TESTIMONY OF

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BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

ON

“PERSPECTIVES ON MONEY MARKET MUTUAL FUND REFORMS”

JUNE 21, 2012
EXECUTIVE SUMMARY

- Money market funds are one of the most significant financial product innovations of the past half century. With $2.6 trillion in assets, money market funds today serve over 57 million retail investors, as well as corporations, municipalities, and other institutional investors as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability of principal, and a market-based yield. They are an important source of direct financing for state and local governments, businesses, and financial institutions, and indirect financing for households.

- Contrary to the suggestions of critics and some policymakers, a careful review of market events demonstrates that money market funds did not accelerate the financial crisis of 2007-2008. Like other market participants, money market funds were directly affected by enormous scale and duration of the crisis, and by the lack of coherent, consistent government policy responses. In contrast to massive failures in the bank sector, a single money market fund could not return the full $1.00 share price to investors after an unprecedented set of failures, including that of Lehman Brothers. The events of 2007-2008 are in stark contrast to those of 1994—the only other time a money market fund ever “broke a dollar.”

- Even as investors lost confidence in the markets and in government policy during the 2007-2008 financial crisis, they remained invested in money market funds, shifting their assets from “prime” money market funds to Treasury and government and agency money market funds. Assets of money market funds achieved an all-time high of almost $3.9 trillion by February 2009.

- Since the crisis, much progress has been made toward the objective of preserving the benefits that money market funds provide to the economy and to investors, while making them more resilient in the face of severe market stress. Most notably, drawing upon recommendations from ICI’s Money Market Working Group, in early 2010 the Securities and Exchange Commission approved rule amendments designed to strengthen money market funds against certain short-term market risks and provide greater protections for investors in a fund that is unable to maintain a stable net asset value (“NAV”) per share. These rule changes proved their value in the face of significant market turmoil last summer, calling into question the need for further reforms.

- Any additional reforms must preserve the fundamental characteristics of money market funds—such as a stable NAV and ready liquidity—and ensure a continued robust and competitive money market fund industry. Unfortunately, some regulators continue to view money market fund reform through the outdated lens of 2008. They are considering structural changes that would alter the characteristics that investors deeply value and reduce competition by driving fund sponsors out of the business. These changes would destroy money market funds, at great cost to investors, state and local governments and the economy.
I. Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

I very much appreciate the opportunity to appear before the Senate Committee on Banking, Housing and Urban Affairs and offer our perspectives on the state of the money market fund industry. Money market funds, which date back to the early 1970s, are one of the most significant and successful financial product innovations of the past half century. Today, over 57 million retail investors, as well as corporations, municipalities, and other institutional investors, rely on the $2.6 trillion money market fund industry as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability of principal value, and a market-based yield. Money market funds also serve as an important source of direct financing for state and local governments, businesses, and financial institutions, and of indirect financing for households. Without these funds, financing for all of these institutions and individuals would be more expensive and less efficient.1

Money market funds owe their success, in large part, to the stringent regulatory requirements to which they are subject under the federal securities laws including, most notably, Rule 2a-7 under the Investment Company Act of 1940 (“Investment Company Act”). The regulatory regime established by Rule 2a-7 has proven to be flexible and effective in protecting investors’ interests and maintaining their confidence in money market funds. The Securities and Exchange Commission (“SEC”) deserves tremendous credit for crafting these requirements and administering them in a manner that has allowed money market funds to thrive and to serve so many investors. The SEC also has modernized and strengthened the rule from time to time as circumstances warranted (most recently in 2010, as discussed below).

In recognition of the importance of money market funds to the global economy and to investors, ICI and its members have devoted significant time and effort to considering how to make money market funds more robust under even the most adverse market conditions—such as those caused by the widespread bank failures in 2008. Over the past few years, the SEC and the fund industry have made a great deal of progress toward their shared goal of strengthening the resiliency of money market funds. Taking the initiative to respond quickly and aggressively to the events of fall 2008, ICI formed a Money Market Working Group to study the money market, money market funds and other participants in the money market, and recent market circumstances.2 The March 2009 Report of the

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1 An overview of the importance of money market funds as financial intermediaries within the broader money market is attached as an appendix to this letter.

2 A copy of the press release announcing the formation of the Working Group is available on ICI’s website at http://www.ici.org/policy/regulation/products/money_market/08_news_mm_group.
Money Market Working Group addressed these topics and advanced wide-ranging recommendations for the SEC to strengthen money market fund regulation.3

In 2010, with the industry’s strong support, the SEC approved far-reaching rule amendments that incorporated many of the MMWG Report’s recommendations and enhanced an already-strict regime of money market fund regulation.4 The amended rules make money market funds more resilient by, among other things, imposing new credit quality, maturity, and liquidity standards and increasing the transparency of these funds. In the event a money market fund proves unable to maintain a stable $1.00 net asset value (“NAV”) per share, the fund’s board of directors is empowered to take prompt action to assure an orderly liquidation of the fund and equitable treatment for all shareholders. These reforms proved their value last summer when money market funds—without incident—met large volumes of shareholder redemptions during periods of significant market turmoil, including a credit event involving the historic downgrade of U.S. government debt.5 Indeed, so far-reaching were these reforms that today’s money market fund industry is dramatically different from that of 2008. Yet, the calls for further reform continue.

Regulators reportedly are pursuing flawed proposals that will harm investors, damage financing for businesses and state and local governments, and jeopardize a still-fragile economic recovery.6 Indeed, the ideas under consideration will drive funds out of business, reducing competition and choice, and alter the fundamental characteristics of money market funds—such as a stable NAV and ready liquidity—thereby destroying their value to investors and the economy. Rather than making our economy and financial system stronger, such reforms have the potential to increase systemic risk by driving investors into less-regulated, less-transparent products. In a recent survey by Treasury Strategies, Inc., four out of five institutional investors said they would reduce or eliminate their use of money market funds if those funds are subjected to a floating NAV requirement or redemption restrictions.7 Based on these investors’ estimates, institutional assets in money market funds would decline by 60 percent or more.8


4 See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010) (“MMF Reform Adopting Release”). The current regulatory requirements for money market funds are discussed in greater detail in Section IV, below.

5 See infra Section IV.F.


7 ICI commissioned Treasury Strategies, Inc. to conduct a study to help understand the effects of various SEC reform concepts on money market fund investors. The report, Money Market Fund Regulation: The Voice of the Treasurer, is available on ICI’s website at http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf (“TSI Survey”). Treasury Strategies surveyed 203 unique corporate, government, and institutional investors between February 13 and March 6, 2012, asking 31
For our part, ICI has consistently supported exploring reasonable options to make money market funds even more resilient while preserving the fundamental characteristics of these funds. ICI’s views on possible additional money market fund reforms also have evolved in recent months, for several reasons. First, as mentioned above, we have had the opportunity to observe the success of the SEC’s 2010 amendments in helping money market funds withstand market stress, which strongly calls into question the need for additional reforms. Second, we have concluded that reform options reportedly under the most serious consideration are severely flawed and would prove extraordinarily detrimental to investors, issuers of short-term debt, and the country, not to mention the industry.

We remain committed to working with regulators on this important issue, but we submit that this process should be guided by two principles. First, we should preserve those key features of money market funds (including the stable $1.00 per-share NAV and ready liquidity) that have made them so valuable and attractive to investors. Second, we should preserve choice for investors by ensuring a continued robust and competitive global money market fund industry. Unfortunately, the proposals we understand some regulators currently are considering are altogether at odds with these principles.

Our comments below begin with a discussion of the events of 2007 to 2008—including the tumultuous weeks during September 2008 after Lehman Brothers failed—to correct the false narrative espoused by some policymakers and critics that money market funds were responsible for accelerating the financial crisis (Section II and Appendix A). Next, we describe efforts undertaken by the regulators and the industry to strengthen money market fund regulation in response to the financial crisis (Section III). We then examine how money market funds are regulated today under the new, stricter SEC amendments and how those new requirements helped position the money market fund industry to successfully weather recent market challenges (Section IV). Finally, we discuss our deep concerns with the policy options the SEC is considering: requiring money market funds to let their share prices float; requiring the funds or their advisers to maintain explicit capital; and implementing permanent restrictions on shareholders’ ability to redeem all of their shares on demand (Section V). To better explain the singular benefits money market funds provide to investors and the economy, we also provide an overview of the money market itself, including its structure and participants and the key characteristics of money market funds (Appendix B).

II. Understanding Money Market Fund Developments in the Financial Crisis

Critics of money market funds often argue that the financial crisis of 2007-2008 demonstrated that money market funds are particularly “fragile” or “susceptible” to runs. They contend that if any one money market fund today were to “break a dollar” (i.e., fail to maintain a $1.00 NAV) shareholders of other funds would redeem en masse. We strongly disagree.
Federal Reserve Chairman Ben Bernanke characterized the market events in the fall of 2008 as “the worst financial crisis in global history, including the Great Depression.”9 He went on to say that “[i]f you look at the firms that came under pressure in that period...only one...was not at serious risk of failure. So out of maybe the 13, 13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two.”10 The events of 2007-2008 were, to be sure, highly unusual. They appear all the more so when compared with the only other time a money market fund broke a dollar, and the differences vividly illustrate the importance of the state of the overall financial economy to investor reaction. How investors are likely to react in the very rare event that a money market fund is unable to return a full $1.00 per share critically depends, in our judgment, on the financial environment—i.e., whether and to what degree there are adverse financial market developments that precede and surround that occurrence.

A. Market Events Leading Up to September 2008

Money market funds were not the cause of the financial crisis, but were directly affected by its enormous scale and duration, and by the lack of coherent, consistent government policy responses.11 Like many market participants, money market funds were hit by a global crisis that began to take hold long before September 2008.

Much of this history is familiar, but the parts of it that relate to money market funds may be less so. It deserves careful review, in light of critics’ broad claims about the experience of money market funds in the crisis. The financial crisis was, first and foremost, a crisis in the real estate markets and the “originate to distribute” model that developed.12 Over the period from 2004 to mid-2006, originations of subprime and other low-documentation mortgage loans soared.13 Many subprime borrowers had taken out deeply-discounted adjustable-rate mortgages or mortgages with negative amortization features,14 partly on the belief that house prices would continue to rise and allow them to refinance on more favorable terms in the future. Over the same period, however, short-term interest rates rose sharply, as monetary policy sought to dampen inflation.15 The rapid increase in short-term interest rates fostered a slowing of the economy, job losses, and a rise in the cost of new mortgage borrowing.

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10 Id.
11 For a timeline of major developments in the financial crisis, see Appendix A.
12 See generally FCIC Report, supra note 9.
13 The number of subprime and other low-documentation mortgage originations doubled from 1.4 million in 2003 to 3 million in 2005 and then leveled off in 2006. These mortgages represented more than 30 percent of the total dollar amount of mortgage lending in 2005, up from only 10 percent in 2003. See Chris Mayer, Karen Pence, and Shane Sherlund, “The Rise in Mortgage Defaults,” Finance and Economics Discussion Series, Federal Reserve Board (November 2008).
14 Generally, negative amortization occurs when a borrower’s payment for a period is less than the interest assessed during that period, resulting in an increase in the borrower’s loan balance.
15 From June 2004 through June 2006, the Federal Reserve, seeking to forestall inflationary pressures and return short-term interest rates to a more normal level, raised the federal funds rate by 425 basis points, from 1 percent to 5.25 percent, and kept the overnight rate at that level until September 2007.
Appreciation of house prices moderated and then faltered. In the face of these developments, subprime borrowers began to default on their mortgages.

Difficulties in the subprime mortgage market began to spill over into the short-term and credit markets by mid-2007. Increasingly, lenders had financed subprime and other mortgages by packaging them into structured products, which were then sold into the financial markets. In some cases, such mortgages were used to back asset-backed commercial paper (“ABCP”) or were channeled into structured investment vehicles (“SIVs”) that then issued commercial paper. In June and July 2007, credit rating agencies began to downgrade many of the assets (such as SIVs and ABCP) that were backed either directly or indirectly by subprime mortgages. This caused difficulties for investment pools that held subprime mortgages, or ABCP and SIVs backed by subprime mortgages, and the auction rate securities market, which were impacted because of spillover effects.

