The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

June 18, 2007

Institute Comment Letter on Amendments to SEC's Financial Responsibility Rules for Broker-Dealers (pdf)

June 18, 2007 Nancy M. Morris Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549-1090 Re: Amendments to Financial Responsibility Rules for Broker-Dealers (File No. S7-08-07) Dear Ms. Morris: The Investment Company Institute1 supports the Securities and Exchange Commission's proposal to expand the use of money market funds under the SEC's broker-dealer financial responsibility rules.2 In particular, we strongly support the proposal to extend to a broker-dealer's investments in shares of certain types of money market funds equivalent treatment to their direct investments in U.S. Treasury securities. We recommend that such treatment be extended to money market funds that invest exclusively in "first tier" securities as defined in Rule 2a-7 under the Investment Company Act of 1940. We further recommend changes to the conditions to be considered a "qualified security" under the proposal. Finally, we recommend that the haircut that broker-dealers would apply to proprietary positions in money market funds be reduced from the proposed one percent to zero percent. Our recommendations are explained in detail below.3 1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is included at the end of this letter. 2 Securities Exchange Act Release No. 55431 (March 9, 2007), 72 FR 12899 (March 19, 2007) ("Release"). 3 The Institute generally supports other initiatives to expand the use of money market funds for purposes of a broker-dealer's financial responsibility rules. Specifically, Congressmen Gregory Meeks (D-NY) and Patrick Tiberi (R-OH) have introduced the "Money Market Fund Parity Act of 2007," which would direct the Commission to revise its rules for the comparable treatment and expanded use of certain money market funds for broker-dealer financing. See H.R. 1171, 110th Cong., 1st Sess. (2007). In addition, Federated Investors, Inc. has filed a petition with the Commission requesting, among other things, that certain money market funds qualify for equivalent treatment provided to other low-risk securities for purposes of the SEC's broker-dealer responsibility rules. See Public Petition for Rulemaking No 4-478 (April 3, 2003), as amended (April 4, 2005), available on the SEC's website at http://www.sec.gov/rules/petitions/petn4-478.htm. Nancy M. Morris June 18, 2007 Page 2 of 7 Expansion of Definition of "Qualified Security" under Exchange Act Rule 15c3-3 Rule 15c3-3 under the Securities Exchange Act of 1934 limits a broker-dealer to depositing cash or "qualified securities" into a bank account it maintains to meet its customer reserve deposit requirements ("special reserve account"). Currently, the rule defines the term

“qualified security” to include investments in securities issued or guaranteed as to principal and interest by the United States (“U.S. Treasury securities”). To address operational difficulties associated with directly holding and managing a portfolio of U.S. Treasury securities, the proposal would expand the definition to include money market funds that invest solely in securities meeting the definition of “qualified security” in Rule 15c3-3. The Institute strongly supports permitting the use of money market funds for this purpose. Both retail and institutional investors rely on money market funds as a cash management tool because of their high degree of liquidity, stability in maintaining a principal value of $1.00 per share, and the current yield that they offer. Money market funds also are subject to the strict regulatory requirements of Rule 2a-7, which are designed to, among other things, limit exposure to interest rate, liquidity and credit risk. This has resulted in the near-total absence of investor losses in money market funds since their inception more than 30 years ago.4 Expanding the definition of “qualified security” to include money market funds would therefore promote numerous cash management efficiencies for broker- dealers without compromising the safety of customer assets or the other customer protections that the financial responsibility rules were designed to effect. Proposal Should be Extended to Include Other Money Market Funds The Institute recommends that the Commission expand the proposal to include money market funds beyond those that invest solely in U.S. Treasury securities. Money market funds have characteristics that significantly reduce the risks associated with direct ownership of securities, including diversification requirements, maturity limits, quality restrictions, professional management and independent board of director oversight. These risk-reducing characteristics justify expanding the definition of “qualified security” and would further address operational difficulties faced by broker- 4 The few instances in which a money market fund has experienced deviations between its stabilized share price and its market based per share net asset value have resulted from investments in lower quality securities that would not be possible under the proposal (or our recommended expansion of the proposal discussed below) or from now-prohibited investments in securities, such as adjustable rate securities that would not re-set to par. Only once has a money market fund failed to repay the full principal amount of its shareholders’ investments. In that case, a small institutional money fund “broke-the- buck” due to extensive derivatives-related holdings. See In the Matter of Craig S. Vanucci and Brian K. Andrew, Securities Act Release No. 7625 (January 11, 1999); and In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G. Guffey, Securities Act Release No. 7626 (January 11, 1999). Nancy M. Morris June 18, 2007 Page 3 of 7 dealers by providing a broader range of funds that can meet broker-dealers’ special reserve account requirements. This is particularly important for smaller firms whose access to the U.S. Treasury markets is more limited than that of larger dealers. Specifically, we recommend expanding the proposal to include money market funds that invest exclusively in “first tier” securities as defined under Rule 2a-7. Under Rule 2a-7, a “first tier” security includes a security that has received the highest short-term rating from a nationally recognized statistical rating organization (“NRSRO”), an unrated security that is of comparable quality to a security that has received the highest short-term rating from an NRSRO as determined by a fund’s board of directors, a security issued by a money market fund, or a “government security”5 as defined in the Investment Company Act.6 Such an expansion would afford investor protections that are even higher than the current strict standards of Rule 2a-77 and that are similar to the safety of U.S. Treasury- only money market funds. By expanding the proposal to include money market funds beyond those that only invest in U.S. Treasury securities, there also would be a significant increase in the availability of funds, and, in turn, an increase in liquidity for broker-dealers to satisfy their special reserve account requirements. If the Commission determines not to extend its proposal in this manner, at the very least, we recommend that it clarify that shares of money market funds that invest

