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May 25, 2012

Via Electronic Mail (MoneyMarket@iosco.org)

Mr. Mohamed Ben Salem
General Secretariat
International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain

Re: *IOSCO Money Market Fund Systemic Risk Analysis and Reform Options*

Dear Mr. Ben Salem:

The Investment Company Institute ("ICI")[1] is pleased to provide comments on the Consultation Report on money market funds issued by the Technical Committee of the International Organization of Securities Commissions ("IOSCO").[2]

Money market funds play a vitally important role for investors and the global economy and constitute one of the great success stories of modern financial regulation. In the interest of preserving the important benefits these funds provide, ICI and its members have devoted significant time and effort to considering how to strengthen the regulation of money market funds and make them more robust under even the most adverse market conditions—such as those caused by the widespread bank failures in 2008.

Over the past few years, the U.S. Securities and Exchange Commission ("SEC") and the U.S. fund industry have made a great deal of progress toward their shared goal of strengthening the resiliency of money market funds. Taking the initiative to respond quickly and aggressively

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

[2] IOSCO, *Money Market Fund Systemic Risk Analysis and Reform Options: Consultation Report* (April 27, 2012) ("Consultation Report"), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf. 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, as appropriate, by July 2012.

to the events of fall 2008, ICI formed a Money Market Working Group to study the money market, money market funds and other participants in the money market, and recent market circumstances. The March 2009 *Report of the Money Market Working Group* addressed these topics and advanced wide-ranging proposals for the SEC to strengthen money market fund regulation.[3]

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

U.S. policymakers, industry participants, and other stakeholders have continued to examine possible additional reforms to money market fund regulation even after adoption of the SEC's 2010 amendments. For example, the President's Working Group on Financial Markets conducted a review of money market funds and in late 2010 issued a report ("PWG Report") seeking comment on various money market reform options.[5] Like the Consultation Report, the PWG Report did not endorse any particular course of action. The PWG Report spawned a voluminous and still growing comment record that reflects not only many good faith attempts to respond to policymakers' concerns, but also a striking absence of consensus around whether further action is needed, and if so, how to proceed.

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[3] *See* Investment Company Institute, *Report of the Money Market Working Group* (March 17, 2009) ("MMWG Report"), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[4] *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010) ("MMF Reform Adopting Release"). For an overview of U.S. money market fund regulation, *see* Investment Company Institute submission to IOSCO (February 7, 2012), available at http://www.ici.org/pdf/25877.pdf, at 15-17.

[5] The PWG directed the SEC to solicit comments on its report to assist the Financial Stability Oversight Council ("FSOC") in its examination of the reform options outline in the report, *see* SEC Release No. IC-29497 (November 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. The PWG Report is appended to the SEC's release and also is available on the Treasury Department's website at http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

In the United States, this lack of consensus stems in part from the substantial reforms already implemented by the SEC in 2010. It also stems from the fact that since the onset of the global financial crisis, regulators around the world have undertaken numerous broader financial reform efforts designed to prevent a recurrence of the events of 2008 and address other perceived gaps in financial regulation.[6] Many aspects of these efforts benefit money market funds, which, like other financial market participants, have a strong interest in a well-functioning global financial system that can withstand periodic shocks. When evaluating the need for further reforms specific to money market funds, it is important to take into account not only the changes already made to strengthen money market fund regulation but also other financial market reforms designed to reduce the likelihood of, and provide better regulatory tools to cope with, any future financial crisis.

For our part, as a result of ICI's own initiatives and extensive engagement with regulators over the past several years, ICI already has conducted extensive analysis of many of the reform options outlined in the Consultation Report (several of which also were included in the PWG Report). ICI's views on possible additional money market fund reforms also have evolved in recent months, for several reasons. First, as mentioned above, we have had the opportunity to observe the success of the SEC's 2010 amendments in helping U.S. money market funds withstand market stress, which strongly calls into question the need for additional reforms. Second, we have concluded that reform options reportedly under the most serious consideration in the United States are severely flawed and would prove extraordinarily detrimental to investors, issuers of short-term debt, and the country, not to mention the industry.

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

Our comments below begin with a brief discussion of why the difficulties that the money market and U.S. money market funds faced during the financial crisis of 2007-2008 do not support the conclusion that money market funds are particularly susceptible to runs, as some claim (Section I). We then review how the SEC's 2010 amendments have made U.S. money market funds more resilient and how their experience under these new requirements during last summer's market events should help inform IOSCO's consultation and recommendations (Section II). Next, we examine three policy options identified in the Consultation Report—requiring money market funds to let their share prices fluctuate or "float," requiring money market funds or their advisers to maintain capital buffers against money market fund assets, and

[6] *See generally* Report of the Financial Stability Board to G20 Leaders, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability* (November 4, 2011), available at http://www.financialstabilityboard.org/publications/r_111104.pdf.

imposing permanent redemption restrictions—which reportedly are the options U.S. regulators are considering (Section III). Finally, with respect to a number of the other options outlined in the Consultation Report, to the extent we have previously examined those approaches, we summarize our views and provide links to our more detailed, earlier comment letters (Section IV).

I. Money Market Funds' Experience During the Financial Crisis

The Consultation Report begins by suggesting that the financial crisis of 2007-2008 highlighted that money market funds are particularly "susceptible" to runs. We disagree. The highly unusual events during the 2007-2008 time period, compared to the only other time a money market fund failed to return a full $1.00 per share (or "broke a dollar"), illustrate the importance of context. How investors react in the very rare event that a money market fund is unable to return a full $1.00 per share depends, in our judgment, entirely on the context—*i.e.*, events that precede and surround that occurrence.

Money market funds were not the cause of the financial crisis, but were directly affected by its enormous scale, duration, and by the lack of coherent, consistent government policy responses. Like many market participants, money market funds were hit by a global crisis that began to take hold long before September 2008. The financial crisis was, first and foremost, a crisis in the real estate markets and the "originate to distribute" phenomenon that developed as regulators stood by.[7] As the real estate markets collapsed, the banking system experienced enormous stress as structured investment vehicles (SIVs), originally designed to move liabilities off of banks' balance sheets, suddenly were brought onto those balance sheets.[8] The banking crisis that followed was catastrophic. At least 13 major institutions went bankrupt, were taken over, or were rescued in the 12 months before Lehman Brothers failed. Lehman's failure was an especially difficult shock for the market because it represented an abrupt reverse in direction by the U.S. government from its previous decisions to intervene and rescue Bear Stearns, Fannie Mae, and Freddie Mac.

In contrast to massive failures in the bank sector, a single U.S. money market fund (Reserve Primary Fund) could not return the $1.00 per share after Lehman failed. As a result of Lehman's sudden failure and widespread uncertainty about the government's stance towards other troubled institutions,[9] certain money market funds and many other money market participants were hit by a severe liquidity freeze when banks, seeking to preserve their liquidity, refused to lend to one another and investors lost confidence in government policy. Even in these extreme conditions, however, investors remained invested in money market funds—they shifted

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[7] *See generally* U.S. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (January 2011), available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf. The Financial Crisis Inquiry Commission is a ten-member commission appointed by the U.S. government with the goal of investigating the causes of the financial crisis.

[8] *Id*.

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

their assets from prime money market funds, which held financial institutions' securities, to Treasury and government and agency money market funds, which did not. About $300 billion flowed out of prime money market funds; for every dollar that left these funds, however, 63 cents flowed into Treasury and government and agency funds. Indeed, investors did not abandon money market funds; they reacted to their concerns about the financial health of banks, the U.S. government's unpredictable response to financial institutions' collapses, and concerns about whether in such an environment prime money market funds could continue to sell assets into a frozen commercial paper market.

The only other time a money market fund broke a dollar was in 1994.[10] In stark contrast to the events of September 2008, the banking system in 1994 was not mired in crisis. Not only did the 1994 event not trigger a run, but money market fund assets *grew* during the month after the fund broke a dollar. At that time, there was no reason for investors to lose confidence in the assets their funds were holding. On the other hand, Reserve's failure in 2008 followed an unprecedented series of events going back to the middle of 2007 involving major banks and other leading financial institutions, and inconsistent responses to these events by the U.S. government.

The steps taken by the U.S. Federal Reserve Bank and the U.S. Department of the Treasury beginning in 2008 were necessary and appropriate to restore liquidity to the money market as a whole.[11] No claims were made on the Treasury Guarantee Program for Money Market Funds. Instead, the Treasury and, as a result, U.S. taxpayers, received an estimated $1.2 billion in fee payments from participating money market funds. As discussed in Section II, the SEC's money market fund regulatory reforms of 2010 addressed the challenges faced by money market funds in 2008, particularly by enhancing liquidity requirements.

II. Policy Options that Work: U.S. Money Market Funds Made More Resilient Under SEC 2010 Amendments

The SEC's 2010 amendments to U.S. money market fund regulation have made these funds even more liquid, transparent, and stable than ever before. As discussed below, today's U.S. money market funds are a stronger and more resilient product than the funds that were available in 2008, as amply demonstrated by the market events of last summer. We therefore urge IOSCO to avoid falling into the trap of looking at these funds and reform options as though it were still 2008, and instead to recognize that U.S. money market funds themselves, and the financial markets in which they operate, are meaningfully different today. As the Consultation Report also notes, money market funds do not operate in the same manner in all jurisdictions, and the markets for these funds may be vastly different. We therefore caution IOSCO about taking a "one size fits all" approach to its efforts.

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

[11] For an overview of some of the U.S. government actions taken in response to the financial crisis, *see* MMWG Report, *supra* note 3, at 64-65.

