7. Recommendations

This Section of the Report lays out our recommendations. Many of these can be implemented voluntarily; some will require Securities and Exchange Commission (SEC) rulemaking. In developing these recommendations, the Working Group asked itself the question: Why did some money market funds survive the credit crisis relatively unscathed, while others had to enter into sponsor support or similar arrangements, find a buyer, or worse, in the case of Primary Fund, break a dollar?

The Working Group carefully examined the operations, practices, and decision-making of those money market funds that fared comparatively well during the credit crisis, in order to learn from those funds and to ensure that other money market funds will be held to those higher standards in the future. We also considered what could be improved—what lessons could be learned from the difficult experiences of the last 18 or so months.

Our recommendations seek to (1) respond directly to weaknesses in money market fund regulation that were revealed by the recent abnormal market climate; (2) identify potential areas for reform that, while not related to recent market events, are consistent with improving the safety and oversight of money market funds; and (3) provide the government detailed data to allow it to better discern trends and the role played by all institutional investors, including money market funds, in the overall money market, and invite greater surveillance of outlier performance of money market funds that may indicate riskier strategies. Our "lessons learned" and recommendations in response to those lessons are listed below:[133]

Lessons Learned	Recommendations
Liquidity: During extraordinary market conditions, money market funds' levels of liquidity may not be sufficient to meet redemption requests.	» Mandate liquidity by adding explicit minimum daily (5 percent) and weekly (20 percent) liquidity standards. » Mandate regular stress testing to assess a portfolio's ability to meet hypothesized levels of credit risk, shareholder redemptions, and interest rate changes.

[133] Unless defined in this Section of this Report, definitions of capitalized terms are found in paragraph (a) of Rule 2a-7.

Lessons Learned	Recommendations
Portfolio maturity: During extraordinary market conditions, some money market funds' average weighted maturities may have been too long.	» Reduce the current weighted average maturity (WAM) limitation for money market funds from 90 days to 75 days. » Create a new "spread WAM" that does not exceed 120 days.
Credit analysis: Credit analysis, and analysis of new structures, may be improved.	» Require that all money market fund advisers establish a "new products" or similar committee. » Encourage money market funds and their advisers to follow best practices for determining minimal credit risks. » Retain references to credit ratings in Rule 2a-7 as an important "floor" on investments. » Require advisers to money market funds to designate and publicly disclose a minimum of three credit rating agencies that the adviser will monitor, to encourage credit rating agencies to compete for this designation by improving their ratings systems for short-term debt.
Client risk: Some clients, whether due to high levels of concentration, lack of transparency, or high frequency of trades in search of yields, may pose risks to money market funds.	» Require advisers to adopt robust "know your client" procedures. » Require advisers to provide monthly website disclosure about client concentration levels and the risks, if any, that such concentration may pose to the fund.
Possibility of a "run": Money market funds must be better equipped to stop an incipient or ongoing run than the Investment Company Act of 1940 currently permits.	» Authorize a money market fund's board of directors to temporarily suspend redemptions and purchases of the fund for up to five days if a fund has either broken or reasonably believes it may be about to break a dollar. » Authorize a money market fund's board of directors to permanently suspend redemptions to allow all shareholders to be treated fairly after a fund determines to liquidate.

Lessons Learned	Recommendations
Investor/market confusion about money market funds: Many investors, despite disclosure to the contrary, believed that money market funds would always return principal in full; some press reports heightened market concerns by confusing products that appeared similar to money market funds, but did not comply with the specific risk-limiting provisions governing those funds, with money market funds.	» Reassess risk disclosure in prospectuses and marketing materials concerning the risks potentially posed by money market funds. » Require money market funds to provide monthly website disclosure of portfolio holdings. » Adopt a rule under the Investment Advisers Act of 1940 designed to reduce investor and market confusion about funds that appear to be similar to money market funds, but do not comply with the same risk-limiting provisions.
Government oversight: In monitoring the money market, the government needs detailed and timely information about all money market institutional investors, including money market funds.	» Develop a nonpublic reporting regime for all institutional investors in the money market, including money market funds. » Formalize an SEC program to monitor money market funds that, by category and excluding fees, have performance that clearly exceeds that of their peers during any month, to determine the reasons for such performance. Task SEC staff to similarly monitor another 10 randomly selected money market funds each month.
Government resources: Under existing SEC regulations, the SEC staff was required to provide individualized relief that became fairly standard, using valuable resources. The SEC also did not have timely information about certain types of sponsor support.	» Amend Rule 17a-9 under the Investment Company Act to allow a money market fund affiliate to purchase an Eligible Security from a fund. » Require nonpublic notice to the SEC of any affiliated purchase in reliance on Rule 17a-9.
Government programs: During these exigent market circumstances, the government had to intervene on a temporary basis to restore liquidity to the market, and instituted programs to benefit money market funds directly, and the markets in general.	» Extend the Treasury Department's Temporary Guarantee Program for Money Market Funds until it expires by its terms on September 18, 2009. » Delegate to SEC staff the ability to reinstate the amortized cost no-action letter if needed in the future.

Lessons Learned	Recommendations
Forward-looking enhancements: We identified two areas that many in the Working Group believe could be strengthened or modernized, even if the provisions in question did not play a role in the recent market volatility.	» Eliminate Second Tier Securities from the definition of an Eligible Security. » Amend Rule 2a-7 to modernize board responsibilities to reflect the appropriate oversight role of money market fund boards of directors.

