In connection with the International Organization of Securities Commissions’ (“IOSCO”) Standing Committee on Investment Management’s (“SC5”) review of money market funds, the Investment Company Institute (“ICI”)2 is pleased to offer the following submission. Our submission focuses on U.S. money market funds and explains why in light of the effectiveness of the U.S. Securities and Exchange Commission’s (“SEC”) recent amendments to the regulatory program for money market funds under the Investment Company Act of 1940 (“Investment Company Act”), no further reforms are necessary.3

Since ICI’s inception in 1940, we have been active participants in the development of laws and regulations that have been instrumental in the growth of fund investing in the United States and worldwide. Most recently, we have been deeply engaged in the development of laws and regulations responsive to the recent financial crisis, including mechanisms to counter systemic risk and to make money market funds more resilient in the face of adverse market conditions, such as those caused by the widespread bank failures in 2008.

Indeed, in recognition of the importance of money market funds to the global economy and to investors, we share the goals of regulators and other policymakers—strengthening the regulation of these funds and making them more robust under adverse market conditions. We have devoted significant time and resources to this end. 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.

1 In response to a request from the G20, the Financial Stability Board (“FSB”) has been developing recommendations to strengthen the oversight and regulation of the “shadow banking” system. As part of this initiative, the FSB is assessing the need for money market fund regulatory reform and has asked IOSCO to undertake work in this area and develop policy recommendations by July 2012. In turn, IOSCO has mandated SC5 to elaborate on such policy recommendations, taking into account regulatory initiatives in various jurisdictions.

2 ICI is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI encourages adherence to high ethical standards, promotes public understanding, and otherwise advances the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.5 trillion and serve over 90 million shareholders.

Since the worst of the 2008 banking crisis, the SEC and the fund industry have made a great deal of progress toward their shared goals of bolstering money market funds. In March 2009, ICI issued the Report of the Money Market Working Group (“MMWG Report”), an industry study of the money market, of money market funds and other similar participants in the money market, and of recent market circumstances.\(^4\) The MMWG Report included wide-ranging proposals for the SEC to enhance money market fund regulation.

Incorporating a number of the MMWG Report’s suggestions, the SEC, in 2010, approved far-reaching rule amendments that enhance an already-strict regime of money market fund regulation. The new 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.\(^5\) The SEC indicated that the amendments are designed to strengthen money market funds against certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value (“NAV”) per share.\(^6\) In fact, these reforms were tested this past summer when money market funds met, without incident, large volumes of shareholder redemptions during periods of significant market turmoil, including a credit event involving the historic downgrade of U.S. government debt.\(^7\)

This experience reinforces our belief that the SEC’s current program for regulating and supervising money market funds is sufficient to meet the challenge of even adverse market conditions. The 2010 regulatory reforms are working, and further changes are not necessary. In particular, replacing this program of money market fund regulation with a model that would fundamentally alter the product and/or impose inappropriate bank-like regulation on money market funds 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.

It also is important to consider the SEC’s 2010 amendments to money market fund regulation within the context of other reform efforts to strengthen the resilience of the international financial system. Since the onset of the global financial crisis, the G20 has established core elements of a new global financial regulatory framework that are intended to make the financial system more resilient and better able to serve the needs of the global economy. Through the efforts of the FSB, which is responsible for coordinating, monitoring, and reporting to the G20 regarding its reform efforts, the national authorities and international bodies have further advanced the G20/FSB financial reform program through various policy reforms. These include reforms designed to, among other things, improve the soundness of the banking system, address the risks posed by systemically important

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\(^5\) See MMF Reform Adopting Release, supra note 3.

\(^6\) Id. at 10060.

\(^7\) See infra Section II.
financial institutions, strengthen the regulation and oversight of the “shadow banking” system, improve the over-the-counter and commodity derivatives markets, develop “macroprudential” frameworks and tools to identify and monitor systemic risk, strengthen and converge global accounting standards, strengthen adherence to international financial standards, and reduce reliance on credit rating agency ratings.8

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act9 provides regulators with an array of new tools to address abuses and excessive risk taking by financial market participants, and to detect new buildups of risk in the financial system. Through these coordinated efforts, the FSB has found that “a comprehensive standard for reform has now been established that, when fully implemented, will enable authorities to resolve failing financial institutions quickly without destabilizing the financial system or exposing taxpayers to the risk of loss.”10

Notwithstanding these global reform efforts, including the proven success of the SEC’s 2010 amendments, the calls for more money market fund reform continue. Unlike the 2010 amendments, however, the reforms now being considered would drive funds out of business, reducing competition and choice, and alter the fundamental characteristics of money market funds, thereby destroying their value to investors and the economy. Rather than making our economies and financial systems stronger, such reforms have the potential to increase systemic risk.

It is therefore imperative that before any further regulatory action is taken, all market participants better understand the singular benefits money market funds provide to investors and the economy. With this in mind, our comments below begin with an overview of the U.S. money market to provide context (Section I). Next, we describe the regulation of U.S. money market funds, including the SEC’s recent reforms (Section II). We then examine each of the reform options currently under serious consideration in the United States and describe how they would undermine money market funds’ value to investors, effectively destroying these funds and disrupting the supply of credit to businesses, state and local governments, and consumers (Section III).

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10 FSB Report, supra note 8, at 1.
I. 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 section provides essential context about the U.S. money market by describing: the structure of the market; the vehicles through which investors can access money market instruments (many of which compete directly with money market funds); the unique characteristics of money market funds; and the role and growth of money market funds as financial intermediaries in the money market.

A. Structure of the U.S. Money Market

In the United States, the market for debt securities with a maturity of one year or less is generally referred to as “the money market.” 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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11 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\textsuperscript{12} and Eurodollar deposits.\textsuperscript{13} 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.”\textsuperscript{14} One alternative to issuing commercial paper is to obtain a bank line of credit, but that option is generally more expensive.\textsuperscript{15}

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

\textsuperscript{12} 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.