We also urge IOSCO to carefully study the U.S. money market fund regulatory regime, including the 2010 amendments, as part of its analysis of money market funds to provide a frame of reference. In particular, we recommend that IOSCO evaluate whether money market funds generally should comply with a set of risk-limiting conditions similar to those found in Rule 2a-7 under the Investment Company Act of 1940. Those requirements are designed to limit a fund's exposure to certain risks by addressing the credit quality, liquidity, maturity, and diversification of a money market fund's investments. We also recommend that IOSCO study whether money market funds should disclose to both regulators and shareholders detailed information about their portfolios on a regular basis (*e.g*., monthly). This disclosure would provide investors with a better understanding of the current risks to which the funds are exposed and enhance regulators' oversight of money market funds and their ability to respond to market events.

A. Overview

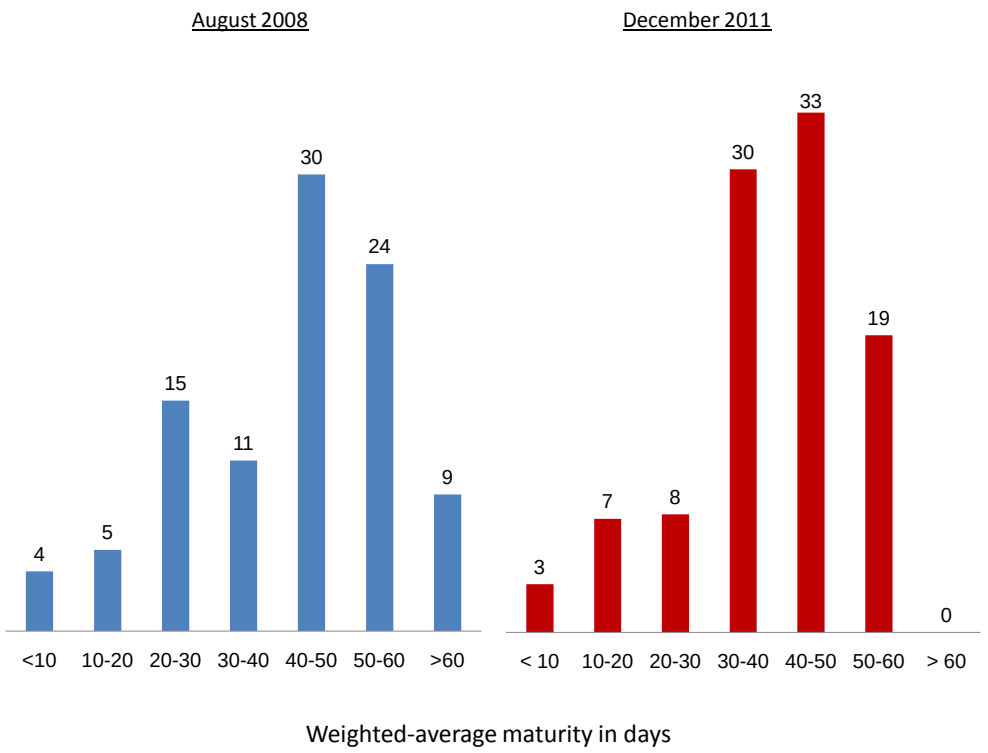
1. *Shorter Maturities*

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

Figure 1

WAMs for Taxable Money Market Funds

Percentage of funds



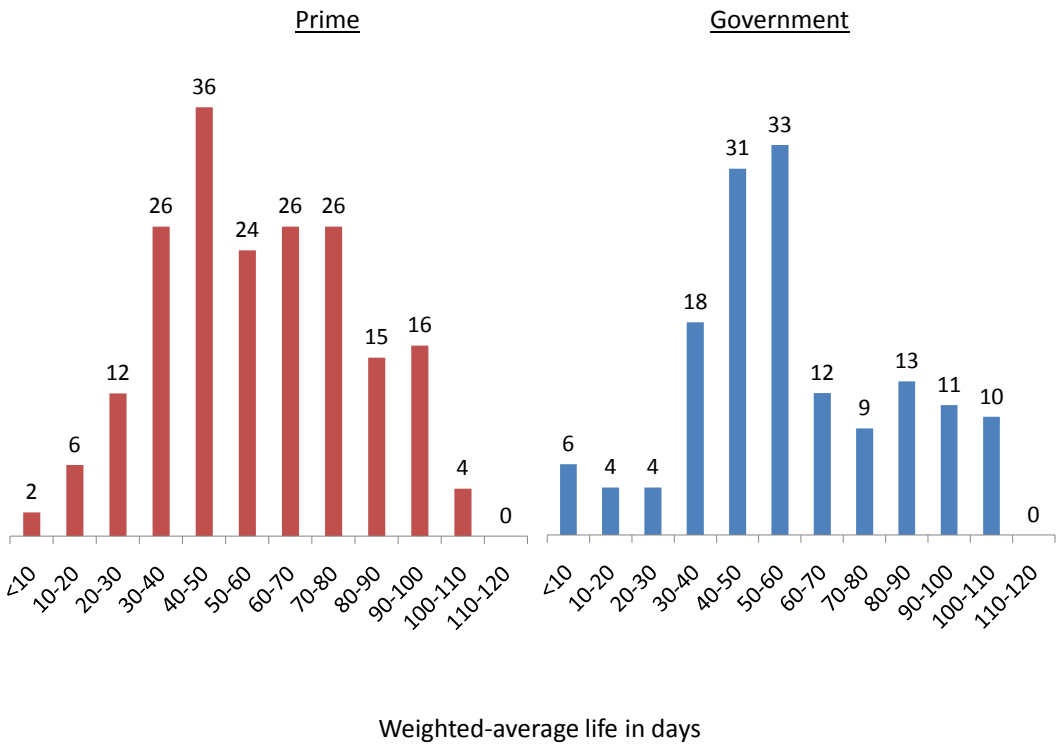
Sources: Investment Company Institute; iMoneyNet

The introduction of a limit on money market funds' weighted average life ("WAL") also has strengthened the ability of money market funds to withstand shocks and meet redemption pressures. Unlike a fund's WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although data on WALs before November 2010 are not publicly available, publicly available data since then suggest that the new WAL requirement likely has bolstered the resilience of funds. Figure 2 depicts the distribution of WALs for taxable money market funds as of December 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 2

WALs for Taxable Money Market Funds

Percentage of funds, December 2011



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

Source: Investment Company Institute

2. *Daily and Weekly Liquidity Requirements*

The 2010 amendments directly and meaningfully addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. Under the new requirements, money market funds must maintain a sufficient degree of portfolio liquidity to meet reasonably foreseeable redemption requests. In addition, at a minimum, all taxable money market funds must maintain at least 10 percent of assets in cash, U.S. Treasury securities, or securities that convert into cash within one day ("daily liquid assets"), and that all money market funds must maintain at least 30 percent of assets in cash, U.S. Treasury securities, certain other U.S. government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week ("weekly liquid assets"). The daily and weekly minimum liquidity requirements are measured at purchase. Thus, if a money market fund's holdings of daily liquid assets or weekly liquid assets falls below

10 percent or 30 percent of total assets, respectively, due to shareholder redemptions or redemptions in combination with changes in the value of portfolio securities, that will not violate these minimum requirements. Rather, Rule 2a-7 forbids the fund from acquiring anything other than a daily liquid asset or weekly liquid asset if, immediately after the acquisition, the fund would have invested less than 10 percent or 30 percent (as applicable) of total assets in daily liquid assets or weekly liquid assets. The purchase by the fund of assets other than daily liquid assets or weekly liquid assets would trigger a violation.

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

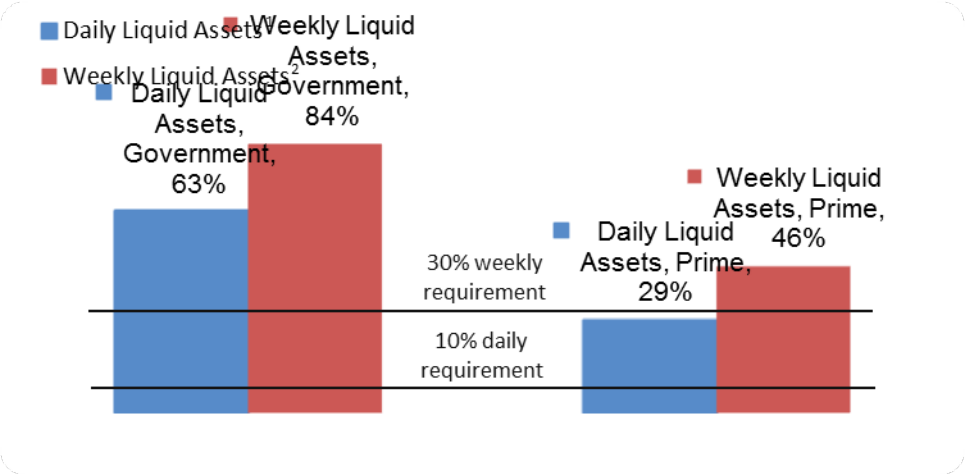
Indeed, the new liquidity requirements have had a transformative effect on U.S. money market funds. As Figure 3 shows, as of December 2011, funds exceeded the minimum daily and weekly liquidity requirements by a considerable margin. For example, 29 percent of the assets of prime money market funds were in daily liquid assets and 46 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated $1.47 trillion in daily or weekly liquid assets, which includes an estimated $660 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.[12] Accordingly, in December 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.

[12] *See* PWG Report, *supra* note 5, at 12.

