Fund Democracy
Consumer Federation of America

September 8, 2009

FILED ELECTRONICALLY

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: File No. S7-11-09

Dear Ms. Murphy:

We are writing on behalf of Fund Democracy and the Consumer Federation of America to comment on the SEC's proposals regarding money market fund ("MMF") regulation. In summary, we strongly support the bulk of the SEC's proposals to protect MMF investors and enhance the stability of MMFs. New public disclosure requirements should provide additional market discipline for MMFs, and confidential filings with the Commission will enable the SEC staff to keep a closer eye on developing trends in individual funds and across the industry. The SEC's proposed daily and weekly cash requirements should improve the actual and perceived safety of MMFs.

We are concerned, however, that certain of the SEC's proposals lack sufficient empirical support. For example, the Commission proposes to ban second-tier securities, but it has not provided any evidence of the relationship between MMF failures or runs and the holding of such securities. It is easy forget, in the wake of recent high profile failure of the Reserve Fund and the ensuing run on MMF assets, that MMFs historically have been a paragon of stability. While thousands of banks have failed over the last three decades, the record of MMFs has been virtually unblemished. Reform of MMF regulation is needed, but only to the extent that identifiable benefits outweigh the costs.

In some respects, we believe that the Commission should take additional steps to protect MMF shareholders. Our principal recommendations are as follows:

- The Commission should evaluate the potential benefits of mandatory private liquidity insurance, especially in view of the Obama administration's position that the SEC's current proposals are not sufficient to address run risk and its specific request that the President's

Working Group evaluate private liquidity insurance as a potential ameliorative.

- The Commission should require the disclosure of a liquidity color bar that would depict an MMF's relative holdings of daily and weekly cash and illiquid holdings to provide investors with an easily understandable measure of MMF risk.

- The Commission should adopt reforms that would protect against abuses occurring during the liquidation of a failed MMF, including prohibiting funds from withholding assets to cover indemnification claims in violation of shareholders' redemption rights and statutory indemnification restrictions.

- The Commission should clarify that employees of privately held fund, managers such as the manager of the Reserve Fund, are entitled to the same whistleblower protections under the Sarbanes-Oxley Act of 2002 as employees of publicly held fund managers.

- The Commission should require advance notification of fee waiver terminations in order to reduce the instability caused by outflows to funds with higher net yields.

Finally, we believe that there is no reasonable basis for requiring that large redemptions be paid in kind or that MMFs be prohibited from using the amortized cost method of valuing their portfolios. Money market funds already have the ability to pay redemptions in kind as necessary to protect shareholders. As a result, the SEC's in-kind redemption proposal would only have the effect of removing MMFs' discretion to pay large redemptions in cash.

Requiring that MMFs allow their net asset values ("NAVs") to float is fundamentally inconsistent with the basis of MMFs' utility. As the Commission is aware, retail MMF shareholders use MMFs as cash management vehicles that are more akin to bank deposits than investment securities. Requiring floating NAVs would transform MMFs into nothing more than short-term bond funds and potentially destroy their usefulness for millions of retail investors.

<u>Money Market Fund Portfolio Disclosure</u>

We applaud the SEC's proposal to require monthly public disclosure of MMF portfolio holdings and the filing of additional detailed portfolio information with the Commission. In January 2008, we filed a rulemaking petition with the Commission requesting that these requirements be imposed on MMFs in order "to minimize the likelihood of a loss of confidence in money market funds resulting from one or more funds breaking a dollar."[1] While is it unfortunate that the

[1] *See* Letter from Fund Democracy, Consumer Federation of America, Consumer Action, AFL-

Commission did not act on our petition prior to the collapse of the Reserve Fund and the subsequent run on the industry, we are gratified that this proposal has been included in the package of reforms on which the Commission has requested comment.

Public Portfolio Disclosure

We agree that monthly public disclosure of portfolio information will allow the markets to make more informed decisions about the comparative risk profiles of different MMFs. The comparative yields of MMFs have assumed far too prominent a place in the marketplace. It needs to be tempered with more and more prominent disclosure of information that will enable investors to evaluate the full risk-reward characteristics of MMFs.

