

MEMORANDUM

To: Investor Advisory Committee

From: Investor as Purchaser Subcommittee

Date: May 3, 2010

Re: Money Market Funds – Stable Net Asset Value

The Subcommittee is placing the issue of the floating net asset value (NAV) for money market funds (MMFs) on the Committee's agenda for the May 17 meeting. This issue would be only for discussion at this time. The Subcommittee strongly recommends that Committee members review, at a minimum, Appendix A to this memorandum, which comprises the SEC's discussion of the floating NAV issue in its June 2009 rulemaking proposal.¹

Under SEC Rule 2a-7, MMFs are permitted to value their securities based on the amortized cost method and to round their per share NAVs to the nearest dollar. In short, this provision enables MMFs to maintain a stable \$1.00 per share NAV. In June 2009, the SEC requested comment on the possibility of rescinding the authority of MMFs to maintain a stable NAV. This change would require that MMFs allow their NAVs to float and has become popularly known as the "floating NAV" proposal. As noted, the SEC's discussion of the floating NAV issue is provided at Appendix A to this memorandum.

The SEC adopted certain MMF reforms on Feb. 23, 2010, but did not adopt the floating NAV proposal. Rather, the Commission stated that it was continuing to explore the possibility of requiring a floating MMF NAV.² Chairman Schapiro has

¹ See *Money Market Fund Reform*, Investment Company Act Release No. 28807 (June 30, 2009) available at <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>.

² See *Money Market Fund Reform*, Investment Company Act Release No. 29132 at 10 (Feb. 23, 2010) ("we requested comment on whether money market funds should move to the "floating net asset value" used by other open-end investment companies. We received over 75 comment letters addressing this issue. We have continued to explore possible more significant changes to the regulation of money market funds in light of these comments and through the staff's work with members of the President's Working Group. We expect to issue a release addressing these issues and proposing further reform to money market fund regulation." (footnote omitted)).

stated that the possibility of requiring floating NAVs is under serious consideration,³ as has Commissioner Aguilar.⁴ The President's Working Group, of which Chairman Schapiro is a member but which is predominantly comprised of banking regulators, has been asked to opine on the floating NAV issue⁵ and is expected to release its analysis soon.

Industry and consumer groups have been virtually unanimous in their opposition to the floating NAV proposal, as illustrated by the attached Appendix B to this memorandum, which provides a sampling of materials arguing the benefits of permitting MMFs to maintain a stable NAV. The most cited expression of support for the floating NAV has come from the Group of Thirty and public comments by former Fed Chairman Paul Volcker, who is the Group of Thirty's Chairman of the Board of Trustees. The Group of Thirty's position on the floating NAV and MMFs generally is provided at Appendix C to this memorandum.⁶

The Subcommittee agrees with Commission's statement that requiring a floating NAV is the kind of "far-reaching change that could transform the business and regulatory model on which money market funds have operated for more than 30 years."⁷ In view of the dramatic consequences that a floating NAV requirement could have for America's retail investors and its short-term debt markets, the

³ See Remarks of SEC Chairman Mary Schapiro at *SEC Speaks*, Washington DC (Feb. 5, 2010) ("Importantly, our money market fund reforms are not yet done. Looking ahead, we will be considering yet more measures to address money market fund risk, especially the risk of a run on money market funds. In particular, I have directed our staff to examine the merits of a floating, mark-to-market NAV for money market funds, rather than the stable \$1 price.").

⁴ See Remarks of SEC Commissioner Luis Aguilar before the Investment Company Institute and Federal Bar Association Mutual Funds and Investment Management Conference, Phoenix, Arizona (Mar. 15, 2010) ("Notwithstanding the substantial reform recently made as to Rule 2a-7, more may be in the works. Besides what may be contained in the pending money market fund report by the President's Working Group on Financial Markets, the Chairman as well as senior staff at the Commission have telegraphed a desire to see more fundamental structural change in the money market fund industry. In particular, the staff is examining the merits of a floating, mark-to-market NAV for money market funds, rather than the stable one-dollar price.").

⁵ See *Financial Regulatory Reform: A New Foundation*, Department of the Treasury at 12 (June 2008).

⁶ See *Financial Reform: A Framework for Financial Stability*, Group of Thirty (Jan. 15, 2009).

⁷ *Money Market Fund Reform*, Investment Company Act Release No. 28807 at 25 (June 30, 2009).

Subcommittee believes that it may ultimately be appropriate to make a recommendation to the full Committee on this issue, but not before obtaining the full Committee's initial views. One form of resolution that the Subcommittee would like the Committee to evaluate, but not vote on at this time, is as follows:

RESOLVED: Money market funds should not be required to use a floating NAV. Money market funds play a vital role as cash management vehicles for millions of Americans and as liquidity facilities for short-term borrowers. They have an extraordinary history of stability, with only two instances of failure in three decades of regulation under Rule 2a-7. If the Commission believes that the stability of money market funds can be improved, then it should consider appropriate prudential measures. Mandating a floating NAV, however, would put the continued viability of money market funds at risk and be detrimental to the interests of America's retail investors.

To reiterate, the Subcommittee seeks input from the full Committee and ***is not asking for a vote on this Resolution or any other resolution at this time.***

APPENDIX A

can be lengthy. Should we include conditions in any rule regarding the treatment of shareholders in a liquidation?²⁹³ For example, should we require that fund assets be distributed on a pro rata basis? Should there be a limit on allowable reserves?

Alternatively, should we permit or require a fund board to recognize that investors will have different preferences for liquidity and capital preservation? For example, a fund that decides to liquidate and suspend redemptions could be allowed to offer shareholders the choice of redeeming their shares immediately at a reduced net asset value per share that reflects the fair market value of fund assets, *i.e.*, at a price below the fund's stable net asset value. Remaining shareholders would receive their redemption proceeds at the end of the liquidation process and may receive the economic benefit of an orderly disposal of assets. Would such an approach be fair to all fund shareholders? What conditions would be necessary and appropriate to ensure that shareholders are treated fairly? Specifically, how would such a mechanism operate? Should funds be able to deduct an additional discount or "haircut" from earlier redeeming shareholders to provide additional protection for later redeeming shareholders? Should we permit boards to decide the amount of the haircut? If so, what factors should boards use to decide such haircuts? What disclosures and information would be necessary to permit shareholders to make an informed decision between the options?

Should investors be required to choose their preferences at the time they purchase fund shares? Should investors be able to change their preferences? If so, how and when? Should they be able to choose their preferences when a fund announces its intention to liquidate and suspend redemptions under the rule? If so, should we (or the fund board) establish a default assumption for investors that fail to respond to the inquiry?

III. Request for Comment

The Commission requests comment on the rules and amendments proposed

²⁹³ The Investment Company Act does not contain any provisions governing the liquidation of an investment company, including a money market fund; rather, liquidations are primarily effected in accordance with applicable state law. The Act does include, however, a provision authorizing Federal district courts to enjoin a plan of reorganization upon a proceeding initiated by the Commission on behalf of security holders, if the court determines that the plan of reorganization is not "fair and equitable to all security holders." Section 25(c) of the Act. A plan of "reorganization" includes a voluntary dissolution or liquidation of a fund. Section 2(a)(33) of the Act.

in this release. Commenters are requested to provide empirical data to support their views. The Commission also requests suggestions for additional changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this release.

We recognize that the events of the last two years raise the question of whether further and perhaps more fundamental changes to the regulatory structure governing money market funds may be warranted. Therefore we are exploring other ways in which we could improve the ability of money market funds to weather liquidity crises and other shocks to the short-term financial markets. We invite interested persons to submit comments on the advisability of pursuing any or all of the following possible reforms, as well as to provide other approaches that we might consider to achieve our goals. We expect to benefit from the comments we receive before deciding whether to propose these changes.²⁹⁴

A. Floating Net Asset Value

When the Commission adopted rule 2a-7 in 1983,²⁹⁵ it facilitated money market funds' maintenance of a stable net asset value by permitting them to use the amortized cost method of valuing their portfolio securities. As discussed above, section 2(a)(41) of the Act, in conjunction with rules 2a-4 and 22c-1, normally require a registered investment company to calculate its current net asset value per share by valuing its portfolio securities for which market quotations are readily available at current market value and its other securities at their fair value as determined, in good faith, by the board of directors. Therefore, using the amortized cost method of valuation is an exception to the general requirement under the Act that investors in investment companies should pay and receive market value or fair value for their shares.²⁹⁶ The Commission did not

²⁹⁴ In addition, we note that the U.S. Department of the Treasury's white paper on Financial Regulatory Reform calls for the President's Working Group on Financial Markets to prepare a report by September 15, 2009 assessing whether more fundamental changes are necessary to further reduce the money market fund industry's susceptibility to runs, such as eliminating the ability of a money market fund to use a stable net asset value or requiring money market funds to obtain access to reliable emergency liquidity facilities from private sources. See Department of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, at 38-39 (June 2009).

²⁹⁵ See 1983 Adopting Release, *supra* note 3.

²⁹⁶ Rule 2a-7 is not the only exception permitting open-end investment companies to value short-term debt securities in their portfolios on an amortized

take lightly its decision to permit money market funds to use the amortized cost method of valuation. Rule 2a-7 essentially codified several of the Commission's exemptive orders relating to money market funds, and these orders were issued only after an administrative hearing in the late 1970s at which the use of the amortized cost method of valuation was a matter of considerable debate.²⁹⁷

The balance the Commission struck was that, in exchange for permitting this valuation method, it would impose certain conditions on money-market funds designed to ensure that these funds invested only in instruments that would tend to promote a stable net asset value per share and would impose on the funds' boards of directors an ongoing obligation to determine that it remains in the best interest of the funds and their shareholders to maintain a stable net asset value. Further, money market funds are permitted to use the amortized cost method of valuation only so long as their boards believe that it fairly reflects the funds' market-based net asset value per share.²⁹⁸

The \$1.00 stable net asset value per share has been one of the trademark features of money market funds. It facilitates the funds' role as a cash management vehicle, provides tax and administrative convenience to both money market funds and their shareholders,²⁹⁹ and promotes money market funds' role as a low-risk investment option. Many investors may hold shares in money market funds in large part because of these features.³⁰⁰ We are mindful that if we were to require a floating net asset value, a substantial number of investors might

cost basis. Subject to certain conditions, the amortized cost method of valuation may be used by open-end investment companies to value investments with a remaining maturity of 60 days or less in accordance with the Commission's interpretation set forth in Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)].

²⁹⁷ See 1982 Proposing Release, *supra* note 25, at text preceding, accompanying, and following nn.2-4.