The banking crisis that followed was catastrophic. At least 13 major institutions went bankrupt, were taken over, or were rescued in the 12 months before Lehman Brothers failed. Lehman’s failure was an especially difficult shock for the market because it represented an abrupt reverse in direction by the U.S. government from its previous decisions to intervene and rescue the smaller Bear Stearns, and Fannie Mae and Freddie Mac.

By contrast, money market funds received a strong vote of confidence. Over the 13 months from the end of July 2007 through August 2008, money market funds absorbed almost $900 billion in new cash, boosting the size of the money market fund industry by more than one-third. Eighty percent of this vast inflow (more than $700 billion) was directed to institutional share classes, as institutional investors, such as corporate cash managers and state and local governments, sought a safer haven for their cash balances.

B. Key Market Events—September 2008

The financial crisis reached a critical stage during September 2008, which was characterized by severely impaired liquidity in the global credit markets and insolvency threats to numerous investment banks and other financial institutions. In contrast to massive failures in the bank sector, a single U.S. money market fund (Reserve Primary Fund) could not return the full $1.00 NAV per share to investors.

16 Several factors have been identified as contributing to the seizing of the ARS market. Monoline insurers, which provided insurance for many ARS, were downgraded due to losses on mortgage-backed bonds that they had insured. These downgrades made investors less willing to come into the ARS market. The number of investors seeking to sell their ARS holdings outpaced the number of investors bidding in the auctions, requiring broker-dealers to step in absorb the excess supply. Ultimately, however, pressures on broker-dealers’ balance sheets (e.g., write downs due to the subprime mortgage crisis) led to broker-dealer firms abruptly ending their participation in the market.

17 This vote of confidence reflected a number of factors. First, compared to other short-term investment pools, money market funds, under the strictures of Rule 2a-7 and with the overall protections of the Investment Company Act, had portfolios with shorter maturity, greater liquidity, higher quality, more diversification, and more transparency, and with no leverage. Second, to the extent that money market funds were indirectly exposed to subprime mortgages through ABCP or SIVs, they had been rapidly divesting themselves of such holdings. Third, in cases where money market funds had not divested themselves of ABCP or SIVs and the market prices of those securities had the potential to put the $1.00 NAV of those money market funds at risk, their sponsors stepped in to purchase or otherwise support the distressed assets.
after Lehman failed. Lehman’s sudden failure and widespread uncertainty about the government’s stance towards other troubled institutions had severe impacts on markets and market participants. Certain money market funds and many other money market participants were hit by a severe liquidity freeze. Banks, seeking to preserve their liquidity, refused to lend to one another. Investors lost confidence in the markets and in government policy.

Following the events of September 15-16, concerns rapidly spread in the financial markets that the debt of other large investment banks (The Goldman Sachs Group, Inc. and Morgan Stanley) and certain large commercial banks (Wachovia Corporation, Washington Mutual, and Citigroup) presented much greater risk than previously thought. The government’s policy on rescuing troubled institutions also caused significant confusion, as many in the market had expected Lehman to be rescued, following the precedent the government set with its actions toward Bear Stearns, Fannie Mae, and Freddie Mac. Reflecting these concerns, the cost of insuring against defaults by these institutions rose dramatically and deepened the credit freeze. At the time, Federal Reserve officials seem to have been surprised by the severity of the market’s reaction. For example, in Congressional testimony on September 23, Federal Reserve Chairman Ben Bernanke noted that:

[t]he failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized—as evidenced, for example, by the high cost of insuring Lehman’s debt in the market for credit default swaps—that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.

While perhaps manageable in itself, Lehman’s default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development . . . of extraordinarily turbulent conditions in global financial markets.19

Even in these extreme conditions, however, investors remained invested in money market funds—they shifted their assets from prime money market funds, which held financial institutions’ securities, to Treasury and government and agency money market funds, which did not. About $300 billion flowed out of prime money market funds; for every dollar that left these funds, however, 61 cents flowed into Treasury and government and agency funds. Indeed, investors did not abandon money market funds; they reacted to their concerns about the financial health of banks, the U.S. government’s unpredictable response to financial institutions’ collapses, and concerns about whether in such an environment prime money market funds could continue to sell assets into a frozen commercial paper market.

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18 One day after Lehman was allowed to fail and the same day the Reserve Primary Fund broke a dollar, the government again switched course and agreed to lend American International Group, Inc. (AIG) up to $85 billion and to take a nearly 80 percent stake in the company, reversing an earlier indication that it would not participate in a rescue of the insurance giant.

Following these events, the Federal Reserve and U.S. Treasury Department announced a series of broad initiatives designed to stabilize the market, which had ceased to function even for very short-term, high-credit securities. One of these programs was the Temporary Guarantee Program for Money Market Funds.  

Although the steps taken by the Federal Reserve and the Treasury Department helped to stabilize the commercial paper market and thereby moderate outflows from money market funds, investors continued to pull back from riskier credits and sought refuge in the U.S. Treasury market. The 4-week and 3-month Treasury bill yields remained well under 1 percent on most days during the first half of October. Issuance in the commercial paper market was heavily weighted to paper with 4 days or less to maturity, and the total amount of commercial paper outstanding contracted through the middle of October. Financial issuers of commercial paper were particularly hard hit, and most issuers were unable to issue paper much beyond a month. For example, in the four weeks after Lehman collapsed, on average, only 12 issues of financial paper with maturities beyond 40 days reached the market each day, compared with a daily average of 140 in early September. The daily dollar volume of new financial paper issuance with these maturities was equally impaired, averaging $117 million, compared with $2.9 billion during the first half of September. Issuance did not pick up until after the Federal Reserve launched the previously announced Commercial Paper Funding Facility (“CPFF”) program in late October.

C. Money Market Funds Were Not the Primary Source of Pressure in the Commercial Paper Market

The FCIC Report and the Federal Reserve suggest that money market funds were the primary source of pressure in the commercial paper market. The data simply do not support this conclusion. In fact, pressures in these and other short-term markets were driven by a wide range of investors pulling back, not just money market funds. Money market funds were simply the most visible and easily observable market participants.

A careful examination of the data shows that by the end of September, the decline in commercial paper outstanding was not primarily from money market funds. Outstanding commercial paper declined by $185 billion during the month of September. ICI data show that money market funds reduced their holdings of commercial paper by $164 billion in September; however, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”) program also held $152 billion in commercial paper as of October 1, all of which arose from money market fund sales to commercial banks. Hence, money market funds’ net reduction (after adjusting for sales to the AMLF program) amounted to $12 billion or about 6 percent of the $185 billion decline in outstanding commercial paper. Other investors clearly were pulling back from commercial paper issuers in a

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20 See Appendix A. No claims were made on this program and taxpayers received an estimated $1.2 billion in premiums. The program expired on September 18, 2009.

21 See FCIC Report, supra note 9, at 354.

22 Federal Reserve Commercial Paper report.

23 Data from iMoneyNet show that money market fund holdings of commercial paper contracted before the AMLF program began during the week of September 22, and a special survey by the Financial Crisis Inquiry Commission of money
stressed market. Data for other investors is not available specifically for September, but the Federal Reserve’s Flow of Funds Accounts show that funding corporations, foreign investors, state and local governments, and the household sector (which includes hedge funds and nonprofit organizations) were significant sellers of commercial paper in the third quarter of 2008. It would appear that much of the selling by these investors occurred during September.

Furthermore, prime money market funds became net buyers of commercial paper in October, and by the end of that month had increased their holdings by $43 billion. Again, factoring in the AMLF program, the $250 billion decline in commercial paper outstanding in September and October resulted from other investors reducing their holdings. Through the end of 2008, prime money market funds steadily increased their holdings of commercial paper and time deposits as inflows to these funds lifted their overall assets by $412 billion.

Apart from the commercial paper market, there is additional evidence that a variety of market participants were pulling back their exposures to financial institutions, particularly banks, during the fall of 2008. Borrowing from the Federal Reserve’s discount window, excluding the commercial paper programs and lending associated with AIG and Bear Stearns, rose from $170 billion as of September 10, 2008 to $587 billion as of December 17, 2008 and remained at that level through the end of 2008. Much of this increase was through the Term Auction Facility, which held biweekly auctions of term funds to depository institutions against collateral that could be used to secure loans at the discount window. At the same time, interbank lending by commercial banks fell more than 30 percent, or nearly $145 billion on a seasonally adjusted basis. The stress in the banking industry was reflected in the spread between the 3-month London Interbank Offered Rate (LIBOR) and the overnight index swap (OIS) rate which jumped from less than 100 basis points on September 12 to nearly 370 basis points one month later (Figure 1). The LIBOR-OIS spread is generally viewed as an indicator of the banking industry’s financial health and a widening of the spread can be interpreted as a reluctance or unwillingness by banks to lend to other banks because of an increase in credit risk.

Data from the Flow of Funds Accounts (not seasonally adjusted) show that these sectors combined reduced their commercial paper holdings on net by $131 billion in the third quarter of 2008.

Confidential data submitted to ICI show that stock, bond, and hybrid funds lowered their holdings of commercial paper by $10 billion in September.

Figure 1

Spread Between Three-Month LIBOR and Overnight Index Swap Rate*

*Basis points, daily

* 90-day LIBOR less the 90-day Overnight Index Swap (OIS) rate. An OIS is an interest rate swap with the floating rate tied to an index of daily overnight rates, such as the effective federal funds rate. At maturity, two parties exchange, on the basis of the agreed notional amount, the difference between interest accrued at the fixed rate and interest accrued by averaging the floating, or index, rate.

Source: Bloomberg

D. Aftermath

The U.S. government's programs were eventually highly successful in shoring up confidence in financial markets generally and money market funds specifically. By mid-October, the assets of prime money market funds began to grow and continued to do so into 2009, indicating a return of confidence by institutional investors in these funds. During this same time period, assets of Treasury and government-only money market funds also continued to grow, although at a much reduced pace.

By the end of February 2009, although assets of prime money market funds had not returned to the level seen at the beginning of September 2008, they had regained much ground. Perhaps more importantly, assets of money market funds had achieved an all-time high of just less than $3.9 trillion by
February 2009, reflecting the renewed confidence in money market funds among both retail and institutional investors.27

In a speech at the Credit Markets Symposium on March 31, 2011, Federal Reserve Governor Daniel K. Tarullo characterized the experience of money market funds in the 2008 crisis as “a small money market fund’s travails . . . provok[ing] a run on the entire industry.”28 Conspicuous by its absence is any mention by Governor Tarullo of myriad other events constituting what Federal Reserve Chairman Bernanke termed “the worst financial crisis in global history.”

Clearly, “a small money market fund’s travails” did not in themselves provoke the wholesale flight from financial assets to Treasury securities that ensued in September 2008. To suggest that they did is a disservice to any serious policy debate. Indeed, the events of 2007-2008 are in stark contrast to those of 1994—the only other time a money market fund broke a dollar.29 At that time, the banking system was not in cataclysmic disarray. But the 1994 incident had no “systemic” consequences, it did not precipitate a run from other money market funds, nor did it have any adverse impact on other parts of the financial market. In fact, money market fund assets grew during the month after the fund broke a dollar. At that time, there was no reason for investors to lose confidence in the assets their funds were holding or in the financial system at large, as there was in 2008. As discussed above, the Reserve Primary Fund’s failure in 2008 followed an unprecedented series of failures going back to the middle of 2007 involving major banks and other leading financial institutions around the world, and bewildering, inconsistent responses to these events by the U.S. and other governments.30

III. Industry and Regulators’ Response to the Financial Crisis

ICI and its members have dedicated enormous effort, in collaboration with regulators, to preserving the benefits that money market funds provide to the economy and to investors, while making them more resilient in the face of severe market stress such as that which followed the collapse of Lehman Brothers. Since the crisis, both the SEC and the money market fund industry have made a great deal of progress toward this objective.