The Commission requests comment on its concern that public portfolio disclosure would increase redemptions and "introduce greater instability." We believe that this concern is misplaced. On the contrary, greater transparency should provide a strong incentive for funds to avoid the excessively risky practices that lead to instability and encourage redemptions.

Limiting MMF portfolio disclosure based on the potential effect on redemptions would move MMF regulation in the wrong direction. Banking regulation has long suffered from a culture of secrecy where undisclosed asset deterioration is allowed to fester behind the scenes until it brings down the bank (or is "fixed" by permitting banks to use false asset values in their financial statements). The better approach to risk management is the kind of continuous price transparency that will prevent the development of large gaps between the carrying value and market value of fund assets. The gap between the carrying and market value of mortgage-backed securities has been one of the leading causes of the current financial crisis.

The best preventative for MMF portfolio illiquidity is a disclosure system that facilitates the current correction of price/value discrepancies and prevents the relentless, self-perpetuating accretion of asset inflation that leads to precipitous market corrections. It would not be surprising to see a significant shift of MMF assets away from relatively risky MMFs whose superior short-term performance

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CIO, Financial Planning Association, and National Association of Personal Financial Advisors to SEC (January 16, 2008) *available at* http://www.funddemocracy.com/MMF%20Rulemaking%20Petition.pdf. In 2000, we had previously petitioned the Commission to require public monthly portfolio disclosure for all mutual funds, after which the Commission adopted the current quarterly portfolio disclosure rule. *See* letters from Fund Democracy and Consumer Federation of America to SEC (June 28 & Aug. 9, 2000) *available at* http://www.funddemocracy.com/Holdings%20Petition.pdf *and* http://www.funddemocracy.com/Consumer%20Petition.pdf.

currently receives much greater and more transparent emphasis than their relative risk level.

We agree with the Commission that it does not necessarily follow from a full-transparency model that portfolio disclosure must be *current* as opposed to *frequent*. Small lags between the date of the data and the disclosure date are consistent with the monitoring of MMF risk. What matters most is the frequency of disclosure and the potential for gaming during the period between disclosure dates.

In this respect, we are concerned that monthly disclosure will not provide sufficient information to the markets to monitor MMF risk. There is empirical evidence that MMFs already engage in portfolio pumping at month-ends in order to manage the appearance of their risk-level.[2] To provide a truly representative picture of an MMF's risk, portfolio disclosure must be at short enough intervals to prevent the hiding of strategic behavior between disclosure dates. We encourage the Commission to monitor variance in MMF portfolios between the disclosure dates to ensure that monthly disclosure is adequate and to continue to develop systems that ultimately would allow for daily disclosure when information collection and dissemination costs become negligible.

We also applaud the proposal to require that portfolio information be provided in XML or some other standardized format. In June 2000, we petitioned the Commission to "require funds to post their portfolio holdings on a free Internet site in XML or other easily manipulated language, and attach to each holding the security's ticker symbol, cusip number, and security industry code."[3] We strongly support the SEC's recent movement in this direction with respect to electronic filings generally and in this proposal in particular. Over the longer term, the Commission should move toward a system in which fund portfolios and prices can be electronically filed with the Commission on an ongoing basis as technology continues to reduce the cost of data collection, transmission, and analysis.

<u>MMF Risk Color Bar</u>

We agree with the Commission that the required disclosure may create an advantage for sophisticated investors, because they will be able to respond more quickly than retail investors to changes in an MMF's perceived risk-reward profile. We believe that the playing field could be leveled by providing similar disclosure in a user-friendly format for retail investors. The disclosure should provide a single graphic reflection of the relative liquidity risk presented by a

[2] *See* David Musto, *Investment Decisions Depend on Portfolio Disclosures* (Aug. 21, 1997).