²⁹⁸ See rule 2a-7(c)(1).

²⁹⁹ A \$1.00 stable net asset value per share relieves shareholders of the administrative task of tracking the timing and price of purchase and sale transactions for capital gain and wash sale purposes under tax laws.

³⁰⁰ Some institutional investors are prohibited by board-approved guidelines or firm policies from investing certain assets in money market funds unless they have a stable net asset value per share. See ICI Report, *supra* note 6, at 109. One survey also reported that 55% of institutional cash managers would substantially decrease their investments in money market funds if the funds had a floating value. See *id.* at 110 (citing a January 2009 survey by Treasury Strategies, Inc.).

move their investments from money market funds to other investment vehicles.

However, a stable \$1.00 net asset value per share also creates certain risks for a money market fund and its investors. These risks are a consequence of the amortized cost method of valuation and the resulting insensitivity of the \$1.00 net asset value per share to market valuation changes. It may create an incentive for investors to redeem their shares when a fund's market-based net asset value per share falls between \$0.995 and \$1.00 because they will obtain \$1.00 in exchange for their right to fund assets worth less than \$1.00 per share. Regardless of the motivation underlying the redemptions, the unrealized losses attributable to redeeming shareholders are now borne by the remaining money market fund shareholders.

Further, particularly in times of market turbulence and illiquidity, regardless of the motivation behind the redemptions, redemptions at \$1.00 in a money market fund whose market-based net asset value is below \$1.00 can further depress the fund's market-based net asset value, exacerbating the impact on remaining shareholders. It can create a level of unfairness in permitting the remaining fund shareholders to pay for the liquidity needs and unrealized losses of redeeming fund shareholders. Because there is a limited window where only so many shareholders can redeem at \$1.00 in a fund with a portfolio under threat (because of holding distressed securities or facing significant shareholder redemptions) before the board of the fund must consider whether to re-price the fund's shares or take other action, there can be an incentive to be the first shareholder to place a redemption request upon any hint of stress at a money market fund. Generalized market dislocations or illiquidity can create this stress on a number of money market funds simultaneously, leading to runs on money market funds similar to those we witnessed in September 2008. Even further, a run may result in fire sales of securities, placing pressure on market prices and transmitting problems that may be originally associated with a single money market fund to other money market funds. Finally, larger, institutional money market fund investors, especially those with fiduciary responsibilities for managing their clients' assets, are more likely to recognize negative events potentially affecting the money market fund and to be in a position to quickly redeem shares of the money market fund and thus protect their money market

investments and those of their clients, leaving other smaller, more passive money market investors to bear their losses.

When we determined to permit money market funds to use amortized cost valuation in 1983, money market funds held only about \$180 billion in assets³⁰¹ and played a minor role in the short-term credit markets. Their principal benefit was to provide retail investors with a cash investment alternative to bank deposits, which at the time paid fixed rates substantially below short-term money market rates. Since that time, money market funds have grown tremendously and have developed into an industry driven in large part by institutional investors, who hold approximately 67 percent of the over \$3.7 trillion in money market fund assets.³⁰² As noted earlier, with the ability of institutional investors today to make hourly redemption requests to money market funds, these investors have the ability to move substantial amounts of money in and out of money market funds (or between money market funds), with potentially detrimental effects on the funds, their remaining shareholders, and the marketplace.

The influx of institutional investments in money market funds, the increased transparency of fund holdings, and the speed with which large shareholders can buy and redeem shares may have increased the possibility that the value of some fund investors' shares will be diluted as a result of the fund's use of the amortized cost valuation method.³⁰³ When short-term interest rates decrease, the fund's portfolio holdings (with their now above-market yields) become more valuable. Institutional investors may pay \$1.00 per share to purchase fund shares whose market value is, for example, \$1.002 per share. Such institutional inflows would be invested by the fund in securities offering the new, reduced market yields, diluting the yield advantage that existing fund shareholders would otherwise enjoy. These institutional investors, in effect, are able to earn a yield through a money market fund above the market rate they could earn on a direct investment. They achieve this yield advantage by capturing a portion of the benefit from declining interest rates that otherwise would benefit existing money market

fund investors.³⁰⁴ Similarly, when interest rates increase, institutional investors could sell shares of money market funds, obtaining \$1.00 per share for a fund that all things being equal likely will be worth less, e.g., \$0.997 per share.³⁰⁵ If instead the institutional investor sells commercial paper in the market under the same conditions, it could only sell such securities at a discount.

In stable markets and with small shareholdings, amortized cost pricing at most results in shareholders who purchase or redeem shares receiving slightly more or less (in shares or in redemption proceeds) than they otherwise would if the fund's net asset value were to fluctuate according to market-based pricing. Net redemptions generally are funded by cash on hand. Any deviation between the market-based net asset value per share of the fund and its amortized cost value is small enough to have an immaterial effect on the fund, and no effect on investors. It could be compared to a rounding convention in a billing system.

In a market under significant stress and with institutions holding billions of dollars of money market fund shares, however, a real arbitrage opportunity can arise, and a race or threat of a potential race for redemptions may become a real possibility. For example, during last fall's market turbulence, as credit spreads on many money market fund portfolio securities widened and the market value of these securities fell, we understand that the market-based net asset value of some money market funds dropped low enough that redemptions by a few large shareholders in the fund at \$1.00 per share alone could have caused the fund to break the buck.

We recognize that a floating net asset value would not necessarily eliminate the incentive to redeem shares during a liquidity crisis—shareholders still

³⁰⁴ This benefit would otherwise be paid out to money market fund shareholders in the form of greater dividend payments from the increased yield.

³⁰⁵ See S&P 2007 Ratings Criteria, *supra* note 139, at 27. Standard and Poor's gives the example of an investor holding \$1 million in 90-day U.S. Treasury bills yielding 5%. If interest rates increased 150 basis points, the value of the investment would drop by approximately \$3700 and the investor's yield would remain at 5%. Compare this to an investor holding one million shares of a money market fund holding exclusively Treasury bills yielding 5% (setting aside fund expenses). If interest rates rose 150 basis points, the investor could sell the fund investment for \$1.00 per share and not experience any loss. The investor could then purchase 90-day Treasury bills yielding 6.5%, instantaneously increasing its return by 1.5%. If the fund is forced to sell these securities to meet redemption requests, the \$3700 unrealized loss would be borne by the fund and its remaining shareholders.

³⁰¹ See ICI Report, *supra* note 6, at 1.

³⁰² See ICI Mutual Fund Historical Data, *supra* note 47 (data for week ended June 10, 2009).

³⁰³ We have considered the impact of dilution in money market funds using the amortized cost method of valuation in the past. See, e.g., 1982 Proposing Release, *supra* note 25, at n.6 and accompanying text.

would have an incentive to redeem before the portfolio quality deteriorated further from the fund selling securities into an illiquid market to meet redemption demands. But a floating net asset value may lessen the impact of any portfolio deterioration by eliminating the ability of shareholders to redeem their shares for more than the current market value per share of the fund's portfolio. It also might better align investors' expectations of risk with the actual risks posed by money market fund investments. We expect that, at least under stable market conditions, the other risk-limiting conditions of rule 2a-7 would tend to promote a relatively stable net asset value per share even if we eliminated the ability of money market funds to rely on the amortized cost method of valuation.

We request comment on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation. Would such a change render money market funds a more stable investment vehicle? Would it lessen systemic risk by making money market funds less susceptible to runs? Would it make the risks inherent in money market funds more transparent? Many money market funds' stable net asset value was supported voluntarily by fund affiliates over the last two years, and shareholders may not have understood that this support was provided on a voluntary basis and may not be provided in the future.

On the other hand, would such a change make money market funds more susceptible to runs because investors might respond quickly to small changes in net asset value? As discussed above, a stable net asset value per share creates certain administrative, tax, and cash management conveniences for fund investors. Accordingly, would prohibiting the use of the amortized cost method of valuation in money market funds encourage investors to shift assets from money market funds to unregulated offshore funds, bank accounts, or other investments? Would it result in some institutional money market funds deregistering with the Commission (in reliance on section 3(c)(7) of the Act) in order to continue to maintain a stable net asset value? Is this a result with which the Commission should be concerned?

What impact would this have on investors' cash management activities? What impact might such a change have on the short-term credit markets and issuers of short-term debt securities? How would money market funds whose share prices were based on market-based net asset values differ from

current short-term bond funds? Should any rule amendment eliminating the ability of money market funds to rely on the amortized cost method of valuation to create a stable net asset value be limited to institutional money market funds? As discussed above, institutional money market funds are at greater risk of instability, runs and the dilutive effect of large redemptions.

B. In-Kind Redemptions

As noted above, one of our concerns relates to the ability of large institutional shareholders to rapidly redeem substantial amounts of fund assets, which can pose a threat to the stable net asset value of the fund and can advantage one group of shareholders over another by requiring remaining shareholders to pay for the liquidity needs of large redeeming shareholders.³⁰⁶ While the liquidity requirements we are proposing today may ameliorate pressures created by redeeming shareholders, during severe market dislocations even more steps may be necessary to help ensure the stability of a stable net asset value money market fund. Accordingly, if we retain a stable net asset value for money market funds, we are interested in exploring other methods of reducing the risks and unfairness posed by significant sudden redemptions.

One possible way of addressing these issues would be to require that funds satisfy redemption requests in excess of a certain size through in-kind redemptions.³⁰⁷ Money market funds currently are permitted to and many money market funds disclose in their prospectuses that they may satisfy redemption requests through in-kind redemptions.³⁰⁸ In the wake of last fall's redemption pressures on money market funds, however, only one announced that it would do so.³⁰⁹ In-kind

³⁰⁶ This situation to some extent could be analogized to the situation that can be created by market timing in which selling shareholders receive benefits to the detriment of remaining mutual fund shareholders.

³⁰⁷ An in-kind redemption occurs when a shareholder's redemption request to a fund is satisfied by distributing to that shareholder portfolio assets of that fund instead of cash.

³⁰⁸ See section 2(a)(32) of the Act (defining a redeemable security as a security where the holder "is entitled * * * to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof" (italics added)). See also rule 18f-1, which provides an exemption from certain prohibitions of section 18(f)(1) of the Act with regard to redemptions in kind and in cash.