Beginning in the summer of 2007, early warnings began to surface that the mortgage lending crisis in the United States could have a detrimental effect on lenders. At that time, ICI began to analyze how those market conditions might affect money market funds, a process that continued and intensified over the ensuing twelve months.

Quickly following the events of September 2008, ICI formed the Money Market Working Group ("MMWG"), a panel of fund industry leaders with a broad mandate to develop recommendations to improve the functioning of the money market and the operation and regulation of

27 It should be noted that any investments made to money market funds after September 19, 2008 were not covered by the Treasury’s Temporary Guarantee Program for Money Market Funds.


29 Community Bankers U.S. Government Money Market Fund broke a dollar in September 1994 and ultimately paid investors $0.96 per share.

30 Reserve Primary Fund ultimately paid investors $0.99 per share.
funds investing in that market. Less than six months later, ICI issued the MMWG Report, an industry study of the money market that included wide-ranging recommendations for the SEC to enhance money market fund regulation.31

In early 2010, the SEC approved rule amendments to enhance an already-strict regime of money market fund regulation. The SEC designed the amendments 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 NAV per share.32 The amendments, which are discussed in detail in Section IV, incorporated a number of the MMWG Report’s suggestions, including minimum liquidity requirements, stress testing, shorter maturities, and increased disclosure.

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, for two years, ICI and several of its members were 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 (“repos”). During this time, task force members put in considerable time and effort to help bring about many improvements and to develop an improved understanding of what further changes are needed in the tri-party repo market.33 Reforms in this market are significant not only to money market funds, which provide about one-third of the lending in the tri-party repo market, but to all participants in that market.

In June 2009, the Treasury Department issued a paper on financial regulatory reform.34 The Treasury paper recommended that the President’s Working Group on Financial Markets (“PWG”) prepare a report assessing whether more fundamental changes were necessary to supplement anticipated SEC money market fund reforms.35 The paper called for, among other things, exploring measures to require money market funds “to obtain access to reliable emergency liquidity facilities from private sources.”36 In response, ICI and its members developed a detailed framework for such a facility, including how it could be structured, capitalized, governed, and operated.37

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31 See MMWG Report, supra note 3, at 123-126.
32 See MMF Reform Adopting Release, supra note 4, at 10060.
35 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. Id. at 39.
36 Id. at 38.
37 For details concerning ICI’s plans for a private liquidity facility to further strengthen “prime” money market funds, see Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011) (“PWG Comment Letter”), available on ICI’s website at http://www.ici.org/pdf/11_sec_pwg_com.pdf and http://www.ici.org/pdf/11_sec_pwg_deck.pdf (appendix). Prime money market funds are funds that may invest in a mix of high-quality, short-term money market instruments including
In October 2010, the PWG issued its report discussing several options for further reform of money market funds and recommending that the Financial Stability Oversight Council (“FSOC”) examine those options. These options ranged from measures that could be implemented by the SEC under current statutory authorities to broader changes that would require new legislation, coordination by multiple government agencies, and the creation of private facilities, including a private emergency liquidity facility for money market funds as mentioned in the Treasury paper. In response to a request for comments on the report, ICI, along with more than 100 other commenters, provided its views on the reform options outlined in the report. There we described how an industry-sponsored emergency liquidity facility for prime money market funds could address policymakers’ remaining concerns by serving as a liquidity backstop for those funds during times of unusual market stress. We also explained how the other options presented in the PWG Report, including forcing money market funds to abandon their objective of maintaining a stable $1.00 share price, 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, we observed, transitioning to a new approach in and of itself would have systemic risk implications.

Throughout 2011, the money market fund industry continued to explore whether additional reform measures could improve upon the 2010 SEC amendments and still ensure a continued robust and competitive money market fund industry and preserve the value of money market funds for investors and the economy. For example, ICI hosted a “Money Market Funds Summit,” which focused on important developments in the money markets since the financial crisis. This high-level event brought together money market professionals, analysts, policymakers, investors, and issuers for an in-depth discussion and exchange of ideas.

To lend perspective and analysis, we examined a variety of proposals put forth by commenters to the PWG Report, including a proposal by a group of 14 economists, known as The Squam Lake Group, to require money market funds to create capital buffers by having funds sell subordinated

Treasury and government obligations, certificates of deposit, repurchase agreements, commercial paper, and other money market securities.


40 See PWG Comment Letter, supra note 37. The PWG Report spawned a voluminous and still growing comment record that reflects not only many good faith attempts to respond to policymakers’ concerns, but also a striking absence of consensus around whether further action is needed, and if so, how to proceed.

41 Information on this event is available at http://www.ici.org/events/highlights/conf_11_mm_summit.
securities in the market. After considerable study, however, including in-depth analysis by capital markets experts, ICI concluded that market-provided capital is not a feasible option for the money market fund industry.

As aptly demonstrated by our actions since 2008, the Institute and its members remain committed to working with regulators on our shared goal of strengthening money market funds. We are deeply troubled, however, by recent statements from regulators suggesting that the money market fund industry is “working without a net” or “susceptible to runs” and therefore that the current and successful program of money market fund regulation should be replaced with a model that would fundamentally alter the product and/or impose inappropriate bank-like regulation on money market funds. Indeed, we believe such a model would not enhance the stability of these funds—or of our global financial system—and, in fact, could have the opposite effect of increasing risk worldwide. This rhetoric is particularly puzzling considering how, as discussed in detail in Section IV, money market funds operating under the SEC’s 2010 reforms have demonstrated their resilience during periods of significant market turmoil, as was experienced last summer.

We are actively analyzing the impact on investors, the economy, and the fund industry of certain proposals currently being considered by the SEC that would fundamentally alter the character of money market funds. For example, ICI commissioned Treasury Strategies, Inc. to conduct a survey of corporate treasurers and other institutional investors on their attitudes toward these proposals. The survey asked more than 200 organizations how they use money market funds; what their views are on floating NAVs, capital requirements, and redemption holdbacks; and how those proposals would change their use of money market funds. Estimates based on the survey indicate that a floating NAV or a redemption holdback will drive 60 percent or more of institutional assets out of money market funds. The results show that imposition of capital buffers on money market funds will have a much smaller impact on institutional assets (a reduction of 13 percent) when the question omits mention of any loss of yield caused by the buffers. Follow-up questioning, however, shows that if a buffer reduced the yield of those funds by just 2 to 5 basis points, a large majority of the respondents would decrease their use or discontinue their use altogether. The survey provides the first clear analysis of the degree to which institutional investors would move their short-term investments away from money market funds if these SEC proposals are put in place.

ICI also has completed a study of the likely effects of capital requirements on money market funds or their advisers. The study indicates that, depending on the details, an SEC-required capital buffer could have profound effects on the money market fund product, the cash management business,

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42 See Letter from René Stulz, Everett D. Reese Chair of Banking and Monetary Economics, The Ohio State University, Fisher College of Business, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (January 14, 2011), available on the SEC’s website at http://sec.gov/comments/4-619/4619-57.pdf.

43 ICI engaged Sullivan & Cromwell LLP, PricewaterhouseCoopers, and Barclays Capital to analyze the potential for funds or advisers to raise capital through the capital markets.

44 Our analysis of the feasibility of market-provided capital through the issuance of subordinated securities is discussed further in Section V.B.2, below.

45 See TSI Survey, supra note 7.
and money markets themselves. In addition, ICI has just issued a study of the operational implications and potential costs that would be associated with the SEC’s proposed imposition of redemption holdback restrictions.

For all of these reasons, and particularly in light of the demonstrated effectiveness of the 2010 amendments, the Executive Committee of ICI’s Board of Governors issued a statement earlier this year reflecting its belief that the further changes in money market fund regulation now under consideration are neither necessary nor appropriate. Although the industry remains open to exploring reasonable options to make money market funds even more resilient, such reforms must preserve the fundamental characteristics of these funds and ensure a continued robust and competitive money market fund industry.

IV. Today’s Regulation of Money Market Funds

Today’s money market funds are stronger and more resilient than the funds that were available in 2008, as amply demonstrated by the market events of last summer.

A. Overview

Money market funds, like all mutual funds, are regulated under all four of the major securities laws: the Securities Act of 1933, which requires registration of the mutual fund’s shares and the delivery of a prospectus; the Securities Exchange Act of 1934, which regulates the trading, purchase and sale of fund shares and establishes antifraud standards governing such trading; the Investment Advisers Act of 1940, which regulates the conduct of fund investment advisers and requires those advisers to register with the SEC; and, most importantly, the Investment Company Act, which requires all mutual funds to register with the SEC and to meet significant operating standards. Indeed, money market funds share key features with other mutual funds. They issue shares that are redeemable upon demand, invest in marketable securities, and, with one exception discussed below, adhere to the same rules and regulations that apply to all mutual funds.

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. As a result, money market funds must comply with an additional set of regulatory requirements in Rule 2a-7 under the Investment Company Act. Rule 2a-7 exempts money market funds from the valuation provisions generally applicable to all mutual funds and permits them to determine their NAV using the amortized cost method of valuation, which facilitates money market funds’ ability to maintain a stable NAV. Under

See infra Section V.B.

See infra Section V.C.


For an overview of the key principles of the Investment Company Act, see Appendix C to Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to the Secretariat of the Financial Stability Board, c/o Bank for International Settlements (June 3, 2011), Appendix C (regarding the FSB’s directive to develop recommendations to strengthen the oversight and regulation of the “shadow banking system”), available at http://www.ici.org/pdf/25258.pdf.
the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount. The basic premises underlying money market funds’ use of the amortized cost method of valuation are: (1) high-quality, short-term debt securities held until maturity will return to their amortized cost value, regardless of any temporary disparity between the amortized cost value and market value; and (2) while held by a money market fund, the market value of such securities ordinarily will not deviate significantly from their amortized cost value. Thus, 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. In practice, the risk limiting conditions of Rule 2a-7 generally keep deviations between money market funds’ per share market value and amortized cost extremely small.51

B. Risk-Limiting Conditions

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 a number of conditions that are designed to limit the fund’s exposure to certain risks by setting minimum standards for the credit quality, liquidity, maturity, and diversification of a money market fund’s investments.52 These risk-limiting conditions, which were strengthened in 2010, include the following:

- **Credit quality**: Money market funds may 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 rate reset of no more than 397 days or a demand feature), and that a fund’s board of directors (or its delegate) determines present minimal credit risks. At least 97 percent of a fund’s assets must be invested in securities held in U.S. government obligations or other securities that either received the highest short-term rating or are of comparable quality.

- **Liquidity**: Money market funds must maintain a degree of portfolio liquidity sufficient to meet reasonably foreseeable redemption requests. All taxable funds must maintain at least 10 percent of assets in cash, Treasury securities, or securities that convert into cash within one day (“daily liquid assets”). All funds must 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 (“weekly liquid assets”).

50 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.

51 See infra Section V.A.

52 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, 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.
• **Maturity:** Money market funds must maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk.

• **Diversification:** Money market funds must maintain a diversified portfolio designed to limit a fund’s exposure to the credit risk of any single issuer.

C. **Transparency**

Today, money market funds are one of the most transparent financial products in the United States. Like other mutual funds, every money market fund must deliver to investors either a summary prospectus or a long-form prospectus that describes, among other things, the fund’s investment objectives, strategies, fees, and principal risks. More detailed information is included in the statement of additional information that a fund must make available to investors upon request. Money market funds also are required to send annual and semi-annual reports to shareholders.

In addition to the risk disclosure that all mutual funds are required to provide in their prospectuses, money market funds must prominently disclose the following in their prospectuses and any advertisements:

> 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.

Despite this disclosure, in the past, when a limited number of money market funds approached the point of deviating from their stable $1.00 NAV (e.g., because of idiosyncratic credit events or valuation concerns), fund advisers have provided limited financial support to those funds through capital infusions, capital support agreements, or purchasing potentially troubled securities from a fund at amortized cost. Fund advisers took such actions to ensure that the fund operated as designed and to manage the sponsor’s risk to its reputation in the marketplace. In most of these cases, fund advisers did not incur financial losses. Neither securities laws nor standard investment advisory contracts, however, require the adviser to guarantee or support the fund’s stable $1.00 NAV.

