidity for eligible money market fund securities has become extremely limited.

- **Repurchase Agreements:** Although we do not believe the proposal to limit money market funds to engaging in repurchase transactions collateralized by cash items or government securities would have a significant effect on the operations of most money market funds, we caution that the proposal could have an effect on funds utilizing joint trading accounts.

**Disclosure of Portfolio Securities:**

- **Public Website Posting:** We support requiring money market funds to publicly disclose certain portfolio holdings information monthly. We do not support, however, conforming the portfolio disclosure to Regulation S-X because it would unnecessarily complicate the required disclosure. Based upon our recent experience, we recommend that money market funds be required to post this information each month after a delay of at least seven to ten days (rather than the proposed two business day delay).

- **Reporting to the SEC:** We support enhancing the SEC's access to money market fund data; however, we do not support making detailed fund-level and security-level information (as proposed by the SEC) available to the public. We also offer comments to proposed Form N-MFP and, given the amount of information that the form would require funds to compile and review each month, recommend money market funds be given at least a 12 to 15 business day delay to file the Form (rather than the proposed two business day delay).

- **Public Disclosure of Market-Value Based Information:** We are particularly pleased that the SEC's proposal would not require money market funds to publicly disclose their shadow prices and the market-based prices of their portfolio securities. We believe that this information would not be helpful or informative to investors and could increase systemic risks.

**Money Market Fund Operations:**

- **Authority to Suspend Redemptions:** We support authorizing boards to suspend redemptions in connection with any fund liquidation (not just after a fund has broken a dollar) and temporarily under other exigent circumstances other than liquidation.

- **Processing of Transactions:** We appreciate the SEC's desire to ensure that funds can process transactions at a price of other than $1.00 per share; however, we are concerned that the proposal would require costly changes to a myriad of systems at a financially precarious time for the industry. We therefore do not support the proposed operational capability requirements and recommend they be eliminated from the final rule.

**Request for Additional Comment:**

- **Floating Net Asset Value:** We strongly oppose eliminating the ability of money market funds to use the amortized cost method of valuation because the stable net asset value provides far more benefits to money market fund investors than a floating net asset value; the floating net asset value could lead to substantial and far reaching negative consequences for the money market fund industry; and a floating net asset value is unlikely to reduce systemic risk.

- **Redemptions in Kind:** We do not support requiring money market funds to satisfy redemption requests of a certain size through redemptions in kind because this method of redeeming shareholders poses operational challenges for both funds and shareholders and could aggravate an illiquid or declining market.

## I. Risk-Limiting Conditions of Rule 2a-7

With the exception of certain important aspects of the proposed liquidity requirements, we strongly support the SEC's proposed amendments to strengthen the risk-limiting conditions of Rule 2a-7. The SEC's proposal would, among other things, amend Rule 2a-7 by introducing liquidity requirements, periodic stress testing of a fund's portfolio, and "know your customer" procedures; and by revising portfolio quality and maturity requirements. We believe that these changes would impart substantial benefits to money market funds and allow money market funds to be more resilient to widespread credit market disruptions, such as those that occurred in 2008. We offer the following comments to the SEC's proposal.

### A. Portfolio Liquidity

The SEC's proposal would amend Rule 2a-7 by adding explicit daily and weekly liquidity requirements for "retail" and "institutional" money market funds and prohibiting money market funds from acquiring illiquid securities. The proposal also would add a general liquidity requirement that would require a money market fund to hold highly liquid securities sufficient to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under Section 22(e) of the Investment Company Act and any commitments the fund has made to shareholders. Finally, the proposal would require the board of each money market fund using the amortized cost method to adopt procedures providing for periodic stress testing of the fund's portfolio.

We commend the SEC for adding explicit risk-limiting conditions to Rule 2a-7 designed to improve money market funds' ability to meet significant redemption demands. We are deeply concerned, however, that certain aspects of the proposal may hinder competition, unduly constrain portfolio management to the detriment of some shareholders, and add burdensome and unworkable responsibilities on the board and the fund. We believe that other approaches, such as those suggested in the Working Group's report, achieve the SEC's goals without the adverse consequences the proposal likely would cause.

1. *Minimum Daily and Weekly Liquidity Requirements*

For the first time, the SEC's proposal would require money market funds to have a minimum daily[5] and weekly[6] percentage of their assets in securities that can be readily converted to cash. The Working Group also recommended minimum daily and weekly liquidity requirements; however, unlike the Working Group's recommendation, the SEC has proposed different liquidity requirements for retail and institutional money market funds.

The Institute supports requiring that money market funds maintain a minimum ready supply of cash to fund redemptions; however, we strongly oppose different regulatory thresholds for money market funds depending on whether their investors are considered retail or institutional. When the Working Group considered a similar concept, it concluded that it was "simplistic, unworkable, and could disadvantage both types of investors."[7] We continue to believe that the better approach to

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[5] Under the proposal, taxable retail and institutional funds could not acquire any securities other than cash, U.S. Treasury securities or securities that mature or are subject to a demand feature exercisable and payable in one business day ("daily liquid assets") if, immediately after the acquisition, (i) the retail fund would have invested less than 5 percent of its total assets in daily liquid assets and (ii) the institutional fund would have invested less than 10 percent of its total assets in daily liquid assets. Compliance with the daily liquidity test would be determined upon the acquisition of a security, and thus a fund would not have to dispose of less liquid securities (and potentially realize an immediate loss) if the portion of the fund held in highly liquid securities fell below five/ten percent as a result of redemptions. A fund could acquire only daily liquid assets, however, until the portfolio investments met the relevant daily liquidity test.

[6] Under the proposal, retail and institutional funds could not acquire any securities other than cash, U.S. Treasury securities or securities that mature or are subject to a demand feature exercisable and payable in five business days ("weekly liquid assets") if, immediately after the acquisition, (i) the retail fund would have invested less than 15 percent of its total assets in weekly liquid assets and (ii) the institutional fund would have invested less than 30 percent of its total assets in weekly liquid assets. The weekly liquidity requirement would supplement the proposed daily liquidity requirement. Similar to the daily liquidity requirement, compliance with the test would be determined upon the acquisition of a security.

[7] *See* MMWG Report, *supra* note 3, at 117.

regulating liquidity is to start with a minimum liquidity "floor" applicable to all money market funds that can be adjusted upwards depending on market events or an individual money market fund's particular liquidity needs. Indeed, the SEC's approach is too prescriptive and may be taken by some money market funds as a safe haven that obviates the need for more fine tuning in light of specific circumstances.

While some fund sponsors do offer money market funds primarily to clearly identifiable retail or institutional investors, many funds include a substantial combination of both types of investors that are not so easily categorized. Indeed, there are important areas of overlap between retail and institutional investors that can make drawing a bright line between types of investors quite challenging and therefore inconsistent across the industry.[8] For example, although retail investors typically invest in money market funds through retail share classes, they also invest through institutional share classes, such as 401(k) plans or broker or bank sweep accounts, where there may be one institutional decision maker acting on behalf of underlying retail customers. Even in these situations, however, a single decision maker may not be authorized to make a transfer of all customer accounts from one money market fund to another without providing written notice to the customers prior to effecting the transfer.[9] Moreover, just as not all retail investors are easily identifiable, not all institutional investors act the same way. Although institutional investors that suddenly move large blocks of shares can have a direct influence on a fund's ability to meet other redemption requests and maintain a stable net asset value, members also have many institutional shareholders that move assets on a pre-set schedule (*e.g.*, payroll dates) and take great pains to avoid disrupting prudent portfolio management with large, unexpected redemptions.

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[8] Based on confidential data submitted to the Institute, 118 of 504 (23 percent) taxable money market funds had both retail and institutional share classes with nearly $1 trillion under management (31 percent of all taxable money market fund assets). For tax-exempt money market funds, 64 out of 237 (27 percent) had both institutional and retail share classes with $123 billion under management (28 percent of all tax-exempt money market fund assets).

[9] *See e.g.,* NASD Rule 2510(d)(2)(D), which allows a broker-dealer to effectuate a bulk exchange of money market funds using negative response letters (rather than prior written consent), provided the exchanges are not activated until at least 30 days after the date on which the letter was mailed; are effected at net asset value; and are limited to situations involving mergers and acquisitions of money market funds, a change of clearing members, or an exchange of money market funds used in sweep accounts. In the event a designated money market sweep fund announces that it intends to close or limit new fund share purchases, FINRA staff have provided guidance allowing firms, under certain conditions, to select and activate an alternative sweep fund without waiting the 30 day negative consent period. *See Use of a Negative Response Process Under NASD Rule 2510(d)(2)(D) to Designate an Alternative Money Market Sweep Fund When Existing Sweep Fund Closes with Inadequate Notice*, FINRA Staff Interpretive Memo (May 15, 2008). In addition, under ERISA's "blackout notice" rules, fiduciaries of 401(k) plans generally must provide 30 days notice to participants before switching the plan's investments, if the change will result in a period of more than three consecutive business days in which participants are restricted from making changes to their account. *See* ERISA Section 101(h), 29 U.S.C. 1021(h). Similarly, where the portion of a participant's account in an eliminated investment will be "mapped" to a similar investment, 30 days notice is generally required to ensure protection under ERISA's fiduciary rules. *See* ERISA Section 404(c)(4), 29 U.S.C. 1104(c).

Indeed, even the three characteristics set forth in the SEC's proposal to distinguish retail money market funds from institutional money market funds—nature of the record owners of fund shares, minimum amount required to be invested to establish an account, and historical cash flows, resulting in expected cash flows that would result from purchases and redemptions—do not necessarily correlate with the manner in which money market funds currently are distributed. For example, a money market fund may be sold to investors through direct accounts, adviser-sponsored wrap programs, or omnibus accounts. With respect to direct accounts, fund management may not be aware of who has discretion to make purchase or sales decisions for these accounts. If discretion over several direct accounts resides with one broker of record, evaluating the record owner of the account in order to designate the fund as either retail or institutional would not correlate with the risks that the SEC is seeking to mitigate because different accounts have different liquidity needs. Similarly, with respect to sales of adviser-sponsored wrap programs, discretion over these accounts typically would reside with the adviser so that considering the record owner of the account would not necessarily correlate with the actual liquidity needs of the account owners. Likewise, a money market fund may be sold to investors through variable insurance products, retirement plans, or 529 accounts, in which case the three factors would not correlate to the persons with discretion to make purchases and sales decisions for those accounts. While adding some additional characteristics for consideration (such as the beneficial owner of the account or the type of account) may be helpful, none of these factors would uniformly or adequately address the various means in which a money market fund may be distributed.

Furthermore, if the practical consequence of the separate liquidity requirements is to segregate retail and institutional investors into two different funds, both types of investors could be disadvantaged. Money market funds provide a low-cost cash management vehicle for both retail and institutional investors. In part, money market funds provide low-cost management through economies of scale through the pooling of investments of hundreds to thousands of retail investors with the large balances of institutional investors.

Given the difficulties of making distinctions between retail and institutional investors, we strongly oppose the SEC's approach, and instead urge it to follow the Working Group's recommendation, which would impose a minimum 5 percent daily requirement for all taxable funds and a minimum 20 percent weekly requirement for all funds. The Working Group considered this recommendation at length, and concluded that these proposed daily and weekly minimums struck the right balance between reducing liquidity risk and limiting the impact on yield. Indeed, we have continued to review the Working Group's recommended minimums and remain convinced, based upon our own analysis, that these are the appropriate thresholds.

The Institute collects money market fund assets as of Wednesday of each week. In 2008, more than 350 prime money market funds with total assets of $2.2 trillion reported information between September 10 and September 24. During this two-week period, these funds reported that assets fell by $350 billion, or 16 percent—the largest two-week outflow in the history of money market funds. Our analysis of the outflows of individual funds during this time period indicates that the daily and weekly minimum liquidity thresholds that the Working Group recommended would have met the redemption demands of a large majority of the prime funds with at least one institutional share class. For example, more than half (52 percent) of these funds had outflows of less than 5 percent of assets during this two-week period, indicating that the Working Group's daily liquidity requirement would have been more than sufficient for these funds to meet their shareholder redemptions. Another 22 percent experienced outflows of between 5 and 20 percent of assets; they also would have been able to meet redemptions with assets using the Working Group's proposed weekly liquidity bucket.