³⁰⁹ On September 19, 2008, the American Beacon Money Market Portfolio announced it would honor redemption requests exceeding \$250,000 in a 90-day period through pro rata payments of cash and "in-kind" distributions of securities held by the fund, to prevent redemptions from "forcing" the

redemptions would lessen the impact of large redemptions on remaining money market fund shareholders and would require the redeeming investor to bear part of the cost of its liquidity needs. If shareholders did not immediately sell these securities, requiring in-kind redemptions in such circumstances may mitigate the impact of large redemptions on short-term credit markets by reducing the likelihood of large fire sales of short-term securities into the market. Finally, it also may encourage large investors to diversify their money market fund holdings among a variety of funds, perhaps lessening the risk that any individual fund would be threatened by a few redemptions.³¹⁰ If proposed, we would expect to set a threshold for requiring in-kind redemptions sufficiently high that we could reasonably assume that such an investor would be in the position to assume ownership of such securities.

We request comment on requiring money market funds to satisfy redemption requests in excess of a certain size through in-kind redemptions. What would be the advantages and disadvantages of this approach? What type of threshold redemption request should trigger this requirement? Should there be a different threshold for third-party shareholders versus affiliated shareholders of a money market fund? Should there be other restrictions on affiliate redemptions (e.g., prioritizing non-affiliate redemptions over affiliate redemption requests that are submitted on the same day)? How should the fund determine the value of the securities to be distributed as a result of such a redemption request? The securities' amortized cost value? The securities' fair value, as determined based on current market quotations or, if no such quotations are readily available, as determined in good faith by the fund's board of directors? Would these shareholders be able to assume ownership of such securities?

We note that a board of directors alternatively could cause a money market fund to impose a redemption fee under rule 22c-2 to impose some of the fund's costs from shareholders' liquidity

sale of fund assets. See American Beacon Funds, Prospectus Supplement for BBH ComSet Class, Institutional Class, Cash Management Class, and PlanAhead Class (Sept. 30, 2008), available at http://www.sec.gov/Archives/edgar/data/809593/000080959308000045/sep3008_prosuppbeacon.txt.

³¹⁰ Large investors that did not wish to receive in-kind redemptions could avoid this risk by spreading their investments among several money market funds such that no single money market fund investment was large enough to possibly trigger the in-kind redemption requirement.

APPENDIX B

All of these comment letters are available on the SEC's website at:
<http://www.sec.gov/comments/s7-11-09/s71109.shtml>. The ICI report is available at:
http://www.ici.org/pdf/ppr_09_mmwg.pdf.

- Vanguard Comment Letter (page 3) (Aug. 19, 2009)
- Fidelity Comment Letter (pages 18 – 19) (Aug. 24, 2009)
- Schwab Comment Letter (pages 9 – 10) (Sep. 4, 2009)
- Mutual Fund Directors Forum Comment Letter (pages 7 – 8) (Sep. 8, 2009)
- American Bankers Association Comment Letter (pages 2-3) (Sep. 8, 2009)
- Chamber of Commerce Comment Letter (pages 4-5) (Sep. 8, 2009)
- Fund Democracy/Consumer Federation of America Comment Letter (pages 13 – 14) (Sep. 8, 2009)
- AARP Comment Letter (Sep. 8, 2009)
- North Carolina Treasurer Comment Letter (Sep. 2, 2009)
- Rhode Island Treasurer Comment Letter (Sep. 16, 2009)
- Report of Investment Company Institute Money Market Working Group (pages 104 – 112) (March 2009)

I. Requests for Comments

A. A Floating NAV Would Eviscerate a Successful and Important Product for Investors

Vanguard strongly opposes any amendment to Rule 2a-7 that would require money market funds to effect shareholder transactions at a shadow-priced net asset value (“NAV”), also known as a “floating” NAV, by eliminating their ability to use the amortized cost method of valuation. The certainty of the stable \$1.00 NAV is a hallmark of a money market fund, and was not the cause of the problems experienced by some funds during the credit market crisis.⁴ It is this very stability that has helped money funds grow to \$3.6 trillion⁵ in assets since the adoption of Rule 2a-7.

The \$1.00 NAV offers certainty to investors: a dollar in, a dollar out. The \$1.00 NAV also offers tax, accounting and recordkeeping simplicity.⁶ A shift to a floating NAV would require significant, and expensive, changes to operational and recordkeeping systems for both funds and investors. Data and analysis provided to the Commission by the Investment Company Institute’s Money Market Working Group in its March 2009 Report highlight our concerns: retail and institutional investors are likely to flee money market funds with floating NAVs, as they will lack the certainty and simplicity of the stable \$1.00 NAV.⁷ Some investors have already reacted strongly to the concept of a floating NAV, commenting that, even if they could get comfortable with the new structure, the tax, accounting and operational challenges would be a “nightmare.”⁸ Vanguard believes that for these reasons investors will reject floating NAV money funds and a large portion of their assets could flow into less-regulated alternatives, such as 3(c)7 cash management vehicles that would not be subject to the Rule and largely unavailable to retail investors.

As the Commission itself stated in the Proposals, the stable \$1.00 NAV is one of the defining features of a money market fund. It was the reliability of the stable NAV, and of money market funds in general, that enabled all but one to successfully weather the recent economic upheaval. When faced with the loss of the \$1.00 NAV and the accompanying legal, operational and recordkeeping challenges of a floating NAV, money markets could face unprecedented instability and cash flow volatility, as investors move assets to different, less regulated investment vehicles. As a result, Vanguard urges the Commission to reject the concept of a floating NAV for money market funds.

B. Public Disclosure of “Shadow Prices” Will Cause Investor Confusion and Could Increase Market Instability

The Commission has requested comment on whether money market funds should publicly disclose their market-based NAVs. Rule 2a-7 currently allows the market-based NAV, or shadow price, of money

⁴ The funds that experienced difficulties during the recent market crisis had purchased and held onto securities of questionable credit quality. Credit quality, not the stable NAV, was the source of stress for these funds.

⁵ See the ICI’s website at www.ici.org/research/stats/mmf/mm_7_23_09.

⁶ For example, because all money market fund returns are distributed to shareholders as income, the burden of timing purchases and sales for the purpose of the “wash sale” rule is lifted from investors. In addition, shares of a floating NAV money market fund would have to be reclassified as “available-for sale” securities under accounting rules. As a result, investors would have to expend considerable resources to mark the securities to market and calculate gains and losses. The floating NAV would also directly impact both institutional and retail investors in other ways.

Institutional investors would not be able to calculate operating cash on hand until after the fund strikes its final NAV at the end of a business day, which would impede their ability to operate their businesses efficiently. Retail investors who utilize options such as check writing, bill pay, and ATM access through money market funds would no longer be able to budget accurately for upcoming expenditures. Finally, due to the certainty of the funds’ NAV, it is often hard-coded into accounting and cash-tracking systems. See *Working Group Report pps. 107-111*.

⁷ See *Working Group Report pps. 105-107*.

⁸ See *Working Group Report p. 110*.

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
August 24, 2009
Page 18

D. In-Kind Redemptions

The Commission seeks comment on requiring money market mutual funds to satisfy redemption requests in excess of a certain dollar amount through in-kind redemptions.⁴⁵ In light of the potential difficulties involved with delivering underlying money market fund investments in-kind, Fidelity opposes any mandatory in-kind redemption requirement.

IV. PRESERVING THE INTEGRITY OF MONEY MARKET MUTUAL FUNDS

Fidelity believes it is critical that the financial services industry, regulators and policy makers work together to arrive at the right answers for improving the resilience of money market mutual funds while, at the same time, preserving the key investment features so many money market mutual fund shareholders rely upon -- most especially the stable \$1.00 net asset value ("NAV").

A. Floating NAV

Fidelity strongly opposes the concept of introducing a floating NAV for money market mutual funds, for a number of reasons. First, we do not believe that a floating NAV would reduce systemic risk. Some have suggested that in a period of market turmoil, funds with floating NAVs would be at lower risk of significant redemptions from shareholders. We are not aware of empirical evidence to support this belief. In fact, a floating NAV would potentially destabilize a large (\$3.6 trillion)⁴⁶ and important segment of the financial markets.

Money market mutual fund shareholders do not favor a floating NAV. Retail and institutional investors rely on money market mutual funds as a low-cost, convenient and reliable cash management tool. Fidelity's internal research shows that a large number of money market mutual fund shareholders, particularly institutional shareholders, would redeem holdings in these funds if they adopted a floating NAV. In a survey of retail money market investors, 33% of respondents indicated that they would withdraw some, most or all of their money from money market mutual funds if a floating NAV were adopted.⁴⁷ In the same survey, 69% of institutional investors said that they would either stop using or decrease their use of money market mutual funds if a fluctuating NAV were adopted. Only 4% of institutional customers favored such a proposal.⁴⁸

⁴⁵ Money Market Fund Reform, 74 Fed. Reg. at 32718-9.

⁴⁶ See *supra* note 3.

⁴⁷ See *supra* note 7 for a description of the survey.

⁴⁸ When asked in an investor survey why they used money market mutual funds, 52% of retail customers responded that money market mutual funds are part of an overall asset allocation strategy and 39% named money market

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
August 24, 2009
Page 19

Second, a floating NAV would limit the availability of short-term funding for governments and corporations resulting in potential unforeseen consequences for the economy. As the Commission notes in the Release, money market mutual funds serve as a reliable source of direct, short-term financing for the U.S. Government, domestic and foreign banks, financial and non-financial corporations, and municipal issuers (including state and local governments as well as universities and hospitals).⁴⁹ The decrease in investor demand for money market mutual funds likely to result from moving to a floating NAV would significantly limit the availability of this important short-term funding, which could have negative impacts across the U.S. and global economies.

Finally, a floating NAV would impose a variety of burdens on shareholders and customers, which would contribute to more shareholders exiting money market mutual funds. As the Commission notes in the Release, “a stable net asset value per share creates certain administrative, tax, and cash management conveniences for fund investors.”⁵⁰ With a floating NAV, investors could expect new tax and record-keeping requirements, especially for those shareholders who write checks from a money market mutual fund. Moreover, moving to a floating NAV would limit the number of available investment product options, resulting in higher costs and lower returns for investors. Additionally, under many state laws and regulations, municipalities, insurance companies and others are authorized to invest in money market mutual funds only if the funds maintain a stable NAV. Sponsors of 401(k) plans also may be reluctant to include non-stable NAV money market mutual funds as an investment option in group retirement plans.

B. Disclosure of Market Value NAV

The Commission also seeks comment on whether money market mutual funds should disclose market-based net asset value per share and the market based prices of their portfolio securities as part of the proposed requirements relating to website posting of portfolio holdings.⁵¹ Fidelity strongly opposes the public disclosure of market value per share of portfolios or market value prices of securities. It is a fund board’s responsibility to monitor market value NAV, and Fidelity believes that a fund’s board should review market value per share pricing on a regular basis and when certain pre-determined thresholds are reached.

mutual funds as a parking place for when you move money in and out of investments. Eighty-four percent of institutional customers named daily liquidity as their top reason for using money market mutual funds followed by 75% listing safety of principal as a use. *See supra* note 7.