Figure 3

Liquid Assets for Taxable Money Market Funds

Percentage of total assets, December 2011



[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; Bloomberg

3. *Increased Disclosure*

By requiring more frequent and vastly more detailed disclosure of money market funds' holdings, the 2010 amendments have made U.S. money market funds the most transparent financial product in the United States. Every U.S. money market fund now provides updated portfolio information on its website as of the end of each month. In addition, each month every money market fund files with the SEC new Form N-MFP, which contains detailed information about the fund and its portfolio, including the market value of each security held. The information provided in Form N-MFP becomes publicly available 60 days after the end of the month covered by the report. Regulators, analysts, and investors have been using this additional data to closely scrutinize fund portfolios. This heightened scrutiny has at times led regulators and analysts to highlight potential risks in particular fund holdings. The additional disclosure also has led certain advisers to avoid investments that, although exhibiting stable credit

fundamentals, may raise investor concerns.[13] Thus, the discipline of far greater disclosure, consistent with the SEC's historical approach to protecting investors, in itself has had a strong palliative effect.

4. *Fund Liquidations*

For the first time, the 2010 amendments also gave U.S. money market fund boards of directors the ability to suspend redemptions if a fund has broken or is about to break a dollar.[14] Although there has been no occasion to utilize it, this powerful new tool will 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 by ensuring that the actions of investors who exit a money market fund first under extreme circumstances do not harm those remaining behind. The rule recognizes that a money market fund's share price can decline in value, and provides for an orderly liquidation of the fund's securities in a manner that best serves the fund's shareholders by avoiding the liquidation of portfolio securities in a "fire sale."

B. Recent Events in the Money Market

As a result of these regulatory changes, U.S. money market funds are much more resilient to economic and financial shocks. This is amply demonstrated by recent events. In 2011, money market funds weathered two financial market shocks attributable in large measure to government gridlock: the looming U.S. federal debt ceiling crisis in mid-2011 and deteriorating conditions in European debt markets throughout the year. Money market funds also had to contend with historically low interest rates and the U.S. federal government's extension of unlimited deposit insurance on non-interest bearing checking accounts, which provided investors a guarantee on business checking account balances held at banks.[15]

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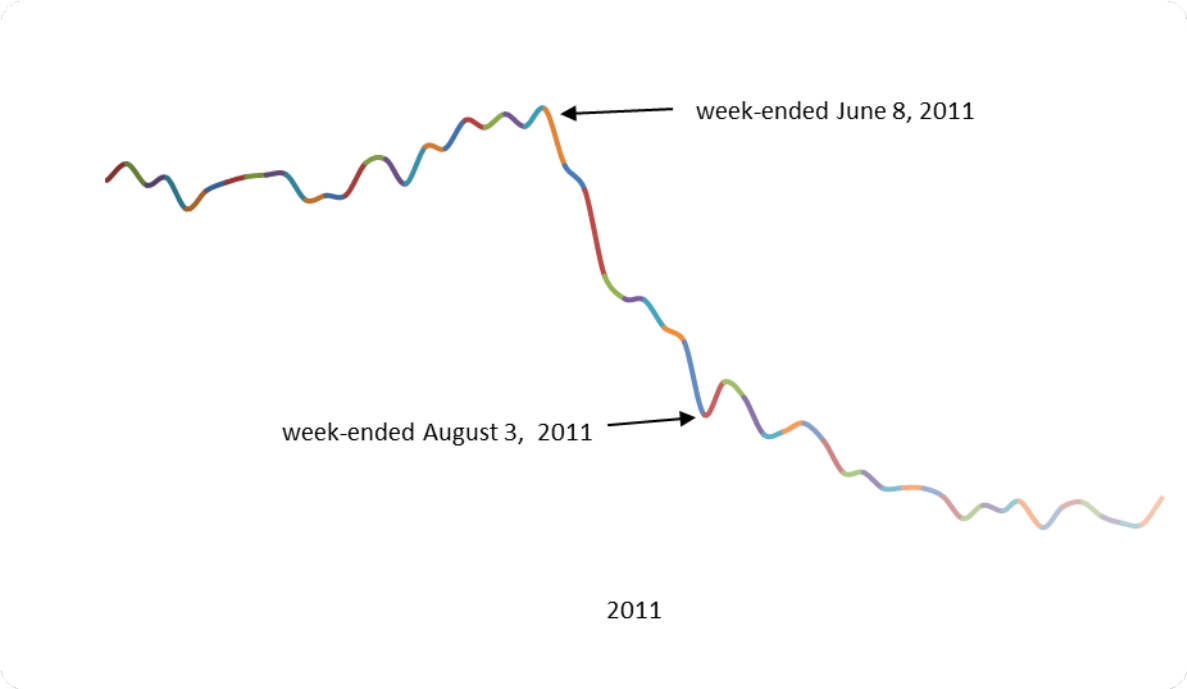
[13] *See* N. Flanders, G. Fink-Stone, and V. Baklanova, *U.S. MMF Shadow NAV Volatility Declines Post-Crisis*, Fitch Ratings (January 18, 2012) ("Fitch Ratings' Special Report").

[14] Like a U.S. operating company, a mutual fund, including a money market fund, is organized as a corporation with a board of directors or as a business trust with a board of trustees. At least 40 percent of directors or trustees on a mutual fund's board are required under the Investment Company Act to be independent from fund management. In practice, most fund boards have a far higher percentage of independent directors or trustees. According to a study of fund boards conducted by ICI and the Independent Directors Council, as of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes. *See Overview of Fund Governance Practices*, 1994-2010, available at http://www.idc.org/pdf/pub_11_fund_governance.pdf. Independent fund directors play a critical role in overseeing fund operations and are entrusted with the primary responsibility for looking after the interests of fund shareholders.

[15] *See* Federal Deposit Insurance Corporation, *Deposit Insurance Regulations; Unlimited Coverage for Noninterest-Bearing Transaction Accounts*, 75 FR 69577 (November 15, 2010). As required by Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the unlimited insurance coverage became effective on December 31, 2010, and will expire on January 1, 2013.

Figure 4

Prime Money Market Funds Accommodated Large Outflows During U.S. Debt Ceiling and Eurozone Debt Crises



Source: Investment Company Institute

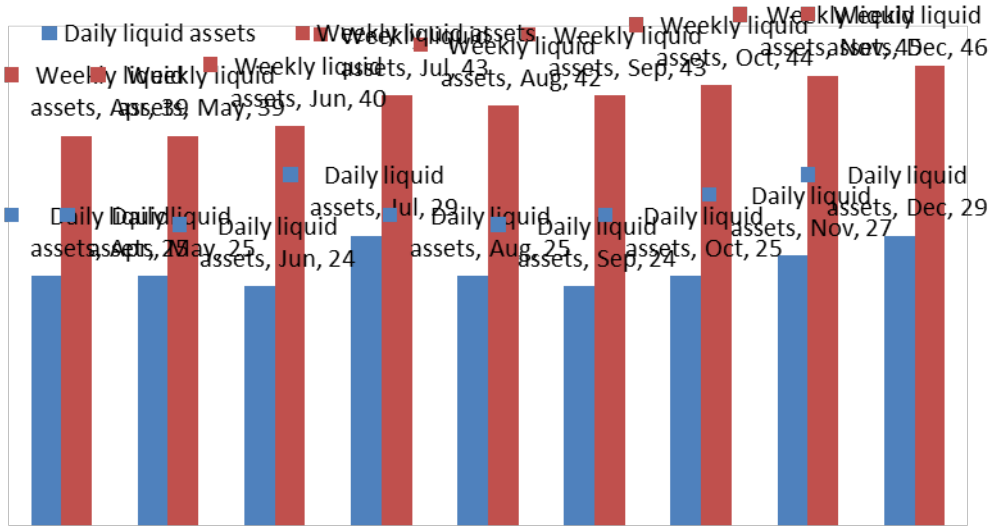
Reflecting these circumstances, investors withdrew $213 billion from prime money market funds over the six-month period June 2011 to November 2011 (Figure 4). To be sure, these outflows were smaller in dollar and percentage terms than the flows prime funds experienced during the worst months of the financial crisis in September and October 2008. Nevertheless, they were quite large, totaling 13 percent of the assets of prime money market funds as of May 2011. Moreover, the bulk of these outflows occurred in a very short time (the weeks ended June 8, 2011 to August 3, 2011) as the U.S. federal debt ceiling crisis came to a head. Over that eight-week period, outflows totaled $172 billion, or 10 percent of prime money market fund assets. Outflows in the month of June 2011 were the second largest on record, totaling $86 billion.

Prime money market funds accommodated these sizable outflows in an orderly manner. Funds had plentiful liquidity to meet redemptions. As of May 30, 2011, prime money market funds held an estimated $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 5).