Requiring all funds with institutional share classes to hold weekly liquid assets equal to 30 percent of their assets—well in excess of the liquidity that most funds needed even during the extreme market events of last fall—is a costly mechanism to increase liquidity.[10] Indeed, the Working Group balanced the need for added liquidity with the recognition that if these requirements are set at too high a level, minimum liquidity requirements would impose a regulatory barrier that disadvantages one form of pooled investment from another, to the detriment of money market fund investors. As discussed in the Working Group's report, there are a range of alternative products and services that also offer a stable share price but that fall outside the careful regulatory framework in place for money market funds.[11] Such a result would be inconsistent with the warning in the Treasury Department's recently issued white paper on financial services regulatory reform that cautioned the SEC to carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as "investor flight" from money market funds into unregulated or less regulated money market investment vehicles.[12]

The Working Group emphasized that each minimum was merely a "floor" that may not always be adequate, as determined by market events (including interest rate movements) and a particular fund's liquidity needs, including its client base and portfolio holdings. In particular, the Working Group stressed that robust "know your investor" procedures, which could include material thresholds for individual clients, types of clients, or both, can mitigate the risk to a fund that its liquidity levels are not sufficient for its client base.[13] Moreover, the Working Group found that a fund's stress testing

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[10] Relying on iMoneyNet data, as the SEC has, to identify the percentage of assets maturing in 7 days or less likely overstates the normal liquidity positions of many prime funds prior to the events of September 2008 and understates the negative effects of requiring 30 percent of fund assets to be allocated to the liquidity bucket in the future. iMoneyNet data appears to include in their 7-day category floating rate notes with weekly resets; such notes would not be included in either the SEC's or the Working Group's liquidity buckets.

[11] *See* MMWG Report, *supra* note 3, at Section 5.

[12] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation,* Department of the Treasury at 37 ("Treasury Department White Paper"), which is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[13] For a discussion of the Working Group's recommendation relating to shareholder due diligence, *see* MMWG Report, *supra* note 3, at 83-84.

results may help it determine whether the fund's shareholder concentration levels match its portfolio's liquidity under various tested scenarios. The Institute believes that these measures, taken together, would significantly improve money market funds' ability to meet significant redemption demands. Indeed, as discussed below, the proposed general liquidity standard may require a fund to maintain a higher portion of its portfolio in cash or securities that can readily be converted to cash, depending on the fund's particular liquidity needs.

We also believe that determining a fund's liquidity levels under any circumstances is a responsibility more appropriate for a fund's adviser than its board. Under the proposal, the fund's board would determine no less frequently than once each calendar year whether the fund is an institutional money market fund for purposes of meeting the liquidity requirements. A retail fund would be defined as any money market fund that the board has not determined within the calendar year to be an institutional fund. Requiring a fund board to make this distinction would require a level of inquiry into matters that are beyond an oversight role and more akin to the operational matters of the fund. For some funds (especially those determined to have a relatively balanced amount of institutional and retail investors), the proposal would most likely require boards to "micro-manage" fund operations. For example, the proposal would essentially require boards to perform ongoing monitoring of client activity and frequent reassessments of the fund's status, a responsibility that is normally beyond the board's oversight role. On the other hand, determining the necessary liquidity levels of a fund's portfolio is squarely within the adviser's expertise and consistent with its overall day-to-day portfolio management responsibilities. It also is an advisory function that can be achieved effectively without requiring funds to make a distinction between retail and institutional investors.

### 2. *Definitions*

As recommended by the Working Group, we suggest the SEC treat fixed-rate government securities (also known as agency discount notes) as weekly liquid assets. Unlike variable- and floating-rate government securities, whose prices tend to be more sensitive to credit spreads, industry participants report that short-term fixed-rate government securities are nearly as liquid as U.S. Treasury securities.[14] Members also report that government securities would be particularly important for taxable money market funds to meet the new weekly liquid assets requirement because the supply of non-Treasury taxable securities that mature within seven days is limited. We therefore recommend that the SEC treat fixed-rate government securities as weekly liquid assets.

We also suggest a technical modification to the proposed rule text to clarify compliance with the "minimum weekly liquidity requirement." Under proposed Rule 2a-7(c)(5)(iv), a money market

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[14] *See, e.g.,* Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co. to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (August 24, 2009) at 5-6 and Appendix B ("Fidelity Letter") (citing data analyzed by Tradeweb LLC, provider of an electronic trading platform regulated by the SEC as an Alternative Trading System).

fund may not acquire "*any security*, if immediately after the Acquisition, a Retail Fund would have invested less than fifteen percent of its Total Assets, and an Institutional Fund would have invested less than thirty percent of its Total Assets, in Weekly Assets."[15] We would suggest the addition of the words "other than a Weekly Liquid Asset" after "any security" to clarify the types of securities a money market fund can purchase towards fulfilling the weekly liquidity requirement. Otherwise, under a literal reading of the proposed text, a fund could not purchase any security unless that particular purchase completely replenished the 15 percent or 30 percent weekly liquidity basket, depending on the type of fund.

3. *Limitation on Acquisition of Illiquid Securities*

The SEC proposal would prohibit money market funds from acquiring securities unless, at the time of acquisition, they are liquid, *i.e*., securities that can be sold or disposed of in the ordinary course of business within seven days "at approximately their amortized cost value." The proposal would not prohibit funds from continuing to hold securities that become illiquid after their purchase. The proposal would change current SEC guidance that requires a money market fund to limit investments in illiquid securities to not more than 10 percent of its total assets.[16] We do not believe that such a change is necessary or desirable.

The Institute concurs with the SEC's assessment of the importance of money market fund liquidity. The SEC seems to suggest, however, that the liquidity determination is always straightforward and binary—securities are either liquid or illiquid. In reality, this determination can sometimes be gray and can change quickly depending on asset type and market conditions, as recent experience aptly demonstrated. As a result, funds typically rely on the business judgment of their advisers in making such determinations, pursuant to procedures approved by fund boards. We are thus concerned that an outright ban on acquiring illiquid securities would leave funds vulnerable to second-guessing by regulators if a fund acquires a security that its adviser has determined to be liquid, but is later deemed to have been illiquid at acquisition by regulators.

Perhaps even more concerning, we fear that precluding a money market fund from acquiring illiquid securities would stifle innovation and competition for new types of high quality securities that have not gained the wide acceptance necessary to support market liquidity. We believe instead that risk-limiting conditions designed to improve a money market fund's ability to meet significant redemption demands more directly address the liquidity risks money market funds face. We therefore oppose the proposed requirement to preclude money market funds from acquiring illiquid securities.

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[15] Emphasis added.

[16] *See Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds),* SEC Release No. IC-13380 (July 11, 1983), 48 FR 32555 (July 18, 1983) ("Rule 2a-7 Adopting Release").

The Institute also recommends that the proposed definition of liquid security be changed to refer to the "market price" or "shadow price" rather than the "amortized cost value." Although most funds that rely on Rule 2a-7 value their securities using the amortized cost method, a security can still be "liquid" in the market if its market value and the amortized cost value deviate. Indeed, it is quite common for the market value of a security to deviate from its amortized cost (either more or less) because of changes in market interest rates, which may not necessarily be related to the liquidity of the security. It is unclear, however, whether securities that can be sold "at approximately their amortized cost value" could accommodate these normal market deviations and still be considered liquid under the SEC's proposed definition.

4. *General Liquidity Requirement*

The SEC's proposal also includes a general liquidity requirement that would require a money market fund to hold highly liquid securities sufficient to meet reasonably foreseeable redemptions in light of its obligations under Section 22(e) of the Investment Company Act and any commitments the fund has made to shareholders, such as undertaking to pay redemptions more quickly than seven days. According to the Release, to comply with this condition, the SEC would expect money market funds to consider a number of factors that could affect the fund's liquidity needs, including the characteristics of its investors and their likely liquidity needs.

The Institute supports the proposed general liquidity requirement because, rather than requiring overly prescriptive requirements, it requires money market funds to have a process to manage liquidity risks, taking into account all relevant facts regarding a fund's investor base and developing market conditions. Under this requirement, the daily and weekly liquidity requirements are, therefore, rightly viewed as "floors" that require money market fund advisers to be responsible for assessing the appropriate level to be maintained above that floor, if any, using measures such as periodic stress testing[17] and shareholder due diligence.[18] Such measures are specifically designed to identify

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[17] Similar to the Working Group's recommendation, the SEC's proposal to require money market funds to stress test their portfolios against their shareholder base also would help to ensure that those liquidity levels are appropriate. The proposal would require the board of each money market fund using the amortized cost method to adopt procedures providing for periodic stress testing of the fund's portfolio. According to the Release, the procedures would require testing of the fund's ability to maintain a stable net asset value per share based upon certain hypothetical events, including an increase in short-term interest rates, an increase in shareholder redemptions, a downgrade of or default on a portfolio security, and widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. The proposed amendments also would require that the board receive a report of the results of the testing at its next regularly scheduled meeting, which report must include: (i) the date(s) on which the fund portfolio was tested; and (ii) the magnitude of each hypothetical event that would cause the money market fund to break a dollar.

[18] The Release notes that a fund should adopt policies and procedures to identify risk characteristics of shareholders, particularly those that hold securities through omnibus accounts, or access the fund through "portals" or through other arrangements that provide the fund with little or no transparency with respect to the beneficial shareholder.

shareholders and other situations deemed to pose an unacceptable risk to a particular fund. Indeed, we believe a general liquidity requirement would be more effective at managing liquidity risk than periodic fund designations as retail or institutional that could result in limitations that are too restrictive for many "institutional" funds.

The Institute is concerned, however, that if sudden market volatility turns an otherwise highly liquid portfolio illiquid, a fund may not be able to comply with this general liquidity condition. To ensure that such unforeseen market events are not viewed as a violation of Rule 2a-7, we would recommend the SEC clarify that compliance with this condition would be treated in the same manner as "downgrades, defaults and other events" under Rule 2a-7(c).

B. Portfolio Quality

1. *Credit Ratings Requirement*

Last year, the SEC proposed to eliminate the use of credit ratings by nationally recognized statistical rating organizations ("NRSROs") in rules under the Investment Company Act, including Rule 2a-7, and instead to rely solely on the fund manager's credit risk determination.[19] Commenters on this proposal, including the Institute,[20] overwhelmingly disagreed with the proposed elimination of the ratings requirement in Rule 2a-7. The SEC has requested, again, that commenters address whether references to credit ratings should be removed from Rule 2a-7. For the reasons outlined below, we continue to strongly oppose removing ratings from Rule 2a-7—such an action is unnecessary to address SEC concerns regarding NRSRO ratings in general and would result in an unacceptable weakening of the rule, to the detriment of money market fund investors.

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[19] *See References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Release No. IC-28327 (July 1, 2008), 73 FR 40124 (July 11, 2008)("2008 NRSRO Proposal"), available on the SEC's website at http://sec.gov/rules/proposed/2008/ic-28327.pdf. Specifically, this proposal would revise the definition of eligible security to mean a security that "the fund's board of directors determines presents minimal credit risks (which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations)." The proposal would revise the definition of first tier security to mean "a security the issuer of which the fund's board of directors has determined has the highest capacity to meet its short term financial obligations." Consistent with the current rule, the proposal would retain the definition of and limitations on investments in, second tier securities. A new standard of review for monitoring credit risks also was proposed. This new standard would require a fund's board to reassess a security if it becomes aware of "any information about a portfolio security or issuer of a portfolio security that may suggest that the security may not continue to present minimal credit risks." *See also* companion releases, *References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-58070 (July 1, 2008), 73 FR 40087 (July 11, 2008) and *Security Ratings*, SEC Release No. 33-8940 (July 1, 2008), 73 FR 40106 (July 11, 2008).

[20] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission (September 5, 2008).

a) Rule 2a-7 Currently Prevents Undue Reliance on Ratings

We understand the SEC's desire to ensure that the use of NRSRO ratings in its rules does not cause market participants to place "undue reliance" on NRSRO ratings or make them "vulnerable to failures in the ratings process."[21] Indeed, the Treasury Department's recently issued white paper outlining a plan for financial services regulatory reform includes a recommendation that "[r]egulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible."[22] We agree that reducing reliance on credit ratings requires a thoughtful analysis of how ratings are used, and are pleased that the Administration did not call for a wholesale elimination of the use of ratings in rules. The Institute therefore supports the SEC's efforts to carefully review and possibly reduce references to NRSRO ratings in its rules, as approriate.

Ratings, however, play a unique role in the regulation of money market funds and have contributed to the success of the industry. In fact, ratings are not required for most securities that are eligible for money market funds to purchase. Furthermore, the plain text of Rule 2a-7 and the rule's regulatory history make clear that it has *never* been appropriate for money market funds to rely solely on credit rating agencies.[23] The current language of Rule 2a-7 states, in the discussion of "Portfolio Quality," that a money market fund:

> shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality *in addition to* any rating assigned to such securities by an NRSRO) and that are at the time of Acquisition Eligible Securities.[24]

That provision of the rule places primary responsibility on the investment manager to perform careful credit analysis and due diligence under the standards set and overseen by the fund's board of directors. The NRSRO ratings requirement embedded in the existing definition of "eligible security" acts only as an initial screening performed by an independent third party (an NRSRO) having expertise as to credit characteristics of securities and issuers. The investment manager (under delegated authority from the fund's board of directors) then must determine whether those nominally high quality investments do, in fact, present minimal credit risk. Thus, the NRSRO ratings serve as a "floor," below

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[21] *See* 2008 NRSRO Proposal, *supra* note 19.

[22] *See* Treasury Department White Paper, *supra* note 12, at 46.

[23] For a history of Rule 2a-7, *see* MMWG Report, *supra* note 3, at Appendix E.