[3] *See supra* note 1.

fund. Such a liquidity chart has the potential to do more to moderate MMF risk than all of the SEC's other proposals combined.

The format that we propose is a simple color bar that shows the liquidity risk for an MMF's assets. The top portion of the bar would be blue to the extent that the fund's assets were invested in daily liquid assets as defined in the SEC's new daily cash standard. Immediately below, the blue would transition slightly to reddish-blue to represent the fund's investments in SEC-defined weekly liquid assets. This blue-to-red transition would continue to the bottom portion, which would be fire-red to reflect the amount of the fund's assets that were invested in illiquid securities (which we believe should continue to be allowed, as discussed below).

Regarding the SEC's concern that portfolio disclosure may exacerbate the institutional hot money problem, we believe that this concern militates for more transparency, not less. Instability is more likely to be caused by the uncertainty that accompanies a lack of knowledge about MMFs' risk profile than by knowledge of an MMF's true risk characteristics. The recent decline in the stock markets did not lead to a run on stock funds partly because the decline was consistent with the general understanding of the volatility of stocks. To the extent that MMFs engender risk of loss, the full disclosure of this risk in the most accessible, understandable format would provide the best means of subjecting MMF risk to market discipline and minimizing instability.

<u>Disclosure to Commission</u>

We strongly support the SEC's proposal to require that additional information be filed with the Commission on a temporarily confidential basis. It is critical that the Commission be able to gauge the stability of the MMF industry on an ongoing basis. As we stated in our January 2008 rulemaking petition, '[o]ngoing monitoring of money market fund portfolios would provide the data necessary to detect and prevent large scale liquidity and pricing problems long before they have systemic effects."

We believe strongly that the values at which MMFs are carrying portfolio securities is the most important piece of information for monitoring potential liquidity problems. Provided that the information is filed in a standardized electronic format, this information would enable the Commission to monitor the credibility of carrying prices, deter the use of inflated prices, and minimize the risk of sudden corrections. This information would have enabled the Commission, for example, to monitor the values at which different MMFs were carrying the Lehman debt that played a role in the collapse of the Reserve Fund.

As the Commission notes, we had requested that it consider requiring disclosure of additional information, "such as the fund's client concentration levels, the percentage of the issue held by the fund, or last trade price and trade volume for each security." We defer to the SEC's judgment as to the particular mix of information that should be filed, taking into account both the cost of filing and importance of each data point in creating a helpful picture of developments in the industry.

Portfolio Liquidity Requirements

We strongly agree with the Commission's focus on the liquidity of MMF portfolios. The September 2008 run on MMFs provided a glimpse of the actual levels of redemptions that could occur during a crisis and empirical support for the SEC's proposals in this respect. The SEC's proposed daily and weekly cash requirements will greatly enhance the actual and perceived liquidity and robustness of MMFs. As discussed below, however, we believe that the Commission's omission of any discussion of mandatory private insurance leaves an important option unaddressed and seriously undermines its ability to claim that it has considered all reasonable alternatives.

Mandatory Private Liquidity Insurance

In June 2008, the Obama administration released *Financial Regulatory Reform: A New Foundation* ("Financial Reform Blueprint"), which set forth a broad range of proposals for improving the regulation of financial markets and services. With respect to money market funds, the Financial Reform Blueprint recommended that the Commission:

> move forward with its plans to strengthen the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to runs.

The Report states that the kind of safety enhancements proposed by the Commission "should not, by themselves, be expected to prevent a run on MMFs of the scale experienced in September 2008." The Blueprint also tasked the President's Working Group on Financial Markets with:

> assessing whether more fundamental changes are necessary to further reduce the MMF industry's susceptibility to runs, such as eliminating the ability of a MMF to use a stable net asset value or *requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources.*

(emphasis added). The Commission has addressed only one of these options, the floating NAV, which, as discussed below, would eliminate the MMF run problem by eliminating MMFs.

We have been unable to find in the SEC's proposal a single reference to, much less any discussion of, the possibility of requiring MMF sponsors to obtain private insurance or other liquidity guarantees from outside parties.

