January 10, 2011

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

Re: President’s Working Group Report on Money Market Fund Reform Options (File No. 4-619)

Dear Ms. Murphy:

The Investment Company Institute ("ICI") is pleased to provide its views on the October 2010 Report of the President’s Working Group on Financial Markets ("PWG") on Money Market Fund Reform Options ("Report"). The Report affirms that money market funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool for investors, and as an indispensable source of short-term financing for the U.S. economy. ICI and its members are committed to working with policymakers to bolster money market funds’ resilience to severe market stress so as to assure their continued ability to serve these purposes. We hope our comments below will be helpful to the constituent members of FSOC as they consider how best to advance toward this important policy goal.

1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.31 trillion and serve over 90 million shareholders.

As indicated in the SEC Release, the Report responds to a recommendation in a June 2009 Treasury Department paper on financial regulatory reform. The Treasury paper recommended that the PWG prepare a report assessing whether more fundamental changes were necessary to supplement anticipated SEC money market fund reforms. Notably, the Treasury paper urged caution in this effort. In particular, it recommended that the PWG carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as investor flight from these funds into unregulated or less regulated money market investment vehicles.

Consistent with the Treasury recommendation, the Report reflects a thoughtful and cautious approach, which we commend. The Report identifies several possible reform measures and discusses in a very balanced fashion potential advantages and disadvantages of each one. It is telling that—notwithstanding its sixteen-month incubation period—the Report does not specifically endorse any particular course of action. This outcome further underscores the reality that there is no simple answer to the question of how to make money market funds even more resilient in the face of the most severe market conditions.

ICI and its members have a strong interest in helping to find an appropriate way to address this question. In recognition of the importance of money market funds to the economy and investors, we have devoted significant time and resources to considering ways to strengthen the regulation of these funds and make them more robust under extreme market conditions—goals we share with the SEC and other policymakers. Beginning in the summer of 2007, early warnings began to surface that the mortgage lending crisis could have a detrimental effect on lenders. At that time, ICI started to analyze how the market climate could impair money market fund shareholders, and that process continued and intensified over the ensuing twelve months.

Since September 2008, both the SEC and the fund industry have made a great deal of progress toward their shared goals. In March 2009, ICI issued the Report of the Money Market Working Group, an industry study of the money market, of money market funds and other similar participants in the money market, and of recent market circumstances. The MMWG Report included wide-ranging proposals for the SEC to enhance money market fund regulation. When that report was issued, ICI’s members pledged to adopt those recommendations voluntarily.

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4 As discussed below, the SEC voted to adopt significant money market fund rule amendments in January 2010. See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010) (“MMF Reform Adopting Release”).

Early last year, the SEC approved far-reaching rule amendments that enhance its already-strict regime of money market fund regulation.6 The SEC indicated that the amendments are designed to strengthen money market funds against certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value (“NAV”) per share.7

The search for ways to make money market funds even more secure under the most adverse market conditions did not stop, however, with the adoption of the SEC’s reforms. For example, ICI and several of its members are actively engaged in a task force sponsored by the Federal Reserve Bank of New York to strengthen the underpinnings of a vital portion of the money market—tri-party repurchase agreements. These reforms are significant not only to money market funds, which provide about one-fifth of the lending in the repurchase agreement market, but to all participants in that market.

In addition, ICI and its members have devoted significant attention to a specific option advanced in the Treasury paper. The paper called for exploring measures to require money market funds “to obtain access to reliable emergency liquidity facilities from private sources.”8 Over the past 18 months, we have made substantial progress on developing a framework for such a facility, including how it could be structured, capitalized, governed, and operated. As discussed in detail later in this letter, we strongly endorse a liquidity facility for “prime” money market funds9 as the means to provide further stability to money market funds.10

Summary of Comments

A lot has happened since ICI and its members first began to focus intently on the experience of money market funds during the financial crisis. Yet none of the many developments during that period has changed our fundamental conviction: money market funds provide singular benefits to investors

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6 See MMF Reform Adopting Release.
7 Id. at 10060.
8 Treasury paper at 38.
9 “Prime” money market funds are funds that may invest in high-quality, short-term money market instruments including Treasury and government obligations, certificates of deposit (“CDs”), repurchase agreements, commercial paper, and other money market securities. They do not include tax-exempt, government, or Treasury money market funds. Based on our study of money market funds, we strongly believe that further reforms should be limited to prime funds, as their role in the broader money market can directly affect the commercial paper market. We do not believe that other types of money market funds pose the same concerns and, in fact, government and Treasury funds saw substantial inflows during the last market crisis. Indeed, investors redeemed $396 billion from prime money market funds and invested $294 billion in government money market funds from September 10, 2008 to October 1, 2008.
10 Although ICI has worked hard to build a consensus on this issue in the fund industry, given the complexities of the issue and the variety of fund business models, industry support is not unanimous.
and the economy and the essential characteristics of these funds can and should be preserved even as measures are taken to fortify them against the worst market turmoil.

With this in mind, our comments below begin with an overview of the U.S. money market to provide context. Next, we describe the regulation of money market funds, including the SEC’s recent reforms. We then examine each of the reform options outlined in the Report.

Three principles have guided our analysis of possible additional money market fund reform measures. First, given the tremendous benefits money market funds provide to investors and the economy, it is imperative to preserve this product’s essential characteristics. Second, in devising a solution, we need to stay focused on the objective policymakers are seeking to achieve: to strengthen money market funds even further against adverse market conditions and enable them to meet extraordinarily high levels of redemption requests. Finally, any solution must be designed to promote this important policy goal while minimizing the potential for unintended negative consequences.

Our examination of the reform options outlined in the Report and other reform ideas has led us to the same conclusion the PWG apparently reached: namely, that there is no “silver bullet” for safeguarding money market funds against the severest market distress. Each option has its drawbacks, ranging from potential detrimental impacts on money market funds, their investors, and the market, to complicated regulatory, structural, and operational hurdles. Nevertheless, we believe the option of a private emergency liquidity facility for prime money market funds has the most promise for addressing policymakers’ remaining concerns with the least negative impact.

We believe the other options presented would not solve the problem at hand, could increase rather than decrease systemic risk, would adversely impact the market, or would result in some combination of the foregoing. In many cases, transitioning to a new approach in and of itself would have systemic risk implications. While we are unable to support any of those other approaches,11 we propose one additional measure: a rule mandating that intermediaries provide information to facilitate money market funds’ ability to comply with “know your investor” requirements.

A summary of our comments on a private emergency liquidity facility and other possible money market fund reform measures follows.

**Private Emergency Liquidity Facility for Money Market Funds.** Over the past year and a half, ICI has worked to develop a model for an emergency liquidity facility for prime money market funds. Our proposed liquidity exchange facility (“LF”) is an industry-sponsored solution intended to serve as a liquidity backstop for prime money market funds during times of unusual market stress. It would be formed as a state-chartered bank or trust company and capitalized through a combination of initial contributions from prime fund sponsors and ongoing commitment fees from member funds. The LF would gain additional capacity from the issuance of time deposits to third parties as well as access to the

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11 As discussed in Section III.E., it is conceivable that we could support a two-tier approach with “enhanced protections” for stable NAV money market funds, depending on the precise details of how such an approach would work.
Federal Reserve discount window in the normal course. All prime money market funds would be required to participate in the LF.

During times of unusual market stress, the LF would buy high-quality, short-term securities from prime money market funds at amortized cost. In so doing, the LF would (1) enable funds to meet redemptions while maintaining a stable $1.00 NAV—even when markets are frozen—and (2) help protect the broader money market by allowing funds to avoid the need to sell portfolio instruments into a challenging market. Also, the very existence of such a liquidity backstop could provide reassurance to investors and thereby limit the risk that liquidity concerns in a single fund might spur increased redemptions in all prime money market funds.

Importantly, the LF is not intended to provide credit support; rather, it is intended to meet liquidity needs brought on by market stresses through the acquisition of high-quality instruments. Furthermore, the LF would provide a liquidity backstop only after a substantial portion of a fund’s legally mandated liquidity positions, discussed in Sections II and III.A., are utilized.

As discussed further below, our LF model addresses many of the policy concerns the Report identifies with respect to a private emergency liquidity facility. While some hurdles remain, such as the cost of participation and the need for regulatory action to implement our design, we believe that the prime money market fund industry generally could support the LF as the best option for further reform so long as: (1) prime money market funds participating in the LF would be permitted to use amortized cost and continue to seek to maintain a stable NAV;12 (2) the cost of participation is reasonable given the current yield environment; and (3) the LF is a factor when regulators consider bank liquidity and capital requirements for banks that sponsor money market funds.

Requiring Money Market Funds to “Float” Their NAVs. As we, our members, issuers, and investors have stated many times, there is strong opposition to requiring money market funds to float their NAVs (i.e., to have an NAV that fluctuates based on the current market prices of portfolio instruments, rather than maintaining a stable $1.00 NAV through the use of the amortized cost valuation method, as explained in Section II). We are highly skeptical that such a requirement would reduce risks in any meaningful way. There is compelling evidence that a substantial portion of money market fund investors either would be unable or unwilling to use a floating NAV money market fund. As a result, the primary effect of requiring money market funds to float their NAVs would be a major restructuring and reordering of intermediation in the short-term credit markets, which would not reduce—and might well increase—systemic risk.

Mandatory Redemptions in Kind. We do not believe that requiring money market funds to make certain large redemptions “in kind” (i.e., through the distribution of a proportionate amount of their portfolio instruments to redeeming shareholders) would be an effective solution for the issue at

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12 The amortized cost method of valuation for money market funds is discussed in Section II.

13 All other types of money market funds also would continue to be permitted to use amortized cost and seek to maintain a stable NAV, subject to the rules governing money market funds that currently exist.
hand. Investors would be likely to work around the requirement such as by allocating investments among multiple funds in amounts below the anticipated redemption threshold. Developing regulatory standards that would establish appropriate circumstances and threshold levels would present significant challenges. Even if this could be established, we are concerned that an in-kind redemption requirement, if triggered, could exacerbate market dislocations. A redeeming shareholder needing liquidity would be forced to sell into a declining market, adversely impacting not only the redeeming shareholder and the redeeming fund (and its remaining shareholders), but also all other money market funds holding the same portfolio instruments. Difficult operational hurdles also cause us to question the practicality of this approach. We believe that funds’ current authority to redeem shares in kind voluntarily appropriately enables them to assess the advisability of redemptions in kind under the circumstances facing the fund and the market at the time. We recommend that the SEC provide additional guidance about the use of this voluntary authority so that money market funds might use this tool to greater effect in the event of another market crisis.

**Insurance Programs for Money Market Funds.** Having reexamined the possibility of developing some form of money market fund insurance—whether federal, private, or a hybrid of the two—we continue to conclude that this is not a viable option. To be effective in the kind of environment the global financial system experienced in 2008, any insurance program would need to cover all prime money market fund assets. An insurance program of that breadth would cause disintermediation from banks, resulting in negative consequences for the financial markets as a whole and the banking sector in particular. Such a program would need to have some kind of federal backstop as well as some access to the discount window to be effective or credible. Moreover, pooling of credit risk across money market fund providers raises moral hazard concerns.

**Two-Tier System with Enhanced Protections for Stable NAV Money Market Funds.** The Report suggests the possibility of having two types of money market funds—stable NAV money market funds subject to “enhanced” regulatory protections and floating NAV funds perhaps operating under less stringent restrictions than currently apply. More details about the precise nature of the “enhanced protections” would be necessary before ICI could determine whether to support or reject this approach.

**Two-Tier System with Stable NAV Money Market Funds Reserved for Retail Investors.** Under this option, stable NAV funds would be made available only to “retail” investors, while “institutional” investors would be restricted to floating NAV funds or alternative products. We believe that—as the Report acknowledges—the inability or unwillingness of many institutional investors to switch to floating NAV money market funds means that this approach could have the same unintended consequences as a requirement that all money market funds adopt floating NAVs. Many of these investors likely would seek to move their assets into less regulated money market fund alternatives. Moreover, we strongly question the feasibility of categorizing “retail” and “institutional” investors for this purpose in a way that makes sense and can be enforced effectively.
Regulating Stable NAV Money Market Funds as Special Purpose Banks. The Report raises the possibility of requiring bank-like regulation of stable NAV money market funds. There is no persuasive case for doing so; indeed, each of several possible motivations for such an approach is problematic. For example, judging from the proliferation of banking crises around the world over the past two decades, it is far from apparent that the bank regulatory and structural model is superior to that of mutual funds, including money market funds in particular. In addition, if the motivation behind this idea is to give money market fund investors deposit insurance protection, such insurance would have to be unlimited to protect against rapid redemptions in severely distressed market conditions. Unlimited deposit insurance could skew the competitive landscape away from bank deposits toward money market funds, possibly resulting in vast flows from one financial sector to another, which raises systemic risk concerns. If the objective is to require capital as a buffer against investment risk, it is unclear whether the business model for money market funds would remain viable. If the idea is to give money market funds a back-up source of liquidity during periods of financial stress, ICI’s view is that our proposed LF is a better and far less disruptive option.

Enhanced Constraints on Money Market Fund Substitutes. The Report discusses the possibility of imposing enhanced constraints on alternative investments to money market funds. These constraints would be intended to address concerns that new regulatory measures that reduce the appeal of money market funds might cause some investors to move their assets into less regulated products, thereby increasing systemic risk. Given the wide variety of alternative cash management products, many of which are beyond the jurisdictional reach of domestic regulators, we do not believe such an approach would be successful in achieving its goal.

Additional Reform for Consideration—Investor Transparency. In addition to a private emergency liquidity facility for prime money market funds, the fund industry has continued to explore other ideas for reform of money market funds and the overall money market. One such idea that we support is consideration of a new SEC rule mandating that intermediaries (e.g., broker-dealers) disclose to money market funds information about underlying investors in the funds to facilitate compliance with “know your investor” requirements. Greater transparency around investors owning shares in money market funds through intermediaries would mitigate risk by improving the funds’ ability to manage liquidity needs.
I. The U.S. Money Market

The money market is a huge, complex, and significant part of the nation's financial system in which many different participants interact each business day. This section provides essential context about the U.S. money market by describing: the structure of the market; the vehicles through which investors can access money market instruments (many of which compete directly with money market funds); the unique characteristics of money market funds; and the role and growth of money market funds as financial intermediaries in the money market.