The Working Group strongly believes that these recommendations, taken together, will make money market funds even more resilient in the worst market conditions. They will provide significant protections for money market fund investors, without exacerbating or creating risks for the money market.

7.1 Portfolio Liquidity Requirements

When the SEC first adopted Rule 2a-7, it observed that money market funds may "experience a greater and perhaps less predictable volume of redemption transactions than do other investment companies," and warned that "[b]y purchasing or otherwise acquiring illiquid instruments, a money market fund exposes itself to a risk that it will be unable to satisfy redemption requests promptly ...."[134] The rule, however, has never included any express requirement to maintain a specified level of liquidity. Instead, money market funds have been subject to the same general restriction on investing in "illiquid securities" as other mutual fund companies, except that while other mutual funds may invest up to 15 percent of their assets in illiquid securities, money market funds may not invest more than 10 percent of their assets in illiquid securities.[135]

Notwithstanding the absence of a regulatory requirement, until last year, money market funds never experienced problems in meeting redemption requests. This is attributable, in part, to the extremely liquid and deep markets for the low risk Eligible Securities permitted by Rule 2a-7. It also is attributable to the weighted average maturity (WAM) limit of 90 days because money market funds that invest in securities with maturities in excess of 90 days also must invest in shorter-term securities (typically overnight investments or weekly variable- or floating-rate obligations) to maintain a WAM of less than 90 days. As a result, a fund operating in compliance with the

[134] *See* Rule 2a-7 Adopting Release, *supra* note 40.

[135] For purposes of these limits, the SEC defines "illiquid" assets as those that "may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment." Investment Company Institute, "*Valuation and Liquidity Issues for Mutual Funds*" (February 1997) at 41 (*citing* Guide 4 to Form N-1A). Last year, the SEC proposed amendments to Rule 2a-7 that would establish a generalized requirement for money market fund portfolio liquidity. Under the proposed amendments, a money market fund must hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions in light of the fund's obligations under Section 22(e) of the Investment Company Act and any commitments the fund has made to its shareholders. In addition, the proposed amendments would expressly limit a money market fund's investments in illiquid securities to not more than 10 percent of its total assets. The proposing release states that the proposal is intended to codify the current standard established by the SEC in prior guidance regarding portfolio liquidity. *See References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Release No. IC-28327 (July 1, 2008), 73 FR 40124 (July 11, 2008) ("Rule 2a-7 NRSRO Release") at n.27, available on the SEC's website at http://sec.gov/rules/proposed/2008/ic-28327.pdf. For a discussion concerning the Institute's positions on this release, *see* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission (September 5, 2008) ("September 5 ICI Letter").

rule has significant cash flows from maturing investments and has the bulk of its portfolio invested in liquid securities.

Recent events plainly demonstrate, however, that sufficiently large forced sales of securities can disrupt any market, even the market for securities that qualify as Eligible Securities. The aftermath of the bankruptcy of Lehman Brothers Holdings, Inc. and the resulting market panic show that even money market funds cannot rely on access to market liquidity during times of extreme market stress, and should therefore be affirmatively required to maintain a minimum ready supply of cash to fund redemptions. To address the risk that market disruptions pose to liquidity, we offer three new liquidity recommendations, which we believe will dramatically strengthen the ability of money market funds to weather future market turmoil:

RECOMMENDATIONS:

- **The SEC should amend Rule 2a-7 to require taxable money market funds to meet a minimum daily liquidity standard such that 5 percent of the fund's assets would be held in securities accessible within one day.**
- **The SEC should amend Rule 2a-7 to require all money market funds to meet a minimum weekly liquidity standard such that 20 percent of the fund's assets would be held in securities accessible within seven days.**
- **The SEC should amend Rule 2a-7 to require all money market funds to regularly "stress test" their portfolios to assess a portfolio's ability to meet hypothesized levels of credit risk, shareholder redemptions, and interest rate changes.**

These requirements would bring an unprecedented level of regulation to money market fund liquidity in two respects. First, it would raise the standard for liquidity from market access (*i.e.*, the ability to sell a security within seven days) to contractual obligation (*i.e.*, the legal right to receive a security's face value within one or seven days). The current market access standard presupposes a willing buyer, which may not be found during adverse market conditions.[136] In contrast, a money market fund with a legal right to payment knows exactly who must make the payment, as well as how much will be paid and when.

Second, these requirements would specify the minimum amount of redemptions that a money market fund could make without having to sell portfolio securities. This should prevent money market funds from having to sell portfolio securities they otherwise may not seek to dispose of, perhaps realizing losses, as a result of significant redemptions. In addition, the requirements will give a money market fund's adviser more time to raise liquidity through more measured sales of portfolio securities, or to determine what other actions might be appropriate in the event of sustained redemptions.

[136] Money market funds would be permitted to use U.S. Treasury securities of any duration to meet either of these new requirements. The Treasury market has proven itself the most resilient during times of economic crisis, and was not significantly disrupted by the sale of Bear Stearns or Lehman's bankruptcy. Moreover, the Treasury market operates on a "cash settlement" basis, so trades settle the same day they are executed. We therefore recommend that all U.S. Treasury securities that are "Eligible Securities" under Rule 2a-7 be treated as a source of ready liquidity.