Even without the prompting of the Financial Reform Blueprint, it would be incumbent upon the Commission to consider an exogenous solution to MMF safety concerns. Federal deposit insurance has long demonstrated the efficacy of government insurance in preventing run-causing panics. The success of the Treasury's temporary insurance program demonstrated the potential benefits of similar insurance in the MMF market. Insuring MMFs arguably would be less risky than insuring bank deposits, because the types of holdings to which MMFs are already limited present less risk than the assets that support insured bank deposits.[4]

While creating a federal insurance regime is obviously outside of the SEC's purview, mandating private insurance coverage or liquidity facilities is not. The ultimate cause of any MMF run is a failure of market confidence. The prospect of some form of outside liquidity that exists independent of the risk characteristics of a particular MMF could not help but to reduce the likelihood of an MMF run. Such insurance or liquidity facilities presumably would be priced to reflect an MMF's risk level, which would provide an additional market-based restraint on excessive risk-taking to supplement the government mandates reflected in rule 2a-7. Some MMFs have, on their own initiative, obtained private portfolio insurance. We strongly encourage the Commission to consider a private insurance mandate before reaching a final decision on MMF regulatory reform.

Illiquid Securities

The SEC historically has taken the position MMFs should not invest more than 10% of their portfolios in illiquid securities. As a general matter, however, the holding of illiquid securities representing 10% or even 20% of a MMF's portfolio would have no practical bearing on its ability to handle heavy redemptions. The first securities sold to honor redemptions would be the MMF's most liquid holdings; its illiquid holdings would be the last to go. Liquidity is a top-down, not bottom-up issue. It is extremely unlikely that an MMF would ever be in a position where it had to sell its last 20% of assets because redemptions that were on their way to consuming the first 80% of an MMF's assets would surely have caused the MMF to fail before any illiquid assets had to be sold. We question whether there is any plausible redemption scenario in which an MMF would find itself unable to honor redemptions at the point it found it necessary to liquidate its illiquid holdings.

The Commission proposes to prohibit the holding of illiquid securities by MMFs. We believe, however, that the weakness in the SEC's historical position has not

[4] *See generally* Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (Mar. 2, 2009) available at SSRN: http://ssrn.com/abstract=1351987.

been that it permits investments in illiquid securities or the amount of the percentage limit, but the fact that the percentage limit is not fixed. The 10% limit applies only when a fund purchases additional securities. An MMF's illiquid holdings could substantially exceed 10% following a period of net redemptions or increase in the value of the holdings. There has been at least one recent instance in which a stock fund's illiquid holdings increased in value sufficiently to cause concerns.[5]

The appropriate protective measure regarding the risk posed by illiquid securities is not to prohibit illiquid securities but to revise (and codify) the current restriction to apply on an ongoing basis. It is unlikely that a 10% illiquid securities position poses a real, independent risk to an MMF's liquidity as long as it stays at 10% -- or even 15% or 20%. We therefore recommend that the Commission impose a fixed limit on the percentage of an MMF's portfolio that can be invested in illiquid securities that, if exceeded, would necessitate the immediate restoration of the limit through sales of illiquid securities or additional investments in the fund.

Daily and Weekly Cash Requirements

We strongly support the SEC's daily- and weekly-liquid assets proposals. These proposals would greatly enhance MMFs' actual and perceived ability to honor redemptions in periods of stress. We disagree, however, with the SEC's proposal to apply the limit only at the time of new investments by a fund. If an MMF begins to experience a run, its daily and weekly cash will decline, yet the SEC's proposal would not specifically require that the fund take any steps to restore the daily/weekly cash minimums. Falling below the minimums only has an effect when the MMF has new money to be invested, which it would then have to invest in daily or weekly cash until the minimums were restored. It is at the early stages of an unexpected increase that an MMF needs to begin focusing on its liquidity capacity.