⁴⁹ Money Market Fund Reform, Fed. Reg. at 32689.

⁵⁰ Money Market Fund Reform, 74 Fed. Reg. at 32718.

⁵¹ Money Market Fund Reform, 74 Fed. Reg. at 32709-10.

F. Stress Testing. CSIM generally supports requiring periodic stress testing as described in the Proposed Amendments. However, we would exclude from the Proposed Amendments the requirement that the investment manager assess the fund's ability to withstand events that are reasonably likely to occur within the following year. A stress test report can be developed to reflect hypothetical changes in interest rates, shareholder redemption rates, potential downgrades or defaults on select portfolio securities, and widening spreads on yields. While such a report would reflect only hypothetical changes—and not known or expected changes—the report would help facilitate a general discussion with the Board regarding the fund's ability to withstand significantly changing or volatile markets. A fund's ability to create a report using a range of variables, however, is much different than creating a report based on events an investment manager believes may be “reasonably likely” to occur. The events most likely to impact the fund—changes in interest rates, redemption rates, and credit risk—are already included in the stress test report. We are uncertain what other “reasonably likely” events the Proposed Amendments contemplate capturing. Nevertheless, we believe a stress test based on the above factors is more than sufficient to facilitate a meaningful discussion with the Board without adding forward-looking and likely speculative assessments by the investment manager of what might occur in the future, which would add little value to the Board's discussion.

CSIM does not believe the Commission should specify any base-line stress tests or otherwise dictate with any greater specificity the form and substance of the stress test reports. Each fund should have reasonable discretion to develop the reports in a manner and format that will be most meaningful to its Board and best facilitate Board discussion.

IV. Diversification

The Commission has requested comment on whether it should further restrict the diversification limits of Rule 2a-7. CSIM would not support any changes to the diversification requirements set forth in the current rule, as more stringent diversification requirements may force a fund to invest in lower quality securities than those in which it might have otherwise invested. This is of particular concern given recent consolidations in the industry resulting in a smaller universe of potential issuers.

V. Disclosure

CSIM generally supports the proposal requiring funds to disclose monthly portfolio holding information via a public web posting (the “Public Report”) and to the Commission (the “Commission Report”). However, the proposed timeframe for providing this information—by the second business day of the month—is not feasible. Two business days is simply not enough time to gather the required information, perform quality assurance review, and prepare and deliver each report. CSIM believes ten business days is a more appropriate timeframe for providing each of the required monthly disclosures. While it may be possible to deliver the Public Report earlier—e.g., by the fifth business day of a month—it is important that both of these disclosures should have the same deadline to ensure consistency of the information contained in each of the reports. As CSIM believes it will take at least ten business days to prepare the Commission Report, that same timeframe should apply to the Public Report.

VI. Additional Comments

A. Floating Net Asset Value. CSIM is very pleased that the Proposed Amendments retain a money market fund's use of amortized cost when calculating its net asset value (“NAV”), rather than requiring a floating rate NAV. CSIM believes elimination of stable NAV pricing would in effect fundamentally change the nature of money market funds and the manner and extent to which they are

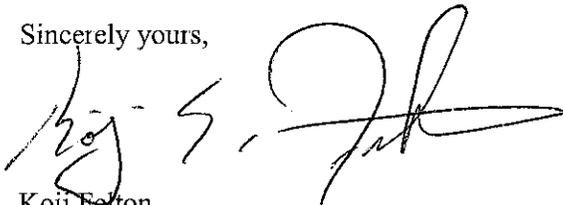
used by investors. Money market funds, in their current form, are highly popular and useful investment vehicles that have historically provided safety and liquidity to their shareholders²³ While we strongly support the Commission's efforts to further ensure the safety of investor assets and reduce risk, adoption of a floating NAV is not consistent with that objective. Most notably, we are not aware of any evidence that floating NAV pricing will add to the safety and stability of money market funds, or lessen the likelihood of runs on funds in times of market stress. Rather, a floating NAV may increase the likelihood of substantial swings in redemptions and potential runs on money market funds when a fund's NAV falls even slightly below \$1 (e.g., \$0.9985). Investors may misinterpret an otherwise *de minimus* deviation in NAV as an indication that the fund is fundamentally less sound than other money funds or comparable investment alternatives and seek to redeem their positions. Thus a floating NAV may precipitate a run on what otherwise may be a financially stable money market fund

B. Fund Liquidations and Temporary Suspensions CSIM strongly supports proposed new Rule 22e-3, which would permit money market funds to suspend redemptions to facilitate orderly liquidation of the fund. CSIM also supports including within Rule 22e-3 a provision allowing the Board to temporarily suspend redemptions during exigent circumstances other than liquidation, as described in the Proposed Amendments. While we believe a Board would rarely, if ever, need to rely on the rule, the ability to suspend redemptions during liquidation and under other exigent circumstances simply gives the Board additional means and flexibility to protect fund shareholders in times when the Board, in its discretion, believes such protection is warranted

* * * * *

CSIM appreciates the opportunity to comment on the Proposed Amendments and thanks the Commission for its consideration of the views we express above. If you have any questions regarding this letter, please feel free to contact Koji Felton at (415) 667-0608 or David Lekich at (415) 667-0660.

Sincerely yours,



Koji Felton
Senior Vice President & Deputy General Counsel
Charles Schwab Investment Management, Inc

Cc: Andrew J Donohue, Director
Robert E. Plaze, Associate Director
Division of Investment Management

²³ As noted in the ICI Letter, stable NAV money market funds offer tax and operational convenience, as well as accounting simplicity to investors, and serve as a principal investment option for various institutions, trusts and municipalities with mandates to invest in stable net asset value products. See ICI Letter at 39.

► *Proposed New Disclosure Requirements*

As a general matter, the Forum supports the new disclosures proposed by the Commission. We agree fully that providing the Commission, other regulators, and the public further information about the activities and portfolio holdings of money market funds will both make regulators more effective and increase investors' understanding of how money market funds operate. At the same time, care should be taken to avoid unnecessary or excessive costs on money market funds (particularly in the current low interest rate environment) and disclosure requirements should not, as a practical matter, impede their portfolio management. We therefore urge the Commission to consider carefully the comments it receives on these issues from money market fund advisers.

We would, however, have significant concerns about any proposal to require money market funds to disclose a market-based net asset value per share (“NAV”). In particular, we believe that this disclosure is more likely to be confusing than helpful to retail investors in money market funds. One of the key benefits of money market funds to retail investors is the certainty they provide about the price at which transactions occur – money market funds are easy to use largely because of their stable \$1/share NAV. Providing information about the market-based NAV when a fund has a stable NAV in accordance with Rule 2a-7 will only serve to confuse investors regarding the significance of a deviation between market value and amortized cost value and may lessen investor confidence in a fund. Indeed, this is an area in which the board plays a key role – by reviewing a money market fund’s market-based NAV and otherwise overseeing its compliance with applicable regulations, the Board stands in for and protects the shareholders of the fund from any harm that might result from there being a material deviation between the market-based NAV and the stable \$1/share reported NAV of the fund.

► *Request for Comment on a Floating NAV*

In the concluding section of its Release, the Commission seeks comment on whether money market funds should be barred from seeking a stable NAV, and instead sell and redeem shares based on a floating NAV. We fundamentally oppose changing money market funds in this manner. First, and most importantly, we believe that the overwhelming success of money market funds – one of the most important innovations in the mutual fund marketplace in the past thirty years – is rooted in a stable NAV of \$1. Especially from the perspective of retail investors, a stable NAV makes money market funds much easier to use and understand, particularly when parking cash in anticipation of making other investments or other purposes. Were the stable NAV eliminated, many investors would likely abandon money market funds for other vehicles, thereby weakening an investment that has held great appeal to investors and provided a ready market for issuers.

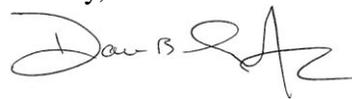
Second, if the Commission is seriously committed to considering this step, it should carefully evaluate potential collateral consequences that could well reduce the size of money market funds. In today’s capital markets, money market funds are an important source of short-term funding for numerous banks, businesses and governmental entities. If investor money moves out of money market funds, these entities will potentially have much greater difficulty raising short-term funds, and both our country’s capital markets and economy could be harmed. Before

taking steps of such a fundamental nature, we believe that the Commission would need to assess and quantify these critical risks.

Finally, we believe that the rule amendments that the Commission proposes in the Release significantly reduce the need to consider more fundamental changes like a shift to a floating NAV. Clearly, the ongoing viability of money market funds depends upon their ability to manage their portfolios in a way that achieves an acceptable return for shareholders while still minimizing to the largest extent feasible the risk that a fund will “break the buck.” Up until the recent turmoil in the markets, Rule 2a-7 has been highly successful in achieving the goal and, even during the difficult market conditions of the past 18 months, the vast majority of funds have been able to maintain a stable NAV of \$1. The amendments that the Commission is now proposing will make it even more likely that funds will be able to maintain a stable NAV, even in highly difficult market conditions. Given this, we simply do not believe that there is a strong basis for the Commission to consider fundamental change to a product that has been highly successful and is clearly highly desired by both individual and institutional investors.

We very much appreciate the opportunity to comment on this important proposal and thank the Commission for considering our comments. Please feel free to contact Susan Wyderko, the Forum’s Executive Director, at 202-507-4490 or me at 202-507-4491 if you would like to further discuss our comments.

Sincerely,

A handwritten signature in black ink, appearing to read "David B. Smith, Jr.", with a stylized flourish at the end.

David B. Smith, Jr.
Executive Vice President and General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Andrew J. Donohue, Director, Division of Investment Management

significantly impacted if MMFs were unable to invest in these instruments. The ABA urges the Commission to retain the exemption authorizing a stable NAV for MMFs and to retain the existing definition of liquidity when altering the liquidity standard.

Stable Versus Floating NAV

MMFs are regulated under Rule 2a-7 of the Investment Company Act which permits MMFs to use amortized cost – as opposed to market or fair value – to value fund assets. This exception in Rule 2a-7 was created to facilitate the dual roles of MMFs as cash management vehicles and low-risk investments. In light of the recent market crisis, the Commission has expressed concern that when a fund's fair value falls below \$1.00, those persons who redeem their shares early have an advantage over investors who have not redeemed their shares and who thus bear the unrealized losses of the fund. The financial impact of this timing creates an incentive to redeem shares early during a liquidity crisis. The Commission seeks comment on whether a floating NAV might serve as a disincentive to such early, rapid redemptions, thus lessening the impact on the fund, and in turn, the market.

