

MEMO# 23705

August 13, 2009

ICI Draft Comment Letter on SEC Proposed Changes to Money Market Fund Regulation

[23705]

August 13, 2009

TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 33-09
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 37-09
SEC RULES COMMITTEE No. 47-09 RE: ICI DRAFT COMMENT LETTER ON SEC PROPOSED
CHANGES TO MONEY MARKET FUND REGULATION

The Securities and Exchange Commission has proposed amendments to rules under the Investment Company Act of 1940 that affect money market funds. Many of the proposed amendments are similar to recommendations from the Institute's Money Market Working Group report. [\[1\]](#) Specifically, the amendments would tighten the risk-limiting conditions of Rule 2a-7, require money market funds to disclose information monthly about their portfolio holdings on their websites and to the SEC, and permit a money market fund that has "broken the dollar" to suspend redemptions to allow for the orderly liquidation of fund assets. The SEC also is seeking comment on other potential changes to its regulation of money market funds, including whether money market funds should have "floating" rather than stabilized net asset values or require redemptions in kind to satisfy certain large redemptions. The Institute has prepared a draft comment letter on the proposed amendments, which is attached and briefly summarized below.

Comments are due to the SEC no later than Tuesday, September 8, 2009. Comments on the Institute's draft letter should be in writing and sent by email to jheinrichs@ici.org by Friday, August 28th.

Risk-Limiting Conditions

With the exception of certain important aspects of the proposed liquidity requirements, the draft letter expresses the Institute's strong support for the SEC's proposed amendments to strengthen the risk-limiting conditions of Rule 2a-7. The SEC's proposal would, among other things, amend Rule 2a-7 by introducing liquidity requirements, including periodic stress testing of a fund's portfolio, and revising portfolio quality and maturity requirements.

- Portfolio Liquidity

- *Minimum Daily and Weekly Liquidity Requirements:* The draft letter expresses the Institute's strong opposition to proposing different liquidity requirements for "retail" and "institutional" money market funds. Given the difficulties of making distinctions between retail and institutional investors, the letter urges the SEC to follow instead the Working Group's recommendation, which imposes a minimum 5 percent daily requirement for all taxable funds and a minimum 20 percent weekly requirement for all funds. If the SEC nevertheless remains convinced that separate liquidity requirements are necessary, the letter urges it to lower the 30 percent proposed weekly requirement for institutional funds to 20 percent. The letter also notes that given the operational nature of the designation, the determination of whether a fund is retail or institutional is more appropriate for a fund's adviser rather than its board. The draft letter also suggests certain changes and clarifications to the new definitions related to the liquidity requirements.
- *Limitation on Acquisition of Illiquid Securities:* The letter opposes the SEC's proposal to prohibit funds from acquiring any illiquid securities, noting that such a ban would leave funds vulnerable to second guessing by regulators and stifle innovation and competition for new types of high quality securities that have not gained the wide acceptance necessary to support market liquidity. The letter also recommends a change to the definition of "liquid security."
- *General Liquidity Requirement:* The letter opposes the SEC's proposal to include a general liquidity requirement, noting that it is unnecessary given the other proposed liquidity measures and could leave money market funds vulnerable to potential liability.

- Portfolio Quality

- *Credit Ratings Requirement:* The draft letter again expresses the Institute's strong opposition to removing ratings from Rule 2a-7. It notes that such an action is unnecessary to address SEC concerns regarding NRSRO ratings in general and would result in an unacceptable weakening of the rule, to the detriment of money market fund investors. As an alternative to removing NRSROs from Rule 2a-7, the letter supports an

approach, similar to one recommended by the Working Group, under which a money market fund's board would designate three (or more) NRSROs that the fund would look to for all purposes under Rule 2a-7 in determining whether a security is an eligible security. The letter notes the Institute's belief that requiring funds to designate specific NRSROs that it would look to would add a degree of rigor to the process and encourage competition among the NRSROs.