We believe that daily and weekly liquidity minimums should be set at levels below which an MMF should never fall. In light of this more rigid standard, we recommend that grace periods be allowed during which an MMF would be permitted to restore the minimums (and required to notify the SEC staff of the problem). It would be counterproductive if a fixed liquidity minimum forced an MMF into a fire sale mode in order to meet the liquidity minimums that are intended to avoid fire sales. The grace period therefore should be long enough to sell noncash holdings at their carrying values, which would be seven days for non-illiquid securities.

[5] *See* Russ Kinnel, *Morningstar Commentary* (2009) (discussing Firsthand Technology Fund).

There must be an objective cutoff point, however, at which an MMF that is unable to maintain an adequate cash position will be in noncompliance and required to take more extreme measures in coordination with SEC staff. We note that the staff's role in such discussions should be to assist the fund in reestablishing its cash position without spooking the market. The Commission should consider carefully how to handle disclosure issues in balancing the need for full disclosure and the need to avoid a panicked run for the exits.

Finally, we believe assets other than cash or U.S. obligations should not be eligible daily cash. As the current crisis has demonstrated, there is a world of difference between assets backed by infinite liquidity (cash itself and U.S. government commitments) and those backed by private contractual commitments. Private contractual commitments, no matter how short their duration, will not hold up in a financial crisis. The recent failure of the auction-rate securities auctions – normally conducted on a weekly basis – casts doubt even on the reliability of one-day repurchase agreement obligations.[6] We have recently seen financial firms fail almost overnight. The purpose of the daily liquid assets minimum should be to establish a pool of assets of unquestioned liquidity that can be sold at a moment's notice.

<u>General Liquidity Requirement</u>

We agree with the SEC's proposed general liquidity requirement that MMFs hold daily and weekly cash "sufficient to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the Act and any commitments the fund has made to shareholders." We recommend, however, that the requirement be stated in terms of a requirement for a set of procedures that are reasonably designed to ensure that the MMF will be able to honor redemptions. The general difficulty with an objective mandate to make such a subjective determination as "foreseeable shareholder redemptions" is that compliance is very difficult to implement and evaluate. It will be possible to comply with the requirement but have been wrong in estimating shareholder redemptions. In contrast, a requirement such as the 5% daily cash requirement is relatively objective. Either the fund has complied or it has not. The better way to implement an enforceable standard, both for SEC inspectors and compliance professionals, would be to impose a requirement that reasonable procedures be established or the board make a good faith finding, in which case the test will clearly be one of the reasonableness of the process used rather than one of the specific determination made.

[6] The Commission discusses the risk of counterparty default in its discussion of repurchase agreements at page 75 – 76 of its proposing release.

Empirical Support for Other Proposals

We believe that a number of the SEC's proposals lack sufficient empirical support to justify the cost that they would impose on investors. The Commission should keep in mind that, notwithstanding the events of last fall, MMFs have a remarkable safety record. Where there is direct evidence that enhancing MMF safety would materially reduce risk, we agree that such enhancements should be made. It is always possible to enhance MMF safety for safety's sake, however. The SEC's goal should be to identify safety enhancements the demonstrable benefits of which exceed their potential costs.

In a number of instances, the SEC's proposals reflect this kind of cost-benefit analysis. For example, the proposals relating to structured investment vehicles and other asset-backed securities are based partly on the actual difficulties that the Commission found were experienced by MMFs in connection with investments in these securities. Alternatively, the SEC's forbearance regarding diversification requirements reflects its recognition that "the issuer diversification provisions of [rule 2a-7] generally were not implicated by the market turbulence last fall."

Other proposals lack such empirical analysis, however. For example, the Commission proposes to prohibit investments in second-tier securities, yet it concedes that: (1) it has previously considered implementing such a prohibition but decided against it, (2) "[s]econd tier securities were not directly implicated in the recent strains on money market funds," and (3) the only empirical basis for its proposal is its conclusion that "second tier securities generally present additional risks to a money market fund."[7] The Commission also concedes that, since 1991, fund holdings of second tier securities bad been "reduced . . . to almost zero." The SEC staff found that "in September 2008 . . . second tier securities represented only 0.4 percent of the $3.6 trillion held by [money market] funds (approximately $14.6 billion)." The insignificance of these holdings belies the utility of banishing them.