\textsuperscript{13} 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 U.S. 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.


\textsuperscript{15} 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) (“Basel III Annex”).
commercial paper, large CDs, Treasury and agency securities, repurchase agreements, and Eurodollar deposits—total roughly $11 trillion.\textsuperscript{16}

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

B. Financial Intermediaries for Money Market Instruments

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

- **Money market funds.** Money market funds offer investors a variety of features, including liquidity, a market-based rate of return, and the goal of returning principal, all at a reasonable cost.\textsuperscript{17} 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. 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.\textsuperscript{18} 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

\textsuperscript{16} For complete data sources, see Figure 2.

\textsuperscript{17} These and other characteristics of money market funds are described more fully in Section I.C.

\textsuperscript{18} The regulation of money market funds, including Rule 2a-7’s risk-limiting conditions and the amortized cost method of valuation, is discussed in greater detail in Section II.
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.

  - **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.\(^{19}\) 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.\(^{20}\) 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.”\(^{21}\) 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

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\(^{20}\) 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.

\(^{21}\) 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).
approximately $600 billion as of December 16, 2011, with $283 billion of those assets in dollar-denominated money funds.22

○ **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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C. Characteristics of Money Market Funds

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

In addition to a stable $1.00 NAV, money market funds seek to offer investors three primary features: 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 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 (see Section II). 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.

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

Money market funds efficiently channel dollars from all types of investors to a wide variety of borrowers, and have become an important part of the U.S. money market. As of November 2011, 641 money market funds had a combined $2.7 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

*Trillions of dollars*

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 November 2011, taxable money market funds held $2.1 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\(^\text{23}\) represent about 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 November 2011, these funds held 39 percent of outstanding short-term agency securities, 36 percent of commercial paper, 16 percent of short-term Treasury

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\(^{23}\) As of November 2011, approximately 90 percent of all taxable money market funds’ total net assets were invested in these instruments. The remaining 10 percent of assets were invested in bank and corporate notes, bankers’ acceptances, cash reserves less any liabilities, and other miscellaneous assets.
securities, 20 percent of repurchase agreements, 21 percent of large CDs, and 5 percent of Eurodollar deposits.

Tax-exempt 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 December 2011, tax-exempt money market funds had $291 billion under management and accounted for an estimated 57 percent of outstanding short-term municipal debt (Figure 2).
Figure 2

Selected Money Market Instruments

November 2011

<table>
<thead>
<tr>
<th>Total taxable instruments</th>
<th>Total</th>
<th>Money market fund holdings</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Billions of dollars</td>
<td>Billions of dollars</td>
</tr>
<tr>
<td>Total taxable instruments</td>
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<td>$2,434</td>
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<tr>
<td>Agency securities(^1)</td>
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<td>384</td>
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<tr>
<td>Commercial paper</td>
<td>1,007</td>
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<tr>
<td>Treasury securities(^2)</td>
<td>2,760</td>
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<td>Repurchase agreements(^3)</td>
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<tr>
<td>Certificates of deposit(^4)</td>
<td>1,712</td>
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<tr>
<td>Eurodollar deposits(^5)</td>
<td>1,354</td>
<td>66</td>
</tr>
<tr>
<td><strong>Total tax-exempt instruments(^6)</strong></td>
<td>510</td>
<td>291</td>
</tr>
</tbody>
</table>

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

\(^2\) Marketable Treasury securities held by the public due to mature by the end of November 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 December 2011. Category includes variable rate demand notes, auction rate securities, tender option bonds, and other short-term debt. Category does not include long-term fixed-rate debt due to mature by the end of December 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*
For 40 years, 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 November 2011, money market funds held $380 billion (38 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 are through November 2011

Source: Investment Company Institute
II. Regulation of U.S. Money Market Funds

A. Overview

While there is no single, global definition of a “money market fund,” U.S. money market funds, like all U.S. mutual funds, are regulated under all four of the major U.S. 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 advisers to mutual funds 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 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 these: (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

24 Although many jurisdictions identify a class of funds as “money market funds,” the market circumstances, the regulatory structure, and the operation of such funds vary significantly from one jurisdiction to another. See Section I.B. and MMWG Report, supra note 4, at Appendix H.

25 Mutual funds are subject to oversight by U.S. state securities commissions and U.S. self-regulatory organizations, such as the Financial Industry Regulatory Association ("FINRA"). FINRA is a self-regulatory organization that oversees broker-dealers that distribute mutual fund shares and mutual fund advertising. For an overview of the key principles of the Investment Company Act, see 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”) ("ICI Letter to FSB"), available at http://www.ici.org/pdf/25258.pdf.

26 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 nearestcent on a share price of $1.00.
of a share price that represents fairly the current NAV per share of the fund. In practice these risk limiting conditions generally keep deviations between money market funds’ per share market value and amortized costs small. Data from a sample of taxable money market funds covering one-quarter of U.S. taxable money market fund assets show that the average per-share market values for prime money market funds\(^{27}\) varied between $1.002 and $0.998 during the decade from 2000 to 2010.\(^{28}\)

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 designed to limit the fund’s exposure to certain risks by governing the credit quality, liquidity, maturity, and diversification of a money market fund’s investments.\(^{29}\) These risk-limiting conditions include requirements that money market funds:

- only invest in high-quality securities that mature in 13 months or less (with exceptions for certain types of securities including variable and floating rate securities that have an interest rate reset of no more than 397 days or a demand feature), which a fund’s board of directors (or its delegate) determines present minimal credit risks, and a requirement that at least 97 percent of a fund’s assets be invested in securities held in U.S. government obligations or other securities that either received the highest short-term rating or are of comparable quality;

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

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

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

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\(^{27}\) Prime money market funds are funds that may invest in high-quality, short-term money market instruments including Treasury and government obligations, certificates of deposit, repurchase agreements, commercial paper, and other money market securities.