Imposing higher and more specific liquidity standards on money market funds will enhance investor confidence by assuring that the funds stand ready to meet significant redemptions without incurring losses that could affect the remaining shareholders.

7.1.1 Daily Liquidity Requirements

For taxable funds, we recommend that a minimum of 5 percent of the fund's assets be held in cash, U.S. Treasury securities, or other securities and repurchase agreements that mature, or are subject to a Demand Feature exercisable in one business day. This requirement would be calculated only when a security is purchased; however, should the disposition of a portfolio security or a large redemption cause a fund to fall below 5 percent (or any higher threshold amount as determined by the fund's adviser), the fund could only maintain cash or purchase U.S. Treasury securities and other securities or repurchase agreements that mature, or are subject to a Demand Feature exercisable, in one business day, until the 5 percent basket (or such higher threshold amount as determined by the fund's adviser) was replenished. We stress that the 5 percent requirement is merely a "floor" that may not always be adequate, as determined by a particular fund's liquidity needs, including its client base and portfolio holdings. Also, during periods of higher market volatility or limited liquidity, funds may find it prudent to hold a greater percentage of their assets in cash or securities that provide daily liquidity. As part of this requirement, we further recommend that a senior portfolio management person, as part of his or her responsibilities, monitor the adequacy of the liquidity thresholds set by the fund's adviser and that the adviser's or the fund's chief compliance officer (CCO)[137] or chief risk management officer (or similar person), as part of his or her responsibilities, monitor compliance with those thresholds.

On the other hand, we do not recommend at this time that daily liquidity standards be applied to Tax Exempt Funds because the supply of daily liquidity tax-exempt securities is limited. Historically, municipalities have shown limited interest in issuing one-day demand obligations; daily tax-exempt securities consist entirely of variable rate demand notes or specifically structured products. The liquidity facilities required for these and other structured tax-exempt products have proven to be in short supply. As a result, Tax Exempt Funds maintain a large amount of their portfolios in seven-day demand instruments.

7.1.2 Weekly Liquidity Requirements

For all money market funds, we recommend that at least 20 percent of the fund's assets be held in cash, U.S. Treasury securities, direct fixed-rate obligations of the U.S. government or its agencies originally issued with a maturity of 95 days or less, or securities that mature, or are subject to a Demand Feature exercisable, in seven business days. This requirement also only applies when a security is purchased and would not be violated if the liquidity position were used to meet a redemption that caused the fund to fall below the 20 percent threshold (or such higher threshold amount as determined by the fund's adviser). Similar to the daily requirement for taxable

[137] Rule 38a-1 under the Investment Company Act requires that boards of directors of registered investment companies, including money market funds, appoint a CCO with responsibility and authority to develop, administer, and enforce appropriate compliance policy and procedures for the fund.

funds, however, a fund could only maintain cash, purchase U.S. Treasury securities, direct fixed-rate obligations of the U.S. government or its agencies originally issued with a maturity of 95 days or less, or securities that mature, or are subject to a Demand Feature exercisable, in seven business days, until the 20 percent basket (or higher amount) was replenished. We stress again that the 20 percent requirement is merely a "floor" that may not always be adequate, as determined by a particular fund's liquidity needs or the general market conditions. Similar to the daily liquidity threshold requirements, a senior portfolio management person, as part of his or her responsibilities, would monitor the adequacy of the weekly liquidity threshold, and the adviser's or the fund's CCO or chief risk management officer (or similar person) would monitor the thresholds for weekly liquidity set by the fund's adviser.

7.1.3 Stress Testing

In addition to the minimum liquidity requirements discussed above, we recommend that Rule 2a-7 require money market funds to adopt and implement written procedures, approved by the fund's board of directors, requiring a fund's adviser to conduct regular portfolio analysis that incorporates stress testing. Stress testing is evidenced in other non-U.S. regulatory regimes.[138] This stress testing should evaluate various market scenarios as determined by the fund's adviser to determine the portfolio's ability to meet hypothesized levels of credit risk, shareholder redemptions, and interest rate risk. For example, a stress test could provide insight into the impact of market dislocations, compounded with shareholder redemptions, on the market value of a portfolio's holdings. Non-U.S. guidance on stress testing suggests that there are other approaches that could be considered too.[139]

We believe a formal stress test requirement is an imperative component of a money market fund's overall risk management. Further, the trend evidenced in other jurisdictions to use stress testing adds additional support to the validity of incorporating such testing into U.S standards. Based upon the results of stress testing, a money market fund's adviser may need to adjust the liquidity thresholds discussed above. As part of this requirement, the adviser's or the fund's CCO or chief risk management officer (or similar person), as part of his or her responsibilities, should monitor compliance with the written procedures.

[138] For example, under the Irish regulations, certain money funds using amortized cost valuation are expected to engage in monthly portfolio analysis incorporating stress testing to examine returns under different market scenarios. *See* Appendix H.