The Commission also proposes to reduce MMFs' maximum average weighted maturity from 90 days to 60 days, on the grounds that shorter maturities reduce risk and increase liquidity, but again no evidence is provided to support its position that shortening maturities will make MMFs sufficiently safer to justify the costs. The Commission notes that funds with shorter maturities had an easier time meeting redemptions in late 2008, but it provides no analysis of this phenomenon. Indeed, the Commission concedes that the actual average weighted maturity of MMFs over the last 20 years has been 58 days and on June 16, 2009 was 53 days, in both cases shorter than the 60-day maturity limit that it has proposed.

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[7] The Commission cites the recent ICI report on MMF reform, but it also provides no empirical basis for revaluating the actual risk presented by second tier securities.

The SEC's proposals regarding long-term unrated securities and credit reassessments similarly lack an adequate empirical foundation. What was the relationship between investments in these securities and the crisis of fall 2009? For decades, the Commission has permitted MMF managers to bail out MMFs under no-action positions and rule 17a-9. To what did these securities play a role in those bailouts? In conjunction with the analysis of data collected pursuant to the new filing requirements described above, the Commission should direct its staff to monitor the circumstances of no-action relief and proposed filings under rule 17a-9 for the purpose of evaluating the need for additional reforms in the future.

Regulation of Liquidating MMFs

In addition to proposing safety enhancements designed to reduce the risk that a MMF will break a dollar, the Commission has proposed reforms that are "designed to protect investors in a fund that breaks a dollar in the future." We believe that these reforms fall short in significant respects.

Lessons of the Reserve Fund Failure

As the Commission is aware, the liquidation of the Reserve Fund has become a textbook illustration of the inadequate regulation of MMF shareholders' rights in liquidation. To some extent, the SEC's current proposals reflect its recognition of problems that arose in the Reserve Fund liquidation. For example, the liquidation has been slow because the Fund did not have systems to handle redemptions at less than $1.00/share. The Commission accordingly has proposed to require that MMFs be prepared to process transactions at per share values of less than $1.00, a proposal which we strongly support.

In significant respects, however, the Commission has failed to address important gaps in regulation relating to MMF liquidations. In May 2009, we asked the Commission to consider certain reforms that would address concerns arising from the Reserve Fund liquidation. The letter asked the Commission to prohibit: (1) funds from withholding shareholder assets to cover claims against the fund where the fund is only a nominal defendant; (2) funds from withholding assets to cover indemnification claims in violation of shareholders' redemption rights and statutory indemnification restrictions, and (3) fund managers from charging excessive fees during the liquidation of a fund. We request that the Commission incorporate these proposals into its current rulemaking.

The illegal conduct occurring in connection with the Reserve Fund's failure is also a reminder of the importance of protecting whistleblowers who report such conduct to regulators. In March 2008, we requested that the Commission clarify that the whistleblower protections of the Sarbanes-Oxley Act of 2002 ("SOXA") extend to employees of fund managers.[8] In at least two cases, fund managers have successfully argued that fund shareholders should be stripped of SOXA's whistleblower protections solely because the manager happens to be privately owned, notwithstanding the public status of the mutual fund and the fact that it is the fund's manager that is responsible for the fund's securities law compliance.

The Reserve Fund is managed by a private firm that the Commission has alleged engaged in misconduct in connection with the Fund's collapse. If one of the manager's employees had blown the whistle on their employer, the employee would not have been protected by SOXA's whistleblower provision under incorrectly decided legal precedents. Chairman Schapiro has announced her intention to improve the handling of whistleblower complaints, but there is no indication that the Commission intends to ensure that whistleblower protections apply to employees at firms such as the Reserve Fund's manager. The Commission should take this step to ensure that all mutual fund investors enjoy the same indirect benefits of whistleblower protection that are enjoyed by investors in other publicly held companies.