[24] Emphasis added.

which investments may not be made. This floor, while providing an important protection to investors, is secondary to the requirement that investment managers make their own credit risk assessment.

When the SEC amended Rule 2a-7 in 1991, it also explained why a rating from a credit rating agency was not sufficient to make a security eligible for investment under Rule 2a-7:

> Possession of a certain rating by a NRSRO is not a "safeharbor." Where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security has minimal credit risks.[25]

Thus, any money market fund that fails to make the necessary independent minimal credit risk decision or that relies solely on the rating of a NRSRO to purchase a portfolio security would already violate Rule 2a-7 as it exists today.

b) Elimination of Credit Ratings will Decrease Protection for Investors and Undermine Investor Confidence

The objective NRSRO ratings test is but one prong of a two-prong test to determine the eligibility of portfolio securities. Removing the objective prong would, in and of itself, weaken the rule by expanding the discretion and the risk that a fund may invest in a security that would not have qualified under the rule's current standards, thereby raising the potential for harm to shareholders.

As noted above, NRSRO ratings—even if occasionally flawed—protect investors by establishing an important floor through which a minimum standard is established among all money market funds. Indeed, ratings also play a vital role under Rule 2a-7 by providing a "clear reference point" for money market funds, both large and small, by which to measure compliance with the rule's requirements. Although ratings are neither perfect nor a substitute for independent, separate investment analysis, they provide a benefit as an additional, independent check on the investment manager's judgment.

By acting as a floor, these ratings keep all money market funds operating at or above the same level and restrain any particular money market fund from taking greater risks than other competing funds to increase yield (thus gaining competitive advantage in a highly yield-sensitive market). They also discourage funds from "stretching" the minimal credit risk concept to include investment opportunities that do not have the requisite high quality rating and that could prove to be inappropriate in light of the fund's objective of maintaining a stable net asset value. Indeed, as markets stabilize, investors will again gravitate towards the top-yielding money market funds, increasing the

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[25] *See Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-18005 (February 20, 1991), 56 FR 8113 (February 27, 1991), at note 18 and accompanying text ("1991 Amendments").

incentive for money market fund managers to shift to riskier assets. By eliminating the ratings' floor, the SEC would remove an important investor protection from Rule 2a-7 that has proven to be highly successful and introduce new uncertainties and unnecessary risks. Such a move seems incongruous in a proposal designed to *increase* investor protections.

Without an objective standard, the investment decision-making process of money market funds also could become increasingly less transparent to investors. The lack of conformity among standards at money market funds resulting from the removal of the minimum rating-based standard might create uncertainty in the industry and thus damage investor confidence. It is difficult to understand, therefore, how the protection afforded by Rule 2a-7's "belt and suspenders" approach to credit analysis is increased by removing the suspenders.

c) NRSRO Reform

The SEC has adopted rules to improve the process by which rating agencies operate and has proposed others.[26] Other countries are considering reforms as well.[27] Reforms of this nature will increase the usefulness, credibility, and reliability of ratings. Indeed, we believe the set of best practices recommended by the Working Group for making minimal credit risk determinations[28] together with

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[26] *See Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-59342 (February 2, 2009), 74 FR 6456 (February 9, 2009) (adopting rule amendments that impose additional requirements on NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies); *see also Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-59343 (February 2, 2009), 74 FR 6485 (February 9, 2009) (proposing rule amendments that would (1) require the public disclosure of credit rating histories for all outstanding issuer-paid credit ratings issued by an NRSRO and (2) prohibit an NRSRO from issuing an issuer-paid rating for a structured finance product unless the information about the product provided to the NRSRO to determine the rating and, thereafter, to monitor the rating, is made available to other NRSROs). For a discussion concerning the Institute's positions on proposed rules to improve the operations of NRSROs, *see* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (March 26, 2009) and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission (July 25, 2008). The SEC also held a Roundtable to examine the oversight of credit rating agencies on April 15, 2009. *See* Press Release, Securities and Exchange Commission, SEC Roundtable to Examine Oversight of Credit Rating Agencies (March 6, 2009), available on the SEC's website at: http://www.sec.gov/news/press/2009/2009-46.htm. *See also* Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, at the SEC Roundtable on Oversight of Credit Rating Agencies (April 15, 2009), available on the Institute's website at http://www.ici.org/pressroom/speeches/09_oversight_stevens_stmt.

[27] *See, e.g.,* Press Release, EUROPA, Approval of New Regulation Will Raise Standards for the Issuance of Credit Ratings in the Community (April 23, 2009) (describing the approval by the European Parliament and Council on the EU's proposed regulation of credit rating agencies), available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/629&format=HTML&aged=0&language=EN&guiLanguage=en.

[28] *See* MMWG Report, *supra* note 3, Appendix I.

the SEC's efforts to address weaknesses in the rating process and to improve regulatory oversight of NRSROs, should further improve the quality of credit analyses undertaken both by NRSROs and independently by money market funds.

d) Designated NRSROs

As an alternative to removing NRSROs from Rule 2a-7, the SEC is considering an approach, similar to one recommended by the Working Group, under which a money market fund's board would designate three (or more) NRSROs that the fund would look to for all purposes under Rule 2a-7 in determining whether a security is an eligible security. Under this approach, the board would be required to determine at least annually that the NRSROs it has designated issue credit ratings that are sufficiently reliable for that use. We strongly support such an approach but suggest a slight modification similar to the approach recommended by the Working Group.

We recommend that a fund adviser (rather than the board) designate and disclose (*e.g.*, via a fund's prospectus or website), pursuant to procedures approved by the fund's board, three or more NRSROs that the fund would look to for all purposes under Rule 2a-7. We believe that requiring such designation would encourage competition among the NRSROs to achieve this designation. We also believe that by committing themselves to particular rating agencies, money market funds would have consistency in the NRSROs that they look to for purposes of Rule 2a-7.

2. *Second Tier Securities*

The SEC's proposal would prohibit money market funds from investing in "second tier securities." Specifically, under the proposed amendments, money market funds could "acquire" only "eligible securities," which would be re-defined to include securities receiving only the highest (rather than the highest two) short-term debt ratings from the "requisite NRSROs" or of comparable quality. The Release notes that compared to first tier securities, the market for second tier securities is smaller, less liquid, and potentially more risky. We agree.[29]

As of August 31, 2009, outstanding "Tier-2" commercial paper accounted for 3 percent ($39 billion) of the $1.2 trillion commercial paper market, whereas "Tier-1" commercial paper accounted for

[29] We note that some members have suggested that at the very least a distinction should continue to be drawn between second tier conduit municipal securities and second tier non-conduit municipal securities to reflect the reduced credit risk inherent in non-conduit securities. These members report that because of the lower default risks presented by second tier non-conduit securities as compared to corporate commercial paper, second tier non-conduit securities should remain permissible investments for tax-exempt funds. If the SEC wishes to continue to recognize this distinction, we would not oppose it.

81 percent ($958 billion).[30] Even considering a longer time horizon,[31] Tier-2 commercial paper has been a relatively small part of the commercial paper market. At its recent peak—both in dollar terms and percentage of total market—on January 17, 2001, Tier-2 commercial paper accounted for only 8 percent ($124 billion) of the $1.6 trillion commercial paper market at that time. The market for Tier-2 commercial paper is less deep with fewer issuers than the Tier-1 market.

The Release also asks for comment on alternatives to eliminating the ability of a money market fund to invest in second tier securities, such as allowing money market funds to hold only second tier securities with a maximum maturity of, for example, 45 days. Although, all other things being equal, a security with a shorter maturity is less risky, this change likely would have little effect on a fund's overall exposure to credit risk because most Tier-2 commercial paper is issued at a maturity of 40 days or less.

For example, as of the end of August, the average weighted maturity of nonfinancial Tier-2 rated commercial paper outstanding was about 24 days compared to a weighted average maturity of 46 days for Tier-1 rated nonfinancial commercial paper.[32] We estimate that only about 15 percent ($6 billion) of Tier-2 commercial paper outstanding had a remaining maturity of greater than 40 days at the end of August.[33] So far this year, daily gross issuance of Tier-2 commercial paper for all maturities has averaged $2.8 billion of which only 3 percent ($97 million) had an original maturity of greater than 40 days.[34] Thus, it would appear that the alternative suggested by the SEC would not measurably decrease the amount of credit risk to which money market funds may be currently exposed to second tier securities.

Furthermore, we do not believe there would be any significant market effect by limiting money market funds to investments in first tier securities. As suggested in the Release, money market funds in the aggregate hold a smaller amount of second tier securities than now permitted under Rule 2a-7, either due to their own actions or their desire to be rated by an NRSRO.[35] We would thus expect that the proposed amendment's impact on issuers of these securities would be manageable.

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[30] *See* Federal Reserve data (not seasonally adjusted) from the Federal Reserve's website at http://www.federalreserve.gov/releases/cp/outstandings.htm. According to the Federal Reserve, the sum of Tier-1 and Tier-2 does not add up to 100 percent due to the inclusion of ineligible securities.

[31] Data on outstanding Tier-2 commercial paper are only available from January 2001 forward.

[32] *See* Federal Reserve website at http://www.federalreserve.gov/releases/cp/maturity.htm.

[33] Estimate based on data found at http://www.federalreserve.gov/releases/cp/maturity.htm.

[34] *See* Federal Reserve website at http://www.federalreserve.gov/releases/cp/volumestats.htm.

[35] To receive a triple-A rating from an NRSRO, money market funds must meet standards that are even higher than those required currently by Rule 2a-7. Among those higher standards is the requirement that triple-A rated money market funds be limited to investing in first tier securities and have a weighted average maturity that does not exceed 60 days. According

Under the proposal, however, a fund that holds a security that is downgraded by the requisite NRSROs would, under existing provisions of Rule 2a-7, have to dispose of the security unless the fund's board of directors finds that such disposal would not be in the best interests of the fund. We therefore caution the SEC to consider the effect of its proposal on "lower quality" first tier securities.[36] As a result of the SEC's proposal, money market funds may avoid purchasing securities that are perceived as potentially "lower quality" first tier securities (although still considered minimal credit risk) because a rating downgrade would result in the fund owning an ineligible security. To avoid this unintended result (and the possible chilling effect it could have on these issuers), we suggest instead that the SEC follow the Working Group's recommendation that would continue to allow a fund to hold a first tier security that is downgraded to second tier after an adviser has purchased the security for the fund.

3. *Limitations on Unrated Long-Term Securities*

The SEC has proposed amendments to the rule's quality standards associated with securities that have received only long-term ratings. Under Rule 2a-7, the measure of quality is the rating given to the issuer's short-term debt. In the absence of a short-term rating, the minimum long-term rating is designed to provide an independent check on a fund's quality determination. Currently, Rule 2a-7 permits money market funds to invest in a long-term security with a remaining maturity of 397 days or less that is an unrated security (*i.e*., neither the security nor its issuer or guarantor has a short-term rating) *unless* the security has received a long-term rating from any NRSRO that is not within the NRSRO's *three highest* categories of long-term ratings. The proposal would permit money market funds to acquire such securities only if they have received long-term ratings in the *highest two* ratings categories. We do not believe such a change is necessary.

According to rating agency literature, the analytical approach to assigning a short-term rating is virtually identical to the one followed in assigning a long-term rating; there is thus a strong link or "correlation" between short-term and long-term ratings. This correlation reflects the inherent importance of liquidity and near-term concerns within the assessment of the longer-term credit profile. These correlations are generally as follows:

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to iMoneyNet, nearly 64 percent of money market fund assets were in triple-A rated money market funds as of September 1, 2009.

[36] *See e.g.,* Fidelity Letter, *supra* note 14, at 11.

| **Long-Term Rating** | **Short-Term Rating** |
|---|---|
| AAA | Tier-1+ |
| AA | Tier-1+ |
| A | Tier-1 |
| A-to BBB | Tier-2 |
| BBB- and lower | Tier-3 and lower |

Thus, it would appear that Tier-1 short term ratings generally are correlated to the top three tiers of long-term ratings, making a change to Rule 2a-7's quality standards associated with securities that have received long-term ratings unnecessary. Indeed, under certain situations the proposed change could result in money market funds being able to purchase an issuer's short-term security but not its "correlated" long-term "stub" security that has a remaining maturity of 397 days or less.

4. *Limitations on Securities Subject to Conditional Demand Features*

Similarly, we do not support the SEC's proposed change to the requirements for securities subject to a conditional demand feature. Under the proposal, for the demand feature to qualify as an eligible security, the underlying security must have received either a short-term rating or a long-term rating from the requisite NRSROs within the NRSROs' *highest* short-term or long-term rating categories or, if unrated, must be of comparable quality. This is a change from the current rule that requires a rating within the NRSRO's *two highest* short-term or long-term rating categories.[37] A change that would limit eligible conditional demand features to those where the underlying securities have received the highest long-term rating would greatly reduce the amount of tender option bonds ("TOBs") that could be acquired by tax-exempt money market funds, which are the principal holders of TOBs. Indeed, industry participants estimate that TOBs account for approximately 15 to 20 percent of the assets of tax-exempt money market funds, and that such money market funds hold approximately 75 percent of the TOBs currently outstanding.