\(^{29}\) Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule’s risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.
In addition, Rule 2a-7 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.\footnote{Indeed, 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 Pricing of U.S. Money Market Funds, supra note 28.} 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 the dollar.” Regardless of the extent of the deviation, Rule 2a-7 also imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Moreover, all funds must dispose of a defaulted or distressed security (e.g., one that no longer presents minimal credit risks) “as soon as practicable,” unless the fund’s board of directors specifically finds that disposal would not be in the best interests of the fund.

Money market funds also must prominently disclose on the first page of their prospectus that “an investment in the [f]und is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the [f]und seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the [f]und.”\footnote{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. See MMWG Report, supra note 4, at 91-92.}

**B. Money Market Funds Made More Resilient Under SEC 2010 Amendments**

Building upon the lessons of the financial crisis, 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.\footnote{See MMF Reform Adopting Release, supra note 3.} For example, the reduction in the maximum allowable weighted average maturity (“WAM”) from 90 days to 60 days lowered the average maturity of taxable money market funds across the board (Figure 4). It also reduced “tail risk” by preventing funds from holding a portfolio with a WAM in excess of 60 days; this is seen in Figure 4 as a “lapping off” of the right-hand tail of the distribution of WAMs across taxable money market funds. This 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 better position to meet shareholder redemptions.
Figure 4

WAMs for Taxable Money Market Funds

Percentage of funds

Source: Investment Company Institute

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 are not publicly available before November 2010, publicly available data since then suggest that the new WAL requirement likely has bolstered the resilience of funds. Figure 5 depicts the distribution of WALs for taxable money market funds as of November 2011. The maximum allowable WAL is 120 days. Most funds, however, are well below this, 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.
Figure 5

WALs for Taxable Money Market Funds

Percentage of funds, November 2011

Note: Excludes money market funds that invest primarily in other funds.

Source: Investment Company Institute tabulation of form N-MFP data

In addition, the 2010 amendments directly 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. The amendments further require funds to have “know your investor” procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly. As Figure 6 shows, as of November 2011, funds exceeded the minimum daily and weekly liquidity requirements by a considerable margin. For example, 27 percent of the assets of prime money market funds were in daily liquid assets and 45 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated $1.44 trillion in daily or weekly liquid assets, which includes $645 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 November 2011, 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.

**Figure 6**

**Liquid Assets for Taxable Money Market Funds**

*Percentage of total assets, November 2011*

![Diagram showing percentage of total assets for daily and weekly liquid assets in government and prime categories.]

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 Form N-MFP data collected from SEC website, and Bloomberg_

Prime money market funds have in part met the minimum liquidity requirements by altering their portfolio holdings toward repurchase agreements and Treasury and agency securities. Figure 7 compares the concentration of prime money market funds’ holdings of these securities in August 2008 to November 2011. The distribution shifts right, indicating that more prime money market funds now hold a higher percentage of their assets in highly liquid securities that can be used to accommodate

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shareholder redemptions. Under Rule 2a-7, Treasury securities automatically satisfy the daily liquidity requirement, while certain agency securities that mature in 60 days or less automatically satisfy the weekly liquidity requirement. Money market funds often use one or seven day repurchase agreements (typically collateralized by Treasury and agency securities) to maintain liquidity to meet redemptions.

Figure 7

Concentration of Prime Money Market Funds Assets by Holdings of Repo, Treasury, and Agency Securities

Percentage of prime funds’ assets

Source: Investment Company Institute

The rule changes also require more frequent and vastly more detailed disclosure of money market funds’ holdings. Regulators, analysts, and investors have been using this additional disclosure 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.34 Thus, the additional disclosure, consistent with the SEC’s historical approach to protecting investors, has alone had a strong palliative effect.

The SEC also bolstered money market funds’ resilience by giving money market fund boards of directors the ability to suspend redemptions if a fund has broken or is about to break the dollar. Although untested, this powerful tool would help assure equitable treatment for all of the fund’s shareholders, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund. Indeed, this capability, which is available only if the board has determined to liquidate the fund, would protect shareholders under extreme circumstances by ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

C. Recent Events in the Money Market

As a result of these regulatory changes, money market funds are now 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 that owed 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 the U.S. federal government’s extension of unlimited deposit insurance on non-interest bearing checking accounts, which provided investors a no-cost guarantee on liquid balances held at banks.35

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35 See Federal Deposit Insurance Corporation, Deposit Insurance Regulations; Unlimited Coverage for Noninterest-Bearing Transaction Accounts, 75 Fed. Reg. 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.
Prime Money Market Funds Accommodated Large Outflows During U.S. Debt Ceiling and Eurozone Debt Crises

Reflecting these factors, investors withdrew $213 billion from prime money market funds over the six-month period June 2011 to November 2011 (Figure 8). 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 $643 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 9).
Figure 9

Liquid Asset Ratios of Prime Money Market Funds, April to December 2011

Percentage of prime fund assets

Sources: Investment Company Institute; selected N-MFP reports; Crane Data

In addition, despite the outflows and stresses in the market, money market funds’ per-share market values were extremely stable. Indeed, for the vast majority of funds, these values tracked very close to $1.00 (shown in Figure 10 as “average”). Even those prime money market funds with the very lowest values (shown in the figure as “1st percentile”) had levels that were comfortably above the $0.9950 mark. 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 2010.36

36 See Fitch Ratings’ Special Report, supra note 34.
Figure 10

Mark-to-Market Values of Prime Money Market Funds

Selected months, 2011

Sources: Investment Company Institute; selected N-MFP reports
III. Thoughts Concerning Money Market Fund Reform

In 2010, the SEC adopted far-reaching amendments to the rules governing U.S. money market funds to make them more resilient to 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. Since the amended rules were put in place, the U.S. money market fund industry has been tested by the twin stresses of a near default and subsequent downgrade of the United States debt and the sovereign and banking credit deterioration across Europe. Throughout this difficult and uncertain period, the funds performed exceptionally well. Yet, the calls for more reform continue.