Figure 5

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

Percentage of prime fund assets



Sources: Investment Company Institute; Crane Data

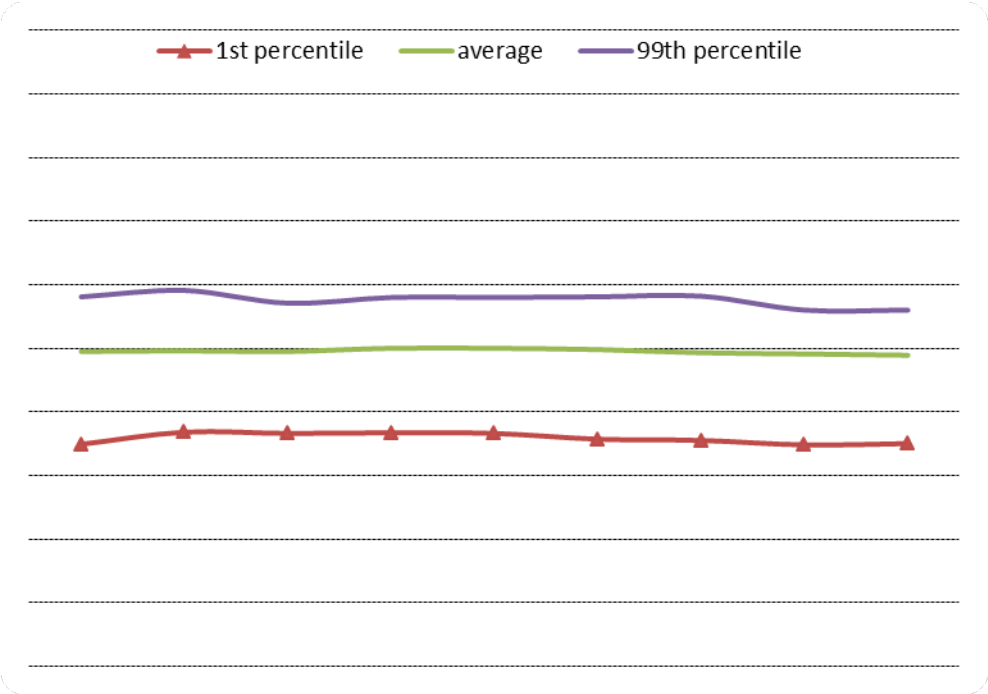
In addition, despite the outflows and stresses in the market, money market funds' per-share market values were extremely stable. For the vast majority of funds, these values tracked very close to $1.00 (shown in Figure 6 as "average"). Even those prime money market funds with the very lowest values (shown in the figure as "1st percentile") had levels that were comfortably above the $.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. [16]

[16] *See* Fitch Ratings' Special Report, *supra* note 13.

Figure 6

Mark-to-Market Values of Prime Money Market Funds

Selected months, 2011



Sources: Investment Company Institute; selected N-MFP reports

III. Flawed Policy Options

The Consultation Report identifies a number of policy options aimed at "reinforcing the robustness and safety of money market funds." We submit, however, that many of the options identified would not strengthen the money market fund industry but instead would alter the fundamental characteristics of money market funds—such as a stable NAV and ready liquidity—thereby destroying their value to investors (especially in the United States) and the global economy, and reduce competition and choice by driving funds out of the business. Moreover, if regulatory changes to money market funds alter those characteristics valued by investors, investors will move to less regulated, less transparent cash pools, increasing systemic risk. In this section, we highlight three such reforms that are under consideration in the United States.[17] First, we explore the proposition that all money market funds should let their share prices float—a structural change for the U.S. money market fund industry that would not reduce systemic risk but instead, could increase it. Next, we discuss the idea that money market funds or their advisers should maintain capital against money market fund assets—an idea that not only alters

[17] *See* Remarks by SEC Chairman Mary L. Schapiro at SIFMA's 2011 Annual Meeting (November 7, 2011), available at http://www.sec.gov/news/speech/2011/spch110711mls.htm.

the product but could cause significant industry contraction. Finally, we discuss the implementation of permanent redemption restrictions in the form of a "minimum balance requirement"—a concept that not only would be prohibitively costly to implement, but also is contrary to the fundamental nature of a mutual fund.

A. Requiring Money Market Funds to "Float" Their NAVs

One reform proposal that continues to draw some support both in the United States and Europe is the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation—forcing them to let their share prices fluctuate or "float." In the United States, some regulators emphasizing the liquidity, maturity, and credit transformation of money market funds,[18] continue to espouse a floating NAV. This is despite hearing from a wide range of businesses, state and local government entities, financial services, companies, and consumer organizations that doing so not only would undermine the convenience and simplicity of money market funds, but also would increase the costs of financing for many segments of the U.S. economy.[19] Also weighing in against a floating NAV are many individual investors who strongly oppose changing the fundamental nature of money market funds. Nevertheless, the option of requiring money market funds to float their NAVs remains a topic of discussion. This would require funds both to use mark-to-market pricing of fund portfolio securities rather than

[18] Some commentators have fixed on 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 addition, a money market fund's WAL cannot exceed 120 days. These requirements reduce liquidity and maturity transformation to very low levels, and in practice, money market funds exceed these requirements. For example, in December 2011, taxable money market funds held 45 percent of their portfolios in daily liquid assets and 62 percent in weekly liquid assets, far exceeding the minimum requirements. Furthermore, the average WAL in December 2011 was 64 days for government money market funds and 73 days for prime money market funds. U.S. money market funds also are required to hold securities that pose minimal credit risk. As of December 2011, over 99 percent of money market fund portfolio assets received the highest short-term credit ratings. In addition, to the extent that a credit issue arises with a security, 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 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.

[19] 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_mmfs_opposefloatingnav. In response to the SEC's request for comment on the PWG Report, ICI, along with over 100 companies or organizations, submitted letters to the SEC in opposition to the floating NAV concept. *See* 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. These type of letters have continued to flow into the public comment file.

amortized cost accounting[20] and abandon penny rounding for the purpose of determining the NAV of fund shares on a daily basis.

The Consultation Report asserts that constant NAV money market funds refer to funds that "use amortized cost accounting to value all of their assets and/or share price rounding method, enabling them to maintain a constant value of a share of a fund."[21] Money market funds in the United States actually have three characteristics that contribute to the stability of the share price. First, money market funds declare dividends on a daily basis so that income does not accumulate in the share values.[22] Second, money market funds hold very short duration portfolios with minimal credit risk, minimizing the effects of even large interest rate changes on the underlying value of the portfolio. For example, about 70 percent of U.S. money market funds had a WAM of 50 days or less at the end of April 2012. The third feature is the use of amortized cost combined with penny rounding.

The effects of the first two characteristics—daily declaration of income and short duration, high-quality portfolios—can be observed by examining money market funds' mark-to-market share prices. Each month, U.S. money market funds report to the SEC on Form N-MFP their underlying mark-to-market share price, without using amortized cost pricing.[23] Using publicly available data from these reports, ICI calculated changes in fund share prices on a monthly basis for each fund between December 31, 2010 and February 29, 2012. More than three-quarters (78 percent) of the prime money market funds had an average absolute monthly change in their share price of 0.5 basis points or less and 99 percent had an average absolute monthly change of less than 2 basis points. Money market funds investing in government securities or repurchase agreements backed by government securities had similarly small changes in their mark-to-market prices, with 83 percent experiencing average absolute monthly changes of 0.5 basis points or less, and all such funds having an average absolute change of less than 2 basis points.

It is important to note that requiring the use of mark-to-market pricing in lieu of amortized cost pricing would not, under normal circumstances, cause a money market fund's share price to float. As noted, between December 31, 2010 and February 29, 2012 virtually all funds mark-to-market monthly prices on average fluctuated by less than 2 basis points. To make the NAV float, using mark-to-market pricing share prices would need to be changed to $100.00 a share (*e.g.*, through a reverse 1 for 100 share split). The stabilizing effect of penny rounding is illustrated during periods of volatile interest rates. For example, assuming a $1.00 NAV, short-

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[20] An overview of the use of the amortized cost method of valuation by U.S. mutual funds, including money market funds, and other industries is attached as an appendix to this letter.

[21] Consultation Report, *supra* note 2, at 10.

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

[23] Share prices that excluded sponsor support were used for the calculation.

term interest rates would need to move by 3 percentage points (or 300 basis points) in one day to cause the typical U.S. money market fund's mark-to-market price to fall by one-half of one percent.[24]

As we discuss below, and as numerous investors and issuers already have advised the SEC, requiring money market funds to move to a floating NAV would be unlikely to reduce systemic risk and may, in fact, increase it. Furthermore, we have deep concerns about the impact such a change would have on financial markets, both during a transition period and afterward.

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 in the United States are not required to follow Rule 2a-7, they do invest in a portfolio of relatively short-dated securities. In contrast to money market funds, however, the NAV of an ultra-short bond fund fluctuates. Beginning in the summer of 2007, the average NAV on these funds began to fall (Figure 7). In February and March 2008, several ultra-short bond funds posted significant NAV declines, and the average NAV of these funds fell about 2 percent. This preceded a large outflow of assets from such funds; during a four-week period ending in early April 2008, these funds experienced cumulative outflows of 15 percent of their assets. By the end of 2008, assets of these funds were down more than 60 percent from their peak in mid-2007.