Tender option bonds are tax-exempt instruments that are typically synthetically created by a bond dealer, which purchases long-term bonds ("underlying bonds") and places them into a trust, which then issues two classes of securities: TOBs and residuals (also known as "inverse floating rate

[37] This change also is inconsistent with the proposed amendment to Rule 2a-7 discussed above that would require that securities that have long-term ratings only must be rated within the NRSRO's two highest long-term ratings categories.

securities"). The interest rate paid on TOBs is reset periodically, typically every week, and the TOBs can be tendered by the holder (*e.g.*, a money market fund) for redemption at par, typically on seven days' notice. The holders of the residuals, which often include long-term bond funds, receive all interest payments received by the trust from the underlying bonds that are not needed to pay interest on the TOBs and expenses of the trust.

Each TOB is usually supported by a conditional demand feature provided by a bank or other financial institution. The conditional demand feature can be terminated in the event of certain adverse credit developments, including a downgrade below a specified threshold, of the rating of the underlying bonds held in the trust. The short-term rating of the TOB, which is one criterion for determining if it is an eligible security under Rule 2a-7, is based on the strength of the provider of the conditional demand feature. The rating on the underlying bonds is an indicator of whether there is risk that circumstances would occur that would result in the conditional demand feature being terminated. The risk of these circumstances for a bond rated in the second highest long-term rating category is entirely consistent with a first tier security. Otherwise, NRSROs would not give TOBs holding these underlying bonds ratings in their highest short-term categories.

Prior to 2008, the underlying bonds in many TOBs were rated in the highest long-term rating category on the strength of credit enhancements (such as bond insurance or letters of credit), which guarantee timely principal and interest payments. Because the obligations of many financial guarantors have been downgraded to below the highest long-term rating category since the beginning of 2008, few TOBs currently outstanding have been issued by trusts that hold bonds rated in the highest long-term rating category. Indeed, in response to this situation, many money market funds obtained changes to their existing contracts with liquidity providers to preserve the conditional demand features regardless of the financial guarantors' rating, by linking the conditional demand features' termination events to the credit rating of the underlying bond issuer and/or financial guarantor, rather than just the financial guarantor. The underlying bonds for most TOB structures today, however, are uninsured and rated in the second highest long-term rating category, although they are essentially the same high quality bonds that have always been used in the TOB structure.

In the TOB example, any amendment to Rule 2a-7 that would limit eligible conditional demand features to those supporting TOBs where the underlying bonds receive the highest long-term rating would drastically reduce the availability of TOBs for money market funds—in particular tax-exempt money market funds—(and, as primary holders of TOBs, a significant source of funding for municipalities), and would disrupt the operations of long-term bond funds that invest in the residuals.

5. *Asset Backed Securities*

The Release requests comment on whether, and if so how, the SEC should amend Rule 2a-7 to address risks presented by structured investment vehicles ("SIVs") or other asset backed securities. The financial market crisis, with its roots in subprime mortgages, demonstrated that new and complex structures demand analysis that extends well beyond that of the nominal issuers' creditworthiness. As the Release notes, beginning in 2007, market-based liquidity for some money market fund assets, despite being eligible securities under Rule 2a-7, proved to be unreliable. Specifically, SIVs typically did not have access to committed liquidity facilities to protect commercial paper investors, including money market funds, against the risk of the issuer's inability to reissue commercial paper caused by either a credit event of the issuer or a disruption in the commercial paper market. SIVs that could no longer reissue their debt and were unable to secure liquidity support were forced to begin selling the vehicles' assets into depressed markets to pay maturing debt and to begin winding down their operations. As a result, many SIVs' credit ratings were downgraded, which put pressure on the valuations of SIV securities held by money market funds. This forced some funds to enter into agreements with their affiliates to support the fund's stable share price of $1.00.

Based on this experience, the SEC requests comment on, among other things, whether it should limit money market funds to investing in asset backed securities that the manager concludes can be paid upon maturity with existing cash flow. Although, as discussed below, we do not believe any changes to Rule 2a-7 regarding asset backed securities are necessary, if Rule 2a-7 were amended to add this requirement, we would ask the SEC to clarify that by "cash flow" it would include all sources of a special purpose entity's source of funds, including both maturing assets and/or access to liquidity facilities, such as bank draws, to pay the maturing notes.

The SEC also has requested comment on whether Rule 2a-7 should require asset backed securities to be subject to unconditional demand features in order to be eligible securities. We believe that this restriction would have a detrimental effect on some sectors of the asset backed securities market. For instance, multi-seller conduits[38] are typically only "partially-supported" by unconditional demand features that are available to cover all losses up to a specified percentage, typically 8-10 percent, in the conduit. The cost of the unconditional demand feature, however, is passed on to the borrowers (*i.e.*, sellers). If the SEC were to require all asset backed securities to be subject to unconditional demand features, multi-seller conduits would be required to be "fully-supported" by such features, raising the borrowing costs to the sellers and ultimately reducing the utility of this otherwise low cost funding alternative.

Furthermore, requiring unconditional demand features would prevent TOB structures, which technically are asset-backed securities, from satisfying the Internal Revenue Service's announced standards for receiving the tax treatment necessary for purchase by tax-exempt money market funds. For the TOB structure to generate income that is exempt from tax as municipal bond interest, the structure holding the municipal bonds must be treated as a partnership for federal income tax purposes.

[38] A multi-seller conduit is a special purpose entity that regularly buys interests in pools of financial assets from one or more sellers and funds such purchases by selling commercial paper notes primarily to institutional investors. Most multi-seller conduits are sponsored and administered by large commercial banks. They organize and administer them to offer an alternative and lower cost source of funding to customers (*i.e.*, the sellers) owning financial assets with historically-measurable cash flows.

The IRS has published guidance[39] providing that partnership status is not achieved unless each partner (including a tax-exempt money market fund holding a variable-rate interest in the TOB) has sufficient risk of loss. More specifically, the IRS guidance lists four conditions that must terminate a variable-rate interest holder's ability to exercise a tender option right; these conditions create the necessary risk of loss. Eliminating these conditions by requiring, for example, all demand features to be unconditional would prevent the TOB from receiving partnership status and cause the income received by the variable-rate interest holder to be treated as taxable income.

On the other hand, we believe the Working Group's recommendations to improve the process by which money market funds select potential investments better addresses the SEC's concerns without requiring specific rulemaking in this area. As recommended by the Working Group, one way to improve the investment process by which money market funds select potential investments is to require that each money market fund have a "new products" committee or similar group that would review and approve novel securities, credit structures, or investment techniques prior to investment by their funds.[40] To enhance the credit analysis of new and complex structures, the Working Group also recommended a set of best practices for determining minimal credit risks based on a variety of practices successfully employed by various money market funds.[41] As noted above, Rule 2a-7 requires a money market fund's investment manager (under delegated authority from the fund's board of directors) to evaluate independently the credit quality of each portfolio investment and determine that each investment presents minimal credit risks. As the SEC stated when it adopted Rule 2a-7, an instrument must be evaluated for the credit risks that it presents to the particular fund at that time (*i.e.*, time of acquisition) in light of the risks attendant to the use of amortized cost valuation or penny rounding.[42] Rather than focusing on specific aspects of asset backed securities that were problematic during the financial crisis, the Working Group's guidance provides a forward-looking process that advisers may consider when evaluating credit risks of *all* existing and new types of issuers, securities, or credit

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[39] *See* Notice 2008-80, 2008-2 C.B. 820.

[40] For a description of this type of committee, *see* MMWG Report, *supra* note 3, at 79-80.

[41] For a copy of the best practices, *see id.* at Appendix I. The recommended practice for credit risk criteria addresses the need to consider alternative liquidity sources, particularly for asset backed securities. ("Generally, an issuer presenting minimal credit risks will have alternative sources of funding for repayment of obligations in the event that the issuer loses access to the originally anticipated source of such funding. Highly rated operating companies typically have a range of funding alternatives, such as using cash from other lines of business, arranging new credit facilities, or raising capital through the issuance of new debt or equity securities. Funding alternatives for issuers of Asset Backed Securities, in contrast, are limited to those included in the original credit structure. Advisers should consider whether these funding alternatives will be adequate in the event that the underlying Qualifying Assets do not perform as anticipated." *Id.* at 194.)

[42] *See* Rule 2a-7 Adopting Release, *supra* note 16. *See also* MMWG Report, *supra* note 3, at Appendix F for a history of the minimal credit risk requirement.

enhancements, including the risks presented by asset backed securities.[43] The success of money market funds depends upon thorough credit review processes, and the Working Group's recommendations seek to institutionalize those industry best practices.

C. Portfolio Maturity

1. *Weighted Average Maturity*

The SEC is proposing changes to Rule 2a-7's maturity limits in order to further limit the exposure of money market fund investors to certain risks, including interest rate risk. Specifically, the SEC has proposed to reduce the maximum weighted average portfolio maturity permitted by Rule 2a-7 to 60 days from the current limit of 90 days.

A shorter weighted average maturity should reduce the effect that interest rate movements have on a fund's net asset value. We believe, however, that the proposed 60 day limit, which appears to incorporate current NRSRO rating requirements into SEC rules,[44] would constrain the ability of many money market funds to produce yields that cover their expenses, particularly during times of low interest rates. Also, during the recent crisis, as investors flocked to short-dated Treasuries for safety, the availability of such securities became extremely scarce or nonexistent. In these situations, a 60-day limit would severely impede the ability for some funds, especially Treasury only funds, to purchase securities further out the yield curve to where securities are more likely still available for sale in the market. In contrast, we believe a portfolio maturity limit of, for example, 75 days, as recommended by the Working Group, would reduce interest rate risk without significantly impairing portfolio flexibility during different market environments.[45]

2. *Weighted Average Life*

As recommended by the Working Group, the SEC also has proposed to add to Rule 2a-7 a new maturity test that would limit the portion of a fund's portfolio that could be held in longer term variable- or floating-rate securities. Specifically, the proposal would require a fund to calculate the weighted average maturity of its portfolio without regard to interest rate reset dates. This calculation, which the SEC has called a "weighted average life," would be limited to 120 days.

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[43] While certain asset backed securities played a role in the recent credit crisis, it is impossible to predict new structures that may present different, but equally challenging credit quality and liquidity limitations. Focusing solely on asset backed securities may result in the SEC's missing the next crisis. The approach taken by the Working Group seeks to avoid this rear window approach.

[44] *See supra* note 35.

[45] For the same reasons, our members hope that the NRSRO community would not further reduce their current weighted average maturity limit of 60 days for funds to receive a triple-A rating.

We strongly support this new weighted average life calculation and believe that it would provide a layer of protection for money market funds and their shareholders in volatile markets that is beyond what is currently required under Rule 2a-7. We further believe that the 120-day limit is the appropriate limit as it is flexible enough even during "normal" market conditions to not unduly restrict a fund's ability to offer a diversified portfolio of short-term, high quality debt securities.

3. *Treatment of Cash*

Money market funds may hold cash balances (*i.e*., cash and amounts deposited in bank transaction accounts that are payable on demand). Indeed, members report that during the credit crisis, funds' holdings of cash balances increased in response to the Federal Deposit Insurance Corporation's Temporary Liquidity Guaranty Program, which provides unlimited FDIC deposit insurance for amounts deposited in non-interest bearing transaction accounts.[46] To more accurately reflect the true maturity of money market funds' holdings, we recommend that Rule 2a-7 specifically address the treatment of cash balances for purposes of the required portfolio weighted average maturity and portfolio weighted average life tests. When funds hold significant cash balances, we believe including these balances in the required calculation would more accurately reflect the fund's portfolio maturity and interest rate risk. Specifically, we recommend that cash balances be included in the calculation of weighted average maturity and weighted average life and that their maturity be equal to one day.

4. *Maturity Limit for Other Portfolio Securities*

The SEC has requested comment on whether it should consider reducing the maximum maturity for individual non-government securities acquired by a money market fund from 397 days to, for example, 270 days. We do not believe that such a change is necessary in light of the proposed reduction in the maximum weighted average portfolio maturity and the new weighted average life maturity test and may actually impair portfolio management. Reducing the maximum maturity limit for individual non-government securities could be disruptive to some issuers' debt management policies and increase their "rollover" risk from adverse market events. Indeed, some highly rated issuers have recently issued money market securities with maturities of one year. For example, since the beginning of the year, Toyota Motor Credit (rated AA) has issued $1.1 billion in medium term notes, with about 40 percent at a one year original maturity. Likewise, Credit Suisse (rated AA) has issued all of its Yankee CDs ($1.6 billion) at an original maturity of one year.