In light of money market funds’ experience during the financial crisis, the MMWG Report recommended that money market funds evaluate whether their disclosures, including advertising and marketing materials, and in particular their risk disclosures, fully capture the risks that money market funds may present and, if appropriate, revise their disclosures. Although many money market fund complexes voluntarily have evaluated the adequacy of their own risk disclosures after the MMWG recommendation, the SEC did not adopt this recommendation as part of the 2010 rule amendments.

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53 Funds that choose to deliver a summary prospectus must make the long-form prospectus and statement of additional information available on the fund’s website and must furnish paper copies upon request.

54 See MMWG Report, supra note 3, at 91-92.
Notably, recent research indicates that investors are well aware of the risks associated with money market funds.\(^{55}\)

While the 2010 amendments did not change money market funds’ narrative risk disclosure requirements, the SEC did make other important enhancements to money market fund disclosure requirements that substantially increase the transparency of money market fund portfolios for the benefit of investors and facilitate regulatory oversight. First, every money market fund is required to provide updated portfolio information on its website as of the end of each month. In addition, each month money market funds must file with the SEC new Form N-MFP, which contains detailed information about the fund and its portfolio, including the market value of each security held. The information provided in Form N-MFP becomes publicly available 60 days after the end of the month covered by the report.

D. Governance

Like other mutual funds, a money market fund is organized as a corporation or business trust governed by a board of directors or trustees, at least a majority of whom typically are independent from fund management. In practice, most fund boards have a far higher percentage of independent directors or trustees than the 40 percent minimum required by the Investment Company Act. According to a study of fund boards conducted by ICI and the Independent Directors Council, as of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes.\(^ {56}\) Independent board members play a critical role in overseeing fund operations and are entrusted with the primary responsibility for looking after the interests of fund shareholders.

Rule 2a-7 also includes certain procedural requirements overseen by the money market fund’s board of directors. One of the most important is the requirement that the fund periodically compare the amortized cost NAV of the fund’s portfolio with the mark-to-market NAV of the portfolio.\(^ {57}\) If there is a difference of more than \(\frac{1}{2}\) 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 a 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

\(^{55}\) See Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (April 26, 2012), available at [http://sec.gov/comments/4-619/4619-170.pdf](http://sec.gov/comments/4-619/4619-170.pdf). In particular, the research described in this letter found that 81 percent of Fidelity retail customers with money market funds indicate that they understand that the securities held by these funds fluctuate up and down daily in value; 75 percent of Fidelity customers know that the money market funds they invest in are not guaranteed by the government; only 10 percent believe the government would step in to prevent money market funds from breaking a stable $1.00 share price; and the majority of customers do not favor further regulation of money market funds, but instead would support additional investor education.


\(^{57}\) As a result of Rule 2a-7’s risk-limiting conditions, money market funds’ underlying per-share market price on average deviates by only a few basis points from $1.00 in all but the most extreme market conditions. See infra Section V.A.
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.

The SEC’s 2010 amendments gave money market fund boards of directors, for the first time, the ability to suspend redemptions if a fund has broken or is about to break a dollar.\textsuperscript{58} In contrast to the September 2008 experience of the Reserve Primary Fund, which did not have the ability to promptly suspend redemptions, this powerful new tool will help assure equitable treatment for all of the fund’s shareholders, stem any flight from the fund, ensure an orderly liquidation of a troubled fund, and minimize the potential for disruption to other funds and the money market generally. Indeed, this capability, which is available only if the board has determined to liquidate the fund, would protect shareholders by ensuring that the actions of investors who exit a money market fund first under extreme circumstances do not harm those remaining behind. The rule recognizes that a money market fund’s share price can decline in value, and provides for an orderly liquidation of the fund’s securities in a manner that best serves the fund’s shareholders by effectively negating any “first mover” advantage for a redeeming shareholder and by avoiding the liquidation of portfolio securities in a “fire sale.”

E. Money Market Funds Are Far More Resilient Under SEC 2010 Amendments

The SEC’s 2010 amendments to money market fund regulation have made these funds even more stable, liquid, and transparent than ever before. We urge regulators and other policymakers to avoid falling into the trap of looking at these funds and reform options as though it were still 2008, and instead to recognize that money market funds themselves, and the financial markets in which they operate, are meaningfully different today.

1. Shorter Maturities

The SEC’s 2010 amendments to Rule 2a-7 raised credit standards and shortened the maturity of money market funds’ portfolios—further reducing credit and interest rate risk. For example, the maximum allowable weighted average maturity (“WAM”) was reduced from 90 days to 60 days, which has lowered the average maturity of taxable money market funds (Figure 1). Preventing funds from holding a portfolio with a WAM in excess of 60 days also has reduced “tail risk”; this is seen in Figure 1 as a cutting off of the right-hand tail of the distribution of WAMs across taxable money market funds. This restriction has made money market funds more resilient to changes in interest rates that may accompany significant market shocks, and puts money market funds in a far better position to meet shareholder redemptions.

\textsuperscript{58} See Rule 22e-3 under the Investment Company Act. Rule 22e-3 permits a money market fund to suspend redemptions and payment of redemption proceeds if (i) the fund’s board, including a majority of directors that are independent of fund management, determines that the deviation between the fund’s amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.
The introduction of a limit on money market funds’ weighted average life (“WAL”) also has strengthened the ability of money market funds to withstand shocks and meet redemption pressures. Unlike a fund’s WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although data on WALs before November 2010 are not publicly available, publicly available data since then suggest that the new WAL requirement likely has bolstered the resilience of funds. Figure 2 depicts the distribution of WALs for taxable money market funds as of March 2012. The maximum allowable WAL is 120 days. Most funds are well below this, however, with the great majority having WALs in the range of 30 to 90 days. Only a very small proportion of funds have WALs in excess of 100 days.
2. Daily and Weekly Liquidity Requirements

The 2010 amendments directly and meaningfully addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. Under the new requirements, money market funds must maintain a sufficient degree of portfolio liquidity to meet reasonably foreseeable redemption requests. In addition, at a minimum, all taxable money market funds must maintain at least 10 percent of assets in daily liquid assets, and all money market funds must maintain at least 30 percent of assets in weekly liquid assets. The daily and weekly minimum liquidity requirements are measured at purchase. Thus, if a money market fund’s holdings of daily liquid assets or weekly liquid assets fall below 10 percent or 30 percent of total assets, respectively, due to shareholder redemptions or redemptions in combination with changes in the value of portfolio securities, that will not violate these minimum requirements. Rather, Rule 2a-7 forbids the fund from acquiring anything other than a daily liquid asset or weekly liquid asset if, immediately after the acquisition, the fund would have invested less than 10 percent or 30 percent
(as applicable) of total assets in daily liquid assets or weekly liquid assets. The purchase by the fund of assets other than daily liquid assets or weekly liquid assets would trigger a violation.

The amendments also require funds, as part of their overall liquidity management responsibilities, to have “know your investor” procedures to help fund advisers anticipate the potential for heavy redemptions and adjust their funds’ liquidity accordingly and to have procedures for periodic stress testing of their funds’ ability to maintain a stable NAV.

Indeed, the new liquidity requirements have had a transformative effect on money market funds. As Figure 3 shows, as of March 2012, funds exceeded the minimum daily and weekly liquidity requirements by a considerable margin. For example, 29 percent of the assets of prime money market funds were in daily liquid assets and 44 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated $1.36 trillion in daily or weekly liquid assets, which includes an estimated $623 billion held by prime money market funds. In comparison, during the business week September 15, 2008 to September 19, 2008 (the week Lehman Brothers failed), prime money market funds experienced estimated outflows of $310 billion. Accordingly, in March 2012, prime money market funds held daily and weekly liquid assets more than twice the level of outflows they experienced during the worst week in money market fund history.

59 See PWG Report, supra note 38, at 12.
Figure 3

Liquid Assets for Taxable Money Market Funds

*Percentage of total assets, March 2012*

1 Daily liquid assets include securities with a remaining maturity of 1 business day, Treasury securities with a remaining maturity of 397 days or less, and securities with a demand feature that is exercisable within 1 business day. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for daily liquid assets.

2 Weekly liquid assets include securities with a remaining maturity of 5 business days or less, Treasury securities with a remaining maturity of 397 days or less, agency securities with a remaining maturity of 60 days or less (regardless of whether those securities were initially issued at a discount), and securities with a demand feature exercisable within 5 business days. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for weekly liquid assets.

Sources: Investment Company Institute tabulation of publicly available Form N-MFP data

3. Increased Disclosure

By requiring more frequent and vastly more detailed disclosure of money market funds’ holdings, the 2010 amendments have made money market funds likely the most transparent financial product in the United States. These funds now disclose every security they hold to the SEC each month (and publicly with a 60-day lag). They also disclose their mark-to-market NAV and other salient information. Regulators, analysts, and investors have been using this additional data to closely scrutinize fund portfolios. This heightened scrutiny has at times led regulators and analysts to highlight potential risks in particular fund holdings. The additional disclosure also has led certain advisers to avoid investments that, although exhibiting stable credit fundamentals, may raise investor concerns.60

Thus, the discipline of far greater disclosure, consistent with the SEC’s historical approach to protecting investors, in itself has had a strong palliative effect.

F. Recent Events in Financial Markets Underscore the Effectiveness of the 2010 Amendments

As a result of these regulatory changes, money market funds are much more resilient to economic and financial shocks. This is amply demonstrated by recent events. In 2011, money market funds weathered two financial market shocks attributable in large measure to government gridlock: the looming U.S. federal debt ceiling crisis in mid-2011 and deteriorating conditions in European debt markets throughout the year. Money market funds also had to contend with historically low interest rates and the U.S. federal government’s extension of unlimited deposit insurance on non-interest bearing checking accounts, which provided depositors a guarantee on business checking account balances held at banks.61

61 See Federal Deposit Insurance Corporation, Deposit Insurance Regulations; Unlimited Coverage for Noninterest-Bearing Transaction Accounts, 75 FR 69577 (November 15, 2010). As required by Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the unlimited insurance coverage became effective on December 31, 2010, and will expire on January 1, 2013. We are pleased that this program will expire in the near term, as we view it as having the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for these transaction accounts. Programs that create and sustain such moral hazard have no place in our markets. See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (October 10, 2010), available at http://www.fdic.gov/regulations/laws/federal/2010/10c48AD37p.PDF.
Reflecting these circumstances, investors withdrew $213 billion from prime money market funds over the six-month period from June 2011 to November 2011 (Figure 4). To be sure, these outflows were smaller in dollar and percentage terms than the flows prime funds experienced during the worst months of the financial crisis in September and October 2008. Nevertheless, they were quite large, totaling 13 percent of the assets of prime money market funds as of May 2011. Moreover, the bulk of these outflows occurred in a very short time (the weeks ended June 8, 2011 to August 3, 2011) as the U.S. federal debt ceiling crisis came to a head. Over that eight-week period, outflows totaled $172 billion, or 10 percent of prime money market fund assets. Outflows in the month of June 2011 were the second largest on record, totaling $86 billion.

Prime money market funds accommodated these sizable outflows in an orderly manner. Funds had plentiful liquidity to meet redemptions. As of May 30, 2011, prime money market funds held an estimated $626 billion in daily and weekly liquid assets, well in excess of the outflows they experienced over the next several months. Moreover, the large outflows in the second half of 2011 had only a small impact on funds’ liquid asset ratios, which remained well above required minimum levels of 10 percent and 30 percent, respectively, for daily and weekly liquid assets (Figure 5).
In addition, despite the outflows and stresses in the market, money market funds’ per-share market values were extremely stable. The average change in the mark-to-market value of prime funds between May and September 2011 was less than 1/100th of a cent. These findings are consistent with the findings of other analysts who note that the variability of prime money market funds’ per-share market values has declined significantly since the 2007-2009 financial crisis, which they attribute in large measure to the revisions to Rule 2a-7 that went into effect in May 2010.  