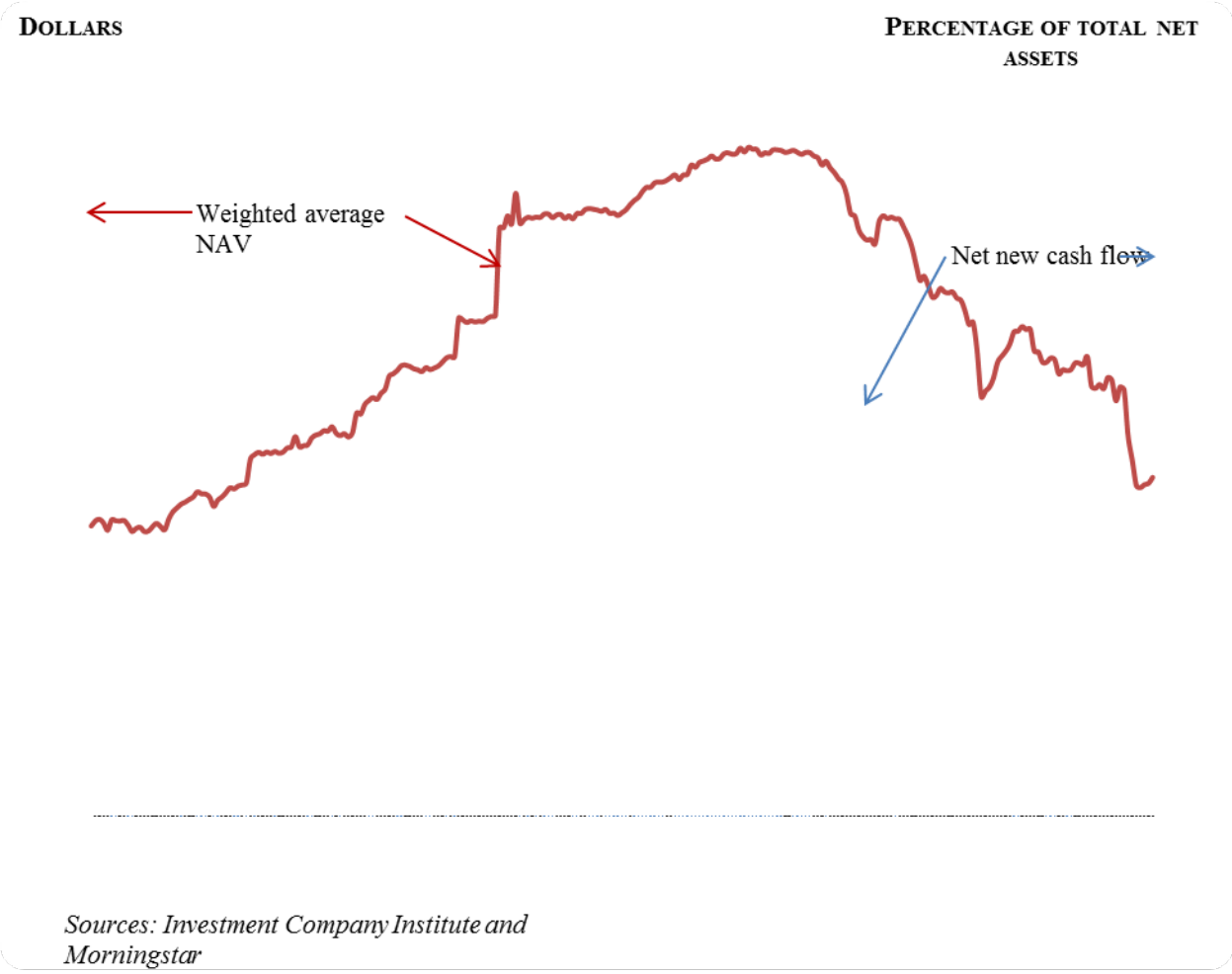
Thus, we remain doubtful that floating the NAV of money market funds would reduce risks in any meaningful way. Rather, prohibiting U.S. money market funds from maintaining a stable NAV likely would lead investors to abandon money market funds for less regulated products that seek to maintain a stable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

[24] *See* Investment Company Institute, *Pricing of U.S. Money Market Funds* (January 2011), available at http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf, at 26.

Figure 7

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

Weekly



Sources: Investment Company Institute and Morningstar

2. *Investor Demand for a Stable NAV Fund Would Remain*

One very significant concern is whether U.S. 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 seek to maintain a stable NAV. Indentures and other trust documents may authorize investments in money market funds on a

similar assumption. Many state laws and regulations also authorize municipalities, insurance companies, and other state regulated entities to invest in stable NAV funds, sometimes explicitly including funds operating in compliance with Rule 2a-7. Thus, absent a stable NAV, many state and local governments no longer would be able to use money market funds to help manage their cash.[25]

Investors that do not face such constraints may be unwilling to invest in a floating NAV product. For example, the $1.00 per share pricing is vitally important to the usefulness of money market funds to a variety of business applications involving automated accounting and settlement systems.[26] Indeed, the use of amortized cost accounting and a stable NAV allow the efficient processing of cash balances through cash sweep programs in which customer cash balances are "swept" into investments in shares of money market funds that are owned by the customer but transacted through accounts registered to a broker-dealer or a bank. A stable NAV also offers significant convenience in terms of tax, accounting, and recordkeeping. For example, as discussed above, all of a money market fund's returns are distributed to shareholders as income. This relieves shareholders from having to track gains and losses, *including* the burden of having to consider the *timing* of sales and purchases of fund shares (*i.e.*, U.S. wash sale tax rule considerations). To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors make fewer purchases and sales from long-term mutual funds because they are used for long-term investing, not cash management. And in any case, many purchases (or exchanges) in long-term funds are made within tax-advantaged accounts (*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 generally are provided only 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 likely would force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

Proponents of eliminating the stable NAV state that there is no direct evidence 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

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[25] *See* MMWG Report, *supra* note 3, at Appendix D.

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

funds. Currently, yields on U.S. 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.[27] Yet, assets in U.S. money market funds are roughly $2.6 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 U.S. money market funds previously have communicated their opposition to floating NAVs. In a letter to the SEC, a group of 36 North Carolina independent colleges and universities noted that "requiring a floating NAV would eliminate money market mutual funds as a stable option and as a reasonable investment for [colleges and universities to use] for cash management purposes."[28] 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.[29] In its comments to the Subcommittee, Financial Executives International noted that corporate treasurers "use money market funds as a diversification tool . . . [and] are not geared to mark-to-market on a daily basis and will have to pull out of money market funds if a floating NAV is adopted."[30]

Members of the U.S. Congress also have communicated their concern regarding proposals that would require money market funds to float their NAVs. A bi-partisan letter to SEC Chairman Mary Schapiro from 33 former state and local government officials who now serve in Congress highlighted the importance of the stable $1.00 NAV to states, municipalities and towns as not only a cash management tool and short-term investment option, but also for "the issuance of debt to fund many [ ] critical public projects."[31] In a speech at the U.S. Chamber of Commerce in Washington, DC, Senator Patrick J. Toomey (R-PA) expressed concern that requiring money market funds to float their NAVs would lessen the appeal and utility of the product to investors. He also stated that he would urge the Senate Banking

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[27] Investment Company Institute; Morningstar; iMoneyNet.

[28] *See* Letter from A. Hope Williams, President, North Carolina Independent Colleges & Universities, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (April 13, 2012), available at http://sec.gov/comments/4-619/4619-167.pdf.

[29] *See* Statement for the Record from the Financial Services Institute on behalf of the independent broker-dealers and financial advisors that they represent and the investors whom they serve, available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/07/FSIs-Statement-for-the-Record-on-Money-Market-Funds-07-14-11.pdf.

[30] *See* Letter from Susan Stalnecker, Chair, Financial Executives International's Committee on Corporate Treasurers, available at http://financialservices.house.gov/UploadedFiles/112-42.pdf. Also available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/06/CCT_ltr_to_House_FSC_Money_Market_Fund_6-24-11_13092105281.pdf.

[31] *See* Letter to Mary Schapiro, Chairman, Securities and Exchange Commission (May 1, 2012), available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658511.pdf.

Committee to hold hearings on any SEC proposal for money market funds and would consider legislative action if need be to preserve the viability of these funds.[32]

Furthermore, surveys of money market fund investors indicate clearly that most of these investors do not want and would not use a floating NAV product. For example, a survey of U.S. treasurers indicated that nearly 80 percent of respondents would either decrease their use of money market funds or discontinue use of them altogether if money market funds are required to have a floating NAV.[33] Indeed, based on this response, over 60 percent of corporate money market fund assets would move to other investments if this concept were adopted.

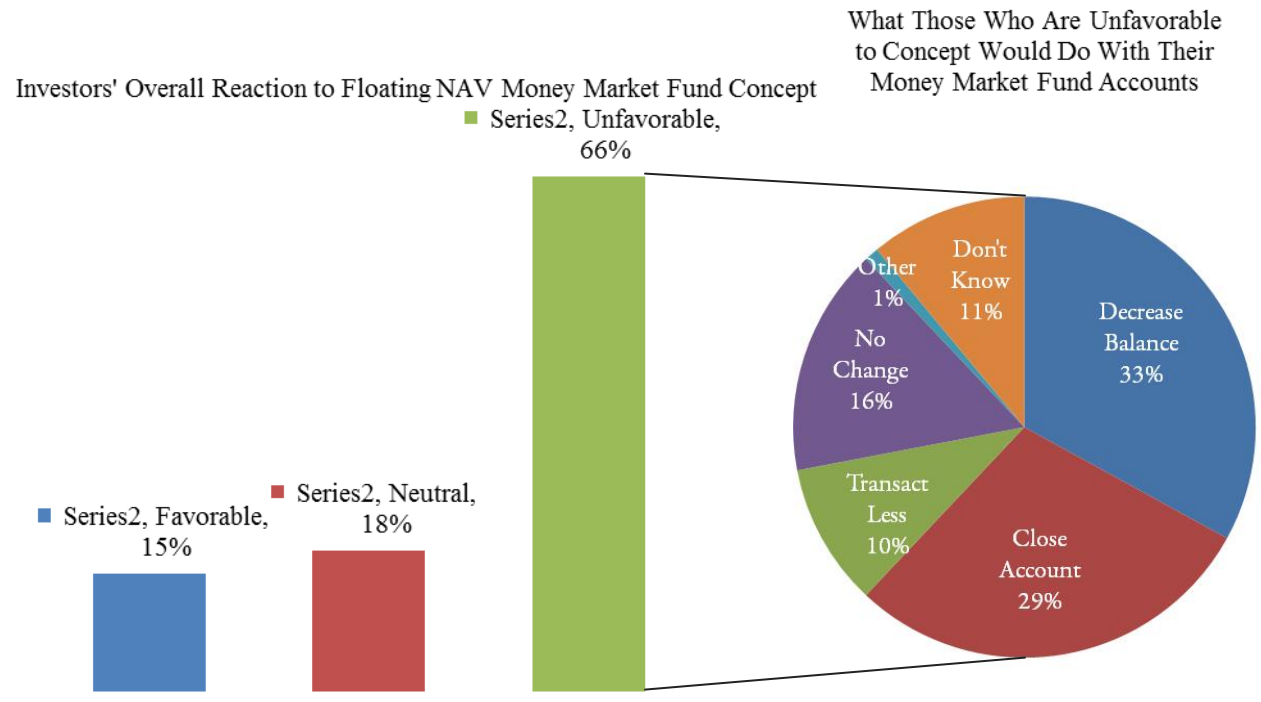
A survey of retail money market fund investors in the U.S. commissioned by T. Rowe Price and conducted online by Harris Interactive indicated much the same response (Figure 8**).**[34]

[32] *See* Remarks by Senator Pat Toomey (R-PA) at the U.S. Chamber of Commerce, Washington, DC (February 8, 2012), available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/04/Toomey_Remarks_2_8_12_13291521511.pdf.