A. Structure of the U.S. Money Market

In the United States, the market for debt securities with a maturity of one year or less is generally referred to as "the money market."\(^1\) The money market is an effective and lower cost mechanism for helping borrowers finance short-term mismatches between payments and receipts. For example, a corporation might borrow in the money market if it needs to make its payroll in 10 days, but will not have sufficient cash on hand from its accounts receivable for 45 days.

The main borrowers in the U.S. money market are the U.S. Treasury, U.S. government agencies, state and local governments, financial institutions (primarily banks, finance companies, and broker-dealers), and nonfinancial corporations. Borrowers in the money market are known as "issuers" because they issue short-term debt securities. U.S. money market funds also provide substantial credit to foreign financial institution issuers in overseas money markets.

Reasons for borrowing vary across the types of issuers. Governments may issue securities to temporarily finance expenditures in anticipation of tax receipts. Mortgage-related U.S. government agencies borrow in the money market to help manage interest-rate risk and rebalance their portfolios. Banks and finance companies often use the money market to finance their holdings of assets that are relatively short-term in nature, such as business loans, credit card receivables, auto loans, or other consumer loans.

Corporations typically access the money market to meet short-term operating needs, such as accounts payable and payroll. At times, corporations may use the money market as a source of bridge financing for mergers or acquisitions until they can arrange or complete longer-term funding. In addition, all types of borrowers may seek to reduce interest costs by borrowing in the money market when short-term interest rates are below long-term interest rates.

Borrowers use a range of money market securities to help meet their funding needs. The U.S. Treasury issues short-term debt known as Treasury bills. Government sponsored agencies such as Fannie Mae and Freddie Mac issue Benchmark and Reference bills, discount notes, and floating rate notes (agency securities). Municipalities issue cash-flow notes to provide short-term

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\(^1\) Securities that have final maturities of more than one year but whose yields are reset weekly, monthly, or quarterly also are generally considered part of the money market.
funding for operations, and bond anticipation notes and commercial paper to fund the initial stages of infrastructure projects prior to issuing long-term debt. They also issue variable rate demand notes to gain access to the short end of the yield curve. Banks and other depositories issue large CDs and Eurodollar deposits. Banks and broker-dealers also use repurchase agreements, a form of collateralized lending, as a source of short-term funding.

Corporations, banks, finance companies, and broker-dealers also can meet their funding needs by issuing commercial paper, which is usually sold at a discount from face value, and carries repayment dates that typically range from overnight to up to 270 days. Commercial paper can be sold as unsecured or asset backed. Unsecured commercial paper is a promissory note backed only by a borrower’s promise to pay the face amount on the maturity date specified on the note. Firms with high quality credit ratings are often able to issue unsecured commercial paper at interest rates that are less than bank loans. Asset-backed commercial paper (“ABCP”) is secured by a pool of underlying eligible assets. Examples of eligible assets include trade receivables, residential and commercial mortgage loans, mortgage-backed securities, auto loans, credit card receivables, and similar financial assets. Commercial paper has been referred to as “the grease that keeps the engine going . . . . the bloodline of corporations.” One alternative to issuing commercial paper is to obtain a bank line of credit, but that option is generally more expensive.

Although the size of the U.S. money market is difficult to gauge precisely (because it depends on how “money market” instruments are defined and how they are measured), it is clear that a well-functioning money market is important to the well-being of the macro-economy. We estimate that the outstanding values of the types of short-term instruments typically held by taxable money market funds and other pooled investment vehicles (as discussed below)—such as

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15 CDs are generally classified as large (or jumbo) or small. Large or jumbo CDs are issued in amounts greater than $100,000. Small CDs are issued in amounts of $100,000 or less.

16 In addition, U.S. banks (including branches of foreign banks in the United States) can lend to each other in the federal funds market. Banks keep reserves at Federal Reserve Banks to meet their reserve requirements and to clear financial transactions. Transactions in the federal funds market enable depository institutions with reserve balances in excess of reserve requirements to lend reserves to institutions with reserve deficiencies. These loans are usually made overnight at the prevailing federal funds rate. Also, banks worldwide can provide funding to each other via the interbank lending market for maturities ranging from overnight to one year at the prevailing London Interbank Offered Rate.


18 Id. The expense of these credit lines is expected to increase, and their availability may decrease, as the Basel Committee on Banking Supervision’s endorsement of capital and liquidity reforms for banks (known as “Basel III”) are implemented and banks are required to include credit commitments in their liquidity, net stable funding, and other calculations. See Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 4 (Basel Committee on Banking Supervision, December 2010).
commercial paper, large CDs, Treasury and agency securities, repurchase agreements, and Eurodollar deposits—total roughly $11 trillion.\textsuperscript{19}

While these money market instruments fulfill a critical need of the issuers, they also are vitally important for investors seeking both liquidity and preservation of capital. Major investors in money market securities include money market funds, banks, businesses, public and private pension funds, insurance companies, state and local governments, broker-dealers, individual households, and nonprofit organizations.

B. Financial Intermediaries for Money Market Instruments

Investors can purchase money market instruments either directly or indirectly through a variety of intermediaries. In addition to money market funds, these include bank sweep accounts, investment portals, and short-term investment pools, such as offshore money funds, enhanced cash funds, and ultra-short bond funds, as described below.

- **Money market funds.** Money market funds offer investors a variety of features, including return of principal, liquidity, and a market-based rate of return, all at a reasonable cost.\textsuperscript{20} These funds are registered investment companies that are regulated by the SEC under the federal securities laws, including Rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"). That rule, which was substantially enhanced in January 2010, contains numerous risk-limiting conditions intended to help a fund achieve the objective of maintaining a stable NAV using amortized cost accounting.\textsuperscript{21} Money market fund shares typically are publicly offered to all types of investors.

- **Bank or broker sweep accounts.** These sweep accounts are passive investment vehicles that require no further action on the part of the customer once the account has been established. Sweeps usually occur at the end of the day, and affect whatever balances remain in the account after all other transactions have been posted. There may be a target balance, above which all funds are swept, or no target at all. Sweep accounts are invested in a variety of money market instruments including Eurodollar deposits, money market funds, repurchase agreements, and commercial paper.

- **Investment portals.** Portals are online interfaces that provide clients the ability to invest easily and quickly in short-term securities or short-term investment pools. Although portals generally focus on a single investment option, such as time deposits

\textsuperscript{19} For complete data sources, see Figure 2.

\textsuperscript{20} These and other characteristics of money market funds are described more fully in Section I.C.

\textsuperscript{21} The regulation of money market funds, including Rule 2a-7’s risk-limiting conditions and the amortized cost method of valuation, is discussed in greater detail in Section II.
or money market funds, many are multi-provider and offer clients an array of choices within the investment option. Corporate treasurers and other institutional investors find portals to be a convenient way to compare money market funds in terms of their assets under management, ratings, yields, and average maturities.

- **Short-term investment pools.** In addition to money market funds, several types of financial intermediaries purchase large pools of short-term securities and sell shares in these pools to investors. Such pools include offshore money funds, enhanced cash funds, ultra-short bond funds, short-term investment funds, and local government investment pools. Each of these pools is described below. Although the basic structure is similar across these products, there are key differences among them and among the types of investors to whom they are offered.

  o **Offshore money funds** are investment pools domiciled and authorized outside the United States. There is no global definition of a “money fund,” and many non-U.S. money funds do not maintain a stable NAV. These funds are typically denominated in the currency of their domicile. In Europe, money funds are available in U.S. dollars, Euros, Swiss Francs, or sterling and many accrue dividends, causing their NAVs to steadily increase. European money funds historically were not bound by Rule 2a-7-like restrictions; however, CESR issued guidelines in May 2010 with criteria for European money funds to operate as either “short-term money market funds” or “money market funds.” CESR’s two-tier categorization is intended to recognize a distinction in Europe between: (1) a “short-term money market fund,” which may have a stable or floating NAV and, among other conditions, must operate with a shorter weighted average maturity (no more than 60 days) and weighted average life (no more than 120 days); and (2) a longer-term “money market fund,” which only may have a floating NAV and, among other conditions, operate with a longer weighted average maturity (no more than 6 months) and

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23 While U.S. mutual funds must annually distribute their income and capital gains, many offshore funds tend to roll-up their income and capital gains. Offshore funds with this “roll-up” treatment therefore provide two advantages over investments in comparable U.S. funds: (1) tax deferral, and (2) conversion of ordinary income into capital gains, which are taxed at a lower rate.

24 On January 1, 2011, CESR became the European Securities and Markets Authority.
weighted average life (no more than 12 months). Europe has an established and strong market of stable NAV money funds, including a large number of dollar-denominated money funds that are triple-A rated by credit rating agencies. The dollar-denominated stable NAV money funds are used by multinational institutions and others seeking dollar-denominated money funds. The market for the European triple-A rated stable NAV money funds has grown from less than $1 billion in 1995 to approximately $640 billion as of December 10, 2010, with approximately $296 billion of those assets in dollar-denominated money funds (both prime and government money funds).  

- **Enhanced cash funds** are investment pools that typically are not registered with the SEC. These funds seek to provide a slightly higher yield than money market funds by investing in a wider array of securities that tend to have longer maturities and lower credit quality. In seeking those yields, however, enhanced cash funds are not subject to and therefore need not abide by the SEC rule restrictions imposed on money market funds governing the liquidity, credit quality, diversification, and maturity of investments. Enhanced cash funds target a $1.00 NAV, but have much greater potential exposure to fluctuations in their portfolio valuations. Enhanced cash funds are privately offered to institutions, wealthy clients, and certain types of trusts. They also may be referred to as “money market plus funds,” “money market-like funds,” “enhanced yield funds,” or “3(c)(7) funds” (after the legal exception from regulation under the Investment Company Act upon which they typically rely).

- **Ultra-short bond funds** are comparable to enhanced cash funds in their portfolio holdings, but most of these funds are not operated to maintain a stable NAV. These funds generally are SEC-registered investment companies and are offered for sale to the public.

- **Short-term investment funds (“STIFs”)** are collective investment funds operated by bank trust departments in which the assets of different accounts in the trust department are pooled together to purchase short-term securities. STIFs are offered to accounts for personal trusts, estates, and employee benefit plans that are exempt from taxation under the Internal Revenue Code. STIFs sponsored by national banks are regulated by the Office of the Comptroller of the Currency (“OCC”). Under OCC regulations, STIFs, like money market funds, use amortized cost accounting to value their assets.

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25 Institutional Money Market Fund Association (“IMMFA”), statistical data available at http://www.immfa.org/stats/default.asp. Total assets of IMMFA funds at the beginning of 2009 were approximately $580 billion and have continued to grow.
Local government investment pools ("LGIPs") typically refer to state- or county-operated funds offered to cities, counties, school districts, and other local and state agencies so they can invest money on a short-term basis. The agencies expect this money to be available for withdrawal when they need it to make payrolls or pay other operating costs. Most LGIPs currently available are not registered with the SEC, as states and local state agencies are excluded from regulation under the federal securities laws. Investment guidelines and oversight for LGIPs may vary from state to state.

C. Characteristics of Money Market Funds

Investors expect to purchase and redeem shares of money market funds at a stable NAV, typically $1.00 per share. Investors view a stable $1.00 NAV as a crucial feature of money market funds, because it provides great convenience and simplicity in terms of its tax, accounting, and recordkeeping treatment. Investment returns are paid out entirely as dividends, with no capital gains or losses to track. This simplicity and convenience are crucial to the viability of money market funds because, in contrast with other mutual funds, they are used primarily as a cash management tool. In money market funds that allow check-writing, the $1.00 NAV gives investors assurance that they know their balance before they draw funds. Without a stable $1.00 NAV, many, if not most, investors would likely migrate to other available cash management products that offer a stable $1.00 NAV as they seek to minimize tax, accounting, and recordkeeping burdens.

In addition to a stable $1.00 NAV, money market funds seek to offer investors three primary features: return of principal, liquidity, and a market-based rate of return.

- **Return of principal.** Money market funds seek to offer investors return of principal. Although there is no guarantee of this (and investors are explicitly warned that this may not always be possible), money market funds manage their portfolios very conservatively.

- **Liquidity.** Money market funds provide “same-day” liquidity, allowing investors to redeem their shares at a price per share of $1.00 and generally to receive the proceeds that day. Retail investors value this feature because it allows them to manage cash both for daily needs and to buy or sell securities through brokers. Corporate cash managers must have daily liquidity in order to manage accounts payable and payrolls.

- **Market-based rates of return.** Unlike competing bank deposit accounts such as money market deposit accounts ("MMDAs"), money market funds offer investors market-based yields.
Other important characteristics of money market funds include:

- **High-quality assets.** Money market funds may invest only in liquid, investment-grade securities. Money market funds maintain their own credit departments to manage their credit risk exposures. Institutional investors value this independent credit analysis, either because they may not have sufficient expertise in credit analysis or because money market funds can provide it more cost effectively. Money market funds generally do not have leverage or off-balance sheet exposure.

- **Investment in a mutual fund.** Money market funds are mutual funds. Their investors receive all of the same regulatory protections that other mutual fund investors have under the Investment Company Act (see Section II). Most money market funds also are publicly offered and therefore registered under the Securities Act of 1933.

- **Diversification.** Money market funds often invest in hundreds of different underlying securities, providing investors diversification that would otherwise be difficult, if not impossible, to replicate and manage through an individual portfolio or through a single bank.

- **Professional asset management.** Like other mutual funds, the assets of money market funds are professionally managed so as to achieve the fund’s objectives, which are laid out in its prospectus.

- **Economies of scale.** Money market funds provide a low-cost cash management vehicle for investors. In part, money market funds achieve low cost through economies of scale—pooling the investments of hundreds to thousands of individual retail investors, sometimes with the large balances of institutional investors.