<u>Free Time-Out</u>

We strongly oppose the SEC's proposal to permit an MMF to freeze shareholder funds for five days following an MMF's failure. Once an MMF has failed, it has failed. It has broken the implied promise that it will be able to maintain a \$1/share NAV. The SEC's proposal also permits it to break the statutory requirement that it meet redemptions promptly. We believe that the concerns raised by the Commission strongly militate against this proposal. The free time-out provision would increase incentives to run for the exits before the fund is closed and virtually guarantee that, once the fund was reopened, a flood of redemptions will follow. The provision provides a potential escape valve that will reduce fund managers' incentives to protect the fund's NAV. The provision provides virtually no benefit to shareholders while serving primarily to protect fund managers' interests.

<u>Voluntary Haircuts</u>

We also oppose the SEC's proposal to permit "voluntary" redemptions at discounted NAVs following the failure of an MMF. This free time-out proposal essentially would allow the fund manager to justify holding fund assets hostage longer than necessary on the ground that if shareholders need their funds they can simply accept a haircut. The haircut may turn out later to have been based on an inaccurate NAV, thereby creating a situation where shareholders would have to balance their right to receive the fair value of their shares against their right to prompt redemption.

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[8] *See* Letter from Fund Democracy, Consumer Federation of America, Consumer Action, and North American Securities Administrators Association to SEC (March 28, 2008) *available at* http://www.funddemocracy.com/whistleblower%20letter%20final.pdf.

We recognize that the proposal assumes that the haircut reflects a fair, current valuation of fund assets. But if that is the case, why could not the fund simply cash out all shares in amount equal to the known value of the fund? In other words, if an MMF's shares can be fair valued at $0.97/share, then every shareholder should be able to receive 97% of their account values at that time. We believe that a $0.97/share valuation that could not be translated into cash is not a sufficiently accurate valuation to justify "redeeming" shares at that price. The potential for abusive conduct is too great, especially where the manager of the failed MMF has been allowed to continue to operate it.

In-Kind Redemptions and Floating NAVs

The Commission has requested comment on requiring MMFs to honor large redemptions in kind and prohibiting the use of the amortized cost method. We strongly oppose these proposals. Both present a threat the continued viability of MMFs, which have become an important cash management tool for millions of American households.

There is simply no need to require in-kind proceeds for large redemptions; MMFs already have the authority to make redemptions in kind as a means of managing liquidity risk. The combination of a number of other proposals made by the Commission would ensure that funds give even greater consideration to in-kind redemptions as an available tool for managing risk. If anything, an in-kind redemption requirement would limit MMFs' flexibility. It would prohibit MMFs from honoring large redemptions in cash, even when doing so is preferred by the fund and better for shareholders. Money market funds were able to avoid resorting to in-kind redemptions in response to last year's run, which certainly militates for continuing to allow them this flexibility.

We also question whether the Commission has the authority to impose such a broad prohibition against cash redemptions where the Investment Company Act expressly defines a redeemable security as one that entitles the holder to receive in-kind proceeds *or cash*. While the exercise of this authority might be viewed as falling within the SEC's exemptive discretion (rule 2a-7 is an exemptive rule), the Court of Appeals for the D.C. Circuit appears to believe that restricting the terms of exemptive rules – even rules that exist only by SEC fiat – is subject to the same standard of review as any other form of agency rulemaking.[9]

We similarly believe that there is no good reason to require MMFs to allow their NAVs to float by banning the amortized cost method of valuing their portfolios. In short, the amortized cost method has played a central role in the extraordinary growth of MMFs over the last three decades. As discussed above, MMFs historically have been a paragon of safety. There is no evidence of that some

[9] *See Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

MMF shareholders are realizing material or net dilutive gains at the expense of others. The SEC's concerns reflect little more than the inherent cross-subsidization that is intrinsic to the structure of every mutual fund.[10] Without anything more than speculative concerns that pricing arbitrage might develop at some point in the future, the Commission does not have a sufficient basis to require floating NAVs.