[33] ICI commissioned Treasury Strategies, Inc. to conduct a study to help understand the effects of various SEC reform concepts on money market fund investors. The report, *Money Market Fund Regulation: The Voice of the Treasurer*, is available on ICI's website at http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf ("TSI Survey"). Treasury Strategies surveyed 203 unique corporate, government, and institutional investors between February 13 and March 6, 2012, asking 31 questions regarding their cash pools, investment objectives, and three SEC concepts for money market fund reform, including floating NAVs. Treasurers are significant users of money market funds: institutional share classes account for $1.7 trillion, or 65 percent, of the $2.6 trillion in U.S. money market fund assets.

[34] Based on a study commissioned by T. Rowe Price and conducted online by Harris Interactive from August 31 to September 7, 2010 of 413 adults aged 35-75 who own money market funds outside of a retirement plan, who also own at least one long-term mutual fund, who invest directly with a mutual fund company, do not rely solely on the advice of an investment adviser, and have $100,000 or more in investable assets. The data are weighted to be representative of the adult population with $100,000 or more in investable assets. A full methodology is available upon request.

Figure 8
Retail Investors' Reaction to Floating NAV Money Market Funds



Source: Harris Interactive / T Rowe Price

Two thirds of U.S. retail investors surveyed found the idea of a floating NAV money market fund unfavorable. Among those who reacted to the concept unfavorably, 72 percent indicated that they would use the product less, and that their most likely response would be to close their money market fund accounts (29 percent), decrease their money market fund balances (33 percent), or execute fewer money market fund transactions (10 percent). A third survey, conducted among both retail and institutional shareholders by Fidelity Investments, found much the same result. This survey found that institutional investors overwhelmingly (89 percent) indicated a preference for keeping the stable NAV and more than half (57 percent) indicated they would use money market funds less or not at all if faced with the prospect of a floating NAV. Retail investors also disliked the floating NAV concept. Seventy-four percent of the retail investors surveyed also favored keeping the stable NAV and 47 percent of those surveyed said they would move all or some of their assets out of money market funds if funds changed to a

floating NAV.[35] In short, data on the subject demonstrates that U.S. investors do not want and likely would reject a floating NAV money market fund.

3. *Floating the NAV Would Harm the Market*

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

Assets in U.S. money market funds now total $2.6 trillion. As discussed above, U.S. money market fund investors of all types are unlikely to use a floating NAV product. Requiring these funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. This transition, in and of itself, could be destabilizing to the financial markets. It would require money market funds to shed hundreds of billions of dollars of commercial paper, bank CDs, Eurodollar deposits, repurchase agreements, and other assets. Even under the calmest of financial market conditions, this would be a highly tricky process. During a period of stress in the money market, such a transition could well set off the very kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs assuredly will shift credit intermediation from one type of product to others. There are a number of alternative products that money market fund investors could use, including enhanced cash pools, local government investment pools, and other vehicles that seek to maintain a stable unit price but are not regulated under the Investment Company Act.[36] Regulatory changes that push assets from regulated products (*i.e.*, money market funds) to less regulated and less transparent products arguably serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.[37]

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).[38] If a stable NAV is eliminated for money market funds, investors can migrate to these other kinds of sweep accounts, which in some cases (*e.g.*, Eurodollar sweeps) largely are beyond the jurisdictional reach of U.S. domestic regulators.

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[35] *See* Fidelity Investments, *The Investor's Perspective: How Individual and Institutional Investors View Money Market Mutual Funds and Current Regulatory Proposals Designed to Strengthen Money Funds* (December 2, 2011).

[36] For an overview of some of these alternatives, *see* MMWG Report, *supra* note 3, at 41-46.

[37] *See* MMWG Report, *supra* note 3, at 62-64.

[38] For a general discussion of overnight sweep arrangements, *see* MMWG Report, *supra* note 3, at 43-44.

Even if investors shift their liquid balances to conventional bank deposits, corporate cash managers and other institutional investors would not view an undiversified holding in an uninsured (or underinsured) bank account as having the same risk profile as an investment in a diversified short-term money market fund. Such investors would continue to seek out diversified investment pools, which may or may not include bank time deposits. Insuring all these new deposits would entail a major increase (perhaps as much as $2 trillion) in the 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, in the United States, issuers of money market securities have expressed serious concerns about the disruptive effects in the market for their securities should regulatory reforms diminish the role played by money market funds. For example, in its letter to the U.S. House Subcommittee on Capital Markets and Government Sponsored Enterprises in June 2011, the Association for Financial Professionals warned that moving to a floating NAV would create "significant disruptions in the corporate funding market. . . . [because] many organizations issue commercial paper to meet their short-term financing needs, such as funding payroll, replenishing inventories, and financing expansion."[39] Similarly, a group of 12 state and local government groups representing both investors in money market funds and issuers of municipal securities that are purchased by money market funds expressed their views to the Subcommittee that mandating a floating NAV "would make [money market funds] far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt issuance costs for many state and local governments across the country."[40]

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[39] *See* Letter from James A. Kaitz, President and CEO, Association for Financial Professionals, available at http://financialservices.house.gov/UploadedFiles/112-42.pdf. Also available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/06/AFP_Comments_on_MMF_Reform_-_June_2011_13089337503.pdf.

[40] *See* Joint Letter of the American Public Power Association, Council of Development Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, International City/County Management Association, International Municipal Lawyers Association, National Association of Counties, National Association of Local Housing Financing Agencies, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National League of Cities, U.S. Conference of Mayors, available at http://financialservices.house.gov/UploadedFiles/112-42.pdf. Also available at http://www.preservemoneymarketfunds.org/wp-content/uploads/2011/06/GFOA-Municipal_Groups_Statement_for_HFSC_062411_13089336282.pdf.

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

Recent comments by SEC officials and others have suggested that money market funds or their advisers be required to hold capital to buffer fund investors from potential future losses on their funds.[41] The Consultation Report has identified several variations on the capital buffer idea, including requiring money market fund advisers to commit capital, requiring funds to raise capital in the market, or having funds build a capital buffer inside funds from fund income. In a recent ICI study, we analyzed the likely outcomes of a capital buffer for the U.S. money market fund industry.[42] A summary of our findings is provided below.

1. *Requiring Fund Advisers to Commit Capital*

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

Imposing capital requirements on a fund adviser would transform the essential nature of a money market fund by interposing the adviser between the fund and its investors. Currently, fund advisers do not allocate capital to absorb losses because investors bear the risks of investing in funds.[43] The U.S. mutual fund structure, including that of money market funds, is designed so fund advisory fees compensate the adviser for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. Advisers are *not* compensated for bearing investment risks of the fund.

Shifting investment risks from fund investors to advisers would require advisers to dedicate capital to absorb possible losses of the funds that they manage. Some advisers would have to raise new capital in the market. Others could perhaps shift capital from other parts of their businesses. Either way, all advisers would have to earn a market rate of return on such capital. If they cannot earn that rate of return, they would seek better business alternatives, such as seeking to move investors to less-regulated cash management products where investors still must bear the risks of investing.

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[41] *See e.g.*, Mary L. Schapiro, Chairman, Securities and Exchange Commission, *Remarks at the Society of American Business Editors and Writers (SABEW) Annual Convention* (March 15, 2012), available at http://www.sec.gov/news/speech/2012/spch031512mls.htm.

[42] *See* Investment Company Institute, *The Implications of Capital Buffer Proposals for Money Market Funds* (May 16, 2012), available at http://www.ici.org/pdf/ppr_12_mmfs_capital_buffer.pdf.

[43] To be sure, some money market fund advisers have at times voluntarily supported their funds, but these advisers did so as a *business decision.* Requiring *all* fund advisers to take on a first loss position would be radical departure from the current agency role that fund advisers play.

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

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

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

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

The payback analysis shows that under current fee structures and market conditions, capital buffers of 1.5 percent to 3.0 percent would absorb every dollar of advisers' net earnings from money market funds for 18 to 43 years, depending on whether only Treasury securities or both Treasury and agency securities are excluded from a capital assessment. Even under best-case assumptions, these buffer requirements would absorb at least 8 to 20 years of advisers' profits from operating money market funds.

For all of these reasons, it is foreseeable that many, if not most, fund advisers would make the business decision to change their cash management offerings radically. Some advisers may simply liquidate their funds and not offer alternative products. Others may refocus their efforts on alternative cash-like products that are less regulated and less transparent, thereby increasing risks in the financial markets.