Many of these reform proposals appear to be based on the premise that money market funds are unregulated (or lightly regulated) and this lack of regulation caused the problems that money market funds experienced during the 2008 credit market crisis. As discussed above, however, U.S. money market funds are subject to far-reaching U.S. federal regulation, both explicitly through amended Rule 2a-7 under the Investment Company Act and more generally as mutual funds through the whole of the Investment Company Act and other federal securities laws. It is simply incorrect to claim that these funds are (or have ever been) not regulated.

Nevertheless, proposals for additional regulatory changes to money market funds are numerous and include potential reforms that could fundamentally alter the nature of money market funds. Three such reforms, which continue to draw some support among regulators and others, are discussed below.\(^\text{37}\) First, we explore the proposition that money market funds should let their share prices fluctuate or “float”—a structural change that would not reduce systemic risk, but rather, 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 discuss the implementation of permanent redemption restrictions—a concept that would be not only costly to implement, but contrary to the fundamental nature of a mutual fund. In any event, it is imperative that all market participants better understand the full costs and benefits of both the 2010 reforms and any additional reform measures before further regulatory action is taken.\(^\text{38}\)

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

One reform proposal that continues to draw some support is the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation—forcing them to float

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\(^{38}\) To this end, on November 2, 2011, six U.S. Senators sent a letter to SEC Chairman Schapiro that also copied other members of the Financial Stability Oversight Commission (“FSOC”), expressing their concerns about proposals that would float money market funds’ NAVs or impose “inappropriate” bank-like requirements on these funds. The letter urges the SEC not to “rush to adopt solutions that could potentially create disruptions in our fragile economy, impair the ability of businesses to raise capital efficiently, harm retail investors, and increase stress on municipal budgets.” The letter concludes by stating that “[a]ny further proposal should preserve the utility of money market funds for investors and avoid imposing costs that would make large numbers of advisers unwilling or unable to continue to sponsor these funds.”
their NAVs. Some regulators, making much of the liquidity, maturity, and credit transformation of money market funds, continue to espouse a floating NAV, despite hearing from a wide range of businesses, government, financial services, and consumer organizations that doing so would not only undermine the convenience and simplicity of money market funds, but damage financing for all sectors of the U.S. economy. Also included among those voices are many from 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 would require funds to use mark-to-market pricing of fund portfolio securities rather than amortized cost accounting for the purpose of determining the NAV of fund shares on a daily basis.

As we discuss below, and as numerous investors and issuers have already 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.

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39 Much has been made of the liquidity, maturity, and credit transformation of money market funds. The degree of transformation, however, is extremely modest, especially when compared to banks. As noted in Section II, taxable U.S. 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 November 2011, taxable money market funds held 41 percent of their portfolios in daily liquid assets and 61 percent in weekly liquid assets, far exceeding the minimum requirements. Furthermore, although under Rule 2a-7 a money market fund’s WAL cannot exceed 120 days, the average WAL in November 2011 was 68 days for government funds and 76 days for prime funds. These requirements reduce liquidity and maturity transformation to very low levels. U.S. money market funds also are required to hold securities that pose minimal credit risk. As of October 2011, 99 percent of money market funds’ portfolios received the highest short-term credit ratings. In addition, to the extent that a credit issue arises with a security, U.S. 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 a 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 and avoid transferring or transforming that credit risk.

40 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_s_opposefloatingnav. In October 2010, the President’s Working Group on Financial Markets (“PWG”) issued a report (“PWG Report”) discussing several options for further reform of money market funds, including a mandatory floating NAV, and recommending that the FSOC examine those options. See PWG Report, supra note 33. The PWG directed the SEC to solicit comments on the Report to assist the FSOC in its examination of the reform options, see SEC Release No. IC-29497 (November 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. In response to this request, ICI, along with over 100 companies or organizations, submitted letters to the SEC in opposition to floating NAV. See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (January 10, 2011), available on ICI’s website at http://www.ici.org/pdf/11_sec_pwg_com.pdf.
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 with money market funds, however, the NAV of an ultra-short bond fund fluctuates. Beginning in the summer of 2007, the average NAV on these funds began to fall (Figure 11). 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 on money market funds would reduce risks in any meaningful way. Rather, prohibiting money market funds from maintaining a stable NAV would likely lead to the demand for less regulated products that seek to maintain a stable NAV as discussed below, and would therefore simply shift the risk to a more opaque and less regulated part of the market.
2. Investor Demand for a Stable NAV Fund Would Remain

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 no.

Many institutional investors that use money market funds would be unable to use a floating NAV fund. These investors often face legal or other constraints that preclude them from investing their cash balances in pools that do not maintain a stable NAV. For example, corporations may have board-approved policies permitting them to invest operating cash (balances used to meet short-term needs) only in pools that do not fluctuate in value. Indentures and other trust documents may authorize investments in money market funds on the assumption that they seek to maintain a stable NAV. Many state laws and regulations also authorize municipalities, insurance companies, and other
state regulated entities to invest in stable NAV funds, sometimes explicitly including funds operating in compliance with Rule 2a-7. Thus, absent a stable NAV, many state and local governments would no longer be able to use money market funds to help manage their cash.41