ABA believes that the MMFs with stable NAVs should remain a viable option for investors who desire transactional stability and accounting ease. For many investors the ability to have access to money market funds with a stable NAV is important in easing fund transactions and reporting. For other investors, however, a MMF with a floating NAV is an appropriate investment option. We believe the market is fully capable of addressing the need for a MMF with floating NAV as it is doing, for example, with Deutsche Bank's announcement of plans to launch a MMF with a floating NAV.³

A. Transactional Stability

Investor demand for MMFs with a stable NAV is strong, as is evidenced by the \$3.9 trillion invested in them, and ABA believes investors must have the ability to invest in this type of fund. A stable net asset value provides a level of simplicity for investors who wish to keep their assets fairly liquid for some period of time, and gives them confidence that the value of the fund will remain constant no matter which day they may purchase or redeem shares. This is particularly important for accounts that are used for transactional purposes rather than as investments.

For example, in the institutional world, MMFs are used to fund transactions that occur over the course of the day. If the NAV floats, service providers would need to request that shares be redeemed prior to the close of the market (when the fund is priced), but the number of shares needed to be redeemed to fund the transaction would be uncertain. Estimating the number of shares needed to be redeemed will result in an end-of-day excess or shortfall. This leads to a potentially significant difficulty in calculating the end-of-day values. By contrast, a stable NAV provides certainty for funding the day's transactions. Similarly, municipal bond issuers who, under their indentures, are required to maintain reserves at a specified level, can be assured that they will not have to advance cash to satisfy that reserve level because funds invested in MMFs will not fluctuate. Finally, trust departments commonly sweep idle cash that must be made productive into MMFs on an overnight or longer basis. For example, if such swept funds are

³ Laise, Eleanor, *Money Fund Floats Plan to Erase \$1 Barrier*, The Wall Street Journal, Sept. 3, 2009, at C1.

intended to cover a future expense, such as college tuition, a floating NAV could result in an insufficient amount to cover the particular expense.

B. Accounting Ease

Investors understand and appreciate the accounting treatment offered by stable NAV funds. With a stable NAV, investors do not need to report the gains or losses in the fund, because the fund is distributing all returns of the fund through dividends as income. With a floating NAV, different reporting would be required, including the reclassification of money market funds as short-term or long-term investments. The investor would then need to mark to market the value of the MMF shares and match purchases and redemptions to calculate capital gains and losses. By retaining the stable NAV, the investor follows a simpler reporting scheme.

C. Legal Requirements

Certain trust investors may face legal or other constraints that would require them to invest their cash balances in funds that maintain a stable NAV. There are a number of state statutes specifying permissible investments under indentures requiring a stable NAV.⁴

Definition of “Liquidity”

The Commission’s proposal would prohibit MMFs from acquiring assets unless they are “liquid” as defined in the proposal. In the past, the Commission permitted stable NAV funds to hold up to ten percent of their assets in illiquid investments. Under the proposal, *all purchases* would need to be “liquid,” meaning that they could be sold or disposed of in the ordinary course of business within seven days at approximately their “amortized cost value.”

ABA is concerned that bank certificates of deposits (CDs) may not meet the proposed liquidity definition. A CD is a special type of bank deposit account that typically offers a higher rate of interest than a regular savings account. An important benefit of CDs is that they are insured by the Federal Deposit Insurance Corporation. When an individual purchases a CD, the funds are invested in a fixed sum of money for a fixed period of time and, in exchange, the issuing bank pays the individual interest at regular intervals. When the CD is redeemed, the individual receives the money originally invested plus any accrued interest. However, if the CD is redeemed before it reaches its maturity date, then an early withdrawal penalty *may* be assessed.

ABA is concerned that a CD may be considered illiquid under the proposal because it may not be liquidated prior to maturity at the amortized cost value without the possibility of incurring withdrawal penalties. CDs may be purchased either directly by MMFs or through reciprocal deposit arrangements, such as the Certificate of Deposit Account Registry Service (CDARs)⁵. Through CDARs, these deposits are available to customers of banks that are members of a group of insured depository institutions, where each member of the group sets the interest rate to be paid on the entire amount of funds it places with other group members and then swaps deposits with other group members. Such an arrangement enables a bank to offer its customers a

⁴ See Texas Public Funds Investment Act, Texas Government Code Sec. 225.014; see also, Louisiana Revised Statutes. RS 33:2955 A.(1)(e).

⁵ CDARS is a product of the Promontory Interfinancial Network.

- Issuers of A2/P2 Securities are high quality credits with investment-grade long-term debt ratings. The historic default risk of A2/P2 Securities is very similar to that of A1/P1 Securities. Issuers of A2/P2 Securities are required to hold 100% backstop facilities to offset this risk.
- The Proposed Prohibition would not have prevented the recent strains on money market funds. In fact, the inability to diversify a money market fund portfolio could exacerbate the negative effects of another major default by an Issuer of A1/P1 Securities.
- The Proposed Prohibition could indirectly discourage non-2a-7 investment in A2/P2 Securities which would severely constrict the market for A2/P2 commercial paper. Such a scenario could also drive companies to draw down their credit facilities which would have a negative impact on the ability of banks to lend to other parts of the economy.
- The Proposed Prohibition could decrease borrowing flexibility and elevate borrowing costs for companies that issue A2/P2 Securities thereby restricting their ability to meet their short-term cash needs, increasing their cost of capital, and driving up consumer costs.

We urge the SEC to consider the direct and indirect impact that the Proposed Prohibition will have on the market for A2/P2 Securities and on the many companies that rely on money market funds to provide critical financing. The negative and unintended consequences the Proposed Prohibition would have on companies, investors, and our economy far outweigh any speculative increase in investor protection.

The SEC Should Not Propose a Requirement for Money Market Funds to Maintain a Floating NAV

The SEC invites comment on the advisability of proposing a rule that would require money market funds to “float their NAV” by letting their share price fluctuate. Money market funds play a vital role for state and local governments, businesses, and non-profits as an important source of short-term funding. According to the ICI, money market mutual funds hold an estimated 65 percent, or \$491 billion,

of outstanding short-term state and local government debt. State and local governments use these funds as a significant source of financing to support public projects, such as schools, roads, bridges, airports, and water and sewage treatment facilities.

The stable NAV is the hallmark of a money market fund that provides investors with significant benefits over alternative investments. Moving to a floating NAV would make money market funds significantly less attractive to investors. In addition to the tax and operational convenience and accounting simplicity that a stable NAV provides, under many state laws and regulations, municipalities, insurance companies, and others are authorized to invest in money market mutual funds only if the funds maintain a stable NAV.

If a floating NAV is adopted, investors with a strong need for a stable value would be forced out of money market funds. This likely decrease in demand would lead to a severe contraction in the availability of funding for many enterprises, including municipal issuers. This would increase the cost of borrowing by municipal issuers that would be passed directly onto taxpayers. These investors would also be forced into investments that offer a lower yield without a proportionate reduction in risk.

Rule 2a-7 currently includes robust protections for investors and many of the proposed amendments to Rule 2a-7 will enhance the ability of these investment vehicles to weather future periods of market distress. Adopting a floating NAV would destroy the usefulness of this investment and capital formation vehicle and negatively affect issuers and investors that use money market funds as sources of financing and cash management vehicles. Accordingly, we urge the SEC not to propose a rule that would require a floating NAV for money market funds.

*

*

*

We appreciate the opportunity to comment on the proposed amendments to Rule 2a-7 and believe the combined efforts of the SEC and the money market fund industry will ensure the long-term resiliency of this important investment vehicle.

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 to 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

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).



*Filed electronically
via rule-comments@sec.gov*

September 8, 2009

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

Re: Money Market Fund Reform; Release No. IC-28807;
File No. S7-11-09

Dear Ms. Murphy:

AARP appreciates the opportunity to comment on the Commission's proposals to amend Rule 2a-7 and other provisions pertaining to money market funds under the Investment Company Act of 1940. AARP commends the Commission's efforts to step up oversight of money market funds and to further protect investors in these widely used financial vehicles.

AARP's comments on the proposed rule amendment are directed principally to the Commission's Request for Comment in Section III A of the Proposed Rules publication (Fed. Reg. Vol. 74, No. 129, July 8, 2009) on the issue of whether the Commission should prohibit the use of the amortized cost method of valuation in money market funds, thus requiring such funds to effect shareholder transactions at the market-based net asset value, *i.e.*, whether they should have "floating" rather than stabilized net asset values.

AARP believes that maintenance of a stable \$1.00 net asset value by money market funds is in the best interests of individual investors. Many investors regard money market funds as stable, simple, and reliable financial vehicles into which they may deposit funds earmarked for future investment or for both anticipated and unforeseen cash needs that may arise. With those purposes in mind, investors view the stable \$1.00 net asset value as critical. The predictable accounting, tax, and funds management implications of money market funds are the essence of the attraction of money market funds to the individual investor.

AARP believes that the requirement of floating net asset values would radically and detrimentally alter the role and function of money market funds, discourage the use of money market funds for individual investors, and disrupt the financial market landscape for investors. Therefore, AARP favors a stable market value for money market shares in ordinary circumstances. AARP also supports the other regulatory proposals that would help strengthen the ability of money market funds to maintain a stable \$1.00 net asset

value, such as those that are aimed at increasing credit quality and shortening portfolio maturity. Should the Commission determine that floating net asset values for money market shares are likely to facilitate a more stable marketplace, then AARP believes that the Commission should institute such a change only after a sufficiently long period of advance notice to investors so as to permit them to assess the continued suitability of money market funds for their investment goals and to transition to other financial instruments if they deem that to be in their best interests.

AARP appreciates the opportunity to present its views on the proposed change to the rules regarding money market funds and related issues. If you have any further questions, please feel free to contact Jay Sushelsky at 202-434-2151.

Sincerely,

A handwritten signature in cursive script, appearing to read "David Certner", with a long horizontal flourish extending to the right.

