

COMMENT LETTER

December 23, 2009

ICI Comment Letter on CESR's Consultation on a Common Definition for European Money Market Funds (pdf)

December 23, 2009 Mr. Carlo Comporti Secretary General The Committee of European Securities Regulators 11-13 Avenue de Friedland 75008 Paris FRANCE Re: CESR/09-850: Consultation Paper—A Common Definition of European Money Market Funds Dear Mr. Comporti: The Investment Company Institute (“ICI” or “Institute”)¹ supports the efforts of the Committee of European Securities Regulators (“CESR”) to improve investor protection by harmonizing the definition of European money market funds.² Similarly, the Institute and its members have invested substantial time and resources in efforts to ensure the continued success of U.S. money market funds, products that are valued by investors and critical to the U.S. money markets. Our views on these issues are informed by the experiences of our members in organizing, advising, and distributing U.S. registered money market funds as well as non-U.S. money market funds. The potential for regulatory convergence or divergence strongly affects the conduct of our members’ businesses as changes in one jurisdiction can, and often do, affect the conduct of asset managers in other jurisdictions. As a result, robust dialogue among international regulators and market participants is vital to the evaluation of new regulatory approaches. 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 \$11.33 trillion and serve almost 90 million shareholders. 2 Committee of European Securities Regulators, Consultation Paper: A Common Definition of European Money Market Funds (CESR/09-850), October 20, 2009 (“Paper”), available at http://www.cesr-eu.org/data/document/09_850.pdf. Unlike a U.S. money market fund that is circumscribed by the single framework of Rule 2a-7 under the Investment Company Act of 1940, CESR proposes two types of money market funds for Europe: (i) a “short-term money market fund”; and (ii) a “longer-term money market fund.” The approach seeks to differentiate between short-term money market funds that have a very short weighted average maturity and weighted average life, and longer-term money market funds that operate with a longer duration and weighted average life. Mr. Carlo Comporti December 23, 2009 Page 2 of 5 In the U.S., money market funds, which date back to the early 1970s, are one of the most significant financial product innovations of the past half century. Today, U.S. retail and institutional investors alike rely on them as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability in principal value, and a market-based yield. Money market funds serve as an important source of

direct financing for governments, businesses, and financial institutions, and of indirect financing for households. In the U.S., financing for all these institutions and individuals would be more expensive and less efficient without these funds. For the U.S. market, not only are money market funds a financial markets success story, they also are a regulatory success story. Since 1983, money market funds have been governed very effectively by the Securities and Exchange Commission, both as mutual funds generally and pursuant to Rule 2a-7, a carefully crafted rule under the Investment Company Act of 1940 that strictly limits the risks these funds can take.³ It is this single framework of Rule 2a-7, combined with all the regulatory protections applicable to registered investment companies, that has made these funds uniquely identifiable and highly desirable to U.S. investors for more than 25 years. In order to hold itself out as a money market fund in the U.S., the fund must comply with the risk-limiting provisions of Rule 2a-7—no other types of funds registered under the Investment Company Act may use this designation. We believe that for U.S. investors who have always had this single designation, the clarity of this naming convention is critical to investor understanding. Indeed, since that rule was adopted, U.S. money market fund assets have grown from about \$180 billion to \$3.3 trillion as of November 2009. Although different from the long-standing single money market fund framework in the U.S. under Rule 2a-7, we are supportive of CESR's efforts to narrow and bring more clarity to the classification of money market funds in Europe.⁴ We agree that, particularly in the context of the European market where there is currently no harmonized definition of a money market fund, these efforts could reduce confusion in the European market. Given the narrow approach to a money market fund in the U.S., our comments will focus on CESR's proposed "short-term money market fund" definition, funds that we believe would be most similar to U.S. money market funds that are registered with the SEC and that comply with Rule 2a-7. We offer the following observations and suggestions.

³ For a detailed discussion of these requirements, see Investment Company Institute, Report of the Money Market Working Group (March 17, 2009), Section 4 at 31-39 ("MMWG Report"), available on the Institute's website at http://www.ici.org/pdf/ppr_09_mmwg.pdf. ⁴ Indeed, in 2002, following events that led several Japanese money market funds to lose their principal value, Japan, through the Investment Trusts Association, went through a similar exercise, resulting in the issuance of "Measures for Ensuring the Stability of Money Market Funds." See Investment Trusts in Japan 2008, The Investment Trusts Association, Japan at 48- 49 ("Investment Trusts in Japan").