D. Diversification

The SEC has requested comment on whether it should further restrict the diversification limits of Rule 2a-7 relating to issuers and/or guarantors. Under the current rule, money market funds generally must limit their investments in the securities of any one issuer (other than government

[46] *See* Temporary Liquidity Guaranty Program, 73 FR 72244 (November 26, 2008).

securities) to no more than 5 percent of fund assets and limit their investments in securities subject to a demand feature or a guarantee to no more than 10 percent of fund assets from any one provider. Due to unprecedented market conditions and consolidations, however, the universe of institutions issuing or providing guarantees or liquidity for eligible money market securities has become extremely limited. Further restricting the diversification limits would only heighten this problem by forcing money market funds to use institutions they may be less comfortable with to meet new diversity requirements. Moreover, given the other proposed changes relating to a money market fund's liquidity, portfolio quality, and maturity, we do not believe that it is necessary at this time to make changes to the rule's diversification provisions.

### E. Repurchase Agreements

Under Rule 2a-7, money market funds may treat the acquisition of a repurchase agreement as an acquisition of the collateral underlying the repurchase agreement for purposes of meeting the rule's diversification requirement, provided that the repurchase agreement is "collateralized fully," *i.e.*, it, among other things, qualifies for an exclusion from any automatic stay of creditors' rights against the counterparty under applicable bankruptcy law. The SEC proposal would limit money market funds to investing in repurchase agreements collateralized by cash items or government securities in order to obtain the special treatment noted above under the diversification provisions of Rule 2a-7. The SEC also proposes to require that the money market fund's board evaluate the creditworthiness of the counterparty, regardless of whether the repurchase agreement is collateralized fully.

Institute members report that they typically use the diversification "look through" provision for repurchase agreements that are collateralized only by cash items and government securities. As a result, we do not believe that the proposed amendment would have a significant impact on the operations of most money market funds. The proposal, however, could curtail the ability of fund complexes that use joint trading accounts[47] to pool their money market funds' excess cash balances in repurchase agreements with other non-money market funds. Typically, a fund complex uses these accounts to facilitate the "bulk purchase" of short-term investments, such as repurchase agreements, so that all of its participating funds, including money market funds, can decrease transaction costs and experience administrative efficiencies. One condition to investing in repurchase agreements through joint trading accounts is that the repurchase agreements are "collateralized fully," as that term is currently defined. Under the proposal, in order to be able to continue to utilize joint trading accounts for all funds, including money market funds, fund complexes would be required to segregate collateral type or limit eligible collateral to cash items and government securities.

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[47] *See* The Chase Manhattan Bank, SEC No-Action Letter (July 24, 2001) (providing no-action relief under Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder if the cash collateral that funds receive, and certain of their affiliated persons, in connection with their participation in a securities lending program is invested in certain short-term instruments through one or more joint accounts).

With respect to that aspect of the proposal requiring the board to evaluate the "creditworthiness" of the counterparty to a repurchase transaction, we believe that such a requirement is not necessary because such an evaluation is already an element of the minimal credit risk requirement. Indeed, the Working Group's set of best practices for determining minimal credit risks specifically addresses the credit analysis associated with repurchase agreements.[48]

## II. Disclosure of Portfolio Securities

We support the SEC's proposal to amend Rule 2a-7 to require money market funds to publicly disclose portfolio holdings information monthly. Currently, mutual funds, including money market funds, publicly file with the SEC their complete portfolio holdings on a quarterly basis, no more than 60 days after the close of the quarter. During the recent market crisis, some money market fund shareholders wanted to know the portfolio holdings of their funds on a more frequent basis. As a result, many money market funds began posting their holdings on their websites at periodic intervals, sometimes on a daily basis, depending largely on what their clients desired. We believe that monthly disclosure of money market funds' portfolio holdings is both acceptable from a portfolio management perspective and desirable for some investors, because money market fund portfolios turn over quickly. Thus, a portfolio could completely turn over between reporting periods, leaving investors often unsure of the issuers of the securities held by their money market funds.

Mutual funds are very sensitive to frequent public disclosure of portfolio holdings information. Any improper public disclosure of this otherwise confidential information can lead to frontrunning of a fund's trades, adversely impacting the price of a security that a fund is buying or selling to the detriment of fund shareholders.[49] On the other hand, Rule 2a-7 restricts the universe of eligible securities that a money market fund can invest in to such an extent that frontrunning, to the extent it exists at all, tends to be immaterial to fund performance. In addition, because of the very short-term nature of money market funds' holdings, frontrunning concerns are far less significant for this type of fund. Combined, these two factors alleviate much of the frontrunning concerns experienced by other funds. Public disclosure should be designed to promote market confidence and not to facilitate the trading strategies of certain market participants. As a result, monthly disclosure of portfolio holdings should *only* apply to money market funds.

We also support the SEC's proposal to enhance its access to money market fund data. As noted above, its current information on money market fund portfolios is limited to quarterly reports that can

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[48] *See* MMWG Report, *supra*, note 3, at 196.

[49] *See* Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission (September 14, 2005, August 29, 2006, and September 19, 2008); *see also* Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission (December 16, 2008).

quickly become stale given money market funds' short maturity horizon. Moreover, as noted in the Release, the current reports are not filed in a format that allows the SEC to search expeditiously across portfolios or within a portfolio.

In response to these concerns, the SEC has proposed to require a fund to (a) post the fund's portfolio holdings to its website two business days after each month end, and (b) file new Form N-MFP detailing fund-level and security-level information with the SEC two business days after each month end. In addition, the SEC has proposed to omit money market fund portfolio holdings information from Form N-Q. We comment on each of these elements of the SEC's proposal below. Finally, we respond to the request for comment on public disclosure of market-based net asset value per share and market-based prices of portfolio securities.

A. Public Website Posting

The SEC's proposal, which is similar to a recommendation from the Working Group, would require a fund to post its schedule of investments no later than the second business day of the month, current as of the last business day of the previous month, and maintain the information on the fund's website for at least twelve months. The schedule of investments would be in conformity with Rules 12-12 to 12-14 of Regulation S-X. As noted above, we support monthly disclosure of the portfolio as a means to provide investors with more timely information on the fund's holdings. We believe, however, that the requirement to conform the portfolio disclosure to Regulation S-X would unnecessarily complicate the required disclosure. Our recent experience also indicates that a two business day time period for posting is not practicable.

Conforming the website posting of the portfolio to Rules 12-12 to 12-14 would require funds to: classify and subtotal securities by type and industry; provide detailed information on repurchase agreement collateral; and provide detailed restricted securities disclosures,[50] all of which we believe would be of little interest or benefit to investors. Further, tying the disclosure requirement to Regulation S-X may compel funds to provide certain notes required by generally accepted accounting principles, as many do for Form N-Q filings.[51] On the other hand, investors are most interested in the names of the issuers in which the fund has invested. We therefore recommend that the SEC require monthly website posting of the investment portfolio without reference to Regulation S-X. Instead, funds should disclose, for each security held as of the month-end, the issuer, the name of each issue (including coupon or yield and maturity), the principal amount, and the current amortized cost.

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[50] In particular, funds would be required to flag each restricted security in the schedule of investments and provide footnote disclosure of the security's acquisition date. In addition, funds would be required to provide the aggregate value of all restricted securities and the percentage that the aggregate value bears to net assets.

[51] Form N-Q does not specifically require funds to include the notes required by generally accepted accounting principles. Nevertheless, many funds elect to include these notes (*e.g.*, valuation policies, FAS 157 disclosures, FAS 161 disclosures) as a prophylactic measure to ensure that the filing could not be viewed as omitting material information.

Members that currently post their portfolio holdings to their websites report that a two-day delay for disclosing this information does not provide adequate time to gather, review, and then post the information in a form that is easy for shareholders to read and understand. Indeed, despite the Working Group's recommendation that portfolio holdings information be posted to funds' websites each month after a two-day lag, we recommend, given our members' recent experience, that the SEC consider imposing a delay of seven to ten business days. We believe this longer delay more accurately reflects the time needed to comply with our recommended disclosure requirement. If the SEC ultimately determines to require the level of detail prescribed by Rules 12-12 to 12-14 of Regulation S-X, we recommend that the SEC consider an even longer time frame.

B. Reporting to the SEC

The SEC is proposing a new rule requiring money market funds to provide the SEC a monthly electronic filing of more detailed portfolio holdings information. According to the Release, the information would enable the SEC to create a central database of money market fund portfolio holdings, which would enhance its oversight of money market funds and its ability to respond to market events. Under proposed Rule 30b1-6 under the Investment Company Act, money market funds would file a monthly portfolio holdings report on new Form N-MFP no later than the second business day of each month, current as of the last business day of the previous month. Form N-MFP, which would be filed through EDGAR in an XML tagged data format, would require money market funds to disclose a number of items enumerated in the Release. The SEC also notes that it expects to make the portfolio reports available to the public two weeks after their filing.

We support the SEC's efforts to enhance its oversight of money market funds through the collection of more detailed holdings information on a monthly basis; however, we question the need for public disclosure of any data beyond what we have recommended above. If the SEC feels that the level of detail in proposed Form N-MFP would be useful for regulators, that information should be collected, but it need not be made publicly available. We would be especially concerned if information required under proposed Item 14 would be made publicly available, as a decline in the amortized cost net asset value of several basis points could be misinterpreted as an indication of problems with a fund. We also have comments on specific items to be included in new Form N-MFP. Furthermore, we comment on the process for development, testing, and implementation of an electronic format to be used by funds when filing Form N-MFP. Finally, we believe the two business day filing period for filing Form N-MFP with the SEC is not a practicable period to gather and prepare in filing format the more detailed information sought in this filing, compared to that which would be provided for website posting of the fund's portfolio holdings.

1. *Public Release*

The proposal contemplates that the portfolio reports filed with the SEC be made available to the public two weeks after filing. We question the utility of publicly disclosing this level of detail of portfolio holdings information. Indeed, such fund accounting details are not readily understood by the average investor. Instead, we believe the monthly public website posting of portfolio holdings information without reference to Regulation S-X, as discussed above, provides sufficient information for investors and others to evaluate the risks in money market funds.

2. *Form N-MFP*

The Form requires certain information intended to identify the fund (*e.g.*, the name and address of the fund, its CIK number, its SEC file number, and the EDGAR series identifier). Part 1 of the Form collects detailed fund level information (*e.g.*, the type of money market fund, weighted average maturity, weighted average life, and 7-day gross yield). Part 2 of the Form collects equally detailed information on each of the fund's portfolio securities (*e.g.*, name of the issuer, CIK number, title of the issue, the credit rating, the maturity date).

Specifically, item 12 of the Form requires the fund to report the total value of the portfolio at cost, to the nearest hundredth of a cent. Item 13 of the Form requires the fund to report the net value of other assets and liabilities, to the nearest hundredth of a cent. Item 37 of the Form requires the fund to report the current amortized cost of each security to the nearest hundredth of a cent. We understand fund accounting systems do not maintain this information to the nearest hundredth of a cent, but rather maintain this information to the nearest cent. Further, we question the utility of collecting this information to the nearest hundredth of a cent. We therefore recommend that the Form be modified to collect these items to the nearest cent in order to avoid unnecessary reprogramming of systems.

We also note that item 12 of the Form requires the total value of the portfolio at cost, while Item 37 requires the current *amortized* cost for each security. We recommend that item 12 be clarified to collect the total value of the portfolio at amortized cost.

Item 14 of the Form requires the fund to report the net asset value per share for purposes of distributions, redemptions and repurchase, to the nearest hundredth of a cent. Due to penny rounding, the net asset value per share for purposes of processing fund shareholder transactions would be $1.00 (or $1.0000 to the nearest hundredth of a cent) unless the fund "breaks the dollar." We suggest Item 14 be revised to clarify that the fund should report its amortized cost net asset value per share to the nearest hundredth cent *before rounding*. As noted above, however, we do not believe this information would provide investors with useful information if made publicly available.

Item 16 of the Form requires the fund to report the dollar weighted average maturity of portfolio securities, based on the time remaining to the next interest rate re-set. We find the reference to "the next interest rate re-set" confusing because not all eligible securities have interest rate re-set features. We suggest that item 16 be revised to cross-reference the instruction for calculation of dollar weighted average maturity contained in Rule 2a-7. Similarly, we recommend that item 17 of the Form, which collects the dollar weighted average life of portfolio securities, also be revised to cross-reference to Rule 2a-7.

Item 20 of the Form requires the CIK number for the issuer of each security held by the fund. We understand that the CIK number—a SEC assigned issuer identification number—is not widely used in the industry to identify issuers or their securities. We are concerned that funds would have to obtain CIK numbers for their portfolio securities solely for the purpose of completing the Form. Indeed, we note that issuers of certain securities have no CIK number (*e.g.*, treasury securities, government agency securities, municipal securities, repurchase agreements). We therefore recommend that the SEC omit the CIK number from the Form.

Item 38 of the Form requires the FAS 157 valuation level for each security held by the fund (*i.e.*, Level 1, Level 2, or Level 3). We understand that industry practice is to categorize all securities valued through reference to amortized cost as Level 2. We expect that a fund, so long as it uses amortized cost to value its securities, would identify all of its holdings as Level 2. Accordingly, we question the utility of collecting this information and recommend that it be omitted.