**D. Money Market Funds as Financial Intermediaries**

Money market funds efficiently channel dollars from all types of investors to a wide variety of borrowers, and over the past 25-plus years have become an important part of the U.S. money market. As of October 2010, 665 money market funds had a combined $2.8 trillion in total net assets under management, up from $180 billion as of year-end 1983, the year the SEC adopted Rule 2a-7 (Figure 1).
The Report notes that “[w]ith nearly $3 trillion in assets under management, money market funds are important providers of credit to businesses, financial institutions, and governments. Indeed, these funds play a dominant role in some short-term credit markets.” By investing across a spectrum of money market instruments, money market funds provide a vast pool of liquidity to the U.S. money market. As of October 2010, money market funds held $2.2 trillion of repurchase agreements, CDs, U.S. Treasury and agency securities, commercial paper, and Eurodollar deposits. Taxable money market funds invest primarily in these short-term instruments and their holdings represent about twenty percent of the total outstanding amount of such money market instruments, underscoring the current importance of money market funds as an intermediary of short-term credit (Figure 2). In comparison, we estimate that money market funds held less than 10 percent of these same instruments in 1983.

26 Report at 7.
27 As of October 2010, approximately 90 percent of all taxable money market funds’ total net assets were invested in these instruments. The remaining 10 percent of assets were invested in bank and corporate notes, bankers’ acceptances, cash reserves less any liabilities, and other miscellaneous assets.
Money market funds also are major participants within individual categories of taxable money market instruments. As of October 2010, these funds held 45 percent of outstanding short-term U.S. agency securities, 37 percent of commercial paper, 12 percent of short-term Treasury securities, 19 percent of repurchase agreements, 25 percent of large CDs, and 7 percent of Eurodollar deposits.

Tax-exempt money market funds are a significant source of funding to state and local governments for public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. As of May 2010, tax-exempt money market funds had $352 billion under management and accounted for an estimated 56 percent of outstanding short-term municipal debt (Figure 2).
## Figure 2

### Selected Money Market Instruments

**October 2010**

<table>
<thead>
<tr>
<th>Total</th>
<th>Money market fund holdings</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total taxable instruments</strong></td>
<td>$10,700</td>
<td>$2,213</td>
</tr>
<tr>
<td>Agency securities</td>
<td>901</td>
<td>409</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>1,051</td>
<td>384</td>
</tr>
<tr>
<td>Treasury securities</td>
<td>2,551</td>
<td>304</td>
</tr>
<tr>
<td>Repurchase agreements</td>
<td>2,894</td>
<td>549</td>
</tr>
<tr>
<td>Certificates of deposit</td>
<td>1,802</td>
<td>457</td>
</tr>
<tr>
<td>Eurodollar deposits</td>
<td>1,501</td>
<td>110</td>
</tr>
<tr>
<td><strong>Total tax-exempt instruments</strong></td>
<td>625</td>
<td>352</td>
</tr>
</tbody>
</table>

1. Debt issued by Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency due to mature by the end of October 2011; category excludes agency-backed mortgage pools.

2. Marketable Treasury securities held by the public due to mature by the end of October 2011.


4. Certificates of deposit are large or jumbo CDs, which are issued in amounts greater than $100,000.

5. Category includes claims on foreigners for negotiable CDs and non-negotiable deposits payable in U.S. dollars, as reported by banks in the U.S. for those banks or those banks’ customers’ accounts.

6. Estimated as of May 2010. Category includes variable rate demand notes, auction rate securities, tender option bonds, and other short-term debt. Category does not include long-term fixed-rate debt due to mature by the end of December 2010.

For nearly 40 years, financial intermediation has developed outside of banks—a phenomenon that has benefited the economy by providing households and businesses more access to financing at a lower cost. Growth in money market fund assets has helped to deepen the commercial paper market for financial and nonfinancial issuers. Many major nonfinancial corporations have come to rely heavily on the commercial paper market for short-term funding of their day-to-day operations at interest rates that are typically less than rates on bank loans. The need for financial issuers to comply with Basel III, such as the new short-term liquidity ratio, will make the ready availability of money market funds to supply liquidity more necessary than ever.

In 1983, the year the SEC adopted Rule 2a-7, the commercial paper market had only about $185 billion outstanding—about one-fifth of the $990 billion in non-mortgage loans then on the books of banks and finance companies. At its peak in mid-2007, prior to the start of the financial crisis, the commercial paper market provided a total of $2.1 trillion in financing—equivalent to over half of the $3.6 trillion in on-balance sheet non-mortgage bank and finance company loans.

In August 2007, outstanding commercial paper, particularly ABCP, began to contract as reports of defaults in commercial paper issued by structured investment vehicles (“SIVs”) started to surface. While money market funds shied away from buying additional paper issued by SIVs, they continued to supply credit to other financial and nonfinancial corporations in the commercial paper market. Over the next two years, even as the commercial paper market as a whole contracted, money market funds’ share of financing in this market grew steadily, reaching a peak of 46 percent ($520 billion out of a total of $1.1 trillion) at the end of 2009. As of October 2010, money market funds held $384 billion (37 percent of the market) in outstanding commercial paper (Figure 3).
The regulation of money market funds is one of the greatest success stories in the history of financial services regulation. The flexible and resilient regulatory structure created by the Investment Company Act has been critical in allowing this product to achieve its full potential. Indeed, since this structure was put into place in 1983, $330 trillion—almost one-third of a quadrillion dollars—have flowed in and out of money market funds.

Money market funds, like all mutual funds, are subject to a comprehensive regulatory scheme under the federal securities laws that has worked extremely well for over 70 years. Their operations are subject to all four of the major federal securities laws administered by the SEC, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and, most importantly, the Investment Company Act.28

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of

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28 Mutual funds also are subject to most of the requirements that apply to U.S. corporate issuers under the Sarbanes-Oxley Act of 2002.
the Investment Company Act are to: (1) provide for a high degree of oversight and accountability; (2) ensure that investors receive sufficient information about the fund, including its fees and expenses, and that the information is accurate and not misleading; (3) protect the physical integrity of the fund’s assets by having explicit rules concerning the custody of portfolio securities; (4) prohibit or restrict affiliated transactions and other forms of self-dealing; (5) prohibit unfair and unsound capital structures (by, for example, placing constraints on the use of leverage); and (6) ensure the fairness of transactions in fund shares.

One defining feature of money market funds is that, in contrast to other mutual funds, they seek to maintain a stable NAV or share price, typically $1.00 per share. The Investment Company Act and applicable rules generally require mutual funds to calculate current NAV per share by valuing their portfolio securities for which market quotations are readily available at market value and other securities and assets at fair value as determined in good faith by the board of directors. Rule 2a-7 exempts money market funds from these provisions and permits them to determine their NAV using the amortized cost method of valuation instead, which facilitates money market funds’ ability to maintain a stable NAV. Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount. The basic premise underlying money market funds’ use of the amortized cost method of valuation is that high-quality, short-term debt securities held until maturity will return to the amortized cost value, regardless of any current disparity between the amortized cost value and market value, and would not ordinarily be expected to fluctuate significantly in value. Therefore, Rule 2a-7 permits money market funds to value portfolio securities at their amortized cost so long as the deviation between the amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current NAV per share of the fund.29

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, Rule 2a-7 contains several conditions designed to limit the fund’s exposure to certain risks by governing the credit quality, liquidity, maturity, and diversification of a money market fund’s investments.30

These risk-limiting conditions include requirements that money market funds:

- only invest in high-quality securities that mature in 13 months or less (with exceptions for certain types of securities including variable and floating rate securities that have an interest

29 Rule 2a-7 also permits money market funds to use the penny rounding method of pricing. Under this method, share price is determined by valuing securities either at market value, fair value, or amortized cost, and rounding the per share NAV to the nearest cent on a share price of $1.00.

30 Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule’s risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.
rate reset of no more than 397 days or a demand feature), which a fund’s board of directors (or its delegate) determines present minimal credit risks, and a requirement that at least 97 percent of a fund’s assets be invested in securities held in government obligations or other securities that either received the highest short-term rating or are of comparable quality;

- maintain a sufficient degree of portfolio liquidity necessary to meet reasonably foreseeable redemption requests, including a requirement that all taxable funds maintain at least 10 percent of assets in cash, Treasury securities, or securities that convert into cash within one day, and that all funds maintain at least 30 percent of assets in cash, Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week;

- maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk; and

- maintain a diversified portfolio designed to limit a fund’s exposure to the credit risk of any single issuer.

In addition, Rule 2a-7 includes certain procedural requirements overseen by the fund’s board of directors. One of the most important is the requirement that the fund periodically “shadow price” the amortized cost NAV of the fund’s portfolio against the mark-to-market NAV of the portfolio. If there is a difference of more than ½ of 1 percent (or $0.005 per share), the fund’s board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) $1.00 per share, an event colloquially known as “breaking the dollar.” Regardless of the extent of the deviation, Rule 2a-7 also imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Moreover, all funds must dispose of a defaulted or distressed security (e.g., one that no longer presents minimal credit risks) “as soon as practicable,” unless the fund’s board of directors specifically finds that disposal would not be in the best interests of the fund.

Money market funds also must disclose in their prospectus that “an investment in the [f]und is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the [f]und seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the [f]und.”

31 In light of money market funds’ experience during the financial crisis, the MMWG Report recommended that money market funds reassess and, if appropriate, revise their disclosures, including advertising and marketing materials, and in particular their risk disclosures, to evaluate whether these disclosures fully capture the risks that money market funds may present. See MMWG Report at 91-92.
The SEC’s January 2010 rule amendments raised credit standards and shortened the maturity of money market funds’ portfolios—further reducing credit and interest rate risk. The rule changes require more frequent disclosure of money market funds’ holdings, so both regulators and investors will better understand funds’ portfolios. The amendments also directly addressed the liquidity challenge faced by many funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements (described above). The amendments further require funds to have “know your investor” procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly.

In addition, the SEC took an important step to help bolster money market funds’ resilience to severe market stress and redemption pressures. The SEC gave money market fund boards of directors, the majority of whose members are independent of fund management, the ability to suspend redemptions if a fund has broken or is about to break the dollar—a powerful tool to assure equitable treatment for all of the fund’s shareholders, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund. Indeed, this capability, which is available only if the board has determined to liquidate the fund, protects shareholders under extreme circumstances by ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

The comprehensive protections of the Investment Company Act, combined with the exacting standards of Rule 2a-7, have contributed to the strength of money market funds.

III. Consideration of PWG Reform Options

The Report discusses seven options for further reform of money market funds. As the Report notes, the SEC previously requested comment on some of the same options in connection with proposing the money market fund reforms it adopted last year. The Report also discusses the possibility of imposing enhanced constraints on less regulated money market fund substitutes to address concerns that new requirements for money market funds will reduce their appeal to many investors.

ICI and its Money Market Working Group previously considered many of the possible reforms outlined in the Report. Nevertheless, in response to the publication of the Report, we reviewed each option presented, including those we considered before. The fund industry also has continued to explore other ideas for reform of money market funds and we discuss one recommendation—greater transparency of money market fund investors to aid in fulfilling a fund’s “know your investor” obligations—at the end of the letter.

Three principles have guided our analysis of possible additional money market fund reform measures. First, given the tremendous benefits money market funds provide to investors and the economy, it is imperative to preserve this product’s essential characteristics. Second, in devising a

32 See MMWG Report; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (September 8, 2009) (commenting on the SEC’s proposed money market fund reforms).
solution we need to stay focused on the objective policymakers are seeking to achieve: to strengthen money market funds even further against adverse market conditions and enable them to meet extraordinarily high levels of redemption requests. Finally, any solution must be designed to promote this important policy goal while minimizing the potential for unintended negative consequences.

A. Private Emergency Liquidity Facility for Money Market Funds

Of all the approaches described in the Report, a private emergency liquidity facility for prime money market funds has the most promise, with the least negative impact, for addressing policymakers’ concerns. The Report lists the advantages, as well as a number of potential risks and challenges, that such a facility might present, and recommends further analysis and discussion.

Over the past year and a half, with the assistance of ICI members, outside legal counsel, and consultants, ICI has sought to develop a model for an emergency liquidity facility for prime money market funds (“LF”). In doing so, we believe we have addressed many of the risks and challenges cited in the Report. To be sure, our proposed LF still presents certain hurdles, most notably the cost of participation and the need for regulatory action to implement our design. Nonetheless, we believe that the prime money market fund industry generally could support the LF as a liquidity backstop as the best option for further reform so long as: (1) prime money market funds participating in the LF would be permitted to use amortized cost and continue to seek to maintain a stable NAV; (2) the cost of participation is reasonable given the current yield environment; and (3) the LF is a factor when regulators consider bank liquidity and capital requirements for banks that sponsor money market funds. Following is a description of ICI’s proposed LF and a discussion of the risks, benefits, and challenges.33

1. Overview and Purpose of the LF

The proposed LF is an industry-sponsored solution intended to enhance liquidity for prime money market funds during times of unusual market stress. Our proposal contemplates that all prime money market funds would be required to participate in the LF.34 The LF would be formed as a state-chartered bank or trust company, and would be capitalized through a combination of initial contributions from prime fund sponsors and ongoing commitment fees from member funds. Additional capacity would be gained from the issuance of time deposits to third parties.

33 A detailed presentation on the LF is attached as an appendix to this letter.

34 As mentioned in the Report, one alternative to requiring all prime money market funds to participate in the LF would be to require participation as a condition for the continued use of amortized cost pricing. Prime money market funds that did not participate would be required to switch to a floating NAV or to a Treasury or government fund. See Report at 29 (suggesting a two-tier system for money market funds in which stable NAV funds would be subject to certain enhanced protections) and Section III.E. of this letter. The Report does not distinguish between prime and other money market funds, but given the very different experiences of these funds when liquidity is scarce, we emphasize that further reform efforts should be addressed to prime money market funds.
During times of unusual market stress, the LF would buy high-quality, short-term securities from prime money market funds at amortized cost. This function has two main benefits. First, the LF would enable participating funds to meet redemptions while maintaining a stable $1.00 NAV, by ensuring them a purchaser for high-quality, short-term paper, essentially serving as a dedicated market maker when markets are frozen. Second, in doing so, the LF would help protect the broader money market by allowing funds to avoid selling into a challenging market, mitigating a downward spiral in the market prices of money market instruments. As a related matter, we believe that the very existence of such a liquidity backstop could provide reassurance to investors, and thereby limit the risk of increased redemptions in all prime money market funds brought on by liquidity concerns in a single fund. Importantly, the LF is not intended to provide credit support; rather, it is intended to meet liquidity needs occasioned by market stresses through the acquisition of high-quality instruments.