[139] In February 2009, the Institutional Money Market Funds Association (IMMFA) issued guidance on generic stress testing for its members, citing the trend of regulators to require, or rely on, such analysis. The guidance generally addresses stress testing for: (1) credit risk, including individual asset events, such as a downgrade, and systemic widening of credit spreads; (2) interest rate risk on assets as well as the overall fund, considering a variety of movements (*e.g.*, parallel shifts, yield curve flattening, steepening, and twists); (3) liquidity risk, as affected by the volume of redemption requests; and (4) combined stresses, meaning the possibility of the positive correlation of risks, including a perfectly correlated risk event.

7.2 Portfolio Maturity

Money market funds currently must comply with a portfolio maturity test that is designed to limit a fund's sensitivity to interest rate changes, and that provides that the portfolio's WAM cannot exceed 90 days. We suggest that this period be shortened to 75 days to further protect against interest rate risk. We also suggest a new additional test of a fund's "spread WAM," which calculates a fund's WAM using a more conservative measurement methodology. The Working Group believes these tests will be far more effective than the single, and longer, WAM test currently required.

RECOMMENDATIONS:

- **The SEC should amend Rule 2a-7 to reduce the weighted average maturity limitation for money market funds from 90 days to 75 days.**
- **The SEC should amend Rule 2a-7 to require money market funds to maintain a new "spread WAM" that does not exceed 120 days.**

7.2.1 Portfolio Maturity Limits That Address Interest Rate Risk

Weighted average maturity limits are designed to ensure that a money market fund's overall sensitivity to changing interest rates does not jeopardize its ability to maintain a stable NAV. Rule 2a-7 currently requires all money market funds to maintain a WAM that does not exceed 90 days. Under the rule, the maturity of a portfolio security is deemed to be the period remaining until the date on which, in accordance with the terms of the security, the principal amount must unconditionally be paid, or, in the case of a security called for a redemption, the date on which the redemption payment must be made.

The rule includes exceptions to this general approach for specific types of securities, referred to as the "maturity shortening provisions." First, a fund may treat a variable- or floating-rate obligation (collectively, "VROs") with a stated maturity of 397 days or less as having a maturity equal to the time remaining until the next interest rate reset, rather than the time remaining before the principal value of the security must unconditionally be repaid. Second, a fund may treat a Government Agency VRO as having a maturity equal to the time remaining until the next interest rate reset, regardless of its stated maturity. Third, if a VRO with a stated maturity of 397 days or less is subject to a Demand Feature, a fund may treat the VRO as having a maturity equal to the time remaining until it could recover the principal by exercising the Demand Feature or the time remaining until the next interest rate reset, whichever is shorter. Finally, if a VRO with a stated maturity of more than 397 days is subject to a Demand Feature, a fund may treat the VRO as having a maturity equal to the time remaining until it could recover the principal by exercising the Demand Feature or the time remaining until the next interest rate reset, whichever is longer.

We believe it would be appropriate to further decrease the exposure of money market fund investors to interest rate risks. We therefore recommend that a fund's WAM limitation under Rule 2a-7 be reduced from 90 days to 75 days. A shorter WAM should reduce the effect that interest rate movements could have on a fund's NAV. We believe that 75 days is a prudent limit to reduce the interest rate risk without significantly impairing portfolio flexibility. We note that many funds already limit their maturities to an even greater extent than this new limit to receive a triple-A rating from an NRSRO, or when market conditions suggest a more conservative limit is appropriate.

7.2.2 Portfolio Maturity Limits That Address Spread Risks

Although not required by Rule 2a-7, many money market fund advisers also measure their fund's WAM using a strict calculation that does not permit the use of interest rate reset dates and instead only uses a security's stated (legal) final maturity date or Demand Feature to measure maturity. (We are calling this concept a "spread WAM"). This helps to limit the effect of changes in interest rate spreads (*i.e.*, the additional yield paid on a security above the risk-free rate of return) on their funds' portfolios. For example, the price of a VRO with a stated maturity of one year but whose interest rate adjusts every three months would be expected to fall more in response to a widening of credit spreads than a comparably rated instrument with a stated maturity of three months. The traditional WAM measure currently mandated by Rule 2a-7 would treat the two securities equally. In contrast, the spread WAM would treat the VRO as more price sensitive because of its longer maturity.

The difference between the WAM calculation currently required by Rule 2a-7 and the spread WAM is that VROs would not be treated as maturing on the date of their next interest rate adjustment. Although variable and floating interest rates provide a reasonable means of protecting a money market fund against changes in interest rates, they do not necessarily protect a fund against the need to liquidate securities in the face of redemptions.[140] Securities that are generally subject to a Demand Feature would still be treated as having a shortened maturity (based on the Demand Feature) for purposes of calculating the spread WAM.

Based on the above rationale, for each instrument in a fund, a spread WAM would be calculated as follows:

- If the instrument is not subject to a Demand Feature, the credit maturity date is equal to the stated (final) maturity date. For example, a floating-rate instrument with a final maturity of one year has a maturity of one year, regardless of how frequently the floating rate is reset.
- If the instrument is subject to a Demand Feature, the credit maturity date is equal to the lesser of (a) the stated (final) maturity date or (b) the latest date on which principal and accrued interest would be due following exercise of a Demand Feature. For example, a one-year master note with a rolling seven-day Demand Feature has a credit maturity of seven days during most of its life in the fund.

[140] Given that interest rate spreads may change based on market factors other than credit risks, the Working Group proposes that all money market funds comply with the 120-day spread WAM limitation, even if they invest primarily in Government Securities.

