SECURITIES AND EXCHANGE COMMISSION
OPEN MEETING OF THE INVESTOR ADVISORY COMMITTEE

Statement of the Investment Company Institute

May 10, 2010

I. Introduction

The Investment Company Institute ("ICI"),[1] the national association of U.S. mutual funds and other investment companies, appreciates the opportunity to offer its views to the Investor Advisory Committee of the Securities and Exchange Commission ("SEC" or "Commission") on money market funds and the issue of net asset value ("NAV"), an agenda item for the May 17 Committee meeting.

Money market funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool for retail and institutional investors, and are an exceptionally important source of short-term financing in the U.S. economy. These funds have been comprehensively and successfully regulated by the SEC—not only under the Investment Company Act of 1940, but through a specialized and highly proscriptive rule, Rule 2a-7, for nearly 30 years.

In September 2008, the failure of Lehman Brothers, coupled with the government's rescue of Fannie Mae, Freddie Mac, and AIG, prompted mounting concerns about the viability of financial and nonfinancial businesses alike. The result was a liquidity and credit crisis that threatened the global economy. This sequence of events affected virtually every part of the financial system, including all issuers, investors, and intermediaries in the money market. The failure of Reserve Primary Fund to maintain its $1.00 NAV and the subsequent redemption pressures on other money market funds, however, focused much of the attention on these funds.

Many forms of government intervention ultimately stemmed the crisis. The Treasury Guarantee Program for Money Market Funds helped calm the waters. Facilities established by the Federal Reserve helped restore liquidity to the markets for commercial paper and asset-backed securities. All market participants, including money market funds, clearly benefited from these interventions.

As markets began to recover, the money market fund industry understood the need to make money market funds more resilient under extreme market conditions. Indeed, the SEC and the fund industry already have made significant and important progress toward making money market funds

[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 $11.94 trillion and serve almost 90 million shareholders.

more secure. In March 2009, ICI issued the *Report of the Money Market Working Group*, which is an industry study of the money market, of money market funds and other participants in that market, and of recent market circumstances.[2] The Report included wide-ranging proposals to address weaknesses in money market fund regulation. When that report was issued, ICI's members pledged to adopt those recommendations voluntarily.

Earlier this year, the SEC approved final amendments to Rule 2a-7[3] that will raise credit standards and shorten the maturity of money market funds' portfolios—reducing credit and interest rate risk. They require more frequent disclosure of money market funds' holdings, so both regulators and investors will better understand funds' portfolios. The SEC amendments also directly address the liquidity challenge. They impose for the first time explicit liquidity requirements that will require taxable money market funds to maintain daily liquidity of 10 percent of their assets, and all money market funds to maintain weekly liquidity of 30 percent of their assets. Funds also must adopt "know your investor" procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly.

In addition, the SEC took an important step to help address any future run on a money market fund, such as the one that struck the Reserve Primary Fund. The Commission gave money market fund boards the ability to suspend redemptions if a fund is about to break the dollar—a powerful tool to assure all of the fund's shareholders of equitable treatment, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund.

The search for ways to make money market funds even more secure under the most adverse market conditions, however, has not stopped. Indeed, the fund industry remains open to a wide range of ideas on reform of money market funds. As discussed below, however, we strongly oppose the notion of forcing money market funds to abandon their objective of maintaining a stable per-share value. The steady NAV—typically $1.00 per share—is a fundamental feature of money market funds. A somewhat related idea to a floating NAV that we also oppose is the suggestion that money market funds be required to publicly disclose market-value based information on a real-time basis. We believe that such disclosure would not be helpful to fund shareholders and very well could, in fact, increase systemic risks.

II. The Case for Stable NAV Money Market Funds

Some observers believe that a simple solution to the challenges faced by money market funds during the financial crisis is to force these funds to float their per-share value. By their account, the amortized cost accounting that allows a money market fund to seek to maintain a stable NAV makes these funds more vulnerable to runs. They argue that investors are prone to sell stable-value shares

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

[3] *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010).

when there are small drops in the value of the funds' underlying securities below the fixed $1.00, but wouldn't sell if the shares' value floated routinely. After a careful review of this proposition, however, we have concluded that, in light of market data and investor behavior, the notion of forcing money market funds to float their value would wreak havoc on our markets—without any offsetting benefits.[4]

Indeed, we have concluded that: (1) a floating NAV could lead to substantial and far-reaching negative consequences for the money market; (2) a floating NAV is unlikely to reduce systemic risk; and (3) a $1.00 stable NAV provides far more benefits to money market fund investors than a floating NAV.