The LF is designed to provide a liquidity backstop only after a substantial portion of a fund’s minimum mandated liquidity positions are utilized. The SEC’s recent amendments to Rule 2a-7, discussed in Section II, create a fund-by-fund buffer of 10 percent of assets under management in daily liquidity, and 30 percent weekly liquidity. For the prime money market fund industry, this amounts to approximately $160 billion in daily liquidity and $485 billion in weekly liquidity.\(^{35}\) And these amounts are minimums; depending on a fund’s “know your investor” analysis and stress testing, liquidity holdings may increase as markets appear more fragile or the liquidity needs of a particular fund are greater. As discussed further below, the access policies and fees of the LF are designed to encourage funds to use their own liquidity before turning to the LF.

2. **Structure of the LF**

The LF would be a state-chartered bank or trust company, compliant with applicable banking laws. It would be a member of the Federal Reserve, eligible to access the discount window in the ordinary course, and would issue time deposits that are eligible for Federal Deposit Insurance Corporation (“FDIC”) insurance, although the LF would not seek to insure those deposits.

The LF would be governed by a board of directors, which would include the LF’s Chief Executive Officer and Chief Operating Officer, independent directors, and representatives of member funds, including a range of large, medium and smaller funds. The LF would have employees, but also likely would outsource a number of functions to third-party service providers. These third-party relationships would be overseen by the board. The board also would review the LF’s policies and procedures, many of which are discussed below.\(^{36}\)

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\(^{35}\) Estimates based on ICI data for prime money market funds with assets under management of $1.65 trillion as of August 31, 2010.

\(^{36}\) For more information on the organization and governance of the LF, see Appendix, slides 35-42.
3. **Capitalization and Capacity of the LF**

The LF would have two direct sources of capital. The LF’s initial capital would come from sponsors of prime money market funds, based on their assets under management, with an aggregated target initial equity of $350 million. The minimum contribution for the smallest funds or new market entrants would be $250,000 and the maximum contribution would be capped at 4.9 percent of the total initial equity.\(^3^8\)

The LF also would require ongoing commitment fees of its member funds, which would accrue for the benefit of current and future money market fund shareholders (not LF equity holders). As proposed, those fees would be set at 3 basis points per year on fund assets under management; the board would have the authority to raise these fees as yields on money market instruments rise to enable the LF to build capital more rapidly. Prime money market fund sponsors are acutely sensitive to costs in the current low-yield environment; many are waiving fees to prevent negative yields, and net prime money market fund fees are at their lowest level in a decade.\(^3^9\) Yet, commitment fees are a critical element in building LF capital, and we would expect the LF board to raise commitment fees should it become feasible.

To further increase capacity, at the end of its third year, the LF would issue to third parties time deposits paying a rate approximately equal to the 3-month bank CD rate.\(^4^0\) Issuance would be capped at 1.3 percent of prime money market fund assets under management to ensure sufficient interest coverage and would be laddered to ensure that the inability to roll any particular issuance would not adversely affect the LF’s liquidity and solvency. The deposits would be “eligible securities” under Rule 2a-7, meaning that money market funds would be permitted to purchase and hold them in their portfolios.

The LF would seek to achieve and maintain a minimum leverage ratio of 5 percent, making it “well capitalized” under the federal banking regulators’ prompt corrective action rules.\(^4^1\) Subject to the 5 percent leverage ratio, the LF would have the ability to borrow from the Federal Reserve discount window during times of market stress. This access, together with the LF’s direct sources of capital, will provide the LF with an estimated capacity of approximately $7 billion at its start, $12.3 billion at the

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\(^3^7\) For more information on the capitalization of the LF, see Appendix, slides 8-9. For more information on the capacity of the LF, see Appendix, slides 17-19.

\(^3^8\) The 4.9 percent cap is in place to avoid deemed “control” by any single fund sponsor under the Bank Holding Company Act of 1956. The Bank Holding Company Act contains a presumption of non-control that ordinarily applies when an investor owns less than 5 percent of any class of voting securities of a bank. See 12 CFR 225.31(e).

\(^3^9\) See Appendix, slides 11-15.

\(^4^0\) Issuance of time deposits would be delayed for three years to ensure that the LF has sufficient capital to make interest payments and to establish a credit and management record.

\(^4^1\) See 12 U.S.C. § 1831o. The leverage ratio is the ratio of total capital to assets. See Appendix, slide 19.
end of the first year, $30 billion at the end of five years, and $50-55 billion at the end of year 10.\footnote{We anticipate that the LF would continue to increase capacity after year 10; we modeled these periods for illustrative purposes.} These figures are based on a steady commitment fee of 3 basis points and $1.65 trillion in industry assets.\footnote{See Appendix, slide 18 for more detail.} Of course, if market conditions improve and the LF board is able to increase the commitment fee, the LF’s capacity would increase more rapidly. As noted above and discussed further below, this capacity would be tapped only after funds have largely used their SEC-mandated liquidity.

4. Operation of the LF in “Normal Mode”

In “normal mode,” which we anticipate would be the vast majority of the LF’s existence, the LF would invest the proceeds of its sponsor capital, commitment fees, and time deposits issued to third parties in a portfolio of short duration Treasury and agency securities. These investments would be carefully managed to ensure their ready ability to be sold to provide liquidity to member funds. At least 75 percent of the portfolio would have a maturity of 90 days or less; the balance could have a maturity of between 91 and 180 days. The proceeds of the LF’s investments would be used both to build capital and to pay third-party investors on the time deposits.

The LF would test its operations and would conduct ongoing credit analysis to establish and maintain a non-public list of securities that are acceptable to the LF, as discussed further below. The LF would issue and pay interest on time deposits, collect commitment fees, and manage the true-up process for equity contributions. The LF would approve contracts with third party service providers, and manage corporate and back office functions. The LF also would collect and analyze data from funds, including trends in the money market fund industry, assets under management levels, and issuer and industry concentration levels.

5. Operation of the LF in “Liquidity Mode”

During times of unusual market stress, the LF would be available to purchase high-quality, short-term assets including commercial paper, ABCP, bank notes and bankers’ acceptances from member funds, subject to the risk-limiting policies and conditions discussed below. We anticipate that the LF would hold these securities to maturity, at which point it would reinvest the proceeds in Treasury securities after the market stress subsides, and return to “normal mode.”

The LF’s access policies and fees, along with the asset policies and other risk management procedures discussed below, are designed to minimize moral hazard, prevent the LF from taking on credit risk, and make the LF unattractive as an arbitrage vehicle in a rising interest rate environment. Stress testing on the LF model suggests that its conservative portfolio policies make it unlikely to suffer a material reduction in capital.
6. The LF’s Risk-Limiting Policies

a) Access Policies

In order to access the LF, a fund would have to demonstrate a liquidity need, evidenced by significant redemption requests. A fund would not be permitted to access the LF if it had already broken the dollar, or if it would do so as a result of a liquidity exchange with the LF. Additionally, a fund seeking liquidity from the LF would be required to present its entire portfolio to the LF’s credit analysts for review, and could only access the LF if it possessed securities that the LF would buy. Finally, a fund accessing the LF would have to pay a fee that is the greater of (1) 25 basis points annualized and (2) the secondary discount rate for borrowing from the discount window less the yield to maturity from the proceeds of the sale of securities to the LF at amortized cost. The requirement that a fund demonstrate a liquidity need, along with the access fees imposed, are intended to prevent funds from attempting to sell low-yield securities to the LF in a rising interest rate environment.

The requirement that a fund not have broken the dollar is intended to prevent a single fund from using a large share of the LF’s available liquidity. Additionally, a fund typically would be limited to its proportionate share of the LF’s available liquidity, based on its assets under management. Because funds would have to pay an access fee, and would have limits placed on the amount of liquidity they could draw from the facility, we believe funds would continue to have strong incentives to maintain adequate levels of liquidity, thus reducing moral hazard.

b) Policies to Address Portfolio Risks

As noted above, the LF is not designed to provide credit support, but rather to meet liquidity needs brought on by market stresses. The LF’s stringent asset policies are intended to prevent the LF from absorbing credit risk, and to minimize through diversification controls the effects of any default that may nevertheless occur. The policies also are designed to limit concentration and duration risk. Importantly, the LF would retain the power to determine which securities—if any—it would accept from a fund seeking liquidity, and would provide no guarantee to member funds that it would accept any given security.

Specifically, the LF’s policies would be carefully tailored to minimize risks as follows:

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44 New SEC Rule 22e-3 permits a money market fund's board to suspend redemptions and wind up the fund in an orderly manner if the fund has or is about to break the dollar; we believe that path to be more appropriate for a fund under these circumstances than to use liquidity from the LF.

45 The LF’s board would have the authority to increase the liquidity made available to a fund if appropriate under the circumstances, such as to correct idiosyncratic events or forestall significant redemption requests at a small subset of funds.

46 We anticipate that member funds would have the option, from time to time, of submitting their portfolios to the LF for review, and receiving a report that would state, as of that time, the percentage of the portfolio that is on the LF’s approved list.
• **Credit risk**: the LF would accept only first-tier securities that are not on credit watch; would maintain a non-public list of acceptable issuers from which it would accept securities, based on independent credit analysis⁴⁷; and importantly, would retain final decision-making authority over which securities to purchase from a fund.

• **Concentration risk**: the LF generally would seek to avoid a single issuer concentration (excluding Treasury and agency securities) greater than approximately 2 percent of LF assets.

• **Duration risk**: no less than 75 percent of accepted securities would have a maturity of 45 days or less, while up to 25 percent could have a maturity of up to 60 days, resulting in a maximum weighted average maturity of 49 days; further, the duration of the time deposits issued by the LF would be closely matched to the accepted commercial paper portfolio, minimizing price and interest rate risks.

c) Stress Testing for Capital Loss

Stress testing performed on the LF model suggests it is highly unlikely that the LF would ever face a capital loss exceeding 5 percent of assets. We considered four potential scenarios that could draw on the LF’s capital, and how they are mitigated by the LF’s design.⁴⁸ The first is a default loss on the commercial paper or other assets purchased by the LF. The LF’s asset policies, specifically concentration and credit quality requirements, should make issuer defaults unlikely. Further, in the event of a default, recovery rates on defaulted first-tier securities historically have been very high, and the LF’s concentration limits should minimize its exposure to a defaulting issuer.

Second, the LF could face a temporary loss due to a difference between the fair market value of purchased securities and the selling fund’s amortized cost. Based on historical experience, this difference is unlikely to be greater than one percent for any security that passes the LF’s credit quality requirements. Moreover, because no more than 25 percent of the securities accepted by the LF may have maturities of between 45 and 60 days, this loss should be reversed in no more than 60 days, when the longest-dated securities mature.

Third, the LF could assume losses from a rise in interest rates during liquidity mode. The short duration of the securities should limit this risk; even if the largest historical Treasury bill interest rate increase (350 basis points) occurred again, the LF’s capital ratio would decline by only 35 basis points.

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⁴⁷ We anticipate that credit analysis for non-governmental securities would be outsourced to a manager that is experienced in evaluating these instruments, but that does not sponsor money market funds. This factor would ensure that one fund complex does not have an advantage over others in having access to the design or contents of the approved list.

⁴⁸ See Appendix, slides 25-34 for more detailed analysis of our stress testing.
Finally, member funds might seek to use the LF for arbitrage during times of rising interest rates by selling low-yielding commercial paper to the LF. The LF access fee and the requirement that funds demonstrate liquidity needs are designed specifically to avoid this risk.

In the event of a capital impairment, the LF could be managed to a quick recovery. Unlike a traditional commercial bank, the LF would be able to: (1) rapidly deleverage, as the balance sheet consists of short duration assets and liabilities, limiting reliance on market liquidity; and (2) rebuild capital from the recurring fee income from the commitment fee.

7. Addressing the PWG’s Concerns

The Report enumerates several potential policy concerns with the concept of a private emergency liquidity facility. We, too, considered each of these concerns in developing the proposed LF. We believe that the LF as currently designed adequately addresses them, as discussed below.

First, the Report recognizes the tension between permitting voluntary participation in a liquidity facility, which would allow non-participating funds to “free ride” on the market stability the facility provides, and requiring participation, which would impose costs on participants and obligations on regulators to ensure the facility was operated equitably and efficiently. Free riding is a serious concern, both from a fairness perspective and as a potential catalyst for further systemic risk. We believe participation in the LF should be mandatory for all prime money market funds. The existence of the LF presumably would provide assurance to investors about the stability of prime money market funds; all such funds should share that cost. Additionally, the existence of two types of prime money market funds, i.e., participating funds and non-participating funds, likely would confuse investors and adversely affect the broader markets. Some investors in non-participating funds might be unaware that their funds do not have access to the LF, and could face unexpected difficulties obtaining redemption proceeds in times of extreme market distress. These investors’ concerns, if widespread and public, could spread to participating funds, where investors could needlessly seek redemptions out of fear of being similarly situated, placing unnecessary but very real pressure on those funds and the LF.

Alternatively, investors that are aware of the differences might redeem from non-participating funds and move to participating funds during difficult markets, thus arbitraging the distinctions between them (obtaining a higher yield from lower cost, non-participating funds during good times but exiting quickly for the participating funds during a market crisis). Those investors would not have paid for their liquidity protection and the LF’s capacity would not have had time to increase to support this higher level of assets under management.

Section 2.e. of the Report suggests one means of mandating participation in the LF: participation would be required for prime funds that wish to continue using amortized cost pricing, and funds that opted out would either switch to a floating NAV or convert to a Treasury or government fund. We would support this approach. We further agree that assuring all prime funds participate in the LF would require regulatory action to enforce, similar to the membership requirements of the Securities Investor Protection Corporation and the Financial Industry Regulatory Authority. It also
would require governmental oversight: the LF we propose would be established as a state-chartered bank and subject to bank regulatory oversight.

The Report also notes the importance of ensuring that the facility has adequate capacity to meet money market funds’ liquidity needs during a crisis. It describes certain risks of inadequate capacity, including creating incentives for some advisers to tap the facility before others do, thereby triggering a run on the facility and possibly expanding a run on money market funds generally. Ultimately, it suggests that any such facility may require access to alternative sources of liquidity.

We fully agree with the PWG that adequate capacity is a critical element of a liquidity facility, and we analyzed a wide range of funding options to achieve capacity without making the LF cost-prohibitive for prospective participants. We drew the same conclusion about the importance of an alternative source of liquidity, and therefore designed the LF as a state-chartered bank that may access the Federal Reserve discount window, with a minimum leverage ratio of 5 percent. We believe the proposed LF, together with the daily and weekly liquidity now required under SEC rules, would offer during future periods of unusual market stress substantial additional liquidity over that available to money market funds in 2008—particularly once the time deposits are issued in year three and beyond.