» After maturities are established for all instruments in the fund, an asset-weighted average (using amortized cost as the asset weight based on net assets) is calculated to get the fund's spread WAM.

The following example demonstrates how the two WAM measures differ:

Portfolio Composition:

» 50 percent of Portfolio: Overnight Government Agency discount notes.

» 50 Percent of Portfolio: Two Year Government Agency VROs that reset daily based on effective federal funds rate.

WAM Calculation:

If the WAM uses reset dates in its calculation as is currently provided by Rule 2a-7, the portfolio has a WAM of one day. In contrast, by applying a spread WAM calculation that does not recognize reset dates, the portfolio has a WAM of 365.5 days, far longer than the 120-day limit we are proposing. A fund subject to a 120-day spread WAM limit could not have invested more than 16 percent of its portfolio in two year Government Agency VROs (assuming the balance of the fund was invested in overnight obligations).

Advisers that utilize a spread WAM believe that this metric provides an additional layer of protection for their funds and shareholders in volatile markets. The Working Group therefore recommends that Rule 2a-7 be amended to require all money market funds maintain a spread WAM that does not exceed 120 days. We believe this new requirement will help provide money market fund shareholders with additional safeguards by ensuring that funds can maintain stability of principal with a high degree of confidence, even during periods of extreme market volatility. We further believe the 120-day limit is flexible enough during "normal" market conditions to continue to allow funds to differentiate themselves through yield and performance, as appropriate.

7.3 Enhance Credit Analysis

The financial market crisis, with its roots in subprime mortgages, demonstrated that new and complex structures demand analysis that extends well beyond that of their issuers' creditworthiness. The success of money market funds depends upon thorough credit review processes, and our recommendations seek to institutionalize those industry best practices.

In the Working Group's judgment, credit rating agencies, notwithstanding their obvious failings, do provide an important "floor" for Rule 2a-7, below which no money market fund may invest. We believe that retaining this requirement as part of a more thorough credit analysis will help ensure that money market funds do not take imprudent risks. Finally, we believe that credit rating agencies' operations can be greatly improved. In addition to supporting those agencies' and the SEC's reform efforts, we recommend that money market funds be required to designate publicly a minimum of three credit rating agencies (*i.e.,* NRSROs) that they will monitor; the

Working Group proposes this change to encourage rating agencies seeking to be chosen for this designation to improve their short-term ratings processes. These recommendations are discussed in more detail below.

RECOMMENDATIONS:

- **The SEC should amend Rule 2a-7 to require money market fund advisers to establish a "new products" or similar committee that would review and approve new structures prior to investment by their funds.**
- **Money market fund advisers should consider and when appropriate, follow best practices in connection with minimal credit risk determinations.**
- **The SEC should retain references to NRSROs in Rule 2a-7 as an important "floor" on permissible investments.**
- **The SEC should amend Rule 2a-7 to require money market fund advisers to designate and publicly disclose, pursuant to procedures approved by the fund's board of directors, a minimum of three NRSROs that the fund's adviser will monitor for purposes of determining Eligibility of portfolio securities.**

7.3.1 New Products Committee

Beginning in the summer of 2007, market-based liquidity for some money market fund assets proved to be unreliable. Complex, derivative securities that met the criteria to be Eligible Securities, such as collateralized debt obligations and structured investment vehicles (SIVs), were designed in low-volatility environments using assumptions regarding the value of the underlying assets that turned out to be wrong as the subprime market shifted. Indeed, despite being Eligible Securities under Rule 2a-7, some of these structures have since raised significant issues for money market funds or other investment vehicles that seek to preserve principal and provide shareholders with ready access to liquidity. In fact, many money market fund sponsors either purchased the structures from, or entered into credit support arrangements with, their affiliated funds in order to maintain the funds' stable share price of $1.00.

As a result of money market funds' experiences with SIVs and other complex structures, and in a further effort to improve the process by which money market funds select potential investments, the Working Group recommends that Rule 2a-7 be amended to require money market fund advisers to establish a "new products" committee or similar group that would review and approve novel securities, credit structures, or investment techniques prior to investment by their funds. The committee, which could be part of a broader group charged with maintaining a formal process for reviewing new or complex securities for all types of funds, or part of a risk management function, would meet periodically to evaluate each new product or structure from a market, counterparty, securities regulatory, disclosure, tax, accounting, and operational perspective. In particular, the committee would provide an assessment of whether a security that is otherwise Eligible under Rule 2a-7 is also

an appropriate investment for a money market fund and consistent with the fund's objective of maintaining a stable NAV per share. In addition, the committee should periodically reevaluate new products and structures previously approved to ensure that they are operating in a manner consistent with the committee's original consideration and approval. While the role and structure of the committee should be tailored for the adviser's particular circumstances, risk profile, and client base, at a minimum, we believe the committee should include, in addition to senior investment professionals, the fund's CCO and a senior executive of the adviser to ensure the appropriate, risk-limiting tone from the top.