David Certner
Legislative Counsel and Legislative Policy Director
Government Relations and Advocacy



NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

JANET COWELL
TREASURER

T. VANCE HOLLOMAN
DEPUTY TREASURER

September 2, 2009



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

Re: Money Market Reform; File Number S7-11-09, Proposed SEC Rule 2a-7

Dear Ms. Murphy,

Thank you for the opportunity to comment on the proposed SEC Rule 2a-7. We believe that many of the proposed changes are beneficial and note that our approved local government fund, the North Carolina Cash Management Trust (NCCMT), already operates under many of the proposed requirements. We have the following concerns about the proposed change that requires the use of floating Net Asset Values (NAV) for money market funds:

- We believe that a change to a floating NAV will discourage local governments from investing in money market funds and instead will choose competing bank products with fixed NAV. Local governments look to the NCCMT for a safe, protected principal, stable investment. This is evidenced by the fact that our local governments overwhelmingly choose the Cash Portfolio of the NCCMT, which has a fixed NAV, over the Term Portfolio, which has a floating NAV. This has consistently been the case in spite of the Term Portfolio's performance exceeding that of the Cash Portfolio by an average of 15 bps annually over the ten year period ended December 31, 2007. North Carolina local governments utilize the Cash Trust as a safe, short-term, liquid investment vehicle for taxpayer moneys; they are not interested in investments that may lose market value.
- Accounting for the change in NAV would complicate the recordkeeping for our local governments. Our larger governments may have multiple accounts and numerous transactions during the year. The cost to account for each could outweigh any value added by the additional information provided. Our smaller governments may not have staff that understand the requirements and as such would choose a bank product in lieu of a money market with floating NAV.

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
September 2, 2009
Page 2

- Money market funds are essential to the local government variable rate debt markets as investors in these securities. A drop in investment in money market funds would decrease the availability of assets available to purchase local government variable rate demand notes. Decreased demand will push rates higher and reduce the availability of this source of funds for local governments.

Again, we thank you for the opportunity to comment on this proposal.

Sincerely,



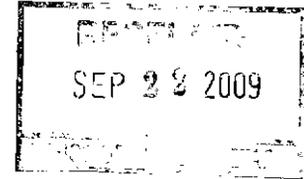
Janet Cowell



S7-11-09
147

State of Rhode Island and Providence Plantations
General Treasurer
State House - 102
Providence, Rhode Island 02903

Frank T. Caprio
General Treasurer



September 16, 2009

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

Re: SEC Proposal of Floating Net Asset Value for Money Market Funds

Dear Ms. Murphy:

As the General Treasurer from Rhode Island, I would like to go on record as opposing the SEC's proposal to promote the practice of a "floating" net asset value (NAV) for money market funds.

My reservations regarding a floating NAV for money market funds center on the following concerns:

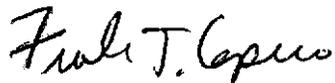
- Money market funds with a stable \$1 per share value represent a low cost, efficient and distinct asset class that provides diversification as a cash management tool. A floating NAV means money market funds will essentially become the equivalent of short term bond funds, and potentially will eliminate money market funds as a distinct investment class providing needed diversification.
- A floating NAV will likely reduce investment yields as it increases complexity and drives up administrative costs.
- Money market funds have historically provided daily liquidity which is highly desirable in managing short term funds, particularly in times of fiscal crisis. I am concerned that the daily liquidity of money market funds will be compromised at a time in our economy when it is most needed.

We are aware of the concerns raised by the National Association of State Treasurers (NAST) in their letter sent to you in July of this year, as well as the concerns set forth by the SEC's own Commissioner Paredes during his speech at the June 24th SEC meeting. We echo these concerns.

Money market funds are an efficient and low-cost cash management tool for managers of public funds. As General Treasurer having the responsibility for short-term cash management for the State of Rhode Island, as well as in my role as a fiduciary of Rhode Island's \$6.5 billion pension fund, it is a matter of importance that money market funds remain a distinct investment class providing an efficient cash management tool. I believe a floating NAV will negatively impact the current benefits of money market funds.

Thank you for your consideration.

Sincerely,

A handwritten signature in black ink that reads "Frank T. Caprio". The signature is written in a cursive style with a large initial "F".

Frank T. Caprio
General Treasurer, State of Rhode Island

Inc. (AIG), and the building financial crisis both in the U.S. and abroad. These events revealed problems at financial firms that were far deeper and more widespread than many market participants had expected. As new concerns mounted about the stability of a growing number of financial institutions, investors questioned whether and how the U.S. and foreign governments would or could protect creditors. These uncertainties and changed expectations about the health of financial institutions fanned market participants' fears. Concerns of money market fund investors about the risk exposure of their money market funds and the ability of sponsors of these funds to support them in the midst of a far-reaching financial crisis led some large institutional investors in money market funds to join the much broader run to Treasury securities, further overwhelming the financial system's ability to accommodate this sudden and broad-based change in the market outlook.

Proposals that seek to restructure regulations to insulate money market funds from future market disturbances pose the risk that money managers will be less responsive to the deterioration of a firm's credit quality, thus reducing overall market discipline to allocate capital efficiently. Furthermore, if regulatory changes reduce the sensitivity of money market fund investors to the credit quality of their funds' investments, market discipline will be further eroded. Finally, if new rules cause assets to flow into other less regulated vehicles, then the government's ability to react to future credit market events will itself be impaired.

The proposals, and our concerns with each of them, are discussed below. The first section explores the proposition that money market funds should let their share prices fluctuate, or be subject to regulation like banks. We believe that neither of these reforms will decrease systemic risk; indeed, they could actually increase it. The second section discusses proposals to preclude funds from commingling assets of retail and institutional investors and to require funds to redeem investors in kind as a means of addressing illiquidity concerns. We do not believe that either of these proposals are practical.

8.1 FLOATING NAVS AND BANK-LIKE REGULATION

Some commentators have suggested that money market funds be required to "float their NAVs" by letting their share price fluctuate. Others have argued that money market funds should be subject to capital requirements. Still others have combined these various proposals and recommended that money market funds be required to choose either to float their NAVs or to become special-purpose banks with capital requirements and deposit insurance.¹⁹⁵

Our main concerns with these recommendations are as follows. First, investors will reject floating NAV money market funds and a large portion of the assets will flow into other less regulated alternatives. Second, imposing capital requirements on existing money market funds faces significant accounting and tax challenges and provides limited protection against the kinds of broad market events that are most likely to cause widespread redemptions. Third, fully insuring money market funds will likely attract assets from direct holdings of securities, existing unregistered cash pools, and possibly drain a significant portion of deposits from traditional

¹⁹⁵ See Group of Thirty Report, *supra* note 8.

banks. And finally, a partial insurance program would do little to alter the behavior of large institutional shareholders of money market funds in periods of stress in the money market.

8.1.1 Floating NAV

A hallmark feature of a money market fund is its stable NAV. Recently, some commentators have recommended that money market funds only be allowed to carry a fluctuating NAV. These commentators suggest that this would reduce systemic risk by addressing some of the difficulties that money market funds encountered in 2008, as they tried to provide both liquidity and a stable NAV.

The Working Group strongly disagrees. Fundamentally changing the nature of money market funds (and in the process eviscerating a product that has been so successful for both investors and the U.S. money market) goes too far and will create new risks. As discussed below, there are substantial legal, operational, and practical hurdles to redirecting retail and institutional demand from a fixed to a floating NAV product. Indeed, because of the very real and well-ingrained institutional and legal motivations driving the demand for a stable NAV product, investors will continue to seek such a product.

8.1.1.1 Reducing Systemic Risk

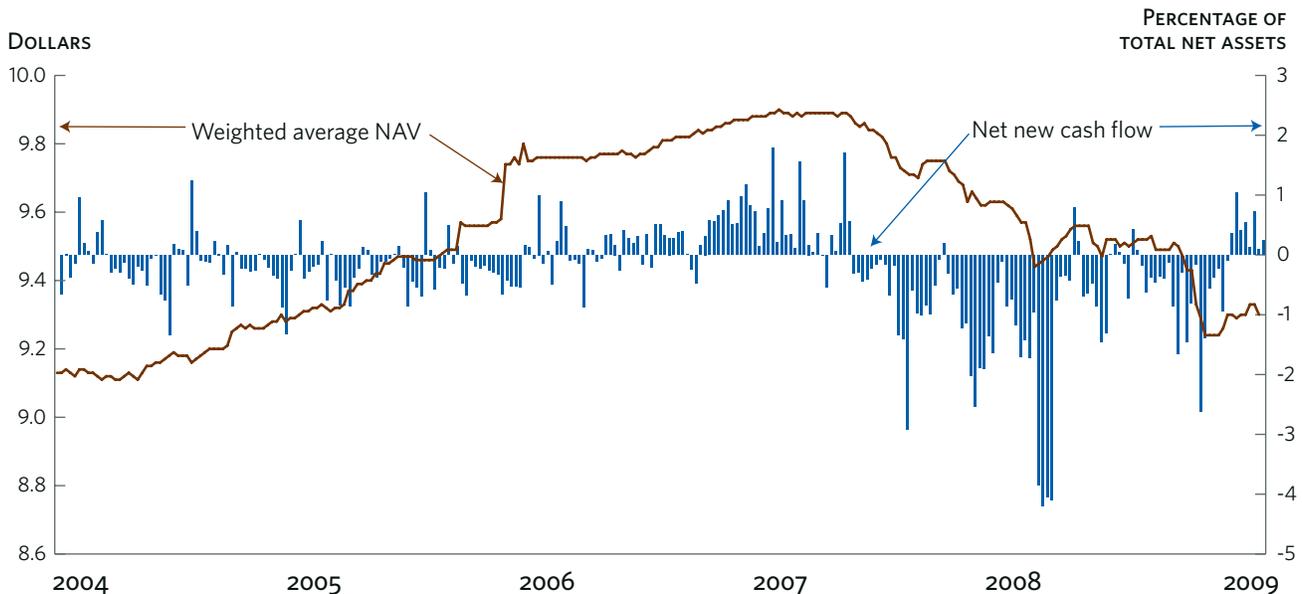
One of the supposed attractions of a floating NAV product is the belief that investors would be less likely to quickly redeem shares, thereby reducing the risk of large, rapid outflows from money market funds. Commentators point to long-term mutual funds, which at times have suffered significant losses but typically experienced only modest outflows. For instance, during the sharp market sell-off during the fall of 2008, stock fund returns suffered losses amounting to 30 percent of fund assets and bond funds declined 10 percent. Net outflows from these funds, however, totaled only 3 percent of their assets during the last three months of the year.