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Common Definition of Money Market Funds The Institute commends the efforts of CESR to harmonize the definition of European money market funds. We believe that because money market funds are playing an increasingly important role in the money markets around the world, it is important to foster a more consistent and common understanding of these funds. As noted in the Paper, a key objective of the proposals is improved investor protection that reflects the fact that investors in money market funds expect a return of principal and daily liquidity. The Paper also notes that a common definition would help provide a more detailed understanding of the distinction between European money market funds that operate in a restricted fashion and those that follow a more "enhanced" approach. Indeed, ICI has advocated to the SEC on at least two occasions that funds that appear to be similar to money market funds (because they use a name that could lead an investor to believe that it was investing in a money market fund or maintain a stable net asset value) be required to comply with the risk-limiting provisions of Rule 2a-7.⁵ Both times, the Institute was concerned that gaps in the regulatory structure could cause investors to be misled about the exact nature of their investments. We believe that such concerns are equally applicable to European money market funds, which do not currently share a common definition of money market fund.

Strong Risk-Limiting Provisions We are particularly pleased to see that CESR's proposed definition of short-term money market fund includes strict limits on

portfolio quality (including an explicit responsibility on the fund's investment manager to perform credit analysis on all portfolio instruments that is in addition to the credit rating of the instruments) and maturity (including limitations relating to weighted average 5 In 1990, the Institute supported a proposal to require that funds that do not rely on Rule 2a-7, but hold themselves out as money market funds, meet the maturity, quality, and diversification requirements contained in Rule 2a-7. See Letter from Matthew P. Fink, Senior Vice President and General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (September 24, 1990). As part of the SEC's 1991 amendments to Rule 2a-7, the SEC adopted an amendment that makes it unlawful for a registered investment company to use "money market" or similar terms as part of its name or title or hold itself out to investors as a money market fund or the equivalent of a money market fund, unless the company meets the risk-limiting provisions of Rule 2a-7 relating to maturity, quality and diversification. See Revisions to Rules Regulating Money Market Funds, SEC Release Nos. 33-6882 and IC-18005 (February 20, 2001). On the other hand, currently there is no corresponding prohibition on a fund that is not registered under the Investment Company Act, such as a so-called enhanced cash fund, a bank collective fund, or other type of fund, that holds itself out as maintaining a non-fluctuating net asset value of \$1.00 per share, from using a name that could lead an investor to believe that it was investing in a money market fund registered under the Investment Company Act and complying with Rule 2a-7. Indeed, at various times during the recent financial crisis, some unregistered cash funds that ran into problems, were widely misreported as money market funds, leading to investor and market confusion. As a result, the Institute, through its Money Market Working Group, recently recommended that the SEC adopt a rule under the Investment Advisers Act of 1940 providing that it would be a fraudulent or deceptive practice to advise any fund that is not registered under the Investment Company Act that either (i) uses the term "cash" or any variant of the word, such as "money," "liquid," etc. in its name; or (ii) holds itself out as seeking to maintain a non-fluctuating net asset value of \$1.00 per share, unless the fund also complies with the risk-limiting provisions of Rule 2a-7. See MMWG Report, *supra* note 3, at 94-95. Mr. Carlo Comporti December 23, 2009 Page 4 of 5 maturity and weighted average life⁶). We believe that CESR's risk-limiting proposals represent a well- balanced approach that should work well in prosperous times as well as during periods of market instability or economic pressures.⁷ The definition also incorporates a requirement that money market funds perform stress testing, a requirement in Ireland's regulations for certain UCITS money market funds and recommended by the Institutional Money Market Funds Association as well as ICI's Money Market Working Group.⁸ Stress testing also was proposed by the SEC as part of its money market fund reform proposals.⁹ We believe that together these provisions would impart substantial benefits to European money market funds and allow money market funds to be more resilient to widespread credit market disruptions, such as those that occurred in 2008. To provide further protection for investors in European money market funds, we recommend that CESR consider a requirement that money market funds maintain a minimum ready supply of cash to fund redemptions through explicit liquidity requirements. Indeed, the Institute's Money Market Working Group recommended that money market funds have explicit daily and weekly liquidity requirements.¹⁰ Similarly, the SEC is considering liquidity standards for such funds.¹¹ We also recommend that CESR's definition include a provision relating to diversification. Under Rule 2a-7, money market funds must maintain a diversified portfolio. This requirement limits a fund's economic 6 Indeed, we believe that a 120-day limit is the appropriate limit for the weighted average life requirement as it is flexible enough even during "normal" market conditions to not unduly restrict a fund's ability to offer a diversified portfolio of short-term, high quality debt securities. See MMWG Report, *supra* note 3, at 77-78 and Letter from Karrie McMillan, General Counsel,

Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (September 8, 2009), at 24-25 ("ICI September 2009 Comment Letter"), available at <http://www.ici.org/pdf/23769.pdf>. On the other hand, we do not support a weighted average maturity limit of 60 days because it could constrain the ability of many money market funds to produce yields that cover their expenses, particularly during times of low interest rates. Instead, we suggest that a weighted average maturity limit of, for example, 75 days would reduce interest rate risk without significantly impairing portfolio flexibility during different market conditions. See MMWG Report, *supra* note 3, at 76-77 and ICI September 2009 Comment Letter, at 24. 7 In contrast, the ICI's comment letter on the SEC's proposed amendments to Rule 2a-7 raised concerns that if certain proposed risk limiting provisions were too restrictive, such provisions may impose a regulatory barrier that disadvantages U.S. registered money market funds and may cause "investor flight" from these money market funds to unregulated or less regulated money market investment vehicles. See ICI September 2009 Comment Letter, *supra* note 6, at 9. 8 See MMWG Report, *supra* note 3, at 75. 9 See Money Market Fund Reform, SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009) ("SEC Release"), available on the SEC's website at <http://sec.gov/rules/proposed/2009/ic-28807.pdf>. 10 See MMWG Report, *supra* note 3, at 72-75. 11 See SEC Release, *supra* note 9. Mr. Carlo Comporti December 23, 2009 Page 5 of 5 exposure to any single issuer. 12 For instance, under Rule 2a-7, in general, money market funds may not invest more than 5 percent of assets in the securities of any single issuer, with exceptions for certain securities including those issued by the U.S. federal government or its agencies. On the other hand, as part of the proposed definition, CCSR has suggested an option that would restrict a short-term money market fund from investing in structured financial instruments or asset-backed commercial papers. Although the financial market crisis of 2008 revealed that some investment advisers did not fully appreciate the risks posed by the credit structures and underlying assets in structured investment vehicles and certain other asset-backed issuers, asset-backed securities come in many different forms and structures with very different risks, including significantly varying collateral and structural risks. 13 Indeed, creditworthy asset-backed securities represent an important sector of the U.S. short-term money market and an important investment for U.S. money market funds. We believe that investment advisers to European money market funds should continue to be permitted to invest in asset-backed securities when appropriate and consistent with the investment objective of the money market fund. 14 * * * * 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 solson@ici.org or 1 202- 326-5813 or Jane Heinrichs, Senior Associate Counsel, at jheinrichs@ici.org or 1 202-371-5410. Sincerely, /s/ Susan M. Olson Susan M. Olson Senior Counsel, International Affairs 12 See also Investment Trusts in Japan, *supra* note 4, at 49 (money market fund measures included a diversification provision). 13 For example, in the U.S., asset-backed securities could describe a wide range of securities collateralized by a pool of underlying assets including government and other mortgage backed securities, as well as varying types of asset backed securities, such as collateralized debt obligations. 14 To enhance the credit analysis of new and complex structures, such as structured financial products, many of our members report that in addition to evaluating independently the credit quality of each portfolio investment, they also have a "new products" committee or similar group that reviews and approves novel securities, credit structures, or investment techniques prior to investment by their funds. Indeed, the Money Market Working Group recommended similar "best practices." See MMWG Report, *supra* note 3, at 78-80.

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