V. Flawed Policy Options

ICI remains deeply concerned that regulators continue to consider policy options that would not strengthen money market funds but instead would alter their fundamental characteristics—such as a stable NAV and ready liquidity—thereby destroying the value of these funds to investors and the global economy. The contemplated changes also would reduce competition by driving fund sponsors out of the business. Moreover, if regulatory changes to money market funds alter those characteristics valued by investors, investors will move to less regulated, less transparent cash pools, increasing systemic risk. In this section, we highlight three such reforms that are under consideration at the SEC. First, we

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62 See Fitch Ratings’ Special Report, supra note 60.
explore the proposition that all money market funds should let their share prices float—a structural change for the money market fund industry that would not reduce systemic risk but instead could increase it. Next, we discuss the idea that money market funds or their advisers should maintain capital against money market fund assets—an idea that not only alters the product but could cause significant industry contraction. Finally, we address the implementation of permanent redemption restrictions in the form of a “restricted share balance requirement”—a concept that not only would be prohibitively costly to implement, but also is contrary to the fundamental nature of a mutual fund.

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

One proposal being advanced is eliminating the ability of money market funds to use the amortized cost method of valuation—forcing them to let their share prices fluctuate or “float.” For example, those commentators who emphasize the liquidity, maturity, and credit transformation of money market funds espouse a floating NAV. Opposed to this idea is a wide range of businesses, state and local government entities, financial services companies, and consumer organizations who argue that a floating NAV would destroy the convenience and simplicity of money market funds for investors, and compromise an important source of financing for many segments of the U.S. economy. Also weighing in against a floating NAV are many individual investors who strongly oppose changing the fundamental nature of money market funds. Nevertheless, the option of requiring money market funds to float their NAVs remains a topic of discussion. This option would prohibit funds from using amortized cost to value portfolio assets, and from using the “penny rounding” method to determine the NAV of fund shares on a daily basis. Instead, money market funds would be required to mark all portfolio assets to market on a daily basis.

It is important to note that requiring the use of mark-to-market pricing in lieu of amortized cost pricing would not, under normal circumstances, cause a money market fund’s share price to float.

63 This degree of transformation, in fact, is extremely modest, especially when compared to banks. As noted in Section IV, taxable money market funds are required to hold a minimum of 10 percent of their portfolios in daily liquid assets and 30 percent in weekly liquid assets. In addition, a money market fund’s WAL cannot exceed 120 days. These requirements reduce liquidity and maturity transformation to very low levels, and in practice, money market funds exceed these requirements. For example, in March 2012, taxable money market funds held 45 percent of their portfolios in daily liquid assets and 60 percent in weekly liquid assets, far exceeding the minimum requirements. Furthermore, the average WAL in March 2012 was 66 days for government money market funds and 74 days for prime money market funds. Money market funds also are required to hold securities that pose minimal credit risk. As of December 2011, over 99 percent of money market fund portfolio assets received the highest short-term credit ratings. In addition, to the extent that a credit issue arises with a security, money market funds have clear rules to allow for the discontinuation of the amortized cost method of valuation and the repricing of the fund shares or suspension of redemptions and liquidation of the fund to ensure that there is no material dilution or unfair results to fund shareholders. These requirements ensure that existing fund investors share in the losses of a fund.

64 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 in 2009. 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_mmf_opposefloatingnav. In response to the SEC’s request for comment on the PWG Report, ICI, along with over 100 companies or organizations, submitted letters to the SEC in opposition to the floating NAV concept. See PWG Comment Letter, supra note 37. These types of letters have continued to flow into the public comment file.
This is because money market funds have three characteristics that contribute to the stability of their share price. First, money market funds declare dividends on a daily basis so that income does not accumulate in the share values.65 Second, money market funds hold very short duration portfolios with minimal credit risk, minimizing the effects of even large interest rate changes on the underlying value of the portfolio. For example, about 70 percent of money market funds had a WAM of 50 days or less at the end of April 2012. The third feature is the use of amortized cost combined with penny rounding.

The effects of the first two characteristics—daily declaration of income and short duration, high-quality portfolios—can be observed by examining money market funds’ mark-to-market share prices. Data from a sample of taxable money market funds covering one-quarter of taxable money market fund assets show that the average per-share market values for prime money market funds varied between $1.002 and $0.998 during the decade from 2000 to early 2010 (i.e., years prior to the implementation of the SEC’s 2010 money market fund reforms).66 More recently, using publicly available data from Form N-MFP reports that require money market funds to disclose their underlying mark-to-market share price, without using amortized cost pricing,67 ICI calculated changes in prime fund share prices on a monthly basis for January 2011 to March 2012. Nearly all (96 percent) of the prime money market funds had an average absolute monthly change in their mark-to-market share prices of 1 basis point or less and all had an average absolute monthly change of less than 2 basis points. To make the NAV float, funds’ NAVs would need to be changed to $100.00 a share (e.g., through a reverse 1 for 100 share split).

The stabilizing effect of penny rounding is illustrated during periods of volatile interest rates. For example, assuming a $1.00 NAV, short-term interest rates would need to move by 3 percentage points (or 300 basis points) in one day to cause the typical money market fund’s mark-to-market price to fall by one-half of one percent.68

As we discuss below, and as numerous investors and issuers already have advised the SEC, requiring money market funds to move to a floating NAV 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.

65 For example, income accrued daily, in the form of either coupon interest receivable or the increase in the amortized cost value of discount instruments, less fund expenses (e.g., management fees), is recognized as net investment income. Each day’s net investment income is distributed to shareholders through the daily dividend. While dividends are declared daily, cash distribution typically takes place monthly, and until that time the fund recognizes a liability for dividends payable. Accordingly, increases in assets (attributable to income accrual) are offset by recognition of a corresponding liability (for dividends payable) so that there is no increase in the fund’s net assets or share price associated with accrual or collection of interest on the fund’s investments.


67 Share prices that excluded sponsor support were used for the calculation.

1. Impact of a Floating NAV on Preventing Investor Runs

Some have argued that requiring money market funds to float their NAVs will reduce the tendency of money market funds to experience large redemptions during periods of financial stress. Evidence from products with floating NAVs suggests this is incorrect.

For example, 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 to 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 6). 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 2008, these funds experienced cumulative outflows of 15 percent of their assets. By the end of 2008, assets of these funds were down more than 60 percent from their peak in mid-2007.

Thus, we remain doubtful that floating the NAV of money market funds would reduce risks in any meaningful way. Rather, prohibiting money market funds from maintaining a stable NAV likely would lead investors to abandon money market funds for less regulated products that seek to maintain a stable NAV, as discussed below, and therefore simply would shift risks to this less regulated and more opaque part of the market.
2. **Investor Demand for a Stable NAV Fund Would Remain**

One very significant concern is whether investors would continue to use money market funds if the stable NAV was eliminated. For a substantial number of investors, the answer is a resounding 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 seek to maintain a stable NAV. Indentures and other trust documents may authorize investments in money market funds on a similar assumption. 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 no longer would be able to use money market funds to help manage their cash.\(^{69}\)

Investors that do not face such constraints still may be unwilling to invest in a floating NAV product. For example, the $1.00 per share pricing is vitally important to the usefulness of money market funds to a variety of business applications involving automated accounting and settlement systems.\(^{70}\) The use of amortized cost accounting and a stable NAV allow the efficient processing of cash balances through cash sweep programs in which customer cash balances are “swept” into investments in shares of money market funds that are owned by the customer but transacted through accounts registered to a broker-dealer or a bank. A stable NAV also offers significant convenience in terms of tax, accounting, and recordkeeping. For example, as discussed above, all of a money market fund’s returns are distributed to shareholders as income. This relieves shareholders from having to track gains and losses, \textit{including} the burden of having to consider the \textit{timing} of sales and purchases of fund shares (\textit{i.e.}, wash sale tax 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 because they are used for long-term investing, not cash management. And in any case, many purchases (or exchanges) in long-term funds are made within tax-advantaged accounts (\textit{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, electronic check payment processing services and products, and Fedwire transfers. These features generally are provided only for stable NAV products. In addition, money market funds typically offer investors same-day settlement on shares redeemed via “wire transfer” (where redemption proceeds are wired to an investor’s bank account via Fedwire), whereas bond funds typically offer \textit{next-day} settlement. Thus, elimination of the stable NAV for money market funds likely would force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

Proponents of eliminating the stable NAV state that there is no direct evidence regarding 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 on average 150 basis points below short-duration bond funds, and 300 to 500 basis points below longer term bond funds.\(^{71}\) Yet, assets in money market funds are roughly $2.6 trillion, \textit{greater} than the assets held in money market funds prior to the start of the financial crisis in the summer of 2007.

\(^{69}\) See MMWG Report, \textit{supra} note 3, at Appendix D.

\(^{70}\) For a detailed description of the specialized business applications and automated systems that use stable NAV money market funds to hold temporary liquidity balances, see Letters from John D. Hawke, Jr, Arnold & Porter LLP, to Chairman Mary Schapiro, Chairman, Securities and Exchange Commission (December 15, 2011) and the Financial Stability Oversight Council (December 15, 2011) (regarding Federated Investors, Inc.’s comments on FSOC’s rulemaking proposal to require supervision and regulation of certain nonbank financial companies), available at \url{http://sec.gov/comments/4-619/4619-112.pdf}.

\(^{71}\) Investment Company Institute; Morningstar; iMoneyNet.
Indeed, a diverse range of investors in money market funds previously have communicated their opposition to floating NAVs. In a letter to the SEC, a group of 36 North Carolina independent colleges and universities noted that “requiring a floating NAV would eliminate money market mutual funds as a stable option and as a reasonable investment for [colleges and universities to use] for cash management purposes.” The stable $1.00 NAV, as the Financial Services Institute told the Subcommittee on Capital Markets and Government Sponsored Enterprises of the U.S. House of Representatives’ Committee on Financial Services in June 2011, provides “a high degree of liquidity, diversification, and convenience, along with a market-based yield” to investors. In its comments to the Subcommittee, Financial Executives International noted that corporate treasurers “use money market funds as a diversification tool . . . [and] are not geared to mark-to-market on a daily basis and will have to pull out of money market funds if a floating NAV is adopted.”

Members of Congress also have communicated their concern regarding proposals that would require money market funds to float their NAVs. A bi-partisan letter to SEC Chairman Mary Schapiro from 33 former state and local government officials who now serve in Congress highlighted the importance of the stable $1.00 NAV to states, municipalities and towns as not only a cash management tool and short-term investment option, but also for “the issuance of debt to fund many [ ] critical public projects.”

Furthermore, surveys of money market fund investors indicate clearly that most of these investors do not want and would not use a floating NAV product. For example, a survey of corporate treasurers and other institutional investors indicated that nearly 80 percent of respondents would either decrease their use of money market funds or discontinue use of them altogether if money market funds are required to have a floating NAV. Based on this response, over 60 percent of corporate money market fund assets would move to other investments if this concept were adopted.


76 See TSI Survey, supra note 7.
A survey of retail money market fund investors commissioned by T. Rowe Price and conducted online by Harris Interactive indicated much the same response (Figure 7).\footnote{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.}

**Figure 7**

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

![Chart showing investors' overall reaction to floating NAV money market fund concept](chart.png)

Source: Harris Interactive / T Rowe Price
Two thirds of retail investors surveyed found the idea of a floating NAV money market fund unfavorable. Among those who reacted to the concept unfavorably, 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 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 (89 percent) indicated a preference for keeping the stable NAV and more than half (57 percent) indicated they would use money market funds less or not at all if faced with the prospect of a floating NAV. Retail investors also disliked the floating NAV concept. Seventy-four percent of the retail investors surveyed also favored keeping the stable NAV and 47 percent of those surveyed said they would move all or some of their assets out of money market funds if funds changed to a floating NAV. In short, data on the subject demonstrate that investors do not want and likely would reject a floating NAV money market fund.

3. Floating the NAV Would Harm the Market

The principal impact of a floating NAV for money market funds will be a major restructuring and reordering of intermediation in the short-term credit markets. If assets move to less regulated and less transparent products or structures, risks in the financial markets will increase.