Advance Notice of Termination of Temporary Fee Waivers

The Commission specifically notes that greater risk is associated with MMFs with "higher gross yields," but it nowhere discusses the higher risk associated with higher net yields that result from temporary fee waivers. We recommend strongly that the Commission consider requiring advance notification of the elimination of fee waivers. Empirical evidence shows that waivers are the most common source of relatively superior investment performance,[11] which is likely to be closely correlated with the presence of hot money. When waivers are removed, hot money, like brokered bank deposits, is likely to redeem shares in favor of higher performing funds. This instability is likely to create greater liquidity pressure and increase failure risk.

This risk might be mitigated; for example, MMFs might be required to provide at least one year's notification of the elimination of a fee waiver or one month's notification prior to each 5-basis-point reduction in a fee waiver. These measures would reduce the risk of sudden outflows of hot money and enhance MMF safety. Currently, the timing of waiver terminations is limited only by disclosure commitments. We do not know whether there is any empirical relationship between the timing of waivers and the stability of MMF cash flows, however, and encourage the Commission to request and analyze data on this question. We also encourage the Commission to consider whether its definition of institutional investor would generally include enough hot money to take care of the potential waiver problem under that rubric.

NRSROs

The Commission also has asked for comments on the use of NRSRO ratings in rule 2a-7, noting, correctly, the questionable reliability of these ratings. We

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[10] *See generally* Mercer Bullard, *The Mutual Fund as a Firm: Fund Arbitrage, Frequent Trading and the SEC's Response to the Mutual Fund Scandal*, 42 Houston L. Rev. 1271 (2006) (reprinted in: 48 Corporate Practice Commentator 413 (2006)). At least one commenter has proposed to permit a fund to hold itself out as a money fund and allow its NAV to float. This would be inherently misleading and violate rule 2a-7. We note that the Commission has not asked for comment on this possibility, and that such a proposal accordingly would be subject to notice and comment before the Commission could take any such action.

[11] *See* E. K. Christoffersen, *Fee Waivers in Money Market Mutual Funds*, Wharton School (May 2000).

reiterate our comments of last year that, regardless of the reliability of NRSRO ratings, they can provide a useful floor below which securities held by MMFs may not fall.[12] The Commission quotes the statement by the most prominent critic of NRSRO ratings that "one of the core causes of the sub-prime crisis was dependence on inaccurate and unsupportable credit ratings." We believe that this criticism is entirely consistent with out position. The problem is not the use of the ratings, but overdependence on the ratings by fund directors and managers. An NRSRO rating does not require investment in a security, it merely permits it. We disagree with the implication that NRSRO ratings must be removed in order to cause fund directors and managers to fulfill their responsibility to oversee the safety of MMF portfolios. Instead, fund managers and directors should be held accountable for conducting adequate due diligence to determine whether particular investments have risk characteristics that are appropriate for the fund.

Conclusion

Recent events have resulted in significant upheaval in the financial affairs of millions of Americans and our financial markets. They also have provided insight into potential weaknesses in the current regulation of MMFs. The SEC's proposals generally find a good balance between needed enhancements to the safety of MMFs and the importance of allowing free markets to determine the most efficient financial vehicles through which investors manage their financial affairs. We commend the Commission on its proposals and look forward to working with the Commission as the proposals are finalized.

Thank you for your consideration of our comments.

Sincerely,

Mercer Bullard
Founder and President
Fund Democracy

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc by electronic mail:

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[12] *See* Letter from Fund Democracy and Consumer Federation of America to SEC (2008) *available at* http://www.funddemocracy.com/mmfnrsrocmtltr9.5.08.pdf.

Honorable Mary Schapiro, Chairman
Honorable Kathleen Casey, Commissioner
Honorable Elisse Walter, Commissioner
Honorable Luis Aguilar, Commissioner
Honorable Troy Paredes, Commissioner

Andrew Donohue, Director, Division of Investment Management