We note that Basel III established a 9-year timeframe for the building of capital for banks, and anticipate that the LF would need a similar time period to build capacity.

Another concern raised by the Report is the potential for conflicts of interest when liquidity is in short supply. As the Report notes, the facility must balance the need to avoid losses on commercial paper against the need to purchase such paper if it is to be an effective liquidity backstop; the facility also would need to balance the needs of different types of participants with different interests. As to the first concern, the LF’s independent credit analysis function, and ability to select which assets it will accept, should enable it to effectively minimize losses while providing liquidity. With respect to conflicts among members or shareholders, the proposed LF governance structure, which includes a board comprised of representatives from a range of fund sizes as well as independent directors, is intended to guide the LF to pursue the best interests of the entire prime money market fund industry. It should be noted that the mutual fund industry has previously been successful in developing an industry solution to a market-wide problem, creating ICI Mutual Insurance Company, RRG ("ICI

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49 Mindful that access to the discount window should not be obtained at taxpayer expense, we designed the LF as a state-chartered bank that would be eligible to access the window in the ordinary course under Regulation A—in other words, paying full Federal Reserve membership and haircuts for window access. See 12 CFR pt. 201.

50 Additionally, a fund or group of funds would typically be prevented from accessing all of the LF’s liquidity, such as through policies that would generally provide for the distribution of liquidity on a proportionate basis among member funds, based on assets under management.
Mutual”) in 1987 in response to problems experienced by the investment management industry in obtaining adequate fidelity bond coverage and D&O/E&O liability insurance at reasonable rates.51

Finally, the Report notes that rules governing access to a liquidity facility “would have to be crafted carefully to minimize the moral hazard problems among fund advisers, who could face diminished incentive to maintain liquidity in their money market funds.” We agree with this concern. Our model would require that funds not only maintain at least the Rule 2a-7 mandated levels of liquidity, but also pay an access fee for using the facility. We balanced those protections with the recognition that excessive restrictions on access would limit the facility’s effectiveness. As discussed above, we gave careful consideration to these concerns in developing the LF access policies, fees, and criteria for acceptable securities, and we believe they strike the right balance.

B. Requiring Money Market Funds to “Float” Their NAVs

In its proposal to amend Rule 2a-7, the SEC requested public comments on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation, forcing them to “float” their NAVs. Out of more than 120 comment letters filed with the SEC during the comment period, the ones that favored floating NAVs could be counted on one hand. By contrast, scores of letters, including one from ICI, opposed this idea.52 Also included among those letters were many from individual investors who strongly opposed changing the fundamental nature of money market funds. Indeed, the SEC’s own Investor Advisory Committee has before it a resolution that calls upon the SEC to preserve the stable NAV as a core feature of money market funds.53 Nevertheless, the Report again discusses the option of requiring money market funds to float their NAVs. This would require funds to use mark-to-market pricing of fund portfolio securities rather than amortized cost accounting for the purpose of determining the NAV of fund shares on a daily basis.

51 ICI Mutual is the predominant provider of Directors and Officers/Errors and Omissions liability insurance and fidelity bonding for the U.S. mutual fund industry. Its insureds represent more than 60 percent of the industry’s managed assets. As the mutual fund industry’s captive insurance company, ICI Mutual is owned and operated by and for its insureds.

52 The SEC received more than 60 comment letters in opposition to the concept of requiring money market funds to float their NAVs during its rulemaking on amendments to Rule 2a-7. These letters came from a broad spectrum of businesses, governments, schools, retirement plans, consumer groups, and financial services firms. The list of these entities is available at http://www.ici.org/policy/regulation/products/money_market/10_mmfs_opposefloatingnav. We are aware of another 40 companies or organizations that submitted letters during preparation of the Report to the SEC or the Treasury Department, or both, in opposition to floating NAV.

53 The resolution states: “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.” The resolution and corresponding memorandum are available on the SEC’s website at http://sec.gov/spotlight/invadvcomm/iacmemo-mmf.pdf.
The Report states that requiring money market funds to move to a floating NAV system “would have some potential benefits, but those benefits would have to be weighed carefully against the risks that such a change would entail.” As we discuss below, and as numerous commenters have already advised the SEC, such a change would be unlikely to reduce systemic risk and may, in fact, increase it. Furthermore, we have deep concerns about the impact such a change would have on financial markets, both during a transition period and afterward.

1. Impact of a Floating NAV on Preventing Investor Runs

The Report presents five features of money market funds, their investors, and sponsors that, taken together, the PWG believes contribute to the incentive for investors to exit money market funds rapidly during market stress. Rounding NAVs to $1.00 is one of these features. Even if money market funds were prohibited from using amortized cost accounting, however, the other features of money market funds, their investors, and the markets that would remain could make prime money market funds susceptible to sudden, high redemption requests.

First, money market funds with floating NAVs would still provide a similar degree of maturity and liquidity transformation because the funds would continue in their role as intermediaries between shareholders who want liquid investments and borrowers that desire term funding. Second, requiring funds to float their NAVs is unlikely to do much to alter investors’ views about whether money market funds are low-risk investments. As the Report notes, under normal conditions, the shadow prices of money market funds’ portfolios generally deviate very little from $1.00. This is simply a reflection of the fact that money market funds invest in very short-term, high-quality, fixed-income securities and the price of these securities deviates little from their amortized cost value absent a large interest rate movement or credit event. Third, money market funds would continue to be exposed to interest rate and credit risk. When risk intolerant investors seek to move away from certain funds or broad sectors of the markets during future crises, the transition would continue to be potentially disruptive.

54 See Report at 8-11. While the Report speaks broadly of runs occurring in money market funds, our understanding is that experience during the financial crisis was more nuanced; investors that redeemed shares of their money market funds typically redeemed from prime money market funds, and often invested those proceeds in Treasury or government money market funds. See supra note 9.

55 While much has been made of the maturity transformation of money market funds, financial markets in general provide maturity transformation of securities. Equities are a perpetual security and equity markets exist to allow investors to transform the maturity of these securities. Pooling buyers and sellers creates liquidity and reduces the costs of maturity transformation. Markets for bonds and money market instruments provide similar maturity transformation. Investors have incentives in these markets to “rush the doors” before imbalances become severe, and at times uncertainty prevents buyers from returning to the markets. For example, in the fall of 2008, even as money market funds once again became net buyers of commercial paper, other investors that had left the commercial paper market remained reluctant to purchase these securities. Total outstanding commercial paper contracted, and the money market fund share of the market rose from 34 percent in September 2008 to 40 percent in January 2009. The contraction of the commercial paper market caused severe funding dislocations, and the Federal Reserve helped to support these markets through the Commercial Paper Funding Facility.
Finally, although the Report does not explicitly discuss the money market as a factor, this market itself historically is susceptible to liquidity pressures. Lenders in this market typically need ready access to their cash and have a low tolerance for financial risk. Borrowers depend on these markets to meet their immediate funding needs. Rollover issuances are a very high percentage of the outstanding short-term securities. During periods of financial stress, risk intolerant investors can and do move quickly out of the markets, leaving large supply and demand imbalances, which can cause volatility in short-term interest rates.

The combination of these factors results in the money market and money market funds operating for long periods of time in relative tranquility punctuated by stress events. Investors’ desire to have exposure to the money market, either directly or through money market funds, declines during these periods of stress. The Report argues that floating the NAV would reduce the likelihood of investors wanting to move away from the money market during these events. We disagree.

Assuming, for the sake of argument, that a floating NAV money market fund would attract a substantial base of investors, the same motivations to shift away from certain areas of the market would remain and could lead to investor withdrawals in a future widespread financial crisis. As discussed in the MMWG Report, ultra-short bond funds illustrate how this can occur outside of money market funds. While ultra-short bond funds are not required to follow Rule 2a-7, they do invest in a portfolio of relatively short-dated securities. In contrast with money market funds, however, the NAV of an ultra-short bond fund fluctuates. Beginning in the summer of 2007, the average NAV on these funds began to fall (Figure 4). In February and March 2008, several ultra-short bond funds posted significant NAV declines, and the average NAV of these funds fell about 2 percent. This preceded a large outflow of assets from such funds; during a four-week period ending in early April, these funds experienced cumulative outflows of 15 percent of their assets. These developments were relatively benign because these funds were small, with assets totaling only about $30 billion at that time. Had their asset levels been comparable in size to those held in prime money market funds in early September 2008, however ($2.2 trillion), a 15 percent redemption rate would have implied outflows of nearly $330 billion, which would likely have put considerable pressure on short-term fixed-income markets. Indeed, by the end of 2008, assets of these funds were down more than 60 percent from their peak in mid-2007.
The experience in Europe of certain money funds likewise demonstrates that floating NAV funds also can face strong investor outflows during periods of market turmoil. For example, French floating NAV dynamic money funds (or trésorerie dynamique funds), lost about 40 percent of their assets over a three-month time span from July 2007 to September 2007.56

For these reasons, we remain doubtful that floating the NAV on money market funds would reduce risks in any meaningful way. Also, as we discuss below, prohibiting money market funds from

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56 For a more detailed discussion of the experience of certain money and bond funds in Europe, see MMWG Report at 106-107.
maintaining a stable NAV would likely lead to the demand for less regulated products that seek to maintain a stable NAV, and would therefore simply shift the risk to a more opaque and less regulated part of the market.

2. Investor Demand for a Stable NAV Fund Would Remain

The Report acknowledges that elimination of a stable NAV would be a dramatic change for money market funds. One very significant concern, as the Report notes, is whether investors would continue to use such a product. For a substantial number of investors, the answer is no.

Many “institutional” investors that use money market funds would be unable to use a floating NAV fund. These investors often face legal or other constraints that preclude them from investing their cash balances in pools that do not maintain a stable NAV. For example, corporations may have board-approved policies permitting them to invest operating cash (balances used to meet short-term needs) only in pools that do not fluctuate in value. Indentures and other trust documents may 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. Thus, absent a stable NAV, many state and local governments would no longer be able to use money market funds to help manage their cash.

Even those investors who do not face such constraints nevertheless may be unwilling to invest in a floating NAV product. A stable NAV offers significant convenience in terms of tax, accounting, and recordkeeping. For example, all of a money market fund’s returns are distributed to shareholders as income. This relieves shareholders of having to track gains and losses, including the burden of having to consider the timing of sales and purchases of fund shares (i.e., wash sale rule considerations). To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors make fewer purchases and sales from long-term mutual funds and, in any case, many such purchases (or exchanges) are made within tax-advantaged accounts (e.g., 401(k) plans), where such issues do not arise.

A floating NAV also would reduce the value and convenience of money market funds to individual “retail” investors. For example, brokers and fund sponsors typically offer investors a range of features tied to their money market funds, including ATM access, checkwriting, and ACH and fedwire transfers. These features are generally only provided for stable NAV products. Also, money market funds typically offer investors same-day settlement on shares redeemed via “wire transfers” (where

57 As used in this context, “institutional” investors generally include businesses, governments, and high net worth households. As discussed in Section III.F., however, we question the feasibility of distinguishing “institutional” investors from “retail” investors for purposes of defining precisely which investors would be permitted to invest in which type of money market fund in a way that makes sense and can be enforced effectively.

58 See generally id. at Appendix D.
redemption proceeds are wired to an investor’s bank account via fedwire), whereas bond funds typically offer next-day settlement. Thus, elimination of the stable NAV for money market funds would likely force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

The Report states that there is no direct evidence on the likely effect of a floating NAV on the demand for money market funds. The current rate environment, however, has proven to be an important test of investor demand for stable NAV funds. Currently, yields on money market funds are 150 basis points below short-duration bond funds, and 300 to 500 basis points below longer term bond funds. Yet, outflows from money market funds have slowed sharply, and since July 2010, assets in money market funds have stabilized at around $2.8 trillion, greater than the assets held in money market funds prior to the start of the financial crisis in the summer of 2007.

Indeed, a diverse range of investors in money market funds previously have communicated their opposition to floating NAVs directly to the SEC.59 The stable $1.00 NAV, as the Association of Public and Land-Grant Universities told the SEC in September 2009, provides a “low-cost, convenient, and reliable cash management tool.”60 Investors, added the American Bankers Association in its comment to the SEC, “understand and appreciate the accounting treatment offered by stable NAV funds.”61

The State of Rhode Island’s General Treasurer has told the SEC that “[a] floating NAV will likely reduce investment yields as it increases complexity and drives up administrative costs.”62 His comment was echoed by a letter to the SEC from the Pennsylvania School District Liquid Asset Fund, which said that a floating NAV would lead to “needless complication of the reporting systems of public schools and local government entities to reflect variations of value that are inconsequential.”63 Similarly, a floating NAV, in the words of the National Association of State Treasurers, could “potentially destabilize financial markets for both investors and debt issuers.”64

Furthermore, surveys of money market fund investors indicate clearly that most investors do not want and would not use a floating NAV product. For example, a survey of “institutional” cash

59 See supra note 52.


64 See Letter from James B. Lewis, New Mexico State Treasurer and President, National Association of State Treasurers, to Timothy Geithner, Secretary of the Treasury (July 2, 2010).
managers indicated that more than half would decrease *substantially* their use of money market funds if money market funds are required to have a floating NAV (Figure 5).

**Figure 5**

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

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, 13 were private, four were state and local governments, four were financial institutional, and one was unclassified.
A recent survey of “retail” money market fund investors commissioned by T. Rowe Price and conducted online by Harris Interactive indicated much the same response (Figure 6).