Assets in money market funds now total $2.6 trillion. As discussed above, money market fund investors of all types are unlikely to use a floating NAV product. Requiring these funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. This transition, in and of itself, could be destabilizing to the financial markets. 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 very kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs assuredly will shift credit intermediation from one type of product to others. There are a number of alternative products that money market fund investors could use, including enhanced cash pools, local government investment pools, 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 and less transparent products arguably serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.

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79 For an overview of some of these alternatives, see MMWG Report, supra note 3, at 41-46.

80 See MMWG Report, supra note 3, at 62-64.
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, repurchase agreement sweeps, commercial paper sweeps, and, importantly, sweeps into offshore (non-money market fund) accounts (e.g., Eurodollar sweeps). 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) largely are beyond the jurisdictional reach of U.S. domestic regulators.

Even if investors shift their liquid balances to conventional bank deposits, 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. Insuring all these new 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.

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. For example, in its letter to the House Subcommittee on Capital Markets and Government Sponsored Enterprises in June 2011, the Association for Financial Professionals warned that moving to a floating NAV would create “significant disruptions in the corporate funding market . . . [because] many organizations issue commercial paper to meet their short-term financing needs, such as funding payroll, replenishing inventories, and financing expansion.” Similarly, a group of 12 state and local government groups representing both investors in money market funds and issuers of municipal securities that are purchased by money market funds expressed their views to the Subcommittee that mandating a floating NAV “would make [money market funds] far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt issuance costs for many state and local governments across the country.”

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81 For a general discussion of overnight sweep arrangements, see MMWG Report, supra note 3, at 43-44.
In sum, there is strong demand for a stable NAV money market fund or money market fund-like product. Many institutional investors will find a way to satisfy that demand, but at least in the short run, retail investors are not likely to be able to do so. And while new financial products eventually will develop, until that time there will be substantial market dislocations.

B. Capital Buffers

Recent comments by SEC officials and others have suggested that money market funds or their advisers be required to hold capital to provide a buffer protecting fund investors from potential future losses on their funds.\(^84\) In a recent ICI study, we analyzed the likely outcomes of a capital buffer for the money market fund industry.\(^85\) Our study considered several variations on the capital buffer idea, including requiring money market fund advisers to commit capital, requiring funds to raise capital in the market, or having funds build a capital buffer inside funds from fund income. A summary of our findings is provided below.

1. Requiring Fund Advisers to Commit Capital

Proposals requiring money market fund advisers to commit capital to absorb possible future losses in their funds would alter fundamentally the money market fund business model. A money market fund, like every other mutual fund, provides investors a pro rata interest in the fund, whereby fund investors share in the risks and rewards of the securities held by the fund. All of the fund’s shares are equity capital. The default risk of diversified portfolios of securities held by money market funds is very low, and is shared by all fund investors, so the likelihood that an individual investor will experience a sizeable loss, or any loss at all, is remote.

Imposing capital requirements on a fund adviser would transform the essential nature of a money market fund by interposing the adviser between the fund and its investors. Currently, fund advisers do not allocate capital to absorb losses because investors bear the risks of investing in funds. To be sure, some money market fund advisers have at times voluntarily supported their funds. But these advisers did so as a business decision. Requiring all fund advisers to take on a first loss position would be radical departure from the current agency role that fund advisers play. The mutual fund structure, including that of money market funds, is designed so fund advisory fees compensate the adviser for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. Advisers are not compensated for bearing investment risks of the fund.

Shifting investment risks from fund investors to advisers would require advisers to dedicate capital to absorb possible losses of the funds that they manage. Some advisers would have to raise new capital in the market. Others could perhaps shift capital from other parts of their businesses. Either

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\(^84\) See, e.g., Schapiro March 2012 Remarks, supra note 6.

way, all advisers would have to earn a market rate of return on such capital. If they cannot earn that rate of return, they would seek better business alternatives, such as seeking to move investors to less-regulated cash management products where investors still must bear the risks of investing.

While the potential for losses is remote, the cost of providing capital likely would be significant. Under money market funds’ current structure, small and highly infrequent losses are spread across a large number of fund investors and a large asset base. Under the structure being contemplated, small losses would be concentrated in a single investor (the adviser) and across a small asset base (the value of the capital). The adviser could face large percentage losses on its capital investment and thus would require a compensatory rate of return.

In theory, advisers could seek to pass along to investors the cost of providing the capital to absorb investment risks. As a practical matter, however, we doubt this is possible. Because of the very low interest rate environment, advisers at present have no ability to pass along cost increases; doing so would raise fund expense ratios, dropping net returns below zero. Even in a more normal interest rate environment, advisers would have difficulty passing the cost of the required capital on to fund investors. Rule 2a-7’s risk-limiting provisions effectively place a ceiling on what a prime money market fund may earn. Yields on Treasury funds set a floor on the yields that prime funds may return to investors after expenses, which in turn limits the fees that prime funds may charge.

In addition, any proposed increase in a fund’s advisory fees must be put to a shareholder vote. Shareholder votes can be costly to undertake and outcomes by no means would be guaranteed. Even if shareholders accepted a fee increase, the increase could be so large as to reduce the net yield on a prime fund below that of a Treasury-only money market fund. All else being equal, an increase in a fund’s advisory fee will lower the fund’s net yield. Any desire to offset the effect on the fund’s yield by holding riskier and therefore higher yielding securities would be constrained by the risk-limiting provisions of Rule 2a-7 and, in any case, counterproductive to the goals of regulators. Presumably no investor would hold a prime money market fund that offered a return below that of a Treasury fund.

By far the most likely outcome is that advisers would have to absorb the cost of providing the capital buffer. Although outcomes depend on the particulars of any proposal, our analysis indicates that capital buffers in the range of 1.5 percent to 3 percent would cause advisers to reconsider the money market fund business model. There are various ways to illustrate this. In our recent study on capital buffers, we focused on two approaches: internal rate of return and payback period. The analysis shows that it would require very sizable increases in the fees of prime money market funds for advisers to earn a reasonable rate of return on capital they might be required to pledge. For example, depending on how the capital requirement is calculated, prime money market fund fees might need to rise between 18 and 40 basis points for advisers to earn a 5 to 7 percent rate of return on invested capital.

Our analysis shows that under current fee structures and market conditions, capital buffers of 1.5 percent to 3 percent would absorb every dollar of advisers’ net earnings from money market funds for 18 to 43 years, depending on whether only Treasury securities or both Treasury and agency securities are excluded from a capital assessment. Even under best-case assumptions, these buffer requirements would absorb at least 8 to 20 years of advisers’ profits from operating money market funds.
For all of these reasons, it is foreseeable that many, if not most, fund advisers would make the business decision to change their cash management offerings radically. Some advisers may simply liquidate their funds and not offer alternative products. Others may refocus their efforts on alternative cash-like products that are less regulated and less transparent, thereby increasing risks in the financial markets.

2. **Requiring Funds to Raise Capital in the Market**

As an alternative to requiring fund advisers to commit capital, some have suggested requiring funds to raise capital in the market. As noted above, ICI engaged capital markets experts to help study this approach in depth.\(^86\) We ultimately concluded, for several reasons, that market-provided capital is not a feasible option for the money market fund industry. Adding subordinated debt or equity would turn a rather simple product—the money market fund—into a considerably more complex offering. Small funds and small fund complexes likely would find it difficult and costly to issue and roll over subordinated securities, resulting in further industry consolidation and raising a barrier to entrants. The approach also would potentially create competing interests between the subordinated investors’ desire to avoid losses and senior shareholders’ (i.e., traditional money market fund investors’) tolerance for taking greater risks for greater yields.

A market-raised capital buffer would reduce the yield available to senior shareholders, and subordinated investors would have a highly levered—and hence potentially volatile—investment. The compensation subordinated investors would demand for assuming such volatility would reduce the yield available to the senior share class. A smaller capital buffer would further magnify losses to the subordinated investors. While the fund would be required to raise less capital, the resulting subordinated securities would be more levered, more volatile, and therefore more expensive and difficult to sell.

Other issues that could complicate the use of this structure include that, to be marketable, the subordinated securities would need to obtain a credit rating (and thus be structured as debt) but for various reasons, credit rating agencies would not be likely to treat the securities as debt. The legal structure of the subordinated securities also would pose challenges—whether they are issued by the fund or issued by a special purpose bankruptcy remote entity. In addition, while in theory capital could be raised more quickly in the markets than through retained earnings, launching a new form of security is likely to be a complex and time-consuming process. And it might require more than 600 individual money market funds to enter the market seeking to raise capital simultaneously. Finally, it is unclear how well this structure would protect senior share class investors during times of market stress.

3. **Requiring a Within-Fund Capital Buffer**

Building a within-fund capital buffer would align more directly the costs of the buffer with the fund’s beneficiaries: fund shareholders. Capital at this level would not absorb large credit losses, but it would provide funds somewhat greater flexibility in selling securities at a price below amortized cost. Legal and accounting considerations, however, would limit a within-fund capital buffer to 0.5 percent

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\(^86\) See supra note 43 and accompanying text.
of a fund’s total assets. Also, because of tax and economic considerations, a fund likely would need many years to build such a buffer. As the analysis shows, under plausible assumptions, building such a buffer might take a typical prime fund 10 to 15 years. The exact horizon depends on whether short-term interest rates rise somewhat more quickly than is currently expected, on how investors respond to a buildup of a within-fund capital buffer, and on the willingness of advisers to continue to absorb the cost of maintaining large fee waivers. In the best of circumstances, building a within-fund capital buffer of 0.5 percent likely would require at least five years.

C. Redemption Restrictions

The SEC is considering subjecting money market funds to “redemption restrictions” that would deny investors full use of their cash. It appears that regulators are looking at a variety of possible approaches that, in essence, would escrow a portion of a shareholder’s money market fund account on an ongoing basis. The money held back from an investor’s account due to redemption activity would be used to absorb first losses if a fund cannot maintain its $1.00 NAV.

Proponents of redemption restrictions believe that such restrictions can prevent or mitigate redemption pressure similar to that experienced by prime money market funds in 2008 by removing investors’ incentives to be among the first to redeem (the so-called first mover advantage). They also believe that redemption restrictions will make explicit to investors that money market funds entail risk, which will be borne by investors in times of severe market stress.

The SEC’s contemplated redemption restrictions for money market funds would permanently alter the ability of fund investors to redeem all of their shares on a daily basis. They apparently would apply to all funds and all investors at all times, under all market conditions. Simply put, they would impair a core mutual fund investor protection and reverse more than 70 years of SEC practice in fund regulation.

Under the Investment Company Act, one hallmark feature of mutual funds, including money market funds, is that they issue “redeemable securities,” meaning that the fund stands ready to buy back its shares at their current NAV. Section 22(e) of the Investment Company Act generally prohibits funds from suspending the right of redemption and from postponing the payment or satisfaction upon redemption of any redeemable security for more than seven days, except under extraordinary circumstances that are delineated in the statute or determined by SEC rule.87 Under this authority, in 2010, the SEC adopted Rule 22e-3, which exempts money market funds from Section 22(e) to permit them to suspend redemptions and postpone payment of redemption proceeds—but only in very limited circumstances, i.e., in order to facilitate an orderly liquidation of the fund.88 By contrast, the

87 Certain foreign regulatory regimes offer fund advisers mechanisms that, provided that the actions are in the interest of fund shareholders, give them significant discretion and flexibility to address extraordinary circumstances, such as an unexpected loss of liquidity in the markets, while also helping them stem an incipient run on a fund. For an overview of the various tools available to offshore funds, see MMWG Report, supra note 3, at 85–86.

88 See supra Section IV.D. When it adopted Rule 22e-3, the SEC noted that the rule “is intended to reduce the vulnerability of investors to the harmful effects of a run on a fund, and minimize the potential for disruption to the securities markets.” MMF Reform Adopting Release, supra note 4, at 10088. The SEC recognized, however, that permitting suspension of this statutory protection should be limited to extraordinary circumstances. “Because the suspension of redemptions may impose
redemption restrictions that the SEC is now contemplating would permanently alter the ability of money market fund investors to redeem all of their shares on a daily basis.