3. *XML Data Tagging*

The SEC's proposal would require new Form N-MFP to be filed electronically through EDGAR in an XML tagged data format. We support the SEC's view that the data should be filed in a format that can be easily searched and analyzed by SEC staff. The Release notes the SEC's desire that the information would allow it to identify quickly those funds that are holding certain types of securities or specific securities and funds that have unusual portfolios that may involve greater risks than are typical. Toward that end, it is essential that the data be submitted in a highly standardized format. The quality and comparability of data submitted on other forms (*e.g.* Form N-PX, Form N-SAR) has suffered greatly from this lack of standardization.

The Institute does not endorse a particular technology for defining an electronic format for submission of Form N-MFP, but the technology chosen must offer tools for data typing and automated validation as strong as those provided by the XML and XBRL standards. The choice of technology, however, does not in itself guarantee that the Form N-MFP electronic format will assure adequate data quality. The process for developing the format is much more important. For example, careful attention must be paid to the definition of data fields, especially the typing of numeric and date information. The electronic format should distinguish required and optional fields.

Just as in recent XBRL taxonomy development efforts, the new electronic format should undergo a review process. Money market funds and service providers should have adequate opportunity to review and comment on the new format in order to identify data consistency problems or potential implementation issues. The Institute would be willing to encourage and coordinate industry participation in such a review. Once the electronic format is final, adequate time then must be allowed to build and test systems that use it. If adequate time for review and implementation testing is allowed, we do not believe that a voluntary pilot program for Form N-MFP filings is needed.

#### 4. *Filing Delay and Compliance Date*

Data to be filed in the new Form reside in different record-keeping systems (*e.g.*, accounting, compliance, portfolio management). We anticipate that funds would need to build applications to pull information from these different record-keeping systems in order to compile the information necessary to complete the new Form.[52] Further, different business units would be involved in compiling and reviewing the information required by the Form. These difficulties would be compounded when an external sub-adviser performs portfolio management, requiring the adviser to reach outside the organization to compile the information necessary to complete the Form. Also, because the Form would be filed with the SEC, we anticipate that funds would apply heightened control and review processes to the data to be filed, as they would any other SEC filing. In order to provide sufficient time for funds to gather, review, format the data as required, and file the Form through EDGAR, we recommend that the SEC provide at least a 12 to 15 business day delay. For many of the same reasons, we also recommend the SEC consider at least a six month delay from the date the XML data tag set is finalized before requiring funds to file the new Form. Once the data tag set is finalized, funds would need adequate time to build and test systems that would compile the data and file the new Form.

### C. Amendments to Rule 30b1-5

To avoid unnecessarily duplicative disclosure obligations, the SEC is proposing to amend Rule 30b1-5 under the Investment Company Act to exempt money market funds from the requirement to file their schedules of investments pursuant to Item 1 of Form N-Q. The Release notes, however, that the SEC is not proposing to exempt money market funds from the controls and procedures and certification requirements of Form N-Q. As a result, under the SEC's proposal, a money market fund's quarterly Form N-Q filing would contain only current item 2 (relating to the fund's disclosure controls and procedures and any changes in the fund's internal control over financial reporting) and current item 3 (the certifications required by Rule 30a-2).

As noted above, we recommend that the monthly posting of the fund's portfolio to its website be limited to the issuer, the name of the issue, the principal amount, and the current amortized cost. If the SEC accepts this recommendation, we suggest that money market funds continue to be required to file their schedule of investments, in conformity with Rules 12-12 to 12-14 of Regulation S-X, in their quarterly Form N-Q filings. This would ensure that investors have access to the detailed notes required by Regulation S-X on a quarterly basis, as they do currently. Further, money market fund portfolio disclosures would be certified quarterly, as they are currently. Finally, this would avoid the need for officers to certify an "empty" Form N-Q (that contains no schedule of investments).

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[52] We anticipate that the costs associated with this proposal could be significant for some advisers. For example, there may be licensing costs associated with sharing the information among various recordkeeping systems.

If instead the SEC requires monthly posting of the fund's schedule of investments to its website in conformity with Rules 12-12 to 12-14 of Regulation S-X, we would then support the SEC's proposal to remove the schedule of investments from the quarterly Form N-Q filing. Including the fund's schedule of investments in the Form N-Q filed with the SEC would be duplicative and unnecessary. We believe, however, that the certification included in the Form N-Q filing would need to be modified for money market funds. In particular, subpart 3 of item 3 of Form N-Q (certifying the accuracy of the schedule of investments) should be omitted.

The SEC also seeks comment on whether to apply the certification requirements of Rule 30a-2 under the Investment Company Act to proposed Form N-MFP. The Institute opposes the extension of the certification requirements to Form N-MFP, which under the proposal would be filed much sooner after the close of the period than Form N-Q. Form N-Q must be filed not more than 60 days after the end of the fiscal quarter covered by the report. This 60 day period provides certifying officers with sufficient time to review the filing and to evaluate the fund's disclosure controls and procedures and its internal control over financial reporting. Further, certification of Form N-MFP would increase the number of certified filings a money market fund files with the SEC from 4 to 14 per year (even assuming these funds are exempt from filing reports on Form N-Q). We believe the increased burden on certifying officers would not provide commensurate benefits.

D. Public Disclosure of Market-Value Based Information

We are especially pleased to see that the SEC is *not* proposing that money market funds also publicly disclose their market-based net asset value per share ("shadow price") and the market-based prices of their portfolio securities. We do not believe that requiring funds to disclose this information, either in the website posting or through Form N-MFP with a two-week lag, would be helpful to fund shareholders and very well could, in fact, increase systemic risks.

There is little evidence that requiring funds to disclose either shadow prices or market-based prices of portfolio securities would be informative. For example, a sample of shadow prices provided on a confidential basis by a number of the largest institutional money market funds indicates that shadow prices deviated very little from $1.00 in the run-up to September 15, 2008. Presumably, for these money market funds, the market-based prices of their underlying securities deviated little from amortized value, and thus, that information also would have been uninformative.

In addition, there is a significant risk that publishing the shadow prices and/or market-based prices for funds' portfolio securities could be destabilizing. Generally, these prices will deviate perceptively from their amortized values only during periods of severe market stress. Contrary to the SEC's intent of helping to reduce systemic risk, publishing such a deviation could potentially set off a surge in redemption requests at a time when the money market is already under duress and consequently, further intensify pressures on the market.

## III. Money Market Fund Operations

The SEC's proposal would make two significant changes to money market fund operations. One change would permit a fund's board to suspend redemptions in order to facilitate an orderly liquidation of the fund in the event a fund's securities are priced below $1.00 per share. Although we strongly support permitting a board to suspend redemptions in order to facilitate an orderly liquidation of the fund, we fail to see why a fund must "break a dollar" first before a board can use this exemption. We also suggest the board be permitted to temporarily suspend redemptions during certain exigent circumstances other than liquidation.

In response to the operational limitations experienced by The Reserve Primary Fund after that fund broke a dollar in September 2008, the SEC also is proposing to require that money market funds have the operational capacity to break a dollar and continue to process investor transactions in an orderly manner. As described below, fund complexes, service providers, and intermediaries have developed intricate and complex systems that allow them to communicate and process significant volumes of money market fund transactions on a daily basis through a variety of mechanisms on behalf of investors. Indeed, in the more than 25 years since Rule 2a-7 was adopted, $371 trillion have flowed in and out of money market funds and, with the exception of the Reserve Primary Fund and a small institutional money market fund in 1994, these transaction volumes have been successfully processed by the industry at a stable $1.00 net asset value without incident or problems.

Although we appreciate the SEC's desire to ensure that funds can process transactions at a price of other than $1.00 per share if the need should arise, we are concerned that the proposal would require costly changes to a myriad of systems at a financially precarious time for the industry. Indeed, the effect of a near zero interest rate environment leaves the industry severely strained financially to complete extensive operational changes that would be required under the proposed rule. Moreover, we are deeply concerned that the proposed requirement would create a strong incentive for intermediaries to utilize unregulated or less regulated money market investment vehicles rather than money market funds for their clients' cash management needs.[53] In addition, because the proposed amendments to strengthen the risk-limiting conditions of Rule 2a-7 further minimize the likelihood that transactions would need to be processed at other than $1.00 per share, we recommend the proposed operational capability requirements be eliminated from the final rule.

### A. Authority to Suspend Redemptions

The SEC is proposing a new rule that would exempt money market funds from Section 22(e) of the Investment Company Act to permit them to suspend redemptions in order to facilitate an orderly liquidation of the fund. Specifically, proposed Rule 22e-3 would permit a money market fund to suspend redemptions upon breaking a dollar, if the board, including a majority of independent

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[53] *See* discussion concerning the Treasury Department White Paper, *supra* note 12 and accompanying text.

directors, approves liquidation of the fund, in order to effect this liquidation in an orderly manner, and the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions by electronic mail.[54]

Similar to the Working Group's recommendation, we strongly support a rule that would permit funds to suspend redemptions upon liquidation. We believe that such a rule represents a very important first step in ensuring shareholder fairness. Indeed, we believe that such a rule is consistent with the policy underlying Section 22(e) of the Investment Company Act. The purpose of Section 22(e) is to ensure that a redeemable security is, in fact, redeemable, and that funds do not institute barriers to redemptions or suspend the right of redemption for improper purposes such as to preserve management fees by limiting redemptions. Liquidation of a money market fund, however, eliminates a source of advisory fees for the adviser, removing any ulterior motives for suspending redemptions. Thus, we do not believe that it should be a condition of the rule that a fund realize losses ("break a dollar") before it is permitted to use this exemption. Indeed, such a condition would seem to defeat one of the purposes of liquidation—to help prevent the sale of fund assets at "fire sale" prices to meet incoming redemptions that would not be in the best interests of all shareholders. Indeed, if the board knows that by continuing to honor redemptions the fund would eventually break a dollar, it will be faced with precisely the situation in which it should be able to suspend redemptions.

We also encourage the SEC to consider an additional measure to protect shareholders recommended by the Working Group that would permit fund boards, with appropriate prospectus disclosure, to temporarily suspend redemptions during certain exigent circumstances other than liquidation of the fund.[55] As the Working Group explained, this internal "circuit breaker" would be designed to provide a short period of time for a fund under stress to seek credit support or otherwise restore its net asset value. Furthermore, we believe that having the ability to proactively suspend redemptions when a board has information to suggest that its fund may be subject to a run should its net asset value become materially impaired would address timing issues associated with the settlement of redemptions and shadow pricing.

Orders to purchase or redeem money market fund shares are delivered to a fund in a variety of methods. The most common methods are through the National Securities Clearing Corporation's

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[54] The proposed rule also contains an additional provision that permits the SEC to rescind or modify the relief provided by the rule (and thus require the fund to resume honoring redemptions) if, for example, a liquidating fund has not devised, or is not properly executing, a plan of liquidation that protects shareholders. Under this provision, the SEC may modify the relief "after appropriate notice and opportunity for hearing," in accordance with Section 40 of the Investment Company Act. The proposed rule also would provide a limited exemption from Section 22(e) for certain conduit funds (such as insurance company separate accounts issuing variable insurance contracts or funds participating in master-feeder arrangements) that invest, pursuant to Section 12(d)(1)(E) of the Investment Company Act, all of their assets in a money market fund that suspends redemptions in reliance on the proposed rule.

[55] For a description of this recommendation, including its limitations, *see* MMWG Report, *supra* note 3, at 87-89.

("NSCC") Fund/SERV® system[56] order routing functionality, through a proprietary money market fund portal,[57] or direct at the money market fund. Once delivered, money market fund transactions settle in essentially two timeframes: either same-day, or next-day. Same-day settlement transactions are those where the order (either buy or sell) is sent to the money market fund on Day 1 and the money settlement, for both purchases and redemptions, also occurs on Day 1.[58] Since the entire process is completed on the same day, these orders are known as same-day settlement transactions.

Same-day settlement transactions, however, are subject to operational timing issues. Money market fund providers enforce intraday cut-off times after which no additional orders are accepted for same-day settlement. There also are cut-off times by which the money to pay for the order must be received by the money market fund's banking institution. These times vary by money market fund and occur throughout the business day. Since the money must be delivered on Day 1 before the cut-off time, the payment must process either through the Federal Reserve Bank's Fedwire® Funds Service or through settlement services provided by Fund/SERV. Both Fedwire and Fund/SERV have cut-off times for same-day settlement after which no money will be accepted for that business day; in particular for Fund/SERV, the cutoff time is mid-morning Eastern time. If any of these cut-off times is breached, the order will not settle on Day 1.

For many other money market fund transactions, orders are delivered to the fund on Day 1 (T) while the payment occurs on Day 2 (T+1). Since settlement is completed T+1, these are known as next-day settlement transactions. Next-day settlement transactions are still subject to cut-off times for placing the order as well as for delivering money to settle the transaction. The difference is that for next-day settlement transactions, the cut-off for delivering money is enforced on T+1.