**Figure 6**

*Retail Investors’ Reaction to Floating NAV Money Market Funds*

![Pie chart showing the reaction of retail investors to floating NAV money market funds.](chart.png)

Two thirds of retail investors surveyed found the idea of a floating NAV money market fund unfavorable. Among those who found the concept unfavorable, 72 percent indicated that they would use the product less, and that their most likely response would be to close their money market fund accounts (29 percent), decrease their money market fund balances (33 percent), or execute fewer

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65 Based on a study commissioned by T. Rowe Price and conducted online by Harris Interactive from August 31 to September 7, 2010 of 413 adults aged 35-75 who own money market funds outside of a retirement plan, who also own at least one long-term mutual fund, who invest directly with a mutual fund company, do not rely solely on the advice of an investment adviser, and have $100,000 or more in investable assets. The data are weighted to be representative of the adult population with $100,000 or more in investable assets. A full methodology is available upon request.
money market fund transactions (10 percent). A third survey, conducted among both “retail” and “institutional” shareholders by Fidelity Investments, found much the same result. This survey found that institutional investors overwhelmingly (78 percent) disliked the idea of a floating NAV product and would use money market funds less or not at all (69 percent of 78 percent) if faced with the prospect of a floating NAV. Retail investors also disliked the floating NAV concept. Forty percent of the retail investors surveyed disfavored the floating NAV concept; however, when informed of the adverse tax consequences, the percent disfavoring jumped to over sixty percent.66 In short, there is good reason, backed by data, to believe that investors do not want and will likely reject a floating NAV money market fund.

3. Floating the NAV Would Harm the Market

The primary, and perhaps only, effect that floating the NAV of money market funds would have on the financial system would be a major restructuring and reordering of intermediation in the short-term credit markets. This would not reduce systemic risk and might well increase it.

Assets in money market funds now total $2.8 trillion. As indicated, money market fund investors of all types are unlikely to use a floating NAV product. Requiring money market funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. The Report correctly notes that this transition, in and of itself, could be systemically risky. It would require money market funds to shed hundreds of billions of dollars of commercial paper, bank CDs, Eurodollar deposits, repurchase agreements, and other assets. Even under the calmest of financial market conditions, this would be a highly tricky process. During a period of stress in the money market, such a transition could well set off the kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs will merely shift credit intermediation from one type of product to others; it will not reduce systemic risk. There are a number of alternative products that money market fund investors could use, including, as described in Section I.B, enhanced cash pools, offshore money funds, LGIPs, and other vehicles that seek to maintain a stable unit price but are not regulated under the Investment Company Act. Regulatory changes that push assets from regulated products (i.e., money market funds) to less regulated products arguably would serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.67

The Report suggests that to preclude this possibility, enhanced regulation might be required for “unregulated” substitutes for money market funds (see also discussion in Section III.H.). This would do little to reduce systemic risk. Many investors already have the ability through banks to select among various sweep arrangements that seek to offer a stable unit value, such as money market fund sweeps,

66 The Fidelity survey of retail investors and institutional investors was coordinated by Northstar Research Partners in conjunction with Fidelity Consulting Group in August 2009.

67 See MMWG Report at 62-64.
repurchase agreement sweeps, commercial paper sweeps, and, importantly, sweeps into offshore (non-money market fund) accounts (e.g., Eurodollar sweeps).\textsuperscript{68} If a stable NAV is eliminated for money market funds, investors can migrate to these other kinds of sweep accounts, which in some cases (e.g., Eurodollar sweeps) are largely beyond the jurisdictional reach of domestic regulators. Sweeps into offshore accounts are particularly popular (Figure 7).

**Figure 7**

**Investments of Bank Sweep Programs**

*Percentage of U.S. commercial bank sweep assets, October 2007*

Such an exodus from money market funds would not reduce systemic risk, but simply transfer it elsewhere and may, in fact, serve to increase systemic risk. Institutional investors that use these money market fund substitutes would likely exit them quickly in a crisis, seeking the safety of Treasury securities. The end result would still be a freeze in the commercial paper, repurchase agreement, or Eurodollar markets. In addition, while some regulators might be tempted to consider bringing sweep

\textsuperscript{68} For a general discussion of overnight sweep arrangements, see MMWG Report at 43-44.
products under the purview of a Rule 2a-7-like regulatory framework, that strikes us as a very challenging proposition, likely requiring coordinated efforts by securities and bank regulators (perhaps even across borders) to regulate these bank-offered products. Moreover, even if regulators could somehow enact a regulatory scheme in an effort to ring-fence systemic risks among the range of current money market fund substitutes, over time new substitutes likely would arise.

The Report suggests that requiring money market funds to float their NAVs could encourage investors to shift their liquid balances to bank deposits. We believe that this effect is overstated, particularly for institutional investors. Corporate cash managers and other institutional investors would not view an undiversified holding in an uninsured (or underinsured) bank account as having the same risk profile as an investment in a diversified short-term money market fund. Such investors would continue to seek out diversified investment pools, which may or may not include bank time deposits.

To the extent that investors would hold deposits in conventional banks they likely would place their cash in demand deposits, negotiable order of withdrawal accounts, and MMDAs to maintain the liquidity that they had with money market funds. Unless these deposits were fully insured, either explicitly or implicitly, institutional investors would likely run during a serious crisis. Insuring these deposits would entail a major increase (perhaps as much as $2 trillion) in the federal government’s potential insurance liability and would result in a vast increase in moral hazard, a development that would simply increase systemic risk. To protect against a run, 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.

In addition, a shift to traditional banks 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.

Not surprisingly, issuers of money market securities have expressed serious concerns about the disruptive effects in the market for their securities should regulatory reforms diminish the role played by money market funds. In its letter to the SEC in September 2009, the National Association of College and University Business Officers has warned the SEC that loss of a stable NAV investment option “could alter both the number of investors and the amount of capital that could be invested in debt issued by colleges and universities, potentially raising the cost of capital for our members.”69 In July 2010, a group of nine leading companies, along with several groups representing treasurers in the

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corporate, educational, and non-profit sectors, wrote to Treasury Secretary Timothy Geithner and SEC Chairman Mary Schapiro to express their view that mandating a floating NAV “would make short-term financing for American business less efficient and far more costly, ensuring a severe setback for an economy emerging from recession.”

In sum, investors will continue to demand a stable NAV money market fund or money market fund-like product. And one way or another, financial markets will find a way to deliver it.

C. Mandatory Redemptions in Kind

The Report discusses another concept previously proposed by the SEC—that of requiring that certain large redemptions be made through the distribution of a proportionate amount of the money market fund’s securities to the redeeming shareholder. These “in-kind” redemptions currently are permitted, but due to operational and other reasons, are rarely invoked. Commenters expressed concerns with this approach.

1. Unintended Consequences of Mandatory Redemptions in Kind

The experience of the fund industry makes it clear that redemptions in kind are very unpopular with shareholders. This method of meeting redemptions places the burden for holding or custodying, valuing, and liquidating underlying portfolio securities, with all the attendant costs, directly on the shareholder. Many investors are not prepared, as a practical matter, to address valuation obligations and other consequences of holding these instruments directly.

The supposed regulatory attractiveness of imposing a redemption-in-kind requirement lies in this very unpopularity—one theory being that shareholders would avoid requesting redemptions in large amounts, absent an urgent need for those funds. According to this theory, fewer investors would make these redemption requests, thus alleviating the pressure on money market funds to sell securities into a declining market.

The problem with this theory is that investors more likely would work around the requirement—e.g., by carefully allocating investments among multiple funds in amounts below the anticipated in-kind redemption threshold in order to preserve flexibility in meeting cash needs. Funds engaging in the “know your investor” analysis required by the SEC would see smaller shareholder

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71 As the Report notes, this requirement “would present some operational and policy challenges. Portfolio holdings of money market funds sometimes are not freely transferable or are only transferable in large blocks of shares, so delivery of an exact pro rata portion of each portfolio holding to a redeeming shareholder may be impracticable.” Report at 26.
positions. In the event of a true market crisis, however, these shareholder redemptions could quickly mount across the industry, which would risk freezing the short-term credit markets as multiple funds seek to meet smaller, but more numerous, redemption requests.

Moreover, shareholders that do trip the threshold and need immediate liquidity (or that lack the expertise in directly managing money market instruments) will have no option but to sell the securities received into a falling market, likely causing further dislocations. As these investors seek to sell these assets quickly, prices for these and similar securities would certainly fall. The decline in prices could cause the money market fund making the in-kind redemption to mark down those securities in its portfolio, and potentially require other funds holding the same securities to do likewise, thus placing additional pressure on the value of all such funds’ shares and further destabilizing the market. The Report accurately notes this effect on the fund that distributes the securities, but it should be clear that the danger is far broader: the effect of the declining market prices will be felt by all other money market funds holding the same securities in their portfolios. As a result, all money market funds holding the securities being sold could find their portfolio valuations under pressure. Finally, remaining shareholders in the redeeming fund likely would be left with those securities that were not easily divisible, thus ensuring that they will hold the less liquid securities.

2. Difficulties Determining the Appropriate Trigger

Presumably, a requirement to redeem shares in kind would be the exception and not the rule, thus necessitating regulations to identify some circumstance or event (in the fund’s portfolio or the market) that would occasion redemptions in kind, and some threshold level of redemptions (whether by a given shareholder or by shareholders in the aggregate) to which the in-kind requirement would apply. Implementing such standards presents significant challenges. The trigger could be set either on a fund-by-fund basis or on a market-wide basis. A fund-by-fund trigger would require any fund that reached a predetermined criterion (e.g., a shadow NAV of x basis points or lower) to immediately institute a mandatory redemption in kind process. A market-wide trigger could be imposed on a prudential basis by a regulatory authority. In either case, a suitable trigger point is difficult to determine in advance and would condition investors to redeem their shares in advance of the trigger event.

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72 A fund redeeming in kind generally must distribute a pro rata slice of the portfolio to the redeeming shareholder; the fund will almost always continue to hold positions in the same securities being distributed to the shareholder. See Section 2(a)(32) of the Investment Company 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”). See also Rule 18f-1, which provides an exemption with regard to redemptions in kind and in cash from certain prohibitions under Section 18(f)(1) of the Investment Company Act on issuing senior securities.

73 The Report states: “If an investor sells securities at a loss, however, and the money market fund also holds the same or similar securities, the fund may be forced to re-price the securities and lower its mark-to-market, shadow NAV. So, remaining investors in the fund may be affected indirectly by the redeeming investors, even if that investor receives redemptions in kind.” Report at note 22.
a) Fund-by-Fund Triggers

A fund-by-fund trigger, we believe, would be ineffective and carry a strong likelihood of sparking a cascade of redemptions. Almost certainly, the trigger would be deemed “material” information and thus would have to be disclosed to investors, permitting them to structure their money market fund investments across multiple funds in amounts low enough to ensure ongoing liquidity. As funds enter periods of net redemptions, however, investors intending to be below the threshold may seek to redeem shares, in order to stay below the threshold or to avoid having to monitor the size of their positions in a shrinking fund. Those redemptions would in turn place additional downward pressure on the market.

Further, while it is unclear how the shareholders of other funds would react to one fund’s imposition of mandatory redemptions in kind, it may cause them concern, leading them to redeem securities in unaffected funds when they otherwise would not have done so.

b) Market-Wide Triggers

We believe a market-wide trigger declared by a regulatory agency carries the same risk as the fund-by-fund approach. Indeed, indications of market fragility may cause investor flight from money market funds in order to be in an investment with assured liquidity before the government announced mandatory in kind redemptions. Such redemptions would again place additional downward pressure on an already declining market. Imposing redemptions in kind on all money market funds, moreover, would be overbroad and unfair to funds that hold sufficient liquid assets. Not all funds experienced the same level of investor redemptions during the last market crisis.

3. Operational Hurdles

Redeeming money market fund shares in kind presents operational problems for both the fund and its shareholders. Since money market funds often invest in hundreds of different underlying securities, creating a vertical slice of the portfolio for a redeeming shareholder can be a complex and challenging process. Depending on the composition of its portfolio, a fund may not be able to transfer title to certain securities or instruments held in the fund, such as privately placed securities, master notes, or term repurchase agreements, which require the consent of the issuer prior to transfer. In other cases, the client may not meet eligibility standards to hold the securities directly (e.g., Rule 144A restricted securities can only be transferred to a qualified institutional buyer). Some instruments may not be permitted to be divided among many investors (e.g., commercial paper cannot be transferred in denominations below $25,000). Even if a security can be divided, transferring only a portion of a fund’s holding of a particular security could leave the fund with an odd lot position that is difficult to trade. As a result of these and other transferability limitations, a greater proportion of other securities that are not subject to transfer restrictions would need to be distributed; however, it is unlikely these securities have the same maturities, sector concentrations, yields, and other characteristics as the securities that cannot be transferred. Indeed, even if substitutions could be made, each redemption in kind would leave the fund more concentrated in non-transferable, restricted securities, and odd lots, to the detriment of the remaining shareholders.
Even if securities could be identified that were capable of fair division, getting them to clients’ accounts could prove challenging. Shareholders would have to establish brokerage or custody accounts in advance, and pay ongoing fees for those accounts, on the off-chance of being required to accept securities from their money market fund. Similarly, financial intermediaries that maintain omnibus accounts would have the burden of further allocating in-kind securities to their underlying customers. This requirement would increase investor costs, with doubtful benefit to the markets.

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

In conclusion, we believe that funds’ current authority to redeem shares in kind voluntarily, as at least one fund complex did during the 2008 market crisis, appropriately enables them to assess the advisability of redemptions in kind under the circumstances facing the fund and the market at the time. A mandatory “one-size-fits-all” approach likely would cause far more problems than it solves, either for the fund or funds generally. Instead, we would urge the SEC to provide funds with more guidance regarding the use of their voluntary authority to redeem in kind. For example, may funds elect to redeem some shareholders in kind but not others? Alternatively, may funds vary the threshold levels at which redemptions would be invoked depending on the market circumstances at the time? Additional regulatory guidance may help money market funds use this tool to greater effect in the event of another market crisis.

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74 Section 12(d)(1) significantly restricts the ability of a registered investment company to invest in securities of other investment companies, except in limited circumstances. Among other things, Section 12(d)(1)(E) provides an exception to this general prohibition by permitting issuers of insurance company separate accounts offering variable insurance products to invest all their assets in one or more investment companies so long as certain requirements are satisfied.
D. Insurance Programs for Money Market Funds

The MMWG Report discussed at length the feasibility and desirability of an insurance program for money market funds. We considered three possible programs: pure federal insurance; pure private insurance; and a hybrid federal/private program. Nearly two years after releasing our report, we still conclude that any insurance program would need to cover all prime money market fund assets to be effective in the kind of environment that swept over the global financial system in 2008. Such a broad insurance program, however, would have negative consequences for financial markets as a whole, and for the banking sector in particular. Moreover, no program without some type of federal backstop would be effective or credible; any such program also would have to be coupled with some access to the Federal Reserve discount window. Finally, we remain concerned about the pooling of credit risk across money market fund providers. We do not see how introducing this type of moral hazard is beneficial to market discipline and the financial markets in general.