in repurchase agreements collateralized fully by U.S. Treasury securities be considered “qualified securities” for purposes of the broker-dealer responsibility rules. Broker-dealers currently utilize repurchase agreements that are collateralized by U.S. Treasury securities in special reserve accounts. Expanding the proposal in this manner, therefore, would be consistent with the current treatment of repurchase agreements. 5 Section 2(a)(16) of the Investment Company Act defines a "government security" as any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the U.S. Government pursuant to authority granted by Congress; or any certificate of deposit for any of the foregoing. 6 Our recommendation would include money market funds, as described above, that invest in certain repurchase agreements, including repurchase agreements: (1) collateralized by “first tier” securities; (2) where the counterparty has a rating equal to that of a “first tier” security; (3) where the obligations of the counterparty are supported by a guarantee from an entity with a rating equal to that of a “first tier” security (e.g., the parent company of the counterparty); or (4) that are “collateralized fully” by certain securities described under Rule 5b-3 under the Investment Company Act. Our members report that money market funds that invest exclusively in “first tier” securities typically hold these types of repurchase agreements. 7 Under Rule 2a-7, money market funds generally may invest in securities either rated by an NRSRO in its two highest short- term rating categories or, if unrated, as determined by the fund’s board of directors to be of comparable quality. Nancy M. Morris June 18, 2007 Page 4 of 7 Conditions to be Considered a “Qualified Security” The proposal would require that a money market fund eligible for deposit into a broker-dealer’s special reserve account meet several conditions: (1) the money market fund may not be affiliated with the broker-dealer; (2) the money market fund must agree to redeem fund shares in cash on the next business day; and (3) the money market fund must have an amount of net assets at least ten times the value of the fund’s shares held by the broker-dealer in its special reserve account. Each of these conditions is addressed below. Affiliation Restriction The proposal would require that a qualifying money market fund not be affiliated with the broker-dealer that holds shares of the money market fund in a special reserve account. According to the Release, this requirement is based on the concern that any financial difficulties experienced by the broker-dealer caused by liquidity problems at the holding company level may adversely impact an affiliated money market fund’s ability to promptly redeem fund shares. The Institute recommends that the Commission eliminate this condition. We do not believe that a money market fund that is affiliated with a broker-dealer holding shares of the fund would limit the ability of the money market fund to redeem fund shares. Most significantly, we are not aware of a set of circumstances where liquidity problems at a broker-dealer’s holding company would have any impact on the affiliated money market fund. The Investment Company Act imposes structural safeguards that limit the extent to which financial problems at an investment adviser or its affiliates can impact a fund. Among other things, • the assets of a money market fund cannot be commingled with those of the broker-dealer or its parent company and are subject to stringent custody requirements;8 • money market funds are prohibited from acquiring securities issued by the broker-dealer or its affiliates; 9 and • a money market fund must be overseen by a board of directors, a majority of the members of which must, as a practical matter, be independent of the affiliated broker-dealer.10 8 See Section 17(f) of the Investment Company Act and the rules thereunder. 9 See Section 12(d)(3) of the Investment Company Act and Rule 12d3-1 thereunder. 10 See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (January 2, 2001). Nancy M. Morris June 18, 2007 Page 5 of 7 We believe these safeguards, and the structure and operation of money market funds in general, should address Commission concerns regarding an affiliated money market fund’s ability to promptly redeem fund