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

As an alternative to requiring fund advisers to commit capital, the Consultation Report suggests requiring funds to raise capital in the market. After considerable study, however, including in-depth analysis by capital markets experts,[44] ICI concluded that for several reasons market-provided capital is not a feasible option for the money market fund industry. Adding subordinated debt or equity would turn a rather simple product—the money market fund—into a considerably more complex offering. Small funds and small fund complexes likely would find it difficult and costly to issue and roll over subordinated securities, resulting in further industry consolidation and raising a barrier to entrants. The approach also would potentially create competing interests between the subordinated investors' desire to avoid losses and senior shareholders' tolerance for taking greater risks for greater yields.

3. *Requiring a Within-Fund Capital Buffer*

Building a within-fund capital buffer would align more directly the costs of the buffer with the fund's beneficiaries: fund shareholders. Capital at this level would not absorb large credit losses, but it would provide funds somewhat greater flexibility in selling securities at a price below amortized cost. In the United States, however, legal and accounting considerations would limit a within-fund capital buffer to 0.5 percent of a fund's total assets. Also, because of tax and economic considerations, a fund might need many years to build such a buffer. As the analysis shows, under plausible assumptions, building such a buffer might take a typical prime fund 10 to 15 years. The exact horizon depends on whether short-term interest rates rise somewhat more quickly than is currently expected, on how investors respond to a buildup of a within-fund capital buffer, and on the willingness of advisers to continue to absorb the cost of maintaining large fee waivers. In the best of circumstances, building a within-fund capital buffer of 0.5 percent likely would require at least five years.

C. Redemption Restrictions—Minimum Balance Requirement

The Consultation Report identifies several possible options regarding liquidity management, including a "minimum balance requirement." Those who favor such a restriction believe that it can prevent or mitigate redemption pressure similar to that experienced by prime money market funds in 2008 by removing the so-called "first mover" advantage. They also believe that a minimum balance requirement 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 some types of redemption restrictions may help prevent or mitigate excessive strain 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 under "normal" market conditions when liquidity within the money market fund is readily available. Indeed, a survey of U.S. treasurers indicated that 90 percent of respondents either would decrease their use of money market funds or discontinue use of them altogether if money market funds had to impose a minimum balance type requirement.[45] Based on this

[44] ICI engaged legal counsel, an accounting firm, and an investment bank to analyze the potential for funds or advisers to raise capital through the capital markets.

[45] *See* TSI Survey, *supra* note 33.

response, 67 percent of corporate money market fund assets would move to other investments if this concept were adopted.

Under the Investment Company Act, one hallmark feature of U.S. 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.[46] 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.[47]

Despite this extraordinary and far-reaching new rule, which has yet to be tested, calls for additional redemption restrictions continue, including a desire to restrict permanently the ability of money market fund investors to redeem all of their shares on a daily basis. The Consultation Report notes that shareholder redemptions of the minimum balance amount would be held back for a specified period of time and subject to loss if the money market fund loses value during the holdback period. The operational challenges and costs of such a concept, however, would be enormous, requiring changes to myriad systems that extend well beyond those under the control of the funds themselves. Indeed, U.S. 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 incur substantial programming and other costs to effectuate these changes, would instead choose to 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.

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[46] 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 3, at 85-86.

[47] Rule 22e-3 permits a money market fund to suspend redemptions and payment of redemption proceeds if (i) the fund's board, including a majority of directors that are independent of fund management, determines that the deviation between the fund's amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions. 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 4, at 10088. The SEC recognized, however, that permitting suspension of this statutory protection should be limited to extraordinary circumstances. "Because the suspension of redemptions may impose 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*.

1. *Background—Investor Use of Money Market Funds*

Today, 56 million institutional and retail investors utilize U.S. 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 impair the fundamental utility of money market funds. U.S. 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 that would not meet the fundamental needs of their customers. Indeed, as noted above, U.S. treasurers have indicated they will scale back or eliminate their use of money market funds if redemption restrictions that restrict daily liquidity are imposed on money market funds. [48] 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. A minimum balance requirement, or even lack of clarity regarding account balances available for redemptions, would severely hamper the flow of funds and the accessibility of cash for transactions that support 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** employed by brokerage firms and trading platforms, use money market funds to invest cash held in customer accounts. Like institutional accounts, sweep vehicles help manage investor cash pending other investments; they are used primarily by

[48] *See* TSI Survey, *supra* note 33.

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. Typically, the total remaining collected balances (or all available cash) in customer accounts, after all other transactions for the day have been posted, are invested in (swept into) money market funds. A minimum balance requirement would impede the availability of funds to settle customers' securities transactions and compliance with the margin requirements applicable to brokerage accounts.

- **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 hold cash temporarily from redemptions 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** may choose to invest a portion of their tax-advantaged retirement assets in money market funds. These assets are often temporary in nature and used to fund other investment transactions or to support ongoing expenses for retired investors.

2. *Operational Complexities and Cost Considerations*

A minimum balance requirement for money market funds would necessitate 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. Industry experts already have warned the SEC that such a requirement would involve "pervasive and expensive systems and operational changes for a wide variety of parties" that provide money market funds to investors.[49]

Fund complexes and their vendors have developed intricate and complex systems to accommodate the needs of money market fund investors.[50] These systems allow funds to settle transactions either on a same-day or next-day basis. 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

[49] *See e.g.*, Letter from DST Systems, Inc. to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (March 2, 2012), available at http://sec.gov/comments/4-619/4619-128.pdf. DST Systems, Inc. provides information processing solutions and services to support the global asset management, insurance, retirement, brokerage, and healthcare industries. The letter focuses on U.S. money market funds and the "significant impacts potential redemption restrictions reform options will have on systems, operations and shareholder behavior that could cripple if not destroy money market funds as a shareholder convenience."

[50] For a detailed description of money market fund operations and systems, *see* Letter from Karrie 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.

result in significant costs and numerous practical difficulties. Entities that would need to effect changes include:

- mutual fund complexes (transfer agents, investment advisers, and distributors);
- intermediaries (broker-dealers, banks, retirement plan administrators, and insurance companies);
- third party systems and service providers;
- the Depository Trust & Clearing Corporation;[51] and
- institutional and commercial investors (corporate entities, federal, state and local governments, trusts, etc.) utilizing money market funds.[52]

Although daily redemption restrictions, such as a minimum balance requirement, may have theoretical benefits, any such restrictions would require costly changes to a myriad of systems at a financially precarious time for the industry. Indeed, U.S. money market funds advisers waived over 50 percent of money market fund expenses in 2011. It is reasonable to expect that requiring money market funds to adopt a minimum balance concept would cost the industry (funds and intermediaries) and its shareholders hundreds of millions of dollars to implement.[53] 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 of unproven value to their customers; (ii) redemption

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[51] For many mutual funds, transactions that occur through intermediaries are processed through the industry utility provided by the DTCC. The DTCC has two services for mutual fund clearance and settlement through its subsidiary, the National Securities Clearing Corporation ("NSCC"): Fund/SERV and Networking. Fund/SERV provides a standardized and fully automated platform to process and settle fund share purchase, exchange, and redemption orders. Networking supports the exchange and reconciliation of account information as held on the books of a fund's transfer agent with that held on the books of each intermediary (*e.g.*, broker-dealer) that distributes fund shares. These automated services for DTCC participants provide secure, efficient, and cost-effective trading, money settlement, and information exchange through dedicated system connections using standardized formats and procedures. Because these systems employ established requirements, timeframes are set so a sender and a receiver know the parameters for exchanging trade and account-related information. Knowing the established requirements and timeframes enables both sides to create control points for receipt of data and exception processing for missing data. Both omnibus and individual account transactions are processed through the NSCC.

[52] For examples of some of the transaction processing systems that use money market funds to hold short-term cash balances including corporate payroll processing, corporate and institutional operating cash balances, bank trust accounting systems, federal, state, and local government cash balances, and municipal bond trustee cash management systems, *see* Letter from John D. Hawke, Jr., Arnold & Porter LLP, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (February 24, 2012), available at http://sec.gov/comments/4-619/4619-122.pdf.

[53] Two years ago, ICI conducted a cost-benefit analysis of proposed rule changes to Rule 12b-1 under the Investment Company Act that would require extensive systems and operational changes. The estimated costs for these changes were $231 million for fund complexes only, not including additional costs that would have been incurred by intermediaries. *See* Investment Company Institute, *Cost-Benefit Analysis of SEC Rule 12b-1 Reform Proposal* (December 1, 2010), available at http://www.ici.org/pdf/10_12b1_sec_cba.pdf, at 11, Figure 4. We believe the changes that would be required for a minimum balance requirement easily could meet or exceed this prior estimate. In any event, ICI will conduct a similar analysis of any future money market fund rulemaking.

restrictions may not work within existing sweep and retirement plan products; and (iii) these changes may dampen the interest and thus reduce 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 likely would be prohibitive for the money market fund industry.