7.3.2 Minimal Credit Risks

Rule 2a-7 requires a money market fund's board (or its delegate, which is usually the fund's investment adviser) to evaluate independently the credit quality of each portfolio investment and determine that each investment presents minimal credit risks. As the SEC stated when it adopted Rule 2a-7, an instrument must be evaluated for the credit risks that it presents to the particular fund at that time (*i.e.*, time of acquisition) in light of the risks attendant to the use of amortized cost valuation or penny rounding.[141] We continue to believe that this requirement is critical for a money market fund to meet its objective of maintaining a stable NAV per share and providing appropriate liquidity to shareholders.

Under the rule, any determination of minimal credit risks "must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO." Although the text of the rule does not identify what additional factors should be considered in determining minimal credit risks, the SEC in the past has provided some guidance in this regard.[142] The money market, however, has changed significantly since this guidance was issued. Changes in the marketplace, along with the experience of money market funds through the recent market turmoil, suggest improved ways in which minimal credit risk determinations could be made. As a result, after considering a variety of practices successfully employed by various money market funds, we have provided in Appendix I industry best practices that we recommend for consideration by any money market fund board, or any adviser that has accepted responsibility for making such determinations under Rule 2a-7.

We stress that every recommendation may not be suitable for every adviser, depending on the details of the adviser's organization or investment process. Rather, the guidance provides a process that advisers may consider when evaluating credit risks of issuers, types of securities, or credit enhancements.

[141] *See* Rule 2a-7 Adopting Release, *supra* note 40. *See also* Appendix F for a history of the minimal credit risk requirement.

[142] *See Investment Company Institute*, SEC No-Action Letter (pub. avail. December 6, 1989); Letter to Investment Company Registrants from SEC staff (pub. avail. May 8, 1990).

7.3.3 Credit Ratings Requirement

The SEC has proposed to eliminate all references to NRSRO ratings from Rule 2a-7 and replace them with a new subjective standard for evaluating and monitoring securities under the rule.[143] In our view, NRSRO ratings play a very important role under Rule 2a-7 by providing a "clear reference point" for money market funds. By acting as a floor, the rating requirement serves to keep all money market funds operating at or above the same level and constrains any money market fund from taking imprudent risks to increase yield. They also discourage funds from "stretching" the minimal credit risk concept to include investment opportunities that do not have a "high quality" rating and that could prove to be imprudent in light of the fund's objective of maintaining a stable NAV.

As the rule's regulatory history demonstrates, NRSRO ratings are only one factor to be considered.[144] As discussed above, a money market fund's board (or its delegate) also must affirmatively determine that each security purchased presents minimal credit risks. Indeed, members of the Working Group and other Institute members have confirmed that they use NRSRO ratings as a critical baseline from which to start their own internal credit review process. By eliminating the ratings' floor, the SEC would remove an important investor protection from Rule 2a-7, introduce new uncertainties and risks, and abandon a regulatory framework that has proven to be highly successful.

We note that the SEC has adopted rules to improve the process by which rating agencies operate and has proposed others.[145] Other countries are considering reforms as well. Reforms of this nature will increase the usefulness, credibility, and reliability of ratings. For its part, as noted above, the Working Group is recommending a set of best practices for making minimal credit risk determinations. Together with the SEC's efforts to address weaknesses in the rating process and to improve regulatory oversight of NRSROs, these efforts should further improve the quality of credit analyses undertaken both by NRSROs and independently by money market funds.

[143] *See* Rule 2a-7 NRSRO Release, *supra* note 135.

[144] *See* Appendix E.

[145] *See Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-59342 (February 2, 2009), 74 FR 6456 (February 9, 2009) (adopting rule amendments that impose additional requirements on NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies); *see also Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-59343 (February 2, 2009), 74 FR 6485 (February 9, 2009) (proposing rule amendments that would (1) require the public disclosure of credit rating histories for all outstanding issuer-paid credit ratings issued by an NRSRO and (2) prohibit an NRSRO from issuing an issuer-paid rating for a structured finance product unless the information about the product provided to the NRSRO to determine the rating and, thereafter, to monitor the rating, is made available to other NRSROs). For a discussion concerning the Institute's positions on proposed rules to improve the operations of NRSROs, *see* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission (July 25, 2008). The SEC also has announced that it will hold a Roundtable to examine the oversight of credit rating agencies, to be held on April 15, 2009. *See* Press Release, Securities and Exchange Commission, SEC Roundtable to Examine Oversight of Credit Rating Agencies (March 6, 2009), available at: http://www.sec.gov/news/press/2009/2009-46.htm.

7.3.4 Designated NRSROs

Rule 2a-7 requires money market funds to take certain actions if a security is downgraded by an NRSRO. Moreover, if a money market fund's adviser becomes aware that any NRSRO has rated a security below its second-highest rating category, the fund's board (or its delegate) must promptly reassess whether to continue to hold the security.