ICI opposes any sort of redemption restriction that would impair investor liquidity when liquidity is readily available within the money market fund. The SEC’s contemplated redemption restrictions, if adopted, represent an experiment on the $2.6 trillion money market fund industry that could have harmful consequences for the broader financial markets, including financing for businesses and state and local governments.

These redemption restrictions also would create serious operational issues that would reduce or eliminate the usefulness of many services that money market funds and financial providers extend to investors. ICI recently issued a paper that focuses on the operational implications of the SEC’s possible proposals for redemption restrictions.89

As discussed in our paper, throughout the 40-year history of money market funds, investors have benefited from the convenience, liquidity, and stability of these funds. Individual or retail investors use money market funds as savings vehicles to amass money for future investments or purchases; as transaction accounts; and as stable-value investments in their retirement or other investment portfolios. Institutional investors—which include corporations of all sizes, state and local governments, securities lending operations, bank trust departments, sweep programs, securities brokers, and investment managers—use money market funds as a cost-effective way to manage and diversify credit risk, while providing same-day liquidity with market-based yields.

To meet these shareholder needs, funds, intermediaries, service providers, and investors have developed a wide array of arrangements for distributing and using money market funds efficiently. Investors can purchase and redeem money market fund shares directly from fund sponsors or through a wide array of platforms, portals, and financial intermediaries such as broker-dealers and retirement plans. Money market funds are the primary investment for sweep accounts offered by broker-dealers and financial advisers. Investors also benefit from the convenience of check-writing or debit-card access to their money market funds. These offerings depend critically on an intricate and complex operational infrastructure created by the industry that allows investors to transact smoothly and efficiently, often with same-day settlement.

Implementing the SEC’s proposed freeze on shareholders’ assets would require changes to a myriad of systems that extend well beyond those under the control of the funds themselves. Fund complexes, intermediaries, and service providers have developed complex systems that allow them to communicate and process significant volumes of money market fund transactions on a daily basis through a variety of mechanisms on behalf of investors. To apply continuous redemption restrictions accurately and consistently across all investors in money market funds, each of these entities, including a host of intermediaries, would need to undertake intricate and expensive programming and other significant, costly system changes.

hardships on investors who rely on their ability to redeem shares, the conditions of the rule limit the fund’s ability to suspend redemptions to circumstances that present a significant risk of a run on the fund and potential harm to shareholders. The rule is designed only to facilitate the permanent termination of a fund in an orderly manner.” Id.89

89 The paper is available at: http://www.ici.org/pdf/ppr_12_operational_mmf.pdf.
In many cases, daily redemption restrictions would simply render money market funds useless for offerings and services that investors and intermediaries value. Intermediaries and funds that can and choose to continue to provide money market funds would be required to make extensive and burdensome changes throughout their operational structure. Our analysis indicates, however, that the costs of these changes could be prohibitive and that the industry would be unlikely to undertake them, particularly if the SEC’s changes result in shrinking the asset base of money market funds.

The SEC’s suggested redemption restrictions would remove money market funds as a viable option in many instances. Fiduciaries, such as retirement plans, trustees, and investment advisers, may be legally prohibited from using money market funds with redemption restrictions for their clients, because such restrictions would impair clients’ liquidity. Sweep programs, which rely upon the ability to move 100 percent of an investor’s available cash on a daily basis, would not be able to employ money market funds if they are subject to a holdback of investor assets. Retail investors’ ability to access their money market funds through checks and debit cards could also be impaired.

In other uses, funds, intermediaries, and institutional investors conceivably could restructure and reprogram operational systems to incorporate daily redemption restrictions. ICI’s paper provides an overview of the systems and processes that would require modification by thousands of institutional investors, funds, intermediaries, and service providers. Based on ICI’s cost-benefit analysis of a prior rule proposal requiring extensive systems and operational changes, it is reasonable to expect that requiring money market funds to adopt the SEC’s contemplated restricted share balance concept would cost the industry hundreds of millions of dollars. These costs are largely fixed and not scalable to the size of the asset base. It would be difficult for intermediaries, in particular, to justify such expenses even if money market fund assets were to remain at their current level.

Investor reaction to the SEC’s contemplated redemption restrictions, however, suggests that enactment of these proposals would greatly reduce investor use of money market funds. In a survey of corporate treasurers and other institutional investors, 90 percent of these investors indicated that they would reduce their usage or stop using money market funds altogether if the SEC’s contemplated redemption restrictions were put in place. Calculations based on these investors’ responses suggest that institutional assets in money market funds would shrink by two-thirds if the restrictions were imposed. Retail investors also have indicated that they would limit their use of money market funds with redemption restrictions. Investors that hold accounts directly with funds may choose alternative

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90 Two years ago, ICI conducted a cost-benefit analysis of proposed changes to Rule 12b-1 under the Investment Company Act that would have required extensive systems and operational changes. The estimated costs for these changes were $231 million for fund complexes only, not including additional costs that would have been incurred by intermediaries. See Investment Company Institute, Cost-Benefit Analysis of SEC Rule 12b-1 Reform Proposal (December 1, 2010), available at http://www.ici.org/pdf/10_12b1_sec_cba.pdf at 11, Figure 4. We believe the changes that would be required to implement the SEC’s redemption restrictions easily could meet or exceed this prior estimate.


92 In a survey of its retail clients, Fidelity Investments found that about half of its retail clients would invest less or stop investing in money market funds with redemption restrictions regardless of whether the restrictions were continual or
products that are less regulated, widely varying, and more opaque, but that would better meet their
liquidity needs. This movement would seem unlikely to reduce systemic risk and, indeed, would be
more likely to increase risk.

A sharp reduction in investors’ use of money market funds would have severe consequences.
Money market funds hold more than one-third of corporate commercial paper and about three-
quarters of state and local government short-term debt. Shrinkage of money market fund assets would
significantly disrupt the flow of short-term financing within the American economy.

The likely consequences of the SEC’s contemplated redemption restrictions are thus mutually
reinforcing. Fund complexes, intermediaries, and service providers will be hard-pressed to justify
undertaking the significant costs of compliance with the restrictions in the face of the rapid shrinkage
of money market fund assets predicted by investors’ response to the proposals. We believe many
intermediaries would make the business decision to migrate to unregulated or less-regulated money
market investment vehicles or bank deposit products where possible, in lieu of implementing costly
changes to their systems in order to continue to offer money market funds to a dwindling shareholder
base. The total effect would be to drive users away from money market funds, disrupt short-term
financing for the economy, and increase use of less-regulated, less-transparent alternatives.

VI. Conclusion

We appreciate the opportunity to share our views with the Senate Committee on Banking,
Housing and Urban Affairs. We look forward to working with Congress and regulators as they seek to
address this important issue in the best possible way for millions of American investors who rely on
money market funds as an effective cash management tool and as an indispensable source of short-term
financing for the U.S. economy.

applied only during periods of market stress. See Fidelity Investments Letter from Scott C. Goebel, Senior Vice President
and General Counsel, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (February 3, 2012),
Appendix A
Timeline of Major Developments in the Financial Crisis

VII. Key Market Events Leading Up to September 2008

June 2007

• Two Bear Stearns hedge funds suspended redemptions in the face of deteriorating investments in securities backed by subprime mortgages.

Summer and Fall of 2007

• A number of additional short-term investment pools (e.g., unregistered “enhanced cash” funds, liquidity pools run by municipalities, and offshore funds) began to fail after investing in securities backed by subprime mortgages.
  
  o BNP Paribas, France’s largest bank, froze three investment funds that operated in a manner similar to European variable NAV money funds but were unable to sell mortgage-related assets to meet redemptions.
  
  o An unregistered commodity cash pool managed by Sentinel Management Group, Inc., erroneously described by CNBC as a money market fund, halted redemptions and failed within a week.
  
  o Local government investment pools run by King County, Washington and the State of Florida experienced difficulties due to structured investment vehicle (“SIV”) and asset-backed commercial paper (“ABCP”) investments. King County intervened to buy the troubled securities, and the Florida pool experienced a cascade of redemptions, until it froze withdrawals in November.

August 2007 to March 2008

• A number of major financial institutions in the U.S. and Europe, including American Home Mortgage Corp., HomeBanc Corp., Sachsen Landesbank, Northern Rock, plc, Financial Guaranty Insurance Company, and Countrywide failed. Others, such as Citigroup, Inc. and the monoline insurers Ambac Financial Group, Inc. and MBIA, Inc. needed significant help (both government and private) to survive.

• The auction rate securities market froze as securities for sale exceeded demand, auction agents refused to take the excess supply on their balance sheets, and the auctions failed en masse.

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During this time, the money market continued to exhibit considerable stress. For example, spreads between yields on one-month asset-backed paper and Treasury bills widened dramatically, reaching nearly 400 basis points at one time.

Weekend of March 15-16, 2008

- The federal government orchestrated a rescue of Bear Stearns, allowing JPMorgan Chase & Co. to purchase Bear Stearns, with the federal government guaranteeing up to $30 billion in potential losses. Under this transaction, Bear Stearns’s shareholders suffered very significant losses but its debt holders were unharmed. As of May 31, 2007, Bear Stearns’s assets were 31 times its shareholder equity.

April 2008

- Wachovia amassed a first quarter loss of $350 million.

July 14, 2008

- Office of Thrift Supervision closed IndyMac Bank, making it the largest-ever thrift to fail.

July 22, 2008

- Washington Mutual reported a $3.3 billion loss. Depositors withdrew $10 billion during the next two weeks.
- Wachovia amassed an $8.9 billion second-quarter loss.

VIII. Key Market Events—September 2008

Weekend of September 6 and 7

- The government placed the nation’s two largest mortgage finance companies, Fannie Mae and Freddie Mac, in conservatorship and made a plan to provide financial support to the agencies through the purchase of senior preferred stock and the extension of short-term secured loans.

Week of September 8


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94 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.” For an overview of the money market, including its structure and participants and the key characteristics of money market funds, see Appendix B.
Weekend of September 13 and 14

- Bank of America Corporation agreed to buy Merrill Lynch for $50 billion.
- The future of AIG, one of the largest underwriters of credit default swaps, remained highly uncertain, as credit rating agencies threatened to downgrade the company’s debt, a move that would have prompted counterparties to make margin calls on their contracts which would be in excess of AIG’s available liquidity.
- The Treasury Department and the Federal Reserve tasked CEOs of major Wall Street firms to come up with a private sector solution to prevent a Lehman bankruptcy.

Monday, September 15

- Lehman, lacking a buyer and failing to obtain government assistance, declared bankruptcy.
  - As with Bear Stearns, the viability of Lehman had been questioned for several months. Nevertheless, Lehman’s failure was an especially difficult shock for the market because it represented an abrupt reverse in direction by the U.S. government from its previous decisions to intervene and rescue Bear Stearns (an investment bank smaller than Lehman), Fannie Mae, and Freddie Mac.
- The collapse of Lehman on September 15 triggered a severe credit freeze in the short-term markets, as investors pulled back from lending to financial institutions and rushed to buy short-dated Treasury securities.
- Yields at the short-end of the Treasury market traded down sharply, with 4-week bills trading at 0.28 percent, down from 1.35 percent on Sept. 12 and 1.51 percent on Sept. 11.
- At the same time, investors retrenched from the commercial paper market. Issuance at the longer end of the market fell sharply. Issuers had difficulty attracting investors to paper with maturities beyond the end of the week. Issuance volume on commercial paper with maturities beyond 4 days dropped to $23 billion on Sept. 15 from $51 billion on Sept. 12.
- In the afternoon, AIG was downgraded by S&P, Moody’s, and Fitch, triggering billions of dollars in additional cash collateral calls on AIG’s credit default swaps.
- On September 15, 2008, prime money market funds had outflows of $50 billion, of which presumably a large fraction simply represented normal outflows associated with tax payments. In the previous four years, outflows from prime money market funds averaged $20 billion on September tax payment days. After accounting for estimated outflows related to tax payments and outflows from the Reserve Primary Fund, outflows for all prime
money market funds totaled approximately $18 billion or 0.9 percent of total net assets.\textsuperscript{95} Government money market funds had inflows of $2 billion on September 15.