If money market funds were required to float their NAVs, this very likely would lead to many investors—both retail and institutional alike—ceasing to use these funds in favor of alternative products that offer a stable NAV, albeit without the market-based returns (bank products) or regulatory protections (private or offshore pools) that money market funds provide. Significantly decreasing the value of this product would have negative consequences to the economy as well, by increasing systemic risk, reducing the supply of short-term credit to corporations, or severely restricting the supply of credit to municipalities.

- *Increase systemic risk*: Asset managers would find other means to offer a stable NAV cash pool, leading to rapid and substantial disintermediation from money market funds, particularly by institutional investors, into pools outside the protections of the Investment Company Act. These large pools of alternative investment, domiciled in either the United States or offshore, would fall outside the careful regulatory framework in place for money market funds, and potentially increase the systemic risk to the financial system.

- *Reduce supply of short-term credit*: Cash held in money market funds also may flow to traditional banks. This would result in a significant reduction in the supply of short-term credit to corporate America, unless banks raised significant amounts of capital, because money market funds hold almost half of the commercial paper that businesses issue to finance their operations, such as payrolls and inventories. Even with the capital to support this expansion of their balance sheets, the allocation of short-term credit would be less efficient and the cost to businesses would rise, putting at risk jobs for American workers.

- *Restrict supply of credit to municipalities*: In the absence of stable NAV investment pools, municipalities would lose an important source of financing in the short-term markets, exacerbating the budget woes of communities, because banks cannot pass through tax-

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[4] For a discussion of our views on requiring money market funds to float their NAVs, *see e.g., Weathering the Worst: Making Money Market Funds Even Stronger,* Remarks by Paul Schott Stevens, President and CEO, Investment Company Institute, Mutual Funds and Investment Management Conference (March 15, 2010); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (September 8, 2009) (commenting on the SEC's proposed money market fund reforms); MMWG Report, *supra* note 2 at 105-112.

exempt income to depositors and simply could not replace tax-exempt money market funds. Indeed, money market funds hold nearly two-thirds of the short-term debt that finances state and local governments.

It is highly unlikely that requiring money market funds to float their NAVs would reduce, and may even increase, systemic risk. Most importantly, floating the NAV of a money market fund would not lessen the incentive for investors to redeem shares rapidly in periods of market turmoil.

- *Experience of floating NAV funds*: Ultra-short bond funds lost more than 60 percent of their assets from mid 2007 to the end of 2008, and French floating NAV dynamic money funds lost about 40 percent of their assets in a three-month time span from July 2007 to September 2007.

- *Shareholder expectations*: Shareholders in fixed-income funds also tend to be more risk adverse and more likely to redeem shares quickly when fixed-income markets show any signs of distress.[5] The demand for redemptions can outstrip the ability of fixed-income funds—even those with floating NAVs—to meet such requests without selling securities at a loss, because assets cannot be sold quickly in an illiquid market.

The benefits to investors of a $1.00 stable NAV are many. The $1.00 stable NAV provides money market fund shareholders convenience and simplicity in terms of tax, accounting, and recordkeeping that should not be underestimated. In addition, many institutional investors are permitted to use money market funds only if such funds maintain a stable NAV. Requiring money market funds to float their NAVs would undermine their convenience and simplicity and would raise new tax, accounting, operational, and legal hurdles that would threaten the continued use of these funds.

- *Tax convenience*: If money market funds had a floating NAV, all share sales would become tax-reportable events, greatly magnifying investors' tax and recordkeeping burdens for only truly minimal changes in actual value. A stable $1.00 NAV also relieves investors of having to consider the timing of purchases and sales of shares of money market funds, as they must with floating NAV funds, to comply with the "wash sale rule."[6]

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[5] Some commentators point to equity funds, which at times have suffered significant losses but typically experienced only modest outflows, as examples of why floating money market funds NAVs would reduce systemic risk. It is misplaced to attribute this seemingly more stable behavior solely to the presence of floating NAVs. Investors in equity funds rationally expect the market value of the fund to fluctuate, perhaps widely at times, and as such are more apt to hold their fund shares in periods of market turmoil than investors in fixed-income funds.