Evidence for specific types of mutual funds, particularly those designed for investors seeking a lower risk investment, however, show a less compelling case. For example, ultra-short bond funds are similar to money market funds in that they generally invest in fixed-income securities with short maturities. The NAV of ultra-short bond funds, however, fluctuates, as shown in Figure 8.1.¹⁹⁶ During 2004 and 2005, the average NAV on these funds rose about 7 percent and then moved in a fairly tight range until mid-2007. Beginning in the summer of 2007, the average NAV on these funds began to fall modestly, and fund flows turned negative. Then in February and March 2008, several ultra-short bond funds posted significant NAV declines, and the average NAV on all these funds fell about 2 percent. During the four weeks ending in early April, ultra-short bond funds experienced a cumulative outflow of 15 percent of assets. Thereafter, even though NAVs stabilized for much of the remainder of the year, moderate outflows continued, and by the end of 2008 assets of these funds were 50 percent below their levels at the beginning of the year and down more than 60 percent from their peak in mid-2007.

¹⁹⁶ Ultra-short bond funds tend to have higher risks than money market funds because they are not subject to Rule 2a-7.

FIGURE 8.1

Weighted Average NAV and Net New Cash Flow of Ultra-Short Bond Funds Weekly



Sources: Investment Company Institute and Morningstar

The experience in Europe of certain money and bond funds likewise demonstrates that floating NAV funds can also face strong investor outflows during periods of market turmoil. For example, in the summer of 2007, French floating NAV dynamic money funds (or *trésorerie dynamique* funds) began to suffer significant investor outflows when problems in the credit markets from exposure to U.S. subprime mortgages surfaced (Figure 8.2).¹⁹⁷ A year later, European bond funds similarly suffered heavy outflows as market turmoil led investors to seek safer havens for their savings. For example, in the fourth quarter of 2008, bond funds authorized in Luxembourg experienced outflows of €48 billion, or 12 percent of their assets, even though the funds had valuation declines of about 3 percent.¹⁹⁸ As in the United States, the last quarter of 2008 in Europe was a remarkable period, as some European countries guaranteed deposits, and countries such as Luxemburg and Germany pledged to support the liquidity of money funds domiciled in their respective countries.¹⁹⁹

¹⁹⁷ See, e.g., Press Release, Société Générale, Activities and Results 2007 (February 21, 2008) (noting that the liquidity crisis prevailing since the summer of 2007 has led to substantial outflows from dynamic money funds in France and that Société Générale Asset Management had decided to ensure liquidity for some funds).

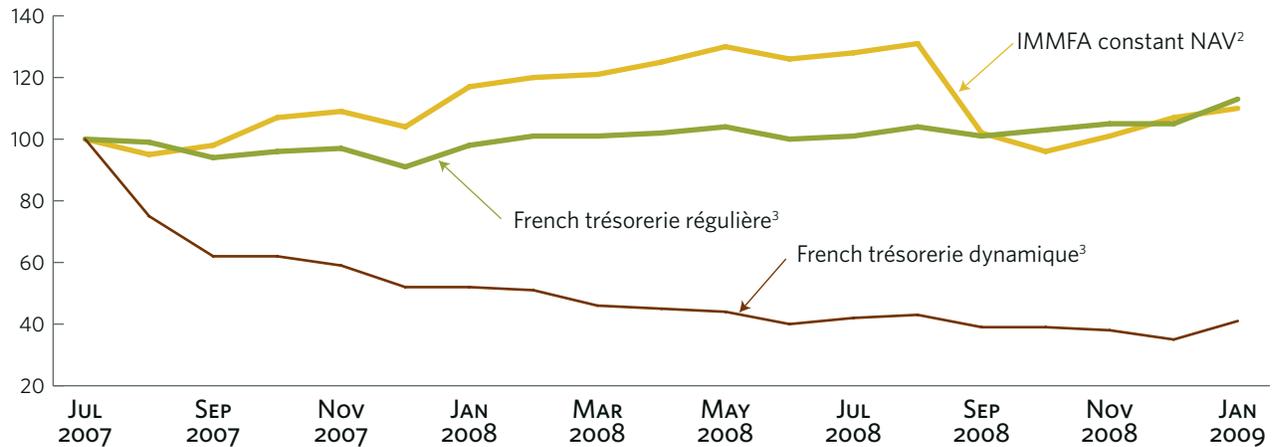
¹⁹⁸ EFAMA, Quarterly Statistical Release, No. 36 (February 2009).

¹⁹⁹ See Heather Dale, "Bond Funds Take Battering," *Ignites Europe* (December 22, 2008) (reporting that bond fund outflows year to date are €157.24 billion); Baptiste Aboulian, "October: Mutual Funds' Worst Nightmare," *Ignites Europe* (November 26, 2008) (noting that investors were taking money from equity and bond funds in part due to panic selling); Luxembourg Government Press Release, *supra* note 131; Standard & Poor's Equity Research, *supra* note 131.

FIGURE 8.2

Growth of IMMFA and French Money Market Fund Assets¹

Index=100, July 2007



¹ IMMFA and French money fund assets converted to USD using month-end exchange rates as of January 2009.

² IMMFA data excludes all government money fund assets.

³ All French money funds have a variable NAV and typically are accumulating shares, meaning dividends are accumulated rather than distributed as yield. The trésorerie dynamique funds generally may seek to outperform traditional money market indices and therefore invest in a broader range of instruments than the trésorerie régulière funds.

Sources: iMoneyNet and Europerformance

These examples demonstrate that despite having floating NAVs, fixed-income funds can experience significant outflows if their investors are highly risk-averse. The reason is that during periods of financial distress, markets for fixed income securities can become illiquid while the risk-averse investors in these funds are seeking to redeem their shares. As a result, investors' demands for redemptions can outstrip the ability of fixed income funds—even those with floating NAVs—to meet such redemptions because assets cannot be quickly sold in an illiquid market. Consequently, in our judgment, and as supported by the situations described above, money market funds with floating NAVs would not significantly reduce the risk of large movements of investor assets.

8.1.1.2 Implications for Investors

The benefits to investors of a stable \$1.00 NAV are many. The \$1.00 NAV provides 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 NAV. Asking or requiring money market funds to replace a stable \$1.00 NAV with a floating NAV would undermine their convenience and simplicity and would raise new accounting, legal, and tax hurdles whose resolution is uncertain, threatening the continued use of money market funds.

Tax convenience: With a stable \$1.00 NAV, all of a money market fund's returns are distributed to shareholders as income. This treatment greatly reduces tax and accounting burdens for both retail and institutional investors. It also relieves investors of having to consider the timing of purchases and sales of shares of money market

funds, as they must with variable NAV funds, to comply with the so-called “wash sale rule.”²⁰⁰ With a floating NAV, investors could be required to track the amount and timing of all money market fund purchases and sales, capital gains and losses, and share cost basis. To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors do not trade in and out of long-term mutual funds on a frequent basis, as many do with money market funds. Thus, if money market funds had a floating NAV, all share sales become tax-reportable events, potentially greatly magnifying investors’ tax and recordkeeping burdens.²⁰¹

Accounting simplicity: With a stable \$1.00 NAV, money market funds qualify as “cash equivalents” under accounting standards.²⁰² Because the NAV is fixed at \$1.00 per share, there is no need for investors to recognize gains or losses for financial accounting purposes. With a floating NAV, different accounting standards would apply.²⁰³ Companies would likely have to reclassify their holdings of money market funds as short-term investments falling into one of three categories:

- » **Held-to-maturity securities.** These are debt securities that the enterprise has the positive intent and ability to hold to maturity. Securities are reported at amortized cost, thus unrealized gains and losses are not recognized.
- » **Trading securities.** These are debt and equity securities that are bought and held principally for the purpose of selling them in the near term. Securities are reported at fair value, with changes in value over the reporting period included in earnings.
- » **Available-for-sale securities.** These are debt and equity securities not classified as either held-to-maturity securities or trading securities. Securities are reported at fair value, with changes in value over the reporting period included in shareholder equity.²⁰⁴

A security is classified at time of purchase, which determines the accounting treatment of gains and losses. Our sense is that money market funds with a floating NAV would have to be categorized as “available-for-sale.”²⁰⁵

²⁰⁰ 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 NAV.

²⁰¹ See Peter Crane, “MoneyVoices: Don’t Mess with \$1 NAV,” *Ignites* (February 5, 2009).

²⁰² For a description of cash equivalents as defined in FAS 95, see *supra* note 25.

²⁰³ Under this treatment, Financial Accounting Standards No. 115 (FAS 115) comes into play. FAS 115 is the governing standard for accounting for equity securities with readily determinable fair values and debt securities. It requires companies to classify their securities into one of three categories. The classification determines the accounting treatment of gains and losses. See FAS 115, Accounting for Certain Investments in Debt and Equity Securities (May, 1993).

²⁰⁴ The establishment of fair value is governed by Financial Accounting Standards No. 157 (FAS 157). The holder of the security must assign the security to one of three levels: (1) Level 1 is a security with a readily determinable market price, (2) Level 2 is a security without a readily determinable market price but is similar to other securities that do have readily determinable market prices, and (3) Level 3 is a security for which no determinable or comparable market prices exist. The holder of a Level 3 security normally uses modeling techniques to estimate fair value based on factors such as credit quality, likely maturity, and cash flows. A money market fund with a floating NAV likely would be deemed a Level 1 security because presumably its NAV would be posted at the end of the trading day as is currently the requirement. See FAS 157, Fair Value Measurements (September 2006).

²⁰⁵ Money market funds with floating NAVs may be ineligible for the held-to-maturity category because they are not debt securities and do not have a stated maturity. Such funds also would not appear to fit well in the trading category, as trading generally reflects active and frequent buying and selling, and with the objective of generating profits on short-term differences in price.

As a result, companies would face the additional burden of having to mark to market the value of their money market fund shares. Corporate treasurers would also have to track the costs of their shares and determine how to match purchases and redemptions for purposes of calculating gains and losses for accounting and tax purposes. Moreover, under the new treatment, companies could not enter and reconcile cash transactions nor calculate the precise amount of operating cash on hand until the money market fund's NAV became known at the end of the day, creating additional disincentives for corporations to use money market funds for cash management purposes.

Operational convenience: For corporations, a stable share price for money market funds simplifies operations: the stable \$1.00 NAV is known in advance, and often is hard-coded into companies' accounting and cash-tracking systems. The same is true for bank sweep account systems that have an option to invest in money market funds. Also, corporations sometimes have internal guidelines or cash management policies specifying that no more than a certain percentage of operating cash may be invested with a particular money market fund or that the company may invest in a given money market fund only if it exceeds a given size; these kinds of restrictions are easier to adhere to with a stable \$1.00 NAV. In addition, broker-dealers typically offer retail investors a range of features tied to their money market funds, including ATM access, checkwriting, and ACH and fedwire transfers. These features are generally provided only for accounts with a stable NAV. For example, money market funds typically offer retail investors same-day settlement on shares redeemed via "wire transfers" (where redemption proceeds are wired to an investor's bank account via fedwire), whereas bond funds typically offer *next day* settlement for wire transfers.