**Tuesday, September 16**

- The Treasury bill market continued to be swamped by heavy demand as investors sought the safety of short-term U.S. Government securities. The 4-week bill traded at 0.23 percent and the 3-month bill traded at 0.84 percent. Stresses in the commercial paper market increased as issuers continued to have difficulty attracting investors beyond the very short end of the market. Issuance beyond 4 days dropped to $20 billion.

- Outflows from prime money market funds began to pick up as some investors in these funds, like other investors, began to seek the safety of U.S. Government securities. Outflows from prime funds totaled $32 billion, while inflows to government money market funds were $33 billion.

- After the markets closed, Reserve Primary Fund announced that it would no longer redeem shares at $1.00. The fund held about 1.2 percent of its assets in Lehman debt.

- Late in the evening after the markets were closed, the Federal Reserve announced that it had agreed to lend AIG up to $85 billion. The U.S. government took nearly an 80 percent stake in the company.

**Wednesday, September 17**

- Other money market funds with exposure to Lehman also experienced difficulties. Nevertheless, all money market funds, with the exception of the Reserve Primary Fund, maintained their $1.00 NAV.

- Investors continued to flee to the Treasury bill market for safety. Four-week bills traded at 0.07 percent and 3-month bills were at 0.03 percent. Meanwhile, the credit squeeze in the commercial paper market continued: issuance beyond 4 days fell to $18 billion, with 40 percent of that issuance between 5 and 9 days. Outstanding commercial paper was down $51 billion from a week earlier, or about 3 percent.

- Colorado Diversified Trust, a local government investment pool (not a money market fund) transferred its assets to another LGIP to maintain its rating (the pool held 1.8

\textsuperscript{95} Data for September 15 includes estimated redemptions of $11.6 billion processed by the Reserve Primary Fund on September 15. As of September 12, the Reserve Primary Fund had $62.6 billion in total net assets. As of the close of business on September 15, the Reserve Primary Fund had approximately $51 billion in total net assets. The fund was effectively frozen at this level until it starting making distributions to shareholders beginning October 30. See http://www.primary-yieldplus-inliquidation.com/pdf/PressReleasePrimDist2008_1030.pdf. Daily data for all other money market funds are from iMoneyNet.
percent of its portfolio in Lehman paper). The trust served as a cash pool for more than 60 local government entities in Colorado.

- Inflows to government money market funds rose to $49 billion and prime money market fund investors redeemed, on net, $106 billion.

**Thursday, September 18**

- Short-term markets continued to trade under pressure of investors' flight to quality. Demand for Treasury bills kept yields well below their prior week levels, with the 4-week bill yield at 0.25 percent and 3-month bills traded at 0.23 percent.

- Commercial paper issuance beyond 4 days remained depressed at $24 billion. Investors' deep concerns about the viability of banks and other financial institutions around the world, and about the willingness and wherewithal of their governments to support them, constricted the access of these firms to funding in the short-term markets. For example, financial firms were only able to place 11 issues of commercial paper with maturities beyond 40 days, compared with 149 issues on September 12.

- For a third day, money market fund investors mirrored behavior in the broader markets, as investors sought the security of government securities. Inflows to government money market funds totaled $58 billion, and outflows from prime funds were $94 billion.

- Putnam Investments announced in the morning that it was closing the Putnam Prime Money Market Fund. The fund had no exposure to Lehman or other troubled issuers, but had experienced significant redemption pressures from its concentrated institutional investor base. The fund determined to close rather than sell portfolio securities into a liquidity constrained market; this action allowed the fund to treat all shareholders fairly. On September 24, the fund merged with Federated Prime Obligations Fund at $1.00 per shares and shareholders did not lose any principal.

**Friday, September 19**

The Federal Reserve and the Treasury Department announced a series of broad initiatives designed to stabilize the market, which had ceased to function even for very short-term, high-credit securities.

- The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance purchases of high-quality ABCP from money market funds.

- The Commercial Paper Funding Facility (CPFF) provided a backstop to U.S. issuers of commercial paper through a special purpose vehicle that would purchase three-month unsecured commercial paper and ABCP directly from eligible issuers.
• The Treasury Department announced its Temporary Guarantee Program for Money Market Funds, which temporarily guaranteed certain account balances in money market funds that qualified for and elected to participate in the program. ICI worked with Treasury and other regulators to limit the reach of the Treasury Guarantee Program, urging that the guarantee be limited and temporary. The program expired on September 18, 2009. No claims were made on the Guarantee program, and no amounts were paid out. Instead, Treasury and, as a result, taxpayers, received an estimated $1.2 billion in premiums paid by participating money market funds.

• Pressures in the Treasury market eased somewhat after the announcement of these programs. The yield on the 4-week bill rose to 0.75 percent, and 3-month bills yields were at 0.99 percent. Commercial paper markets remained under pressure, however, with only $25 billion in new issuance beyond 4 days.

• Money market fund flows returned to the level and pattern seen on September 16. Outflows from prime funds totaled $36 billion, and inflows to government money market funds were $47 billion.

IX. Key Events of Late September 2008 to October 2008

Although the steps taken by the Federal Reserve and the Treasury Department helped to stabilize the commercial paper market and thereby moderate outflows from money market funds, further developments added to investor concerns about overall stability of the global financial markets. These events unfolded through September and into October.

September 21

• The Federal Reserve Board approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

September 25

• After nearly two weeks of speculation about the future of Washington Mutual, Inc., the FDIC officially placed it in receivership. A credit downgrade on September 15 had sparked a run and caused investors to pull $16.7 billion in assets, or 9 percent of its June 2008 deposits, from the bank.96 The FDIC subsequently sold the savings bank to JPMorgan.

96 http://files.ots.treas.gov/730021.pdf
September 28

• The governments of the Netherlands, Belgium, and Luxembourg rescued Fortis Bank.

September 29

• The British government rescued Bradford & Bingley plc, a mortgage lender. Iceland nationalized Glitnir Bank.

September 30

• The governments of Belgium, France, and Luxembourg rescued Dexia SA, a major European banking group.

September 22 through September 30

• Money market fund investors continued to shift their holdings from prime funds to government money market funds. Outflows from prime funds during the week totaled $103 billion and inflows to government funds were $146 billion.

October 2

• The Irish president signed legislation guaranteeing Irish banks.

October 3

• Congress passed and President George W. Bush signed the Emergency Economic Stabilization Act of 2008, which included the Troubled Asset Relief Program (“TARP”) that allowed Treasury to purchase assets and equity from banks. The FDIC approved Wells Fargo’s offer to buy Wachovia, reversing an earlier offer by Citigroup to purchase the banking firm.

October 7

• Icelandic bank Landsbanki was placed into receivership.

October 8

• Icelandic bank Kaupthing was nationalized.

October 13

• Treasury invested $125 billion from TARP in preferred shares of nine large commercial banks.

• The Federal Reserve, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank announced a coordinated program “to provide broad access to liquidity and funding to financial institutions.”
Appendix B
The U.S. Money Market

The U.S. money market is a huge, complex, and significant part of the financial system in which many different participants interact each business day. This appendix 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.

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.” The money market is an effective and low 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 lend to large foreign-domiciled corporations that may need dollars, often because they have U.S.-based operations.

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. U.S. Government sponsored agencies such as Fannie Mae and Freddie Mac issue Benchmark and Reference bills, discount notes, and floating rate notes (collectively, “agency securities”). State and local municipalities issue cash-

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97 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.
flow notes to provide short-term 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. Furthermore, banks and broker-dealers 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 is 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 below bank loan rates. 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

98 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.

99 In addition, U.S. banks (including branches of foreign banks in the United States) can lend to each other in the U.S. 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.


101 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), rev. June 2012.
commercial paper, large CDs, Treasury and agency securities, repurchase agreements, and Eurodollar deposits—total roughly $10.5 trillion.\footnote{For complete data sources, see Figure 2.}

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.

**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 liquidity, a market-based rate of return, and the goal of returning principal, all at a reasonable cost.\footnote{These and other characteristics of money market funds are described more fully below.} These funds are registered investment companies that are regulated by the SEC under the U.S. federal securities laws, including Rule 2a-7 under the Investment Company Act of 1940. That rule, which was substantially enhanced in 2010, contains numerous risk-limiting conditions intended to help a fund achieve the objective of maintaining a stable NAV using amortized cost accounting.\footnote{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 IV of this letter.} 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 typically affect the total remaining collected balances (or all available cash) in customer accounts, after all other transactions have been posted. 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 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.” 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 $516 billion as of May 4, 2012, with $206 billion of those assets in dollar-denominated money funds.\(^{108}\)

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\(^{106}\) 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.

\(^{107}\) 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 weighted average life (no more than 12 months).

\(^{108}\) Institutional Money Market Fund Association, statistical data available at http://www.immfa.org/stats/default.asp. These figures include assets of funds denominated in Euros or sterling, converted to dollars at spot exchange rates as of May 4, 2012.
- **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 U.S. Internal Revenue Code. STIFs sponsored by U.S. banks are regulated by the U.S. Office of the Comptroller of the Currency (“OCC”). Under OCC regulations, STIFs, like money market funds, use amortized cost accounting to value their assets.  

- **Local government investment pools (“LGIPs”)** typically refer to U.S. 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 U.S. federal securities laws. Investment guidelines and oversight for LGIPs may vary from state to state.

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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: liquidity, a market-based rate of return, and return of principal.

- **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, money market funds offer investors market-based yields.

- **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.

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 are not permitted to rely on credit rating agencies; instead, they 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 U.S. mutual fund investors have under the Investment Company Act. Most money market funds also are publicly offered and therefore registered under the U.S. 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 disclosed 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.

Money Market Funds as Financial Intermediaries

Money market funds efficiently channel dollars from all types of investors to a wide variety of borrowers, and have become an important part of the U.S. money market. As of April 2012, 609 money market funds had a combined $2.6 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).

Figure 1

Total Net Assets of Money Market Funds

*Data through April 30, 2012*
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 March 2012, taxable 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’ investments in these short-term instruments represent 20 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.

Money market funds also are major participants within individual categories of taxable money market instruments. As of March 2012, these funds held 38 percent of outstanding short-term agency securities, 37 percent of commercial paper, 17 percent of short-term Treasury securities, 19 percent of repurchase agreements, 21 percent of large CDs, and 4 percent of Eurodollar deposits.

Money market funds are a significant source of funding to U.S. state and local governments for public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. As of March 2012, money market funds had $337 billion under management and accounted for an estimated 74 percent of outstanding short-term municipal debt (Figure 2).

**Figure 2**

**Selected Money Market Instruments**

**March 2012**

<table>
<thead>
<tr>
<th>Total taxable instruments</th>
<th>Total</th>
<th>Money market fund holdings</th>
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<td>Billions of dollars</td>
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<td>Total taxable instruments</td>
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<td>Eurodollar deposits⁵</td>
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Tax-exempt instruments\(^6\)  

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<td>454</td>
<td>337</td>
<td>74</td>
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</tbody>
</table>

1 Debt issued by Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency due to mature by the end of March 2012; category excludes agency-backed mortgage pools.

2 Marketable Treasury securities held by the public due to mature by the end of March 2012.

3 Repurchase agreements with primary dealers; category includes gross overnight, continuing, and term agreements on Treasury, agency, mortgage-backed, and corporate securities.

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 March 2012. 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 March 2012.

Sources: Investment Company Institute, Federal Reserve Board, U.S. Treasury Department, Fannie Mae, Freddie Mac, Federal Housing Finance Agency, Federal Reserve Bank of New York

Since the early 1970s, money market funds have 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. As of March 2012, money market funds held $363 billion (37 percent of the market) in outstanding commercial paper (Figure 3).

Figure 3

Money Market Funds’ Holdings of Commercial Paper

*Percentage of total commercial paper outstanding, quarterly*
* Data through March 2012

Sources: Investment Company Institute and the Federal Reserve Board.