shares. Redemption Period The Institute generally supports the condition in the proposal that would require a broker- dealer to utilize a money market fund that agrees to redeem fund shares in cash on the next business day. We do not agree, however, that there should be no ability for a fund to delay redemptions beyond one day where failure to redeem is beyond the control of the money market fund. Situations may arise, particularly where there are unscheduled closings of Federal Reserve Banks or registered securities exchanges, where such a delay may be necessary and appropriate. For this reason, we recommend that the Commission include an exception to the proposed condition for these situations. Concentration Requirement To prevent a broker-dealer from holding too concentrated a position in a single money market fund, the proposal would limit a broker-dealer from holding fund shares in its special reserve account that are more than ten percent of the value of the fund's net assets. The Institute believes the proposed concentration requirement is too restrictive in light of the extremely high liquidity of money market funds. As discussed above, Rule 2a-7 establishes extensive requirements for money market funds, including requirements for liquidity, diversification, and quality. We, therefore, recommend that the Commission adopt a higher threshold limitation for purposes of Rule 15c3-3 (e.g., 25 percent). "Haircut" Reduction for Money Market Funds under Exchange Act Rule 15c3-1 The proposal would reduce the "haircut"11 under Exchange Act Rule 15c3-1 that broker-dealers are required to apply to proprietary positions in money market funds that are registered under the Investment Company Act and subject to Rule 2a-7 from two percent to one percent. The Release notes that money market funds have been historically stable investments and that the risk limiting investment restrictions in Rule 2a-7 were adopted by the SEC after the two percent haircut was imposed. The Institute strongly supports reducing the haircut for money market funds. Given the safety, stability, and liquidity of money market funds and the strict requirements of Rule 2a-7, however, we 11 Rule 15c3-1 seeks to ensure that broker-dealers maintain sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers. When calculating the value of their assets for purposes of establishing their net capital under the rule, broker-dealers must reduce the market value of the securities and commodities they own by certain percentages -- so-called "haircuts." The applicable percentage haircut is designed to provide protection from the market risk, credit risk, and other risks inherent in particular positions. Applying a haircut to the value of a broker-dealer's proprietary positions provides a capital cushion in case the portfolio value of the broker-dealer's positions decline. Nancy M. Morris June 18, 2007 Page 6 of 7 believe the Commission should lower the haircut for money market funds to zero percent. We believe reducing the required haircut to this level would "better align the net capital charge with the risk associated with holding a money market fund."12 To the extent the Commission determines it is necessary to impose a haircut of greater than zero percent on money market funds, we recommend that a bifurcated haircut scheme be implemented. Bifurcation could, for example, recognize the distinction between Rule 2a-7 money market funds generally (which would be subject to a haircut greater than zero percent) and money market funds that qualify for deposit in a broker-dealer's special reserve account under Rule 15c3-3 (which would be subject to a zero percent haircut). * * * * * The Institute appreciates the opportunity to comment on this proposal. If you have any questions about our comments or would like any additional information, please contact me at 202-371-5410 or Ari Burstein, Senior Counsel, at 202-371-5408. Sincerely, /s/ Jane G. Heinrichs Jane G. Heinrichs Associate Counsel cc: The Honorable Christopher Cox The Honorable Paul S. Atkins The Honorable Roel C. Campos The Honorable Annette L. Nazareth The Honorable Kathleen L. Casey Erik R. Sirri, Director Robert L.D. Colby, Deputy Director Michael A. Macchiaroli, Associate Director Division of Market Regulation 12 See Release at 50. The SEC staff has granted no-action relief permitting money market funds to be treated like cash for

certain purposes of the Investment Company Act. See Willkie Farr & Gallagher, SEC No-Action Letter (pub. avail. October 23, 2000). Nancy M. Morris June 18, 2007 Page 7 of 7 Andrew J. Donohue, Director Robert E. Plaze, Associate Director Division of Investment Management * * * * * About the Investment Company Institute ICI members include 8,781 open-end investment companies (mutual funds), 665 closed-end investment companies, 428 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $10.917 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.