[6] Under IRS rules, the so-called "wash sale rule" prevents investors from using losses on the sale of a security to offset gains if the sold security had been purchased within the previous 30 days or is repurchased within the next 30 days. Instead, losses on sales must be added to the basis of the replaced securities. The rule does not come into play with money market funds in their present form because money market funds have a stable NAV.

- *Accounting simplicity*: With a $1.00 stable NAV, money market funds qualify as "cash equivalents" under accounting standards. Because the NAV is fixed at $1.00, there is no need for investors to recognize gains or losses for financial accounting purposes. With a floating NAV, more complicated accounting standards would apply. Companies likely would have to reclassify their holdings of money market funds as "available-for-sale" and mark them to market on a daily basis. All investors, retail and institutional alike, would face the additional burdens of tracking the cost basis of their money market fund shares and matching purchases and redemptions in order to calculate gains and losses for tax and accounting purposes.

- *Operational convenience*: For corporations and bank sweep accounts, a stable share price for money market funds greatly simplifies operations because the $1.00 NAV is known in advance. It allows money market funds to offer their shareholders intra-day and same day settlement for wire transfers. Also, broker-dealers typically offer retail investors a range of features including ATM access, check writing, ACH, and Fedwire transfers. These features are generally provided only for accounts with a stable NAV.

- *Legal and other constraints*: Institutional investors often face legal or other constraints that preclude them from investing their cash balances in other than a stable NAV product. Most corporations have board-approved policies requiring them to invest operating cash balances only in cash pools that do not fluctuate in value. Indentures and other trust documents often authorize investments in money market funds because of their stable NAV. Many state laws and regulations also authorize municipalities, insurance companies, and other state regulated entities to invest in stable NAV funds.[7] Under a floating NAV, many corporations, trusts, and state and local governments would no longer be willing or able to use money market funds to help manage their cash.

III. Real-Time Public Disclosure of Market-Value Based Information

Another solution that some observers have suggested to help reduce systemic risk is to force money market funds to publicly disclose their market-based NAV per share ("shadow price") and/or the market-based prices of their portfolio securities on a real-time basis. These observers believe that this information would enable money market fund investors to understand the fund's exposure to distressed securities and the risk that the fund may be unable to maintain a $1.00 stable NAV. On the other hand, we believe that such disclosure would not be helpful to fund shareholders and could, in fact, introduce greater market instability.

Indeed, there is little evidence that requiring funds to disclose either shadow prices or market-based prices of portfolio securities would be informative. For example, a sample of shadow prices provided on a confidential basis to ICI by a number of the largest institutional money market funds

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[7] For a review of states specifying that money market funds are permissible investments, *see* MMWG Report, *supra* note 2 at Appendix D.

indicates that shadow prices deviated very little from $1.00 in the run-up to September 2008. Presumably, for these money market funds, the market-based prices of their underlying securities deviated little from amortized value, and thus, that information also would have been uninformative.

In addition, there is a significant risk that publishing the shadow prices and/or market-based prices for funds' portfolio securities could be destabilizing. Generally, these prices will deviate perceptively from their amortized values only during periods of severe market stress. Contrary to the belief that such information could help to reduce systemic risk, publishing such a deviation could potentially set off a surge in redemption requests at a time when the money market is already under duress and consequently, further intensify pressures on the market.

IV. Conclusion

ICI appreciates the Committee's attention to this important issue for money market funds, their shareholders, and our economy. We urge the Committee to carefully consider the implications of forcing money market funds to float their NAVs or requiring such funds to publicly disclose market-value based information on a real-time basis. Instead, we urge the Committee to consider other efforts to further strengthen money market funds. For example, ICI and its members have responded to an idea advanced by the Treasury Department's June 2009 white paper on financial regulatory reform, which called for exploring measures to require money market funds "to obtain access to reliable emergency liquidity facilities from private sources."[8] Indeed, ICI is moving forward rapidly to complete a blueprint for such a liquidity facility.[9]

We would be pleased to offer our assistance to the Committee as it considers recommendations to the Commission regarding the issue of a money market fund's NAV and other important initiatives relating to these funds. Please direct questions to Karrie McMillan, General Counsel, at 202-326-5815 or Jane Heinrichs, Senior Associate Counsel, at 202-371-5410.

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[8] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[9] This would be a state-chartered bank or trust company, organized and capitalized by the prime money market fund industry and managed and governed in accordance with applicable banking laws.