- *Second Tier Securities:* The letter expresses the Institute's support for prohibiting money market funds from investing in "second tier securities."
- *Limitations on Unrated Long-Term Securities:* The SEC proposal would make changes to the quality standards associated with securities that have received only long-term ratings. The draft letter notes the Institute's belief that such a change is unnecessary.
- *Limitations on Securities Subject to Conditional Demand Features:* The SEC proposal would make changes to the requirements for securities subject to a conditional demand feature. The letter notes that the proposed change would drastically reduce the availability of tender option bonds for money market funds and disrupt the operations of long-term funds that invest in inverse floating rate securities.
- *Asset Backed Securities:* The SEC requests comment on whether it should amend Rule 2a-7 to address risks presented by asset backed securities. Among other things, the SEC requests comment on whether it should require asset backed securities to be subject to unconditional demand features in order to be eligible securities under Rule 2a-7. The draft letter notes that such a restriction would have a detrimental effect on some sectors of the asset backed securities market, including multi-seller conduits and tender option bond structures. The letter instead suggests that in order to achieve its investor protection goals without creating adverse results, the SEC could require that asset backed securities have a back up liquidity facility. On the other hand, the letter notes that the Working Group's recommendation to improve the process by which money market funds select potential investments better addresses the SEC's concerns without requiring specific rulemaking in this area.

- Portfolio Maturity

- *Weighted Average Maturity:* The draft letter expresses the Institute's support for reducing the current weighted average portfolio maturity limit to further protect against interest rate risk. The letter notes, however, that the proposed 60 day limit could impair portfolio flexibility and instead recommends that SEC consider a portfolio maturity of slightly more, for example, 75 days.
- *Weighted Average Life:* The letter expresses the Institute's strong support for the proposed weighted average life maturity test, noting its belief that it would provide a layer of protection for money market funds and their

shareholders in volatile markets that is beyond what is currently required under Rule 2a-7.

- *Treatment of Cash:* To more accurately reflect the true maturity of money market funds' holdings, the letter recommends that Rule 2a-7 specifically address the treatment of cash balances for purposes of the required portfolio weighted average maturity and weighted average life tests. Specifically, the letter recommends that cash balances be included in the calculation of these tests and that their maturity be equal to one day.
 - *Maturity Limit for Other Portfolio Securities:* In response to the SEC's request on whether it should consider reducing the maximum maturity for individual non-Government securities acquired by a money market fund from 397 days to, for example, 270 days, the draft letter expresses the Institute's concern that such a change could be disruptive to some issuers' debt management policies and increase their "rollover" risk from adverse market events.
-
- **Diversification:** In response to the SEC's request on whether it should further restrict the diversification limits of Rule 2a-7 relating to issuers and/or guarantors, the draft letter notes that due to unprecedented market conditions and consolidations, the universe of institutions issuing or providing guarantees or liquidity for eligible money market securities has become extremely limited. As a result, and because of the other proposed changes to Rule 2a-7's risk-limiting conditions, it cautions the SEC against changes to the rule's diversification provisions.
 - **Repurchase Agreements:** The draft letter notes that the SEC's proposal that would limit money market funds to investing in repurchase agreements collateralized by cash items or government securities in order to use the diversification "look through" provision of Rule 2a-7 would curtail the ability of money market funds to use a joint trading account with other non-market funds that are not limited to the proposed Rule 2a-7 definition.

Disclosure of Portfolio Securities

The draft letter supports the SEC's proposal to require money market funds to disclose portfolio holdings information monthly and to enhance the SEC's access to money market fund data. The letter, however, provides a number of comments to the proposal.

- **Public Disclosure of Market Value Based Information:** The draft letter notes that the Institute is pleased to see that the SEC is not proposing that money market funds also publicly disclose their market-based net asset value per share and the market-based prices of their portfolio securities. The Institute does not believe that requiring funds to disclose this information, either in the website posting or through Form N-MFP with a two-week lag, would be helpful to fund shareholders and very well could, in fact, increase systemic risks.
- **Public Website Posting:** Although the draft letter supports the SEC's proposal to

require money market funds to disclose portfolio holdings information monthly, it notes that the proposed requirement to conform the portfolio disclosure to Regulation S-X would unnecessarily complicate the required disclosure. Instead, the letter recommends that the monthly posting of the fund's portfolio be limited to the issuer, the name of the issue (including coupon or yield and maturity), the principal amount, and the current amortized cost. The letter also notes that our recent experience indicates that a two business day time period for posting is not practicable and recommends instead that the SEC consider a delay of 5 business days, or longer if the SEC continues to require the detailed disclosure prescribed by Regulation S-X.