We recommend instead that Rule 2a-7 be amended to require that fund advisers designate and disclose to shareholders (*e.g.*, via a fund's prospectus or website), pursuant to procedures approved by the fund's board, a minimum of three NRSROs that the fund's adviser would monitor for purposes of determining eligibility of portfolio securities under the rule. We believe that requiring an adviser to monitor at least three NRSROs will encourage competition among the NRSROs to achieve this designation. We also believe that by committing themselves to particular rating agencies, money market funds will have consistency in the NRSROs that they look to for purposes of Rule 2a-7.[146] As part of this recommendation, we also encourage members of the NRSRO community that wish to be among those commonly followed to expand their expertise in rating short-term instruments and to identify which short-term ratings correspond to the NRSRO's "highest category." This could help reduce the current uncertainty surrounding the short-term credit rating categories of various NRSROs.[147]

7.4 Assessment of Client Risk

A money market fund's ability to maintain sufficient liquidity is closely related to the composition and diversification of its shareholder base. Unexpected large redemptions can have a direct influence on a fund's NAV because during a declining or a frozen market, those redemptions could result in forced sales at prices that are less than what the fund would recover if it held the securities to maturity. In particular, funds with a concentrated shareholder base or a new shareholder base with uncertain liquidity requirements may need to take a more conservative approach with regard to the WAM test and liquidity than suggested by our recommendations. Such funds should be aware of the possible impact of a large redemption by one or more major shareholders and its potential risk to the fund's ability to meet other redemption requests and maintain a stable NAV. On the other hand, funds with more stable or predictable cash flows, such as funds with large numbers of retail investors or funds with large numbers of diverse institutional shareholders, may be less exposed to such risk and need to manage their portfolio accordingly.

[146] The SEC had estimated that approximately 30 credit rating agencies will register as NRSROs under the regulatory structure established in 2007. Credit rating agencies that specialize in rating particular types of structured products or that utilize new methods of rating products also are expected to register as NRSROs. *See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organization*, SEC Release No. 34-55857 (June 5, 2007), 72 FR 33564 (June 18, 2007).

[147] For instance, DBRS, Inc., defines securities with any level of an R-2 rating as having "adequate" credit quality, while securities with an R-1 (low) rating are defined as having "satisfactory" credit quality. In comparison, both Standard and Poor's (S&P) and Fitch Ratings (Fitch) use "satisfactory" to define their second-highest short-term rating categories and "adequate" to define their third-highest short-term rating categories. Thus, securities that could only obtain the third-highest short-term rating from S&P and Fitch could nevertheless become an Eligible Security based on the DBRS rating.

RECOMMENDATIONS:

- **The SEC should require that money market funds develop procedures for admitting shareholders to their funds to ensure, to the extent possible, that funds either (1) understand the expected redemption practices and liquidity needs of those investors or (2) when such information is not available, mitigate possible adverse effects that may result from such unpredictability.**
- **The SEC should require money market funds to post monthly website disclosures of client concentration levels by type of client and the risks that such concentration, if any, may pose to the fund.**

7.4.1 Shareholder Due Diligence/Know Your Client Procedures

Although there is no "right" level of client concentration appropriate for every fund, a robust shareholder due diligence/know your client process can mitigate the risk to a fund that its liquidity levels are insufficient for its client base. Specifically, the process of developing a relationship with a client is an important step in controlling that risk to a fund. The Working Group therefore recommends that the SEC require money market funds to have procedures reasonably designed to evaluate new, and periodically re-evaluate existing, clients. The purpose of these procedures would be to seek to identify (and perhaps exclude) those shareholders with frequent investment activities in search of yield (sometimes referred to as "hot money"), or whose actions otherwise may pose a higher degree of risk to a particular money market fund, based on its structure and operations. This may be accomplished in a variety of ways, including:

- Understanding the client's time horizon for investing in the money market fund;
- Setting a maximum target percentage that any one client or type of client can hold of a fund;
- Evaluating the level of transparency that a portal or similar trading platform may provide;
- Understanding the client's business and liquidity needs (*e.g.*, through a review of trading patterns or its practice of notifying and of adhering to schedules of redemptions [*e.g.*, payroll deductions on the 15th and 30th of each month]);
- Seeking to determine whether there are identifiable economic, operational, or systemic trigger events that likely would cause a client to redeem shares;[148]
- Meeting the client, visiting its business locations, or conducting frequent contacts through telephone or email;
- Reviewing client documentation; and/or
- Performing ongoing monitoring of client activity.

[148] For example, some institutional investors limit their holdings to a maximum percentage of a money market fund's outstanding shares. If net redemptions of one fund cause these institutional investors' holdings to exceed their internal maximum percentage, their policies may require them to redeem sufficient shares to bring their holdings under the limit. If a money market fund has a number of institutional investors subject to such limitations, significant redemptions by one institution could trigger redemptions by the other institutions, leading to a continuing cycle of redemptions.

In particular, funds should consider the various risk levels of shareholders that are omnibus accounts, external direct clients, or internal accounts or cash sweeps from other lines of business of the fund sponsor. Funds also should look closely at the shareholders' use of portals (especially those portals that do not provide funds with the identities of the underlying users) or other third-party distribution methods, because the intentions of the shareholders using the portal may be unclear. In addition, a fund may wish to consider the proportion of retail versus institutional investors (to the extent distinguishable).[149] Finally, the results of the stress testing previously recommended in this Report should be evaluated to determine whether the fund's actual shareholder concentration levels match its portfolio's liquidity under various tested scenarios. Our recommendation is designed to encourage money market fund advisers to take a more active role in their assessment of clients as a means of identifying (or excluding) those shareholders that could be detrimental to their funds, and adjusting their liquidity needs accordingly.

We further recommend that money market funds consider adopting maximum target percentage levels for individual clients, types of clients, or both. Funds also should have a mechanism in their procedures to address situations in which a client inadvertently exceeds a target because of developments outside the fund's control—for example, if the fund experiences redemptions that cause remaining shareholder concentrations to rise beyond what would have been permitted under the procedures for new purchases. A fund should discuss with its board of directors on a periodic basis the risks that some members of the fund's client base may pose to other shareholders.