1. Pure Federal Insurance

On September 19, 2008, to help stem the unusual outflows from money market funds, the Treasury Department instituted the Treasury Guarantee Program for Money Market Funds (“Treasury Guarantee Program” or “Program”), a temporary and limited money market fund guarantee program.\(^75\) For a quarterly fee of 1 to 1.5 basis points of assets under management, an eligible money market fund could purchase from the Treasury Department a guarantee that would provide coverage to its shareholders for amounts that they held in the fund as of September 19, 2008. The guarantee would have been triggered if a participating fund broke the dollar. In particular, under the terms of the Program, the Treasury Department guaranteed that, upon the liquidation of a participating money market fund, the fund’s shareholders would receive the difference between the fund’s stable price and the market value for each fund share owned as of September 19, 2008.\(^76\) The Program expired by its terms on September 18, 2009, and taxpayers incurred no losses under the program.\(^77\) While the Treasury Guarantee Program helped to calm financial markets and investors, including money market fund investors, the Program’s exclusion of future balances above the high-water mark on September 19, 2008 (which ICI and money market fund sponsors supported) prevented widespread dislocation in the money market and depositories.


\(^{76}\) The Program provided coverage only to shareholders of record as of September 19, 2008, and the coverage was limited to the number of shares they held as of the close of business on that day. In addition, a participating money market fund that broke the dollar was required to suspend the redemption of its outstanding shares and commence liquidation within five business days.

\(^{77}\) As the Report notes, “Treasury neither received any claims for payment nor incurred any losses under the program.” Report at note 23. The Treasury Department received an estimated $1.2 billion in fee payments for the Treasury Guarantee Program.
Although the Treasury Guarantee Program served a useful purpose at the time, a permanent federal insurance program along these lines would raise deep concerns about market distortions. We have noted these concerns in other contexts including the extension of unlimited insurance on demand deposits at banks. For example, if there were an unlimited federal guarantee on investments in money market funds, the insured product likely would offer a higher return than bank deposits in many market environments. We can explore this hypothesis by examining historical yields on Treasury-only money market funds and MMDAs. The yield on a Treasury-only money market fund would be representative of the yield on a prime money market fund that is insured against credit risk. In the past 16 years, historical yields on Treasury-only money market funds have been considerably above those on MMDAs except during periods in which the federal funds rate has been at or below 1 percent (Figure 8). The larger the difference between yields on insured money market funds and MMDAs, the more we would expect insured money market funds to draw money from traditional banks, and possibly even other cash pools and direct investments in the money market. This disintermediation could and likely would cause 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 that investors play in monitoring fund activities.

If the insurance program were partial (for example, capped at $250,000 per account), many institutional investors likely would invest in this partially insured product rather than directly in the market or in other cash pools because the insured funds would offer liquidity, portfolios that were somewhat less risky than other pools, and yields only slightly lower than alternative cash pools. Without insurance covering the full value of investors’ account balances, however, there would still be an incentive for these investors to withdraw the uninsured portion of their assets from these funds during periods of severe market stress.

Even if there were unlimited federal insurance of money market fund assets, some access to the Federal Reserve discount window likely would be necessary. Deposit insurance programs for banks are coupled with discount window access. Future market events due to interest rate movements, for example, could cause investors to shift among or out of insured funds. In that event, money market

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78 See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (October 14, 2010) (expressing concerns regarding the FDIC’s proposed rule to provide unlimited insurance for “noninterest-bearing transaction accounts” for two years starting December 31, 2010).

79 Short-term Treasury yields tend to be closely aligned with the federal funds rate. The federal funds rate hovered around 1 percent from July 2003 to June 2004 and since October 2008 has remained well below 1 percent.

80 The liquidity requirements of Basel III and the new standards to be imposed on large bank holding companies under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) likely will cause many banking organizations to seek more insured deposits and, thus, compete more aggressively for such funds in the future. Nevertheless, it is unlikely that deposit rates would rise to equal those on money market funds because deposit rates at these levels would reduce net interest margins at most banks to unsustainable levels.
funds would have to quickly liquidate their assets to meet investor flows. Without discount window access, the funds might experience losses as they sold assets to meet redemptions.

Finally, as the Report notes, moral hazard is always a problem with insurance programs. This hazard could be reduced—though not eliminated—through the pricing of premiums, insurance deductibles, and specific provisions in insurance contracts. Even so, the program would require extensive ongoing monitoring and supervision to implement. This external monitoring is imprecise and cannot replace the market discipline that a fund’s own investors impose in the absence of insurance.

Figure 8
Treasury-Only Money Market Fund Yields and MMDA Rates

Percent, weekly

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2. Pure Private Insurance

Extensive discussions with insurance industry experts indicate that private, unlimited break-the-dollar insurance for money market funds is not feasible. While there is a precedent for private insurance for money market funds, the program offered by ICI Mutual 81 was far more restrictive than

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81 ICI Mutual, through a wholly-owned subsidiary, offered a money market fund insurance program with bonds in effect from June 1999 through June 2003, when the program was discontinued because of a lack of demand.
the Treasury Guarantee Program. The ICI Mutual insurance covered only defaults on securities and in very limited quantities. It did not cover losses resulting from movements in interest rates or securities that were downgraded or impaired.

Without a federal backstop, private insurance companies would consider unlimited guarantees on money market funds’ NAVs uninsurable because of the possibility of contagion. One critical aspect of an insurance company’s decision to provide insurance lies in its ability to predict future losses. An insurance company endeavors to maintain solvency (the ability to pay claims and pay for operational costs) by predicting the dollar amount of losses that, in turn, are offset by premiums and investments. For insurance companies to be economically incented to provide insurance, the occurrence of an insured event cannot be positively related to the number or severity of the resulting losses. In the case of money market funds, underwriters have indicated that they would be concerned about the possibility that a break-the-dollar event at a single fund could trigger outflows from other funds causing those funds’ shadow NAVs to fall below $0.995. The possibility of these events, though rare, compounds the amount of the predicted loss to such high levels as to make private break-the-dollar insurance infeasible.

Finally, but perhaps most importantly, confidence of market participants in a private insurance scheme for money market funds would be critical to its success in stemming a run. Unfortunately, confidence in private insurers, particularly those specializing in financial products, has been deeply eroded by the downgrades and near bankruptcies of insurance companies during the financial crisis. As a result, financial market participants reasonably could question the credibility of any private insurance scheme for money market funds. Our discussions with a number of institutional investors and advisers to retail investors confirmed this point.

3. Hybrid Insurance Programs

An alternative to either pure federal or pure private insurance would be to combine the two in a hybrid plan. For example, a three-tier system might require money market fund sponsors to purchase private insurance with a deductible on any loss of the first 0.5 percent of fund assets, private insurance covering the next 2.5 percent of fund assets, and the federal government backstopping losses amounting to more than 3 percent of fund assets. A hybrid insurance program would limit the federal government’s exposure by placing it last in line for losses.

A federal backstop would boost confidence by market participants in the program and presumably would contain the contagion feared by private insurers. If money market fund investors know the federal government is the “insurer of last resort,” they will be far less likely to redeem en masse

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82 The money market fund bonds offered by ICI Mutual offered deductibles ranging from 10 to 40 basis points of the total assets of the insured money market fund and carried a premium of 1 to 3 basis points depending on various underwriting factors, including portfolio composition. Bond coverage limits per fund ranged from $10 million to $100 million.
when there is a trigger event, such as a default of a security in a money market fund’s portfolio that causes the fund to break the dollar.

While insurers are better able to predict their losses in this hybrid scheme, they still would require very high levels of capital to support such insurance, probably at least 10 times expected losses. Losses on securities that advisers either purchased from or supported on behalf of their money market funds since August 2007 are estimated to have totaled at least $4 billion. By that measure, a private insurer would require at least $40 billion in capital to support this insurance concept. We understand that the insurance industry (including reinsurers) would not have such a large amount of free capital available. As a result, capital for the private insurance portion, even when that insurance is limited to 2.5 percent of assets after an initial deductible, would be extremely difficult to obtain. Furthermore, the problem identified above with insured money market funds offering superior yields to bank deposits, thus encouraging disintermediation from banks, would remain. In addition, many banks will need to raise significant capital under the Basel III framework, which may mean that a private insurer’s cost of capital may be greater than otherwise would be the case.

E. A Two-Tier System with Enhanced Protections for Stable NAV Money Market Funds

Another option included in the Report would allow two types of money market funds to be regulated under Rule 2a-7. Under this option, stable NAV money market funds would continue to maintain stable, rounded NAVs, but they would be subject to “enhanced protections,” which might include “some combination of tighter regulation (such as higher liquidity standards) and required access to an external liquidity backstop.” The Report notes that other options to provide enhanced protection for stable NAV funds might include mandatory distributions of large redemptions in kind and insurance.

Additionally, under this option, the Report indicates that although floating NAV money market funds would still have to comply with many of the current restrictions of Rule 2a-7, these restrictions might be somewhat less stringent than those for stable NAV funds, allowing floating NAV funds to bear somewhat greater credit and liquidity risks than stable NAV funds. The Report also notes the possibility of regulatory relief for floating NAV funds that might preserve the attractiveness of such funds for many investors—for example, allowing simplified tax treatment for small NAV changes in funds that adhere to Rule 2a-7.

The Report asserts that a two-tier system could mitigate the systemic risks that arise from a stable, rounded NAV, by requiring funds that maintain a stable NAV to have additional protections that directly address some of the features that contribute to their vulnerability to runs. The Report is vague, however, regarding what “enhanced protections” the PWG contemplated. More details would be necessary before ICI could determine whether to endorse or reject the approach. As an example, if “enhancements” meant required access to an emergency liquidity facility for prime funds, ICI could

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83 Losses are the difference between the par value of the impaired debt and any amounts recovered through payment of principal and interest. The $4 billion estimate is based on conversations with industry representatives and analysts.
support the approach if the liquidity facility met the conditions described in Section III.A. On the other hand, if “enhanced protections” made the product less attractive to investors, this approach would not address systemic risks. For example, if stable NAV money market funds were required to satisfy even more stringent risk-limiting conditions than Rule 2a-7 currently requires (such as those relating to liquidity and maturity), this could lead many investors—especially institutional investors—to abandon these funds in favor of alternative products that offer a stable NAV and higher returns, but without the transparency and other regulatory protections that money market funds provide.

The Report also contends that under a two-tier system, investors who choose floating NAV funds presumably would be less risk-averse and more tolerant of NAV changes than the shareholders of stable NAV funds. Of course, this assumes that investors would fully appreciate the difference between the two types of funds and their associated risks.\textsuperscript{84} Indeed, the Report acknowledges that a two-tier system would not be effective in mitigating the risk of runs if investors who do not make this distinction flee indiscriminately from both floating NAV and stable NAV funds. We agree, and as discussed in Section III.B., note that recent experience has shown that floating the NAV of a money market fund would not lessen the incentive for investors to redeem shares rapidly in periods of market turmoil. For example, ultra-short bond funds lost more than 60 percent of their assets from mid-2007 to the end of 2008. Likewise, French floating NAV dynamic money funds lost about 40 percent of their assets over a three-month time span from July 2007 to September 2007.

F. A Two-Tier System with Stable NAV Money Market Funds Reserved for Retail Investors

A variation on the two-tier system described above would be to distinguish stable NAV and floating NAV funds by investor type. Under this option, stable NAV money market funds could be made available only to “retail” investors, while “institutional” investors would be restricted to floating NAV funds or alternative products. The Report asserts that because institutional investors have historically generated greater risks of runs for money market funds than retail investors and institutional money market funds typically have greater cash flow volatility than retail funds, this approach would bring enhanced protections to stable NAV money market funds by mitigating the risk arising from the behavior of institutional investors.

The Report acknowledges, however, that because many institutional investors may be particularly unwilling to switch to floating NAV money market funds, a prohibition on sales of stable NAV money market funds shares to such investors may have many of the same unintended consequences as a requirement that all money market funds adopt floating NAVs. We agree. Indeed, as discussed above in Section III.B., many investors that use money market funds often face legal or other constraints that would prohibit them from using a floating NAV equivalent. Even for investors that do

\textsuperscript{84} As noted in Section I.B., in May 2010 CESR issued guidelines for a common definition of European money funds and adopted a two-tier categorization system. CESR’s efforts narrow and bring more clarity to the classification of money funds in Europe where there was, until recently, no harmonized definition of a money fund. These guidelines are intended to reduce confusion in the European market. In contrast, the U.S. market has been accustomed to only one type of money market fund for a long time, and the introduction of a new, potentially riskier alternative could create investor confusion.
not face such constraints, surveys have shown that most investors do not want and would not use a floating NAV product. Instead, prohibiting investors from using stable NAV money market funds might cause many of these investors to move their assets from money market funds into less regulated money market fund alternatives. Of course, such a large shift in assets is of particular concern given that, as the Report notes, “institutional” money market funds currently account for almost two-thirds of the assets under management in money market funds. As discussed in Section III.B., a floating NAV product also likely would not deter investors from exiting quickly in a crisis, and in doing so putting stress on securities held in common between retail stable NAV funds and institutional floating NAV funds.

Furthermore, successful enforcement of a rule prohibiting institutional investors from using stable NAV money market funds would require the SEC to carefully define “retail” and “institutional” investors. The ICI’s Money Market Working Group considered a similar concept, but it concluded that it was “simplistic, unworkable, and could disadvantage both types of investors.” The SEC also acknowledged that it has not identified an effective way to distinguish between types of money market funds. For example, while some fund sponsors do offer money market funds primarily to clearly identifiable retail or institutional investors, many funds include a substantial combination of both types of investors that are not so easily categorized. Not all institutional or retail investors behave alike, so any broad categorization likely will be both over- and under-inclusive. Moreover, there are important areas of overlap between retail and institutional investors that can make drawing a bright line between types of investors quite challenging and therefore inconsistent across the industry. For example, although retail investors may invest in money market funds through retail share classes, they also invest through institutional share classes, such as 401(k) plans or broker or bank sweep accounts, where there may be one institutional decision maker acting on behalf of underlying retail customers.