Even those investors that do not face such constraints nevertheless may be unwilling to invest in a floating NAV product. 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.42 Indeed, the use of amortized cost accounting and a stable NAV allow the efficient processing of cash balances through cash sweep programs by which customer cash balances are “swept” into investments in shares of money market funds that are owned by the customer but held in custody through the broker-dealer. A stable NAV also offers significant convenience in terms of tax, accounting, and recordkeeping. For example, all of a money market fund’s returns are distributed to shareholders as income. This relieves shareholders of having to track gains and losses, including the burden of having to consider the timing of sales and purchases of fund shares (i.e., U.S. wash sale rule considerations). To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors make fewer purchases and sales from long-term mutual funds because they are used for long-term saving, not cash management. And in any case, many purchases (or exchanges) in long-term funds are made within tax-advantaged accounts (e.g., 401(k) plans, a type of retirement savings account in the United States), 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 U.S. Fedwire transfers. These features are generally only provided for stable NAV products. In addition, money market funds typically offer investors same-day settlement on shares redeemed via “wire transfers” (where redemption proceeds are wired to an investor’s bank account via Fedwire), whereas bond funds typically offer next-day settlement. Thus, elimination of the stable NAV for money market funds would likely force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

Proponents of eliminating the stable NAV state that there is no direct evidence on the likely effect of a floating NAV on the demand for money market funds. The current rate environment, however, has proven to be an important test of investor demand for stable NAV funds. Currently, yields on money market funds are on average 150 basis points below short-duration bond funds, and 300 to 500 basis points below longer term bond funds.43 Yet, assets in money market funds are roughly

[41] See MMWG Report, supra note 4, at Appendix D.


[43] Investment Company Institute; Morningstar; iMoneyNet.
$2.7 trillion, greater than the assets held in money market funds prior to the start of the financial crisis in the summer of 2007.

Indeed, a diverse range of investors in money market funds previously have communicated their opposition to floating NAVs. 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.44 Corporate treasurers, added the Financial Executives International in its comments to the Subcommittee, “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.”45

Furthermore, surveys of money market fund investors indicate clearly that most investors do not want and would not use a floating NAV product. For example, a survey of institutional cash managers indicated that more than half would decrease substantially their use of money market funds if money market funds are required to have a floating NAV (Figure 12).


Figure 12

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

![Bar chart showing expected usage of floating NAV money market funds.]

- Increase somewhat: 3
- Remain about the same: 18
- Decrease somewhat: 5
- Decrease substantially: 55
- No response: 18

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

Source: Treasury Strategies Inc. flash survey of 78 institutional cash managers on January 30, 2009. Of the 78 institutional cash managers, 43 were commercial, 13 were education-related, 13 were private, 4 were state and local governments, 4 were financial institutional, and 1 was unclassified.
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 13).46

Figure 13
Retail Investors’ Reaction to Floating NAV Money Market Funds

![Pie chart showing investors' overall reaction to floating NAV money market fund concept]

Investors' Overall Reaction to Floating NAV Money Market Fund Concept

<table>
<thead>
<tr>
<th>Reaction</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Favorable</td>
<td>15%</td>
</tr>
<tr>
<td>Neutral</td>
<td>18%</td>
</tr>
<tr>
<td>Unfavorable</td>
<td>66%</td>
</tr>
</tbody>
</table>

What Those Who Are Unfavorable to Concept Would Do With Their Money Market Fund Accounts

- Decrease balance: 33%
- Close account: 29%
- Transact less: 10%
- No change: 16%
- Don't know: 11%
- Other: 1%

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 found the concept unfavorable, 72 percent indicated that they would use the product less, and that their most likely response would be to close their money market fund accounts (29 percent), decrease their money market fund balances (33 percent), or execute fewer money market fund transactions (10 percent). A third survey, conducted among both retail and institutional

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46 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.
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.\(^7\) In short, there is good reason, backed by data, to believe that investors do not want and would likely reject a floating NAV money market fund.

3. *Floating the NAV Would Harm the Market*

The primary, and perhaps only, effect that floating the NAV of money market funds would have on the financial system would be a major restructuring and reordering of intermediation in the short-term credit markets. If the assets move to less regulated products or structures, risks in the financial markets could well increase.

Assets in money market funds now total $2.7 trillion. As indicated, money market fund investors of all types are unlikely to use a floating NAV product. Requiring money market funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. 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 kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs will merely shift credit intermediation from one type of product to others. There are a number of alternative products that money market fund investors could use, including as described above, enhanced cash pools, LGIPs, and other vehicles that seek to maintain a stable unit price but are not regulated under the Investment Company Act. Regulatory changes that push assets from regulated products (*i.e.*, money market funds) to less regulated products arguably would serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.\(^8\)

Indeed, 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).\(^9\) If a stable NAV is eliminated for money market

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\(^8\) See MMWG Report, *supra* note 4, at 62-64.

\(^9\) For a general discussion of overnight sweep arrangements, see MMWG Report, *supra* note 4, at 43-44.
funds, investors can migrate to these other kinds of sweep accounts, which in some cases (e.g., Eurodollar sweeps) are largely beyond the jurisdictional reach of domestic regulators. Sweeps into offshore accounts are particularly popular (Figure 14).

**Figure 14**

**Investments of Bank Sweep Programs**

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

Even if investors shift their liquid balances to bank deposits in conventional banks, unless these deposits were fully insured, either explicitly or implicitly, institutional investors would likely run during a serious crisis. 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 U.S. 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. In its letter to the House Subcommittee on Capital Markets and Government Sponsored Enterprises in June 2011, the Association for Financial Professionals warned the Subcommittee 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.”

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.”

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

B. Capital Buffers

The idea that money market funds or their advisers should maintain capital against money market fund assets is a radical departure from the U.S. system of regulating mutual funds or their sponsors and appears to stem from incorrectly likening money market funds to banks. Money market funds are not banks. Banks use leverage; hold long-term, often highly opaque investments; may have

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52 For a thorough discussion regarding the complementary, yet separate, role of banks and non-banks in the markets and credit intermediation, see ICI Letter to FSB, supra note 25.
substantial off-balance sheet commitments; and have deposit insurance. Banks extend loans to businesses, consumers, and households. These loans are often highly illiquid; they may have maturities of 10 to 30 years and unique characteristics. Also, because loan characteristics may be unique, they can be hard to value. As a result, banks may be unable to quickly liquidate their assets when faced with deposit outflows. Banks are required to hold capital to protect the U.S. Federal Deposit Insurance Corporation, depositors, and other creditors from losses that may arise from holding a portfolio of illiquid, opaque assets. Money market funds, on the other hand, are highly restricted by Rule 2a-7 on the maturity, liquidity, diversification, and credit quality of their securities, and do not have insurance. Investors in money market funds are shareholders, not creditors. Even though fund sponsors at times purchase securities from their money market funds to protect their investors from losses and to protect the franchise value of their businesses, they are not required to do so.