In contrast to the process of settling transactions discussed above, money market funds typically shadow price their portfolios at the end of the day after the market has closed or early the next morning before the market has opened. Thus, even if a board acts immediately upon receiving the fund's official shadow price showing the fund's net asset value is below $0.995, the fund has likely already received orders from direct shareholders and intermediaries that have been priced and settled at $1.00. We believe the ability for a fund's board to temporarily suspend redemptions for those transactions that

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[56] Fund/SERV provides a conduit between intermediary participants and money market fund transfer agents to provide efficient and cost-effective trading and settlement. In Fund/SERV, the transaction may be same-day or next-day settlement depending on when the order is placed and monies received by scheduled cut-off times.

[57] Portals are established by vendors as proprietary, automated, typically web-based services. Portals provide an order-routing conduit between institutional investors and an array of money market funds. Settlement of portal money market fund transactions is typically done through the Fedwire system for same-day settlement.

[58] About two-thirds of money market fund assets are in institutional share classes that primarily utilize same-day settlement for their money market fund transactions.

have not yet settled before the fund breaks a dollar under certain exigent circumstances would help to address these inherent timing issues and better treat all shareholders alike.

B. Processing of Transactions

The proposal would require that all money market funds be able to process purchases and redemptions electronically at a price other than $1.00 per share. Specifically, the proposal would require that each fund's board determine in good faith, at least once each calendar year, that the fund (or its transfer agent) has the capacity to redeem and sell its securities at a price based on the current net asset value per share. The proposed amendment also clarifies that this capacity includes the ability to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share.

Fund complexes and their vendors have developed intricate and complex systems to accommodate the needs of money market fund investors. As discussed above, these systems were developed to process money market fund transactions that may settle either same-day or next-day. The systems used to process both types of transactions would require in some cases minor and in other instances major modifications—depending on the complexity of the systems and the types of intermediaries and investors utilizing a fund complex's money market fund products.

A large percentage of the fund industry utilizes one of three large, external transfer agent vendors in some capacity to process investor transactions. These arrangements vary—some fund complexes operate their own transfer agency, but utilize the vendor's transfer agent systems via remote access, while others rely on an external provider to perform some or all of the fund's transfer agency function. A few large fund complexes have completely internalized the transfer agent function utilizing proprietary and highly customized transfer agent systems. Some smaller fund complexes also use proprietary systems, although many small fund complexes use systems and services from a number of smaller transfer agent vendors.

Even though a fund complex's transfer agent system is the primary recordkeeping system for tracking share ownership in a fund, there are additional sub-systems and ancillary systems that are integrated with, overlay, or feed from a fund's primary transfer agent system that also would require modification to process money market shares at other than a $1.00 net asset value. These systems have been created to accommodate the various features and services demanded by investors, and to comply with a fund's regulatory and compliance obligations. Finally, there are sub-transfer agent and recordkeeping arrangements with intermediaries that would require similar system changes to match the changes made to the funds' processing systems to meet the requirements of the proposal.

Each of the affected systems, the likely changes necessary to implement the SEC's proposal, and the estimated costs of such changes, are discussed below.

1. *Fund Transfer Agent Recordkeeping Systems*

Many money market fund investors (primarily intermediaries or institutions on behalf of beneficial owners) utilize same-day settlement to move money in and out of their accounts intra-day for a variety of time-sensitive business and personal transactions.[59] Since these transactions occur sporadically throughout the day or late in the day (especially for west coast investors), the NSCC Fund/SERV order routing system handles only a small volume of same-day settlement transactions that occur early in the day.[60] As a result, most same-day settlement investors transact directly with the fund through vendor portals or through customized transmissions with the fund and settle via multiple Fedwires intra-day. Many fund complexes, therefore, have developed proprietary customized systems that overlay or integrate with their fund transfer agent systems in order to utilize real-time processing. These systems were created to allow fund transfer agents to receive, process, and transmit updated settlement and share balance information intra-day on transactions for intermediaries and customers utilizing same-day settlement funds.[61] In most situations, these special systems were programmed at a $1.00 net asset value per share to process same-day settlement transactions. As discussed below, modifying these special same-day settlement processes and systems, customized transmissions, and reporting mechanisms to allow for processing at a price of other than a $1.00 net asset value per share would result in significant costs for the fund industry that would ultimately be borne by fund investors.

As described above, fund complexes also process transactions for investors in money market funds that settle the next business day (T+1). These transactions are received through the NSCC Fund/SERV system or directly by the fund transfer agent. Although some larger external transfer agent systems today have the ability to process these transactions at a price of other than $1.00 per share, most proprietary systems and some vendor systems do not. These systems are complex because they collect all investor transactions received by various means[62] throughout the trading day and then batch process[63] them as part of a nightly cycle. Shareholder balances are then updated to the core transfer

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[59] These include brokerage sweep, corporate, partnership, bank/trust, institutional, and individual investor accounts. Monies moved intra-day are needed to fund other transactions (*e.g*., securities purchases, real estate settlements, corporate treasury cash management). In addition, many of these shareholder transactions are dependent on the available shares and dollars in a money market fund account.

[60] As discussed earlier, NSCC cut-off times for same-day settlement are mid-morning on trade date (T).

[61] Many same-day settlement transactions are received in a compressed timeframe late in the day (prior to the fund and Fedwire's closing).

[62] Money market fund (T+1) transactions are received directly by the fund from investors or intermediaries through: checks and applications; the Internet; automatic investment and systematic withdrawal plans; debit cards and check writing; exchange transactions; phones, etc. Intermediary transactions also flow to the fund through: portals; customized interfaces; and the NSCC Funds/SERV system for T+1 settlement.

[63] In "batch processing" all the collected orders are processed at the same time on a predetermined schedule.

agent system as part of overnight processing and available to investors the next business day. The cost to modify these core transfer agent systems to accept a price of other than a $1.00 net asset value per share is significant and would include extensive analysis, programming, and testing prior to implementation. Therefore, a long lead time would be needed to implement these changes.

2. *Ancillary Systems*

A number of essential ancillary systems are used by funds in conjunction with the core transfer agent systems to complete the purchase or redemption processing cycle and related shareholder communications. These systems also would require programming changes (analysis, coding, and testing) to accommodate rounding, truncation, and the presentation of information on investor statements for a money market fund that breaks the dollar. These ancillary systems may be proprietary or vendor dependent. For example, most transfer agents (whether proprietary or external) utilize print vendors to produce trade confirmations and shareholder statements. Many of these ancillary systems incorporate custom developments and default to a stable value net asset value for money market funds. Additional messaging on confirmations and statements would be necessary to provide the required appropriate disclosure to investors.

Ancillary systems and related processes, reporting obligations,[64] and shareholder communications that integrate with a fund's core transfer agent system also would require analysis, modification, and testing to ensure that the fund has the capacity to redeem and sell its money market fund securities at a price other than a $1.00 net asset value per share. This would include potential systems changes for reconciliation and control functions; transactions accepted via the Internet and by phone; modifying related shareholder disclosures and phone scripts; and education and training for transfer agent employees, including customer service representatives. Moreover, this would include potential changes to the systems used by fund accountants that transmit net asset value data to fund transfer agents for processing money market fund transactions. Fund transfer agents also may need to make similar changes to daily pricing files that contain fund net asset values that are provided to intermediaries (via NASDAQ, the NSCC Profile Service or through other communications) for processing transactions.

The SEC's proposal did not contemplate the complexity of the ancillary systems involved that are integrated with or feed from the fund's transfer agent system to complete the processing cycle for every money market fund transaction. These ancillary systems also would need to be taken into account in connection with the board's annual determination of the transfer agent's processing capabilities to comply with the proposed rule. As discussed below, the costs to modify ancillary systems would be quite significant for most fund complexes and a long lead time also would be needed to implement the necessary changes.

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[64] Ancillary systems also include year-end tax reporting for 1099-Bs and cost basis related systems that do not apply normally to money market funds but that may apply if a fund breaks the dollar.

3. *Sub-Transfer Agent/Recordkeeping Arrangements*

Although the proposed amendments are silent with respect to sub-transfer agent or similar recordkeeping arrangements in which the fund, its transfer agent, or distributor are engaged in, the ability to process transactions for a money market fund that breaks the dollar would require similar systems changes for broker-dealers, banks, insurance companies, trusts, 401(k) record keepers, and others that process such transactions. Currently many broker-dealer sweep programs, 401(k) recordkeeping systems, and bank/trust systems are hardcoded to process money market funds at a $1.00 net asset value. Consequently, it's very likely that significant changes would be required to a maze of intermediary systems—similar to what is outlined above for funds—in order to meet the requirements for processing transactions on behalf of beneficial owners of money market funds. Many fund shareholder accounts are not held directly on fund transfer agent systems, but are held through intermediaries (in omnibus or NSCC Networked accounts[65]) who control the beneficial shareowner relationship and thus are responsible for the applicable record keeping, communications, tax reporting, etc. For transactions to process at other than a $1.00 net asset value per share, these intermediaries would need to make system changes similar to those described above. As a result, the costs to the broader financial services industry would be a multiple of the costs and efforts to modify fund transfer agent systems and ancillary systems.

The process is further complicated for intermediaries whose systems are more complex than mutual fund transfer agent systems, as they are designed to accommodate a host of different types of securities. Shareholder communications (statements and tax reporting) also are more complex for intermediaries as they incorporate non-mutual fund investments and their required disclosures. All of these factors, including today's restrictive economic environment, would challenge intermediaries when considering whether or not they can justify making the necessary changes in order to continue to support money market funds as a core offering to their customers.

4. *Cost Estimates*

In response to the SEC's request for comment on the cost benefit analysis in the proposal, we conducted a survey of ten of our members, representing 63 percent of money market fund assets, and the three largest transfer agent service providers.[66] The five-question survey addressed two broad topics related to the proposal as follows:

- Impact to the core transfer agent system and service; and

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[65] An omnibus account is a master account representing subaccounts of multiple investors. A "Networked" account refers to an account that is automated for processing through an NSCC service, known as Networking. The Networking service supports the exchange and reconciliation of investor account activity data.

[66] Two out of the three transfer agents replied to the survey.

- Impact to ancillary systems and services necessary to complete trade processing.

In contrast to the SEC estimates, survey respondents that anticipated having to make changes to their core transfer agent systems estimated significantly higher costs necessary to meet the proposal's requirements. Six of the twelve respondents indicated that their transfer agent system already had the capability to process money market trades at other than a $1.00 stable net asset value. Cost estimates for changes needed to the core transfer agent system averaged $1.1 million for respondents that need to make such changes, substantially more than the $39,040 per complex estimated by the SEC (Exhibit 1). In addition, the sum of the cost estimates across survey respondents exceeded by nearly three times the SEC's cost estimate for the entire industry ($2.2 million versus $6.6 million).

Survey respondents also provided additional cost estimates for changes to ancillary and other systems that would be necessary as a direct result of the requirement to process trades electronically at other than a $1.00 net asset value. Ten out of the twelve respondents indicated that they expect, on average, to spend $1.7 million each for these changes to ancillary systems (including primarily systems for same-day settlement processing and tax reporting) for an aggregate cost of $17.4 million. Two out of twelve respondents provided cost estimates for other systems affected (*e.g.*, investor web, voice response, reconciliation, and money movement) for a total of $1.4 million.

In summary, survey respondents estimate the total cost for changes to transfer agent, ancillary, and other systems to be $25.5 million. Since the survey respondents do not represent 100 percent of the money market fund sponsors, the total costs across all money market fund sponsors would be higher. The SEC cost analysis also does not address the significant costs that would be borne by intermediaries to modify systems to be in sync with the modified processing functionality that money market funds and their service providers would need to employ to meet the proposed requirements. From a complete industry perspective (*i.e.*, including all money market fund sponsors, service providers, and intermediaries distributing money market funds), it is reasonable to assume that the estimates cited in our survey responses could be higher by a factor of two or more.

**Exhibit 1**

*Estimated Cost for Changes to Mutual Fund Transfer Agent and Related Systems*

| Operational Capacity Systems Changes | Cost Per Complex | | Total Cost | |
|---|---|---|---|---|
| | SEC | ICI Respondents[1] | SEC | ICI Respondents[2] |
| Core transfer agent systems & services | $39,040 | $1,106,100 | $2,225,280 | $6,636,800 |
| Ancillary systems & services to complete trade processing | - | $1,744,300 | - | $17,443,300 |
| Other systems requiring changes | - | $713,800 | - | $1,427,700 |
| Totals | n.a. | n.a. | $2,225,280 | $25,507,800[3] |

n.a.- Not applicable
1. Average across fund complexes and transfer agents that indicated they would require changes to comply with the proposed requirement.
2. Sum of cost estimates provided by respondents, including respondents that reported zero cost because they already have the ability to process and complete trades at other than a $1.00 net asset value.
3. This represents the minimum expected cost to the industry, as survey respondents do not comprise the universe of money market fund complexes or transfer agents.