Legal and other constraints: Institutional investors often face legal or other constraints that allow them to invest their cash balances in money market funds only if such funds maintain a stable NAV. For example, most corporations have board-approved policies permitting them to invest operating cash balances (balances used to meet short-term needs) only in cash pools that do not fluctuate in value. Many indentures and other trust documents authorize investments in money market funds on the assumption that they seek to maintain a stable NAV. Many state laws and regulations also authorize municipalities, insurance companies and other state regulated entities to invest in stable NAV funds, sometimes explicitly including funds operating in compliance with Rule 2a-7.²⁰⁶ Thus, under a floating NAV, most state and local governments would no longer be able to use money market funds to help manage their cash.

In sum, there are substantial legal, tax, recordkeeping and other hurdles that would prevent the easy utilization of money market funds with a floating NAV. Some state and local governments and trust accounts would be precluded by law or regulations from using such a security. Internal policies would prevent certain corporations from using such a security. Presumably, some investors might be able to adapt over time to the additional tax, accounting, and recordkeeping burdens associated with floating NAV money market funds. The institutional cash managers with whom we spoke, however, indicated that they would most likely migrate to other, readily available cash-management products that are still able to offer "dollar-in, dollar-out." Such cash managers told us

²⁰⁶ See Appendix D for a summary of state specific money market fund permissible investments.

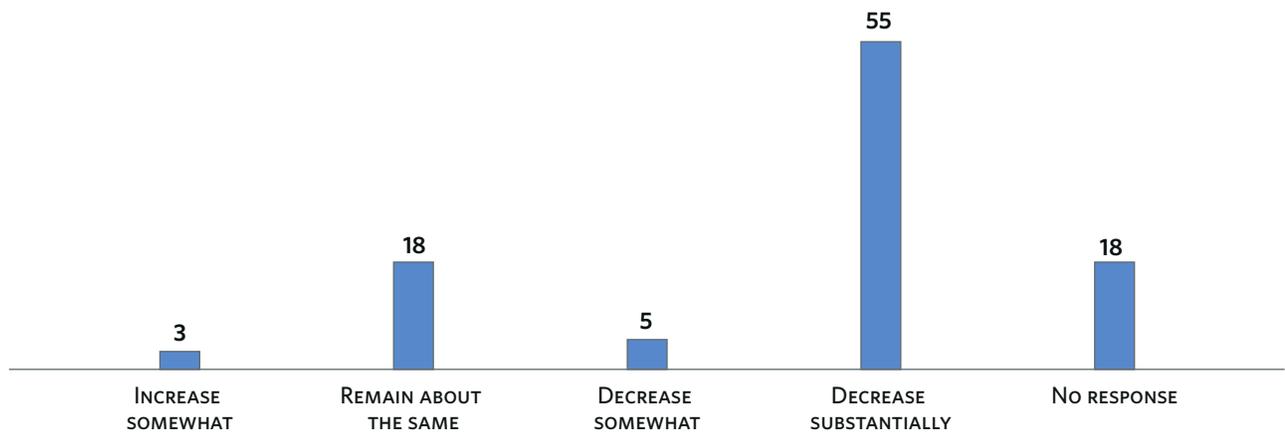
that the pecuniary and “headache” costs of adjusting to a floating NAV would outweigh the potential benefits of continuing to invest in money market funds.

Survey evidence supports this view. In January 2009, Treasury Strategies, Inc., conducted a survey of institutional cash managers, asking how they would respond to money market funds with a floating NAV. Fifty-five percent of the cash managers surveyed indicated that they would substantially decrease their investment in money market funds, and another 5 percent indicated that they would decrease their holdings somewhat (Figure 8.3). Less than one-fifth of the respondents indicated that they would continue to use money market funds to the same degree.

FIGURE 8.3

Institutional Cash Managers’ Expected Usage of Floating-NAV Money Market Funds

Percentage of respondents, January 2009



Note: Percentages do not add to 100 percent because of rounding.

Source: Treasury Strategies, Inc., flash survey of 78 institutional cash managers on January 30, 2009. Of the 78 institutional cash managers, 43 were commercial, 13 were education-related, four were state and local governments, four were financial institutions, and 14 were unclassified.

The survey also invited respondents to comment on the usefulness of money market funds with a floating NAV. The individual responses underscore the new accounting and valuation complexities that would accompany the change. Many anticipated that they would divest largely or even completely from their money market fund holdings. As one respondent stated, “if this investment is used for your daily operating needs, what a nightmare.”²⁰⁷ Another stated that he “would expect to see a level of chaos as investors struggle to revalue their liquidity positions each day. Transfers would be subject to pricing whims and possibly intraday volatility.”²⁰⁸ When specifically asked whether there would be any accounting ramifications or systems issues associated with a fluctuating NAV money market fund, a respondent expressed the views of many by declaring, “ABSOLUTELY. This is a terrible idea and will not work in practice. It would create accounting and tracking nightmares with

²⁰⁷ Treasury Strategies, Inc., Money Market Mutual Fund Flash Survey, Final Results (January 30, 2009) (providing verbatim responses of 78 survey participants). See Appendix K for full text of responses.

²⁰⁸ *Id.*

the daily data feeds necessary to pull in and apply.”²⁰⁹ Another said that in addition to accounting issues, “there would also be system implications, because the value adjusting would take time and could be complex given investments that are usually increased or decreased daily. Add that to changing the value and frankly that is too much complexity for a standard Treasury group.”²¹⁰

8.1.1.3 Alternative Investments and Implications for Markets

Prohibiting money market funds from having a stable NAV would likely lead many, if not most, institutional investors to migrate from money market funds to other financial products.²¹¹ There are three possible scenarios if money market funds were required to float their NAVs.

First, asset managers would find other means to offer a stable NAV cash pool, leading to rapid disintermediation from money market funds into pools outside the protections of the Investment Company Act. Prohibiting mutual funds from offering a stable NAV product thus would impose a regulatory barrier that disadvantages one form of pooled investment from another. As discussed in Section 5, there are a range of products and services that could readily provide access to the money market at a stable share price. Inflows into these alternative investments likely would create large pools of assets either domestically or offshore that would fall outside the careful regulatory framework in place for money market funds, and potentially increase the systemic risk to the financial system.

In the unlikely event that there were no clear means of creating alternative stable NAV investment pools, the cash held in money market funds would presumably 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 to be able to support their expanded balance sheets. Even if they could raise the capital to support this expansion, the market would be less efficient and the cost of short-term credit would rise. Furthermore, 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. Institutional and retail investors likely would place their cash in demand deposits, negotiable order of withdrawal accounts, and money market demand accounts to maintain the liquidity that they had with money market funds. Banks would then need to hold more liquid and higher quality assets in order to meet the requirements of this funding source, especially if institutional investors became concerned about counterparty risk and sought to withdraw their deposits during periods of financial stress. To the extent that banks did not increase their liquidity, systemic risk could *increase*.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ Retail investors have fewer alternatives available to them; over time, they would likely migrate to bank products despite the lower yield paid by those products.

Finally, if stable NAV funds were required to register as special purpose banks with deposit insurance and capital requirements, the cost of such a structure would certainly be greater than currently for money market funds. The risk levels of such banks holding highly rated, short-term securities, however, would be so low that properly priced insurance premiums and capital costs would allow these banks to offer yields above those on bank deposits. Insured special purpose banks offering superior yields would cause significant market dislocations, as discussed below.

8.1.2 Insurance Programs for Money Market Funds

This section considers and rejects the possibility of establishing a permanent insurance program for money market funds. We examine some possible scenarios of permanently extending insurance to money market funds or a special purpose bank, and discuss our concerns with how such insurance would affect the financial markets as a whole. Finally, we examine three possible structures for such an insurance program: pure federal insurance; pure private insurance; and a hybrid federal/private program.

8.1.2.1 Pure Federal Insurance

On September 19, 2008, to help stem the unusual outflows from money market funds, the Treasury Department instituted the Temporary Guarantee Program for Money Market Funds (Treasury Guarantee Program), a temporary money market fund guarantee program.²¹² For a quarterly fee of 1 to 1.5 basis point of assets under management, a fund could purchase from the Treasury Department a guarantee that would cover any losses for any assets in accounts in the money market fund as of September 19.

There is no industry consensus that a permanent federal insurance program is desirable for investors or financial markets. There is strong agreement that the Working Group's recommendations will enhance the existing risk-limiting provisions of money market funds. To the extent that concerns remain about the effects of significant redemptions on a fund, the best solution is to modify Rule 2a-7.

A permanent federal insurance program raises deep concerns about market distortions. For example, if there were an unlimited federal guarantee on investments in money market funds, the insured product would still likely offer a higher return than bank deposits in many market environments. Indeed, the historical yield differential on Treasury-only money market funds and bank deposits indicates that yields on the insured funds with no credit risk would be typically well above those offered on bank deposits. Insured funds would draw large sums of money from traditional banks, and possibly even other cash pools and direct investments in the money markets, causing significant disruption to the banking system and the money market. Finally, full insurance would reduce the sensitivity of investors to the credit, interest rate, liquidity, and client risks of their funds and erode an important role investors play in monitoring their funds' activities.

²¹² See Press Release, U.S. Department of the Treasury, Treasury Announces Guaranty Program for Money Market Funds (September 19, 2008), available at <http://www.ustreas.gov/press/releases/hp1147.htm>.

APPENDIX C

2. Consolidated Supervision of Non-Bank Financial Institutions

Recent experience in dealing with troubled but systemically significant non-bank financial institutions in some countries points to the need for consolidated regulation and supervision of such institutions.

Recommendation 2:

- a. For those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established.
- b. An appropriate prudential regulator should be designated for those large investment banks and broker-dealers that are not organized as bank holding companies.

3. Money Market Mutual Funds and Supervision

The widespread run on money market mutual funds has underscored the dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk. These have been compounded by provision of transaction account services, with withdrawals on demand at par, mimicking the services of regulated commercial banks. A regulatory distinction should be drawn between those services that are most appropriately housed in regulated and supervised banks, particularly the right to withdraw funds on demand at par, and those that can reasonably be provided by mutual funds focused on short-term fixed-rate credit instruments.

Recommendation 3:

- a. Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.
- b. Those institutions remaining as money market mutual funds should only offer a conservative investment option with modest upside potential at relatively low risk. The vehicles should be clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds, with no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV. Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US\$1.00 per share.