Yet, despite these fundamental differences between money market funds and banks, current proposals under consideration envision capital buffers for money market funds. Such a fundamental shift in the nature and regulatory scheme of the money market fund product (and by extension the mutual fund product in general) must be thoroughly studied. Regulators must clearly define the problem they seek to address. Protecting funds from all but the smallest credit losses is beyond the scope of any money market fund, regardless of size, structure, or strength of sponsor. Creating a buffer to absorb small losses permits funds more freedom to sell in falling or depressed markets, or absorb large and sudden interest rate changes, but will not offer absolute certainty that no fund will break the dollar under extreme market conditions. It is therefore imperative for regulators to articulate their goals before determining whether capital is an appropriate solution.

If regulators should determine that capital would achieve their stated goals, the next logical question is how large the capital base must be, and whether it is possible for funds to raise that level of capital without destroying the product. These considerations raise important issues relating to the amount, the source, and the time necessary to accrue capital.

1. Amount of Capital Base

Not surprisingly, the size of a capital buffer is a major source of concern for the industry. SEC Chairman Schapiro recently echoed this concern. “A challenge is how to establish a capital buffer that offers meaningful protection against unexpected events, without over-protecting and unnecessarily interfering with the prudent and efficient portfolio management of the fund.”53 She also acknowledged the challenges of developing and implementing money market reforms in a low or nearly “no” interest rate environment. “Reforms need to be implementable now, yet workable in all interest rate environments.”54 In addition, not all assets that money market funds hold should be treated the same. Certain assets, such as Treasury and agency securities, should be treated as riskless. Securities maturing soon (within 7 days or less) increase the fund’s ability to meet redemptions and also should be excluded from any capital buffer requirement. Finally, any capital buffer proposal should allow for entry and

53 See Schapiro Speech, supra note 37, at 5.
54 Id.
innovation in the money market fund industry, perhaps by making allowance for newer or smaller funds.

2. Source of Capital

The source of capital—whether it should come from the fund’s sponsor, either directly or through a subordinated class structure, the fund’s shareholders through the retention of income, or some combination thereof—also is a concern and would likely be determined by the size of the buffer, how quickly the buffer must be built, and whether sponsor contributions would require the sponsor to consolidate the fund on the sponsor’s books for financial reporting purposes.

a. Sponsor Capital

The economic and business costs to fund sponsors of pledging capital would depend on the percentage of capital required, what assets capital must be held against, the length of the phase-in, and whether sponsors are required to or may elect to pledge capital (with the balance being built up from fund income, for example). To begin with, certain levels of capital would threaten the viability of the money market fund product. Regulators, academics, and media reports have at times suggested a capital ratio of 3 percent of fund assets, which would amount to $8.1 billion. Fund sponsors, however, have indicated that such a level—or even levels close to that amount—would be prohibitive. Whether lower amounts of capital could be accommodated is a question for careful study. Money market fund sponsors already are under strain due to historic low interest rates. To allow their funds to maintain a positive yield in this near-zero short-term interest rate environment, funds have had to waive over $5 billion in expenses in 2011 (Figure 15), putting significant pressure on fund sponsors’ margins. The U.S. Federal Reserve’s recent announcement that it would likely leave rates untouched through at least 2014 erased hopes for improvement anytime soon.56

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55 As of December 2011, the assets of money market funds were $2.7 trillion.

Requiring sponsors to pledge capital, even seemingly modest levels, risks industry consolidation and threatens competition. Even now, fund sponsors are exiting the money market fund business. Since 2008, there has been a 17 percent decrease in the number of money market fund sponsors (Figure 16). Independent analysis suggests that certain fund sponsors would likely face very significant (perhaps insurmountable) hurdles of raising capital. Sponsors may instead elect to use their expertise to manage large private cash pools that could serve as money market fund substitutes, potentially increasing systemic risk if a significant portion of the U.S. $2.7 trillion currently in money market funds were to shift to less regulated vehicles.

Requiring sponsors to provide capital also would raise accounting issues. For example, GAAP requires a reporting company to consolidate entities it controls on its balance sheet for financial reporting purposes.\textsuperscript{58} If a fund sponsor were deemed to have a “controlling financial interest” in its money market funds, it might be forced to consolidate those money market funds into its financial statements for financial reporting purposes.\textsuperscript{59} Arrangements that obligate the sponsor to bear the risk of loss may cause the money market fund to be deemed a “variable interest entity” and would require the sponsor to perform an analysis to determine whether it is acting in a “principal” or “agent” capacity. If the sponsor is deemed to be acting in a principal capacity, it would be deemed to have a controlling financial interest and would be required to consolidate the money market fund for financial reporting purposes.\textsuperscript{60} This could be particularly significant for bank-sponsored funds if sponsor-provided capital triggers balance sheet consolidation of money market fund assets on the balance sheets of parent firms. Regulators should carefully consider whether such consolidation would force banks, under existing banking regulations, to raise additional capital relating to the consolidated money market fund’s assets.

\textsuperscript{58} FASB Accounting Standards Codification Topic 810.

\textsuperscript{59} In a consolidation, the assets, liabilities, and equity of the money market fund, as well as its income and expenses, would be combined with those of the sponsor in the sponsor’s financial statements.