IV. Consideration of Other Policy Options

In addition to the three policy options discussed above, the Consultation Report identifies several other options, many of which are largely similar to those included in the PWG Report. A summary of our comments on those options previously considered follows. [54]

A. Private Emergency Liquidity Facility for Money Market Funds.

A significant part of our response to the PWG Report explained how an industry-sponsored emergency liquidity facility for prime money market funds could address policymakers' remaining concerns by serving as a liquidity backstop for those funds during times of unusual market stress. Specifically, the letter described the industry's substantial progress on developing a framework for such a facility, including how it could be structured, capitalized, governed, and operated.[55]

B. Mandatory Redemptions in Kind

Requiring money market funds to make certain large redemptions "in kind" (*i.e.*, through the distribution of a proportionate amount of their portfolio instruments to redeeming shareholders) would not be an effective way to further strengthen money market funds.[56] Investors likely would circumvent the requirement—for example, by allocating investments among multiple funds in amounts below the anticipated redemption threshold. Developing regulatory standards that would establish appropriate circumstances and threshold levels would present significant challenges. Even if this could be established, we are concerned that an in-kind redemption requirement, if triggered, could exacerbate market dislocations. A redeeming shareholder needing liquidity would be forced to sell into a declining market with the distressed sales price, adversely impacting not only the redeeming shareholder and the redeeming fund (and its remaining shareholders), but also all other money market funds holding the same portfolio instruments. Difficult operational hurdles also cause us to question the practicality of this approach. We believe that U.S. funds' current authority to redeem shares in kind *voluntarily* appropriately enables them to assess the advisability of redemptions in kind under the circumstances facing the fund and the market at the time.

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[54] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011), available on ICI's website at http://www.ici.org/pdf/11_sec_pwg_com.pdf and http://www.ici.org/pdf/11_sec_pwg_deck.pdf (appendix).

[55] For details concerning ICI's plans for a private liquidity facility to further strengthen prime money market funds, *see id*. at 23-31. While we believe the 2010 SEC amendments addressed the liquidity weaknesses in Rule 2a-7 revealed by the 2008 market crisis, a private liquidity facility remains a means to provide further liquidity should regulators deem that necessary.

[56] For details, *see Id*. at 42-45.

C. Insurance Programs for Money Market Funds

The possibility of developing some form of money market fund insurance—whether federal, private, or a hybrid of the two—is not a viable option.[57] To be effective in the kind of environment the global financial system experienced in 2008, any insurance program would need to cover all prime money market fund assets. An insurance program of that breadth could cause disintermediation from banks, resulting in negative consequences for the financial markets as a whole and the banking sector in particular. Such a program would need to have some kind of federal backstop as well as some access to the U.S. Federal Reserve's discount window to be effective or credible. Moreover, pooling of credit risk across money market fund providers would raise moral hazard concerns.

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

Under this option, stable NAV funds would be made available only to "retail" investors, while "institutional" investors would be restricted to floating NAV funds or alternative products. As stated above, the inability or unwillingness of many institutional investors to switch to floating NAV money market funds means that this approach likely could have the same unintended consequences as a requirement that all money market funds adopt floating NAVs. Many of these investors likely would seek to move their assets into less regulated money market fund alternatives. Moreover, as the Consultation Report acknowledges, we strongly question the feasibility of categorizing "retail" and "institutional" U.S. investors for this purpose in a way that makes sense and can be enforced effectively.[58]

E. Regulating Stable NAV Money Market Funds as Special Purpose Banks

There is no persuasive case for requiring bank-like regulation of stable NAV money market funds; indeed, each of several possible motivations for such an approach is problematic.[59] For example, judging from the proliferation of banking crises around the world over the past two decades, it is far from apparent that the bank regulatory and structural model is superior to that of mutual funds, including money market funds in particular. In addition, if the motivation behind this idea is to give money market fund investors deposit insurance protection, such insurance would have to be unlimited, as institutional investors would find current levels of FDIC-type insurance to be of little value. Unlimited deposit insurance could skew the competitive landscape away from bank deposits toward money market funds, possibly resulting in vast flows from one financial sector to another, which raises systemic risk concerns. If the objective is to require capital as a buffer against investment risk, as discussed above, it is unclear whether the business model for money market funds would remain viable.

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[57] For details, *see id.* at 46-50.

[58] For details, *see id.* at 51-52.

[59] For details, *see id*. at 53-56.

We would welcome the opportunity to speak with you in more detail about our comments. If we can provide any more information, please feel free to contact me directly at kmcmillan@ici.org or 202-326-5815 or Jane Heinrichs, Senior Associate Counsel, at jheinrichs@ici.org or 202-371-5410.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel
Investment Company Institute

cc: The Honorable Mary L. Schapiro
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
The Honorable Daniel M. Gallagher

Eileen Rominger, Director, Division of Investment Management
Robert E. Plaze, Deputy Director, Division of Investment Management

U.S. Securities and Exchange Commission

Appendix to ICI Comment Letter to IOSCO

May 25, 2012

Use of Amortized Cost Valuation

The following discussion briefly summarizes the use of the amortized cost method of valuation by U.S. mutual funds, including money market funds, as well as other industries.

Mutual Funds Other Than Money Market Funds

All U.S. mutual funds calculate their net asset value ("NAV") daily. NAV is the value of the fund's assets, less liabilities, divided by the number of fund shares outstanding and rounded to the nearest cent. Fluctuating NAV funds (*e.g.*, equity and bond funds) are required to value their portfolio securities at market prices (or fair value if no market price is available). These funds, which often invest a portion of their assets in short-term debt securities, also routinely use amortized cost to value securities with a remaining maturity of 60 days or less.[60]

Money Market Funds

As expressly allowed by SEC rules, nearly all U.S. money market funds use amortized cost to value their securities, provided that amortized cost remains close to market value.[61] 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: (1) high-quality, short-term debt securities held until maturity will return to their amortized cost value, regardless of any temporary disparity between the amortized cost value and market value; and (2) while held by a money market fund, the market value of such securities ordinarily will not deviate significantly from their amortized cost value. Thus, Rule 2a-7 permits money market funds to value portfolio securities at their amortized cost *so long as* the deviation between the amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current NAV per share of the fund.

In practice, the risk limiting conditions of Rule 2a-7 generally keep deviations between money market funds' per share market value and amortized cost extremely small. 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 varied between $1.002 and $0.998 during the decade from 2000 to 2010 (the

[60] *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies*, SEC Release No. IC-9786, Accounting Series Release No. 219 (May 31, 1977) (issued prior to adoption of Rule 2a-7 in 1983).

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

decade prior to the implementation of the SEC's 2010 money market fund reforms).[62] As noted in the letter, using SEC Form N-MFP reports, ICI also calculated changes in fund share prices on a monthly basis for every U.S. money market fund between December 31, 2010 and February 29, 2012. More than three-quarters (78 percent) of the prime money market funds had an average absolute monthly change in their share price of 0.5 basis points or less and 99 percent had an average absolute monthly change of less than 2 basis points. Money market funds investing in government securities or repurchase agreements backed by government securities had similarly small changes in their mark-to-market prices, with 83 percent experiencing average absolute monthly changes of 0.5 basis points or less, and all such funds having an average absolute change of less than 2 basis points.

Many of the securities in which money market funds invest (*e.g.*, commercial paper, Treasury bills) are so-called "discount instruments." These securities make no coupon interest payment. Instead, they are issued at a discount to maturity value. For example, 60-day commercial paper may be issued at a price of $99.70. At maturity the issuer will pay $100.00. The $0.30 difference represents implicit interest on the security. Under the amortized cost method of valuation, securities are valued at their acquisition cost adjusted for accretion of discount or amortization of premium. Accretion of discount involves increasing the value of the security ratably over its life so that at maturity its amortized cost value is equal to the maturity value. In the case of the security above, 1/60th of $0.30, or $0.005 would be added to the amortized cost value of the security each day, so that at the end of the 60-day period when the security matures, its amortized cost will be $100.00.

The amortized cost method of valuation also may be applied to bonds or other fixed-income securities that have explicit coupon payments. For example, assume a money market fund purchases a bond with a principal amount of $100.00 with a remaining maturity of 365 days at $105.00 (*i.e.*, the bond is purchased at a premium). The bond may trade at a premium because the coupon rate exceeds the market rate for one year instruments of comparable credit quality. A ratable portion of the premium is subtracted from the amortized cost value of the bond each day during the life of the bond. If the bond has 365 days remaining to maturity, 1/365 of the $5.00 premium is subtracted from the amortized cost value of the bond each day so that at maturity the amortized cost is equal to the maturity value of $100.00.

The amortized cost method of valuation makes no attempt to reflect changes in the credit quality of the issuer or changes in prevailing market interest rates. Such changes will affect the market value of the security. To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, however, Rule 2a-7 contains a number of conditions governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments. Moreover, Rule 2a-7 also requires the fund periodically to compare the amortized cost NAV of the fund's portfolio with the mark-to-market NAV of the portfolio. If there is a difference of more than ½ of 1 percent (or $0.005 per share), the fund's board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) $1.00 per share. 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

[62] *See* Investment Company Institute, *Pricing of U.S. Money Market Funds* (January 2011), available at http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf, at 26.

the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders.

Use of Amortized Cost in Other Industries

Both U.S. Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS") *require* use of the amortized cost method of valuation for financial assets in certain instances. For example, under GAAP, companies (other than investment companies) that invest in debt securities must classify those securities into one of three categories: trading; available-for-sale; or held-to-maturity. Debt securities classified as held-to-maturity are valued at amortized cost. The justification for using amortized cost valuation for debt securities classified as held-to-maturity is that no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gains or losses when the issuer pays the amount promised at maturity. IFRS also require certain financial assets to be valued at amortized cost. For example, IFRS require financial assets to be measured at amortized cost if both of the following conditions are met: (1) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and (2) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Similar to GAAP, financial assets valued at amortized cost are subject to impairment testing (*i.e.*, an assessment of whether the borrower of funds will be able to pay all contractual interest and principal payments when due). If a financial asset is deemed to be impaired, then the creditor must recognize a loss for the impairment.