The complexity of these modifications to systems and procedures results in a considerable time allocation of resources to staff the projects and implement the changes. Survey respondents that would need to make changes to their transfer agent systems estimated a timeframe of one year, on average, for implementation of the changes. The expected timeframe for changes to ancillary and other systems averaged an additional 18 months *after* changes to the transfer agent system were completed. Not to be overlooked is the fact that these requirements would be coming at a time when money market funds have cut expenses to the minimum and are waiving advisory fees in order to deal with the unprecedented low interest rate environment.

Requiring costly, time consuming operational modifications appears to be an overly ambitious reaction to a single major occurrence of a fund not maintaining a stable net asset value in the nearly forty year history of money market funds. The consensus of the survey respondents is that the costs associated with implementing capabilities necessary to enable compliance with the proposal—especially in light of the proposed enhancements to Rule 2a-7—greatly outweigh any potential benefits to investors, intermediaries, or money market funds.[67] As noted above, we also believe the proposed

[67] Indeed, a question was raised as to whether a central processor, which has the capability to process transactions at other than a $1.00 net asset value, could be engaged to complete redemptions should a money market fund that lacks the ability to

requirement would create a strong incentive for intermediaries to utilize unregulated or less regulated money market investment vehicles rather than money market funds for their clients' cash management needs. As a result, we recommend the proposed requirements be eliminated from the final rule. If the SEC were to adopt the proposal, the money market fund industry—fund sponsors, service providers, and intermediaries—would need to expend tens of millions of dollars to implement these changes whose costs would be borne ultimately by investors. Given the current economic environment and the extent of operational systems changes required, the industry would need a period of no less than two and half years to implement the modifications.

## IV. Request for Additional Comment

The SEC also requests comment on whether more fundamental changes to the regulatory structure governing money market funds may be warranted in the future. In particular, the SEC is requesting comment on whether money market funds should be required to float their net asset values and/or whether funds should be required to satisfy redemption requests in excess of a certain size through redemptions in kind.

We strongly disagree with both suggestions. Fundamentally changing the nature of money market funds—a product that has been so successful for investors and the U.S. money market—goes too far, would not solve the problems perceived by the SEC, and would create new and potentially far greater risks than those the SEC is seeking to avoid. Our comments on the advisability of pursuing either of these measures are discussed below.

### A. Floating Net Asset Value

The SEC requests comment on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation. The SEC also poses a range of related questions, such as whether this change would render money market funds a more stable investment vehicle or lessen systemic risk.

The industry's views on this issue are laid out in detail in the Working Group's report.[68] In that report, we concluded that: (1) a $1.00 stable net asset value provides far more benefits to money market fund investors than a floating net asset value; (2) a floating net asset value could lead to substantial and

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do so break a dollar. This idea is not feasible due to the complexity of the non-standardized and highly customized proprietary and ancillary systems used by money market funds today that overlay and are integrated with each fund's transfer agent system. The conversion of such transfer agent data from the money market fund systems to the centralized or backup processor could not be seamlessly transitioned but would, in fact, take weeks or months to complete in order to enable the processor to perform the necessary transaction processing. In addition, this type of effort would require significant financial and staff resources and would not address redemption transactions to beneficial owners held in omnibus positions, which would require further processing by intermediaries whose systems may also lack operational capability.

[68] *See* MMWG Report, *supra* note 3, at 105-112.

far-reaching negative consequences for the money market; and (3) a floating net asset value is unlikely to reduce systemic risk.

The benefits to investors of a $1.00 stable net asset value are many. As the SEC itself recognized in the Release, the $1.00 stable net asset value provides money market fund shareholders convenience and simplicity in terms of tax, accounting, and recordkeeping. In addition, many institutional investors are permitted to use money market funds only if such funds maintain a stable net asset value. Requiring money market funds to float their net asset values would undermine their convenience and simplicity and would raise new tax, accounting, operational, and legal hurdles that would threaten the continued use of these funds.

- *Tax convenience*: A stable $1.00 net asset value relieves investors of having to consider the timing of purchases and sales of shares of money market funds, as they must with floating net asset value funds, to comply with the "wash sale rule."[69] If money market funds had a floating net asset value, all share sales become tax-reportable events, greatly magnifying investors' tax and recordkeeping burdens.

- *Accounting simplicity*: With a $1.00 stable net asset value, money market funds qualify as "cash equivalents" under accounting standards. Because the net asset value is fixed at $1.00, there is no need for investors to recognize gains or losses for financial accounting purposes. With a floating net asset value, more complicated accounting standards would apply. Companies likely would have to reclassify their holdings of money market funds as "available-for-sale" and mark them to market on a daily basis. All investors, retail and institutional alike, would face the additional burdens of tracking the cost basis of their money market fund shares and matching purchases and redemptions in order to calculate gains and losses for tax and accounting purposes.

- *Operational convenience*: For corporations and bank sweep accounts, a stable share price for money market funds greatly simplifies transaction settlement because of the expected $1.00 net asset value. It allows money market funds to offer their shareholders intra-day and same day settlement for wire transfers. Also, broker-dealers typically offer retail investors a range of features including ATM access, check writing, ACH, and Fedwire transfers. These features are generally provided only for accounts with a stable net asset value.

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[69] Under IRS rules, the so-called "wash sale rule" prevents investors from using losses on the sale of a security to offset gains if the sold security had been purchased within the previous 30 days or is repurchased within the next 30 days. Instead, losses on sales must be added to the basis of the replaced securities. The rule does not come into play with money market funds in their present form because money market funds have a stable net asset value.

- *Legal and other constraints*: Institutional investors often face legal or other constraints that preclude them from investing their cash balances in other than a stable net asset value product. Most corporations have board-approved policies requiring them to invest operating cash balances only in cash pools that do not fluctuate in value. Indentures and other trust documents often authorize investments in money market funds because of their stable net asset value. Many state laws and regulations also authorize municipalities, insurance companies, and other state regulated entities to invest in stable net asset value funds.[70] Under a floating net asset value, many corporations, trusts, and state and local governments would no longer be willing or able to use money market funds to help manage their cash.

If money market funds were required to float their net asset values, this very likely would lead to many investors—both retail and institutional alike—ceasing to use these funds in favor of alternative products that offer a stable net asset value, albeit without the returns (bank products) or regulatory protections (private pools) that money market funds provide. Significantly decreasing the value of this product would have negative consequences to the economy as well, by increasing systemic risk, reducing the supply of short-term credit to corporations, or severely restricting the supply of credit to municipalities.

- *Increase systemic risk*: Asset managers would find other means to offer a stable net asset value cash pool, leading to rapid and substantial disintermediation from money market funds, particularly by institutional investors, into pools outside the protections of the Investment Company Act. These large pools of alternative investment, domiciled in either the United States or offshore, would fall outside the careful regulatory framework in place for money market funds, and potentially increase the systemic risk to the financial system.

- *Reduce supply of short-term credit*: Cash held in money market funds also may flow to traditional banks. This would result in a significant reduction in the supply of short-term credit to corporate America, unless banks raised significant amounts of capital. Even with the capital to support this expansion of their balance sheets, the allocation of short-term credit would be less efficient and the cost to businesses would rise.

- *Restrict supply of credit to municipalities*: In the absence of stable net asset value investment pools, municipalities would lose an important source of financing in the short-term markets because banks cannot pass through tax-exempt income and simply could not replace tax-exempt money market funds.

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[70] For a review of states specifying that money market funds are permissible investments, *see* MMWG Report, *supra* note 3, at Appendix D.

It is highly unlikely that requiring money market funds to float their net asset values would reduce, and may even increase, systemic risk. Most importantly, floating the net asset value of a money market fund would not lessen the incentive for investors to redeem shares rapidly in periods of market turmoil. The Working Group illustrated this fact by including examples of United States ultra-short bond funds that lost more than 60 percent of their assets from mid 2007 to the end of 2008 and French floating net asset value dynamic money funds that lost about 40 percent of their assets in a three-month time span from July 2007 to September 2007.[71] Indeed, shareholders in fixed-income funds tend to be more risk adverse and more likely to redeem shares quickly when fixed-income markets show any signs of distress.[72] The demand for redemptions can outstrip the ability of fixed-income funds—even those with floating net asset values—to meet such requests without selling securities at a loss, because assets cannot be sold quickly in an illiquid market.

B. Redemptions In Kind

According to the Release, one of the SEC's concerns relates to the ability of large institutional shareholders to rapidly redeem substantial amounts of fund assets, which can pose a threat to a fund's stable net asset value at the expense of the remaining shareholders. The SEC has suggested that one possible way of addressing these issues would be to *require* that funds satisfy redemption requests in excess of a certain size through redemptions in kind. For the following reasons, we strongly believe that money market funds should not be required to satisfy redemptions requests through redemptions in kind.

Money market funds, like all mutual funds, are currently permitted under the Investment Company Act to satisfy redemption request through redemptions in kind.[73] In general, however, this method of redeeming shareholders poses operational challenges for both the fund and shareholders.[74] Depending on the composition of its portfolio, a fund may not be able to transfer title to the securities it holds to its investors because of investor eligibility and transfer restrictions. Indeed, some instruments may not be permitted to be divided among many investors (*e.g.*, commercial paper cannot be transferred in denominations below $25,000). Even if a security can be divided, transferring only a

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[71] *See* MMWG Report, *supra* note 3, at 106-107.

[72] Some commentators point to equity funds, which at times have suffered significant losses but typically experienced only modest outflows. It is misplaced to attribute this seemingly more stable behavior solely to the presence of floating net asset values. Investors in equity funds rationally expect the market value of the fund to fluctuate, perhaps widely at times, and as such are more apt to hold their fund shares in periods of market turmoil than investors in fixed-income funds.

[73] Members have reported, however, that some older funds incorporated in, for example, Maryland, are required by specific charter provisions to redeem in cash.

[74] Indeed, members report that redemptions in kind are typically only used to facilitate shareholder exchanges between affiliated funds.

portion of a fund's holding of a particular security could leave the fund with an odd lot position that is difficult to trade. Some securities may be privately offered, and distributing them broadly could compromise the issuer's private offering exemption (*e.g.*, Rule 144A securities can be transferred only to qualified institutional buyers). Other securities may be held by the money market fund through a contract that is generally not transferrable. As a result of these and other transferability limitations, a greater proportion of other securities that are not subject to transfer restrictions would need to be distributed; however, it is unlikely these securities have the same maturities, sector concentrations, yields, etc. as the securities that cannot be transferred. Indeed, even if substitutions could be made, each redemption in kind would leave the fund more concentrated in non-transferable, restricted securities, and odd lots, to the detriment of the remaining shareholders.

Even if the fund does not face obstacles in respect of the transferability of the securities it wishes to distribute, it may still face investor relations issues. Not all investors are well positioned to accept redemptions in kind because of the relative difficulty of liquidating such assets efficiently, which may require continued management prior to liquidation or a negotiated disposal. Many corporate investors also are not prepared, as a practical matter, for the valuation obligations imposed on them if they directly hold these instruments. Indeed, many of these operational and valuation issues would be particularly difficult for shareholders who are fiduciaries to underlying investors, such as trusts and 401(k) or defined contribution plans.

Redemptions in kind also would be difficult for funds that are investment options for variable insurance products. Most variable insurance products today are issued through a two-tiered investment company structure. The top tier is an insurance company separate account, which is a segregated investment account established under state insurance law and that is generally registered as a unit investment trust under the Investment Company Act. The separate account is commonly divided into sub-accounts, each of which invests in the shares of a single underlying open-end management investment company. These underlying funds, including many money market funds, make up the bottom tier of the two-tiered structure.

This two-tiered structure poses several problems for money market funds that would seek to provide redemptions in kind to an insurance company separate account. First, separate accounts are creatures of state law, which may through regulation effectively bar such accounts from holding any assets other than mutual fund shares. Second, as unit investment trusts, these separate accounts have no investment adviser who could manage a portfolio of securities. Third, any separate account that holds portfolio securities of more than one issuer may not be able to rely on the exemption provided by Section 12(d)(1)(E) of the Investment Company Act. Fourth, the variable insurance contracts themselves (which are filed with state insurance departments) and the prospectuses and other disclosure documents (filed with the SEC) typically do not contemplate anything other than mutual fund shares as the investment options available under the contracts. For all these reasons, separate accounts supporting variable insurance products are simply unable to accept redemptions in kind from underlying money market funds.

Finally, and perhaps of greatest concern, redemptions in kind pose the potential for aggravating an illiquid or declining market. As investors seek to sell quickly the assets they received in kind, prices for these and other securities would certainly fall. The decline in securities prices would then lead money market funds to mark down the remaining securities in their portfolios, placing additional pressure on the value of these funds' shares. These actions can almost be predicted to further destabilize the market, a result that the SEC should at all costs seek to avoid.

We therefore believe that the option to redeem in kind should continue to be available to be employed but only on a case-by-case basis as funds deem appropriate and as permitted by law.

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We look forward to working with the SEC as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 326-5815 or Jane Heinrichs, Associate Counsel, at (202) 371-5410.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
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