In fact, the Report even acknowledges that simple rules that might be used to identify institutional investors, such as defining as institutional any investor whose account size exceeds a certain threshold, would be imperfect and could motivate excluded institutional investors to gain access to a money market fund unbeknownst to its sponsor. Industry experience suggests that any such categorization will be difficult to enforce. For these reasons, we continue to oppose this artificial categorization of money market fund investors.

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85 Institutional money market funds are held primarily by businesses, governments, and high net worth households. But they also are used by individuals that invest in institutional share classes, for example, through 401(k) plans or broker or bank sweep accounts. We believe, as explained below, that definitively categorizing investors or funds as “institutional” or “retail” is unworkable and unenforceable.

86 See MMWG Report at 117.

87 See MMF Reform Adopting Release at 60. Indeed, the concept of a retail/institutional split generated a significant number of negative comments.
G. Regulating Stable NAV Money Market Funds as Special Purpose Banks ("SPBs")

The Report raises the possibility of requiring bank-like regulation of money market funds that maintain a stable NAV. As discussed below, it is unclear what the motivation would be for such a significant regulatory and structural change. If the rationale for change is that the bank structure and regulation is superior to that of mutual funds or money market funds in particular, we are not aware of the evidence supporting this position. In the past two decades, individual countries and the global economy have been buffeted by numerous banking crises, providing ample evidence that this structure has its own challenges. If the proposal’s motivation is to provide money market funds with deposit insurance, we have noted above that only unlimited insurance would guarantee that investors would not redeem shares in the midst of another widespread financial crisis. Even partial insurance would introduce a significantly larger amount of moral hazard into the asset management business, and would create some of the same monitoring challenges that insurance currently creates for the banking regulators. If the objective is to require capital that would protect investors from some or all of the investment risk that they currently bear in money market funds, it is unclear whether the business model for money market funds would remain viable to support the capital needed to absorb enough risk to keep fund investors quiescent during a future financial market crisis. Finally, if the goal is to provide an alternative to market-based liquidity during periods of financial market stress, we believe that the LF, as described in Section III.A., is a superior solution to restructuring money market funds as banks.

1. Differences between Bank and Money Market Fund Structures and Regulation

Banks take deposits, which are reflected as debt on banks’ balance sheets, and may invest in long-term, highly opaque and illiquid investments (such as mortgages). Banks issue equity to investors, who absorb losses on assets and help insulate depositors and other creditors from portfolio losses. Bank depositors in many countries have deposit insurance as an added layer of protection. In the United States, depositors are protected by FDIC insurance up to $250,000 per account, which limits the incentives for insured depositors to rapidly withdraw deposits from a bank.\(^88\) While it protects retail depositors, deposit insurance creates significant moral hazard. Bank regulation is largely designed to restrict the types of risks that banks can undertake through their operations. These restrictions are intended to limit the costs to the FDIC and ultimately the U.S. taxpayer, in the event of a bank failure. They also provide protections to the Federal Reserve, which serves as a lender of last resort to U.S. banks.

Money market funds issue securities, and like all mutual funds, they must redeem their shares on demand. Unlike deposits, fund shares are paid in capital, not debt, and unless the fund adviser chooses to absorb losses in the fund, fund investors bear the investment risks of the portfolio. As

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\(^88\) In addition, funds held in non-interest bearing transaction accounts are provided temporary unlimited coverage and are fully insured through December 31, 2012. See Deposit Insurance Regulations; Unlimited Coverage for Noninterest Bearing Transaction Accounts, 75 Fed. Reg. 69,577 (November 15, 2010) (to be codified at 12 C.F.R. pt. 330).
discussed in Section II, however, money market funds are constrained by Rule 2a-7, which specifies strict limits on portfolio credit quality, readily available liquidity for redemptions, diversification of issuers and guarantors of portfolio securities, and maturity of portfolio securities.

2. Advantages of Bank Regulation and Structure are not Evident

Bank structures and regulation are not free of problems. In the past twenty years, global economies have been shaken by a series of banking crises, with the crisis that began in 2007 being the most widespread and severe. In a recent study of this crisis, one-third of the 66 countries that were examined were in the throes of a banking crisis by late 2008. 89 Only a decade before, nearly one-quarter of the sampled countries suffered through a slightly less severe series of crises. 90 Banking crises, and their attendant severe economic contractions, have occurred even though global bank capital rules have undergone major changes through Basel I and II, and a third major change to the global regulatory framework is now being framed under Basel III. It is unclear whether these new rules will increase or decrease the likelihood of future banking crises, particularly since they incentivize banks to hold larger amounts of sovereign debt in an era when the credit quality and liquidity of such debt for many countries is under question.

Given the lack of evidence that banking structure and regulation provide superior protections to financial markets and the global economy, perhaps the motivation for the recommendation is for money market fund investors to be protected by deposit insurance, and that deposit insurance requires bank capital to protect the insurer from losses. As discussed in Section III.D, only unlimited insurance would ensure that large investors did not rapidly redeem money market fund shares under extreme market conditions. Unlimited insurance, however, would skew the competitive landscape away from bank deposits and towards money market funds. It also would discourage investors from monitoring the investment risks of any particular SPB. Although money market funds might benefit from substantial inflows at the expense of banks, the mere possibility of vast flows from one financial sector to another raises systemic risk concerns. Finally, even if the insurance were only partial, such an insurance program would pool the risks taken on by fund managers, just as deposit insurance does for banks, and create a significant degree of moral hazard among money market funds.

The Report suggests that requiring money market funds to reorganize as SPBs would provide a means of capitalizing the funds or their sponsors and thereby protect investors from investment losses. If bank regulators required these SPBs to be fully capitalized in accordance with Basel III standards, the economic viability of money market funds would no longer exist. The leverage ratios for banks are designed to protect creditors, the FDIC, and the Federal Reserve from the losses in their exposures to banks. The risks that banks take on in their operations and portfolios are much greater than those faced by money market fund investors or fund sponsors. Barring some other kind of regulatory relief,

89 Carmen M. Reinhart and Kenneth S. Rogoff, This Time Is Different 252 (Princeton University Press 2009).
90 Id.
money market funds would be better off simply reorganizing as conventional banks to avoid dual bank/Rule 2a-7 regulation. Perhaps in acknowledgment of the risk-limiting conditions of Rule 2a-7, regulators might seek to offer these SPBs or fund sponsors some relief, such as by allowing the SPBs to maintain considerably less capital than conventional banks. It is an open question whether that could be accomplished without legislation or whether such legislation would be politically feasible.

The Report also suggests that one reason for the SPB option is to provide money market funds access to the Federal Reserve discount window. Creating a SPB and subjecting money market funds to some form of banking regulation, could provide the capital to insulate the Federal Reserve from losses and allow individual SPBs to borrow with recourse from the discount window. As discussed, however, we have serious concerns about the wisdom of converting an investment product, such as a money market fund, into a bank. A better option, in our view, is to form a private emergency liquidity facility, as recommended in Section III.A., that would be structured and capitalized as a bank. As discussed, the LF would hold high-quality, liquid assets that could be sold and the proceeds used to purchase securities from money market funds when financial markets become illiquid as they did in September 2008. The LF would eventually be very highly capitalized, providing it with sufficient capital should it ever need to access the discount window.

Finally, if the objective is to provide a package of protections to fund investors and the markets to reduce systemic financial risks, it seems unlikely that sophisticated investors would choose to leave their assets in the banking system. A very significant feature of money market funds’ structure is that the funds automatically pass through to fund shareholders the yields on the money market instruments they hold (less operating expenses). This means that yields on money market funds mechanically track yields on money market instruments. Historically, this has worked to the benefit of money fund investors: since 1995, yields on taxable money market funds have exceeded those on bank MMDAs by 1.55 percent (Figure 9). Investors wanting a market-based yield, therefore, would be considerably disadvantaged by this new SPB model relative to the benefits they currently receive from money market funds. Bank deposit rates are "administered": they are set by banks and historically have responded only very sluggishly to changes in yields on money market instruments. Banks’ profits are paid to their equity shareholders.
Even if regulators could somehow structure regulations so that money market fund investors could be *forced* to maintain their assets with new SPBs that are fully capitalized (according to Basel standards) but only partially insured (up to the current maximum of $250,000), significant challenges would still remain. As the Report notes, a “simple transformation” of the assets of money market funds into depositories could lead to a decline in the availability of credit through the money market, such as lending to companies and state and local governments that rely on money market funds to meet short-term financing requirements. Indeed, the effect of such a transformation on the U.S. economy cannot be overstated. Money market funds serve as an important source of direct, cost-efficient financing for various entities that cannot easily be replaced. Money market funds hold nearly 40 percent of outstanding commercial paper issued by a wide variety of institutions. Regulators, therefore, ought to be highly careful about implementing any proposal that contracts credit available to firms and governments, given both the fragility of the economic recovery and expected credit contractions that may take place as banks comply with Basel III’s capital and liquidity regimes.
H. Enhanced Constraints on Money Market Fund Substitutes

As noted above, new measures intended to mitigate money market fund risks also may greatly reduce the appeal of money market funds to many investors. Indeed, if money market funds are required to float their NAVs or if the regulation of such funds becomes too burdensome, meaningfully reduces the availability of money market funds to investors, or substantially reduces the yields of such funds, then institutional investors will have every incentive to move their assets into less regulated products such as offshore money market funds or sweeps, enhanced cash funds, and other stable value products. These alternative investment products would fall outside the careful regulatory framework in place for money market funds, and potentially increase the systemic risk to the financial system.

To address this concern, the Report discusses the possibility of imposing enhanced regulatory constraints on alternative investments. The Report notes that such reforms could include prohibiting unregistered investment vehicles from maintaining stable NAVs, perhaps by amending Sections 3(c)(1) and 3(c)(7) of the Investment Company Act to specify that exemptions from the requirement to register as an investment company do not apply to funds that seek a stable NAV. The Report also suggests that banking and state insurance regulators might consider additional restrictions to mitigate systemic risk for bank common and collective funds and other investment pools that seek a stable NAV but that are exempt from registration under Sections 3(c)(3) and 3(c)(11) of the Investment Company Act. As noted above in Section III.B., however, such reforms would likely do little to reduce systemic risk given the wide variety of alternative cash management products available to institutional investors, including offshore money funds and overnight sweep arrangements, many of which are largely beyond the jurisdictional reach of domestic regulators.

IV. Additional Reform for Consideration—Investor Transparency

In addition to a private emergency liquidity facility for prime money market funds, as described in Section III.A., the fund industry has continued to explore other ideas on reform of money market funds and the overall money market. One such idea is a rule mandating that intermediaries disclose information regarding underlying investors in order to facilitate money market funds’ ability to comply with “know your investor” requirements.

As part of the SEC’s new rules for money market funds, funds must adopt “know your investor” procedures that help them identify factors that could affect the fund’s liquidity needs, including characteristics of a money market fund’s investors and their likely redemption patterns. While this is an important idea in concept, identification of these risks is challenging when share ownership lacks transparency because the shares are held or traded, for example, by intermediaries through omnibus accounts, portals, sweep arrangements, or other trading platforms.91

91 The MMF Reform Adopting Release acknowledges these difficulties and notes that funds may seek to access this information about the investors who hold their interests through omnibus accounts (such as through contractual arrangements with their financial intermediaries) in addition to considering information about the omnibus accounts, including their aggregate historical redemption patterns and the account recordholder’s ability to redeem the entire account.
To help facilitate this new requirement, we recommend that the SEC consider a rule that would directly mandate that, upon request of a money market fund, intermediaries provide the fund with sufficient investor information to aid the fund’s efforts to meet its obligations under the SEC’s 2010 money market fund reforms.\(^9\) For example, intermediaries, upon request, could provide funds with investor-specific data related to trading activity over a specified period or investor data related to holdings of a certain percentage. Such data would assist the fund’s adviser and board in monitoring a fund’s investor profile and adjusting liquidity accordingly.

We note that in previous rulemakings the SEC has imposed an obligation on funds, but not on intermediaries, to obtain similar information from intermediaries.\(^9\) Getting this information in a timely fashion, however, has proven to be quite burdensome and costly for funds. By imposing an affirmative legal requirement on intermediaries, the SEC can significantly mitigate these burdens, an especially desirable result at a time when money market funds are not well positioned to absorb additional costs.

V. Conclusion

ICI and its members are firmly committed to working with policymakers to further strengthen money market funds’ resilience to severe market stress. We believe that creating a private emergency facility to serve as a back-up source of liquidity for prime money market funds in the event of unusual market stress is the best way to achieve this goal. In contrast to other options presented in the Report, the LF will help fortify money market funds against adverse market conditions while still preserving the key characteristics that make these funds so important to the U.S. economy and so highly valued by investors. In addition, the LF is designed to avoid potential unintended negative consequences that several of the other options would entail, such as harmful effects on the market or an increase in systemic risk. While we do not support the other approaches outlined in the Report, we recommend one additional measure: a rule mandating that intermediaries provide information to facilitate money market funds’ ability to comply with “know your investor” requirements.

\[\text{\textstar}\text{\textstar}\text{\textstar}\text{\textstar}\]

\(^9\) To address intermediary concerns about the proprietary nature of this information, we believe existing agreements contain, or could be modified to include, provisions limiting the use of customer information provided to the fund (e.g., where the fund agrees not to use such information for marketing or any other similar purpose without the prior written consent of the intermediary). In addition, federal and state laws that govern when financial intermediaries may share customer nonpublic personal financial information with other entities or persons would not appear to restrict the ability of a financial intermediary to share this information for this purpose. Such laws also limit the use of such information by a fund that receives it.

\(^9\) Twice in the recent past, the SEC has imposed on funds or their advisers an obligation to obtain shareholder information that is held by intermediaries and that is not within the fund’s or adviser’s possession or control. See Rule 22c-2 under the Investment Company Act relating to redemption fees, and Rule 204-2(a)(18) under the Investment Advisers Act of 1940 relating to recordkeeping requirements under the SEC’s new investment adviser pay-to-play rule.
We look forward to working with the SEC and other members of FSOC as they examine these critical issues. In the meantime, if you have any questions, please feel free to contact me at (202) 326-5901, Karrie McMillan, General Counsel, at (202) 326-5815, or Brian Reid, Chief Economist, at (202) 326-5917.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President & CEO

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
    Jennifer B. McHugh, Acting Director
    Robert E. Plaze, Associate Director
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Financial Stability Oversight Council