- **Reporting to the SEC:** The draft letter supports the SEC's efforts to enhance its oversight of money market funds through the collection of more detailed holdings information on a monthly basis; however, it questions the need for public disclosure of any data beyond those items recommended above. If the SEC feels that the level of detail in proposed Form N-MFP would be useful for regulators, the letter notes that the information should be collected, but it need not be made publicly available. The letter also makes comments on specific items to be filed in new Form N-MFP. Furthermore, it expresses the Institute's belief that the two business day filing period for filing Form N-MFP with the SEC is not a practicable period to gather and prepare in filing format the more detailed information sought in this filing, compared to that which would be provided for website posting of the fund's portfolio holdings. The letter recommends instead that the SEC provide at least a 10 business day delay. Finally, the letter also comments on the process for development, testing, and implementation of an electronic format to be used by funds when filing Form N-MFP.
- **Amendments to Rule 30b1-5:** The letter notes that changes to Rule 30b1-5 to exempt money market funds from the requirements to file their schedules of investments pursuant to Item 1 of Form N-Q are unnecessary if the monthly website portfolio information is limited to the items noted above. The letter suggests that money market funds continue to be required to file their schedules of investments in conformity with Regulation S-X in their quarterly Form N-Q filings. If instead the SEC requires monthly posting of the fund's schedule of investments to its website in conformity with Regulation S-X, the letter supports the SEC's proposal to remove the schedule of investments from the quarterly Form N-Q filing but recommends certain modifications to certain items of Form N-Q.

Money Market Fund Operations

- **Authority to Suspend Redemptions:** The draft letter expresses the Institute's strong support for the proposed new rule that would permit funds to suspend redemptions upon breaking a dollar in order to facilitate an orderly liquidation of the fund. The letter also encourages the SEC to consider an additional measure to protect shareholders recommended by the Working Group that would permit fund boards, with appropriate prospectus disclosure, to temporarily suspend redemptions during certain exigent circumstances other than liquidation of the fund. The letter notes that having the ability to proactively suspend redemptions when a board has information to suggest that its fund may be subject to a run should its net asset value become materially impaired would address timing issues associated with the settlement of redemptions and shadow pricing.
- **Processing of Transactions:** The proposal would require that all money market funds

be able to process purchases and redemptions electronically at a price other than \$1.00 per share. The letter notes that the Institute appreciates the SEC's desire to ensure that funds can process transactions automatically at a price of other than \$1.00 per share if the need should arise; however, the systems changes required to implement the proposal would be far reaching and extremely costly for an industry already feeling the effects of the economic downturn and the current low interest rate environment. In addition, the letter notes that the proposed amendments to strengthen the risk-limiting conditions of Rule 2a-7 further minimizes the likelihood that a need to process transactions at a price of other than \$1.00 per share would ever arise. The letter then details the systems, the likely changes necessary to implement the SEC's proposal, and the estimated costs of such changes.

Request for Additional Comment

The SEC also requests comment on whether more fundamental changes to the regulatory structure governing money market funds may be warranted. In particular, the SEC is requesting comment on whether money market funds should be required to float their net asset values and/or whether funds should be required to satisfy redemption requests in excess of a certain size through redemptions in kind.

The letter expresses the Institute's strong opposition with both suggestions. The letter notes that fundamentally changing the nature of money market funds—a product that has been so successful for investors and the U.S. money market—goes too far, would not solve the problems perceived by the SEC, and would create new and potentially far greater risks than those the SEC is seeking to avoid.

- **Floating Net Asset Value:** The draft letter concludes that: (1) a \$1.00 stable net asset value provides far more benefits to money market fund investors than a floating net asset value; (2) a floating net asset value could lead to substantial and far-reaching negative consequences for the money market; and (3) a floating net asset value is unlikely to reduce systemic risk.
- **Redemptions in Kind:** The draft letter highlights the valuation and operational challenges of redemptions in kind for both money market funds and shareholders. The letter also notes that redemptions in kind pose the potential for aggravating an illiquid or declining market. The letter concludes by noting that the option to redeem in kind should continue to be available and employed but only on a case-by-case basis as funds deem appropriate.

Jane G. Heinrichs
Associate Counsel

[Attachment](#)

endnotes

[\[1\]](#) The Working Group report is available on the Institute's website at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.