\textsuperscript{60} See FASB Proposed Accounting Standards Update, Principal versus Agent Analysis (November 3, 2011).
b. Shareholder Capital Through Retained Income

An alternative to requiring fund sponsors to pledge capital is to allow money market funds to build a buffer internally by retaining part of their income over time.61 Under this method of building capital, a portion of the income generated by the fund’s investments is retained by the fund—rather than distributed to shareholders—causing the fund’s mark-to-market NAV to rise over time.62 Of course, as discussed below, monetary policy must return short-term interest rates to a more “normal” level for this to be a viable reform option.

3. Time to Accrue Capital

As reflected in Chairman Schapiro’s remarks, the current interest rate environment makes raising capital—in any amount—highly challenging. Whether through sponsor-provided capital or fund-retained income, one possible formula could be to phase in any capital requirement with a schedule tied to a fund’s net income (e.g., 5 percent of net income is set aside each year for the buffer) rather than imposing a fixed schedule of capital that must be achieved in each year (e.g., accumulating 20 percent of required capital the first year, 50 percent by the second year, etc.). Tying the phase-in to a fund’s net income automatically adjusts for the timing of monetary policy. Particularly for the retained income method of accumulating capital, if short-term interest rates begin to rise sooner than expected, funds would earn and can set aside more, allowing capital to accumulate more rapidly. On the other hand, if short-term interest rates begin rising later than currently expected, funds would earn and set aside less. Absent this approach, allowing funds to accumulate the buffer through retained income is a moot option: in years with low interest rates, funds would not have the ability to accumulate or increase substantially a capital buffer. The burden of funding the buffer would automatically return to the sponsor, which as discussed above, may raise significant competitive and other concerns.

Finally, regulators should recognize that under Basel III, long-standing capital intensive businesses have been given 9 years—a very substantial time period—to comply with new capital mandates.63

C. Redemption Restrictions

Another reform idea that has generated some interest is the implementation of restrictions that create “redemption frictions” in money market funds. Those who favor such restrictions believe that they can prevent or mitigate redemption pressure similar to that experienced by prime money market

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61 See e.g., Letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity Investments, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (January 10, 2011), available at [http://www.sec.gov/spotlight/4619/4619-36.pdf](http://www.sec.gov/spotlight/4619/4619-36.pdf)

62 Under U.S. tax law, establishing a capital buffer within a money market fund through retained income, however, would require the fund to pay income tax on retained income. Even at smaller levels, it is not a tax efficient method of building capital.

63 See Basel III Annex, supra note 15.
funds in 2008 by removing the so-called “first mover” advantage. They also believe that redemption restrictions can make explicit to investors that money market funds do entail some risk, which in times of severe stress will be borne by investors. Although the implementation of redemption restrictions may help prevent or mitigate excessive drain on money market funds’ liquidity, there is a widespread view among ICI members, based on discussions with their shareholders, that such restrictions should not be imposed during “normal” market conditions. Indeed, we would vehemently oppose any sort of redemption restriction that would impair investor liquidity when liquidity within the money market fund is readily available.

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. In the United States, Section 22(e) of the Investment Company Act generally prohibits funds, including money market 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. 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 in order to facilitate an orderly liquidation of the fund.

Despite this extraordinary and far-reaching new rule, which has yet to even be tested, calls for additional redemption restrictions remain. In particular, the SEC and others have indicated a desire to add provisions to Rule 2a-7 that would permanently alter the ability of money market fund investors to redeem all of their shares on a daily basis. To this end, we understand that the regulators are looking at a variety of possible approaches that, in essence, would escrow a portion of a shareholder’s money market fund account (e.g., a percentage of account balances or redemption proceeds would be restricted for a specified period of time), which would then be used under specified conditions to assume first loss in the event the fund broke the dollar. The operational challenges and costs of such a concept, however, would be extensive, requiring changes to a myriad of systems that extend well beyond those under the

64 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, like 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 4, at 85-86.

65 Rule 22e-3 permits a fund to suspend redemptions and payment of redemption proceeds if (i) the fund’s board, including a majority of disinterested directors, 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. When it adopted the rule, the SEC noted that “Rule 22e-3 is intended to reduce the vulnerability of investors to the harmful effects of a run on the fund, and minimize the potential for disruption to the securities markets.” MMF Reform Adopting Release, supra note 3 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 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.

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control of the funds themselves. Indeed, fund complexes, service providers, and intermediaries have developed intricate and complex systems that allow them to communicate and process significant volumes of money market fund transactions on a daily basis through a variety of mechanisms on behalf of investors. We anticipate that intermediaries which would be subject to lengthy and expensive programming and significant other costs to effectuate these changes, would utilize unregulated or less regulated money market investment vehicles for their clients’ cash management needs—especially if those needs are no longer met by the money market fund product—because of the lack of utility these new money market funds would have for investors.

1. Background—Investor Use of Money Market Funds

Today, almost 60 million institutional and retail investors utilize money market funds. These investors interact with their funds in a variety of ways. Investors can purchase shares and maintain their accounts directly with a fund company, through a broker-dealer, within a fund supermarket or platform, via a financial planner or registered investment adviser, within a retirement plan, or through a bank trust department. These investors and their intermediaries use various technologies to interact with their fund complex. For example, an investor can obtain information and transact business by visiting a branch office, calling the toll-free number of a fund or intermediary, by using touch tone telephone services, or through proprietary internet websites. The technologies and processes used to support each of these distribution channels require funds, intermediaries, and the various companies that provide services to them to synchronize efforts and share data near real time so that investors receive accurate information on their transactions and balances, regardless of the channel or technology used.

Redemption restrictions that would be applied on a continuous basis under normal market conditions would drastically impair the fundamental utility of money market funds. Money market funds are used today by a wide variety of investors primarily because of the product’s liquidity and stable NAV per share. Many financial intermediaries that offer institutional account and sweep services have indicated that they may choose to offer alternative cash products rather than build complex systems to offer a dramatically different money market fund product, which would not meet the fundamental needs of their customers. Investors that hold accounts directly with funds also may choose alternative products that better meet their liquidity needs. As described below, investors use money market funds for a variety of purposes.

- **Institutional investors**, which include corporations of all sizes, securities lending operations, bank trust departments, sweep programs, securities brokers, investment managers, and state and local governments, use money market funds as a cost-effective way to manage and diversify credit risk, while providing same-day liquidity with market-based yields. These investors often use money market funds as a temporary holding vehicle for cash to facilitate transactions for capital expenditures and day to day operations, including payroll. Daily redemption restrictions, or even lack of clarity regarding available redeemable account balances, would severely hamper the flow of funds and the availability of cash for transactions that are supporting these entities’ ongoing operations. Similarly, trust account arrangements use money
market funds on a short-term basis pending other activity, such as securities’ transaction settlements, beneficiary expenses, real estate transactions, and other beneficiary related distributions.

- **Sweep vehicles** by brokerage firms and trading platforms use money market funds to invest cash held in customer accounts. Like institutional accounts, sweep vehicles hold investor cash that is temporary in nature, which is then used primarily by customers to fund trading activity (for a wide variety of security types—stocks, bonds, mutual funds, ETF’s, currency positions, etc.) conducted in their accounts. Sweeps are initiated by intermediaries at the end of the day when typically the total remaining collected balances (or all available cash) in customer accounts, after all other transactions have been posted, are invested in money market funds. Daily redemption restrictions could not be implemented on existing sweep products as currently structured.

- **Retail investors** often use money market funds as a short term holding vehicle for their liquid assets to pay their ongoing expenses (utilizing both check writing and debit card functionality) and to temporarily hold cash from redemption transactions that may be used to fund other purchase transactions (through exchanges or other reinvestment transactions) or to fund tuition and educational expenses.

- **Retirement account investors** also may choose to invest a portion of their tax-advantaged retirement assets in money market funds. These assets are often temporary in nature and needed to fund other investment transactions or to support ongoing expenses for retired investors.

2. **Operational Complexities and Cost Considerations**

Requiring money market funds to have daily redemption restrictions would require an extraordinary amount of coordinated effort to create and enhance technology programs, processes and procedures, and the communication links necessary to accommodate the new product feature. Fund complexes and their vendors have developed intricate and complex systems to accommodate the needs of money market fund investors.66 These systems allow funds to settle transactions either same-day or next-day. Modifying this infrastructure to process transactions and report the new information or data required in an accurate and consistent fashion to fund investors through all investor contact points, as well as providing the necessary transparency between funds and intermediaries, is an extremely complex undertaking that would result in significant costs and numerous practical difficulties.

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66 For a detailed description of money market fund operations and systems, see Letter from Karrin McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (September 8, 2009), available at [http://sec.gov/comments/s7-11-09/s71109-117.pdf](http://sec.gov/comments/s7-11-09/s71109-117.pdf).
These include:

- Development of technology at the fund complex and at each intermediary to: (i) compute and age escrow balances and to restrict applicable shares in investor accounts that are held direct at funds and through intermediaries; and (ii) address share restriction impacts on redemption transaction processing through a variety of mechanisms, including communications to investors.

- Modifications to investor documentation and communications to explain the product changes (investors are likely to find a daily redemption restriction difficult to understand) and capture the escrow data where needed.

- Development of intermediaries’ systems, processes, and procedures to deliver and reconcile escrow share data to funds’ systems for underlying investor accounts held in omnibus positions.

- Modifications to intermediaries’ and funds’ systems, processes, and procedures to handle capital contribution transactions processed on restricted or escrowed shares in the event of a crisis event, including the costs basis impact to investors for tax reporting purposes.

Although daily redemption restrictions may have perceived benefits, any new rule incorporating such restrictions would require costly changes to a myriad of systems at a financially precarious time for the industry. Indeed, as noted above, funds waived over 50 percent of money market fund expenses in 2011. It is reasonable to expect that requiring money market funds to adopt a daily redemption restriction concept would cost the industry (funds and intermediaries) and its shareholders hundreds of millions of dollars to implement.\(^6^7\) These costs must be considered against the very real possibility that (i) intermediaries may choose to offer alternative cash products (that may be unregulated or less regulated investment vehicles) rather than build complex systems to offer a dramatically different money market fund product, which would then not meet the fundamental needs of their customers; (ii) redemption restrictions may not work within existing sweep and retirement plan products; and (iii) these changes may curtail the number of retail investors if popular features, such as check writing, debit cards, and exchanges associated with money market funds are affected or possibly eliminated. Thus, the cost to implement these new requirements for a dwindling shareholder base would likely be prohibitive for the industry.

The combined effects of investor rejection of the new daily escrow money market fund product, a capital requirement that either will place tremendous pressure on sponsors or further decrease shareholder yield, and the operational changes required both of funds and their intermediaries would, in our view, effectively remove money market funds subject to these rules as a viable investment option. The loss of these investment vehicles goes well beyond the cost to shareholders and the industry—the

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\(^6^7\) In recent years, the industry has engaged in cost-benefit analysis on rulemaking proposals that would have required extensive operational changes, similar to those captured above. Likewise, the industry will conduct and submit a cost-benefit analysis on any future money market fund rulemaking.
cost would ripple through the global economy as businesses would face higher financing costs which in turn would slow their expansion rate and reduce job growth. State and local governments also would lose an important source of financing, which may force them to limit projects, spend more on financing, or increase taxes.

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68 Many major nonfinancial corporations have come to rely heavily on the commercial paper market for short-term funding of their day-to-day operations at interest rates that are typically less than rates on bank loans. The need for financial issuers to comply with Basel III, such as the new short-term liquidity ratio, will make the ready availability of money market funds to supply liquidity more necessary than ever. See Basel III Annex, supra note 15.