7.4.2 Website Disclosure of Client Concentration

As previously discussed, under certain circumstances, high client concentrations can pose risks to a money market fund's stability. Investors and their advisers may wish to assess these risks by evaluating a fund's client profile. Just as there likely is no "right" level of client concentration appropriate for every fund, different investors may have different tolerances for the risks of other clients' behaviors. Therefore, rather than mandating a particular maximum level of concentration, the Working Group believes that monthly website disclosure of client concentration, by categories of investor type, will alert investors and third-party commentators to the potential risks that particular types of investors may pose to the fund.

Some types of investors, such as street name accounts, omnibus accounts, and non-transparent portals, do not provide a fund manager with much (or any) transparency about the intentions of the various participants in that account. In those instances, we anticipate that the fund would disclose the percentage of its portfolio held

[149] On the other hand, as discussed in Section 8, we are not recommending that funds be required to split their institutional and retail clients into two separate funds or definitively categorize each client into these two buckets. We do not believe that such distinctions can easily be made from a regulatory standpoint. For example, is a broker-dealer sweep account, whose underlying account holders are retail customers, but that operates through a single decision maker, an institutional client or a retail client?

by street name accounts, omnibus accounts, non-transparent portals or similar investors.[150] We also expect that money market funds would include a discussion of the potential risks, if any, their client base may pose to the fund. This disclosure would alert the public to the size of potential clients with whom the fund sponsor would have little or no relationship. To assist with comparability among funds, we look forward to working with the SEC to develop the format that this disclosure should take, and the methodology to be used to determine how to categorize clients.[151]

7.5 Addressing the Possibility of a "Run"

In evaluating how to stem a run on a fund, we looked at other models, particularly those of offshore funds, to determine whether there are useful tools that could assist a money market fund adviser when faced with heavy redemptions. 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 any incipient run on a fund.

For example, in Europe, advisers have provided liquidity through actions such as purchases of assets and guarantees[152] without the need for regulatory approval, as is generally the case in the United States.[153] In addition, a manager of a UCITS fund[154] generally has the ability, as provided in the fund's governing documents, to temporarily suspend purchases and redemptions in exceptional cases and when the suspension is in the interests of shareholders.[155] This action has in fact been recently utilized by European funds, including by European money funds. Similarly, in Australia, the governing documents of a registered investment fund set out the circumstances when redemptions may be limited or suspended or when the period of time for satisfying

[150] In master-feeder fund situations, for example, one feeder may only have information about that feeder's investors, but not about the investors in other funds feeding into the master. A master-feeder fund is a two-tier structure—a "master fund" that invests in a specified range of portfolio securities consistent with its stated objectives, and one or more "feeder funds" that have investment objectives identical to the master, and that invest exclusively in shares of the master fund. The feeder funds offer their shares to investors and impose individualized administrative, distribution and/or other fees and services appropriate for the targeted shareholder base. In such instances, we would expect the feeder not only to disclose its own client concentrations, but also to disclose the percentage that it represents of the master fund, and that the actions of investors in the other feeders could have a detrimental effect on the master fund, and so also on the feeder. In time, in response to competitive pressures, some master funds may require all feeders to agree to share with each other client concentration data in order to provide investors with a clearer picture of the potential risks of the fund.

[151] In addition, we recommend that this disclosure be designed to respect the privacy expectations of clients. If this disclosure requirement is adopted, we also recommend that the SEC eliminate the current requirement in Form N-1A that a money market fund must disclose all 5 percent shareholders in the fund's Statement of Additional Information.

[152] *See* Baptiste Aboulian, "Money Market Funds Under Watch," *Ignites Europe* (October 6, 2008) (noting that fund sponsors have provided liquidity by buying assets at face value, providing guarantees on assets in trouble, and, in the case of massive redemptions, parents have provided liquidity in various forms such as redeeming the asset, providing cash, or investing in the fund themselves).

[153] *See Protecting Investors: A Half Century of Investment Company Regulation*, Securities and Exchange Commission, Division of Investment Management (1992) at 203 (noting that most European Union (EU) member states do not prohibit transactions between a fund and an affiliate but instead rely on a fund's depositary to prevent abuses that may arise from affiliated transactions).

[154] A major category of mutual funds domiciled in the EU is composed of undertakings for collective investment in transferable securities (UCITS). UCITS are established under national regulations implementing the EU's UCITS Directives. The UCITS regulations include general requirements in areas such as disclosure, diversification, concentration, and permissible investments. UCITS regulations are not specific to money market funds; rather, the regulations cover all types of open-end collective investment funds.

[155] *See* Article 37 of the UCITS Directive (85/611/EEC), available at http://eurlex.europa.eu/LexUriServ/Lex UriServ.do?uri=CONSLEG:1985L0611:20050413:EN:PDF.

a redemption request may be extended.[156] In response to the recent market turmoil, France approved a measure in December 2008 that allows funds, under exceptional circumstances, to create a side pocket fund to spin off identified assets that would not be in the interest of investors to sell, *e.g.*, for illiquidity reasons.[157] Examples of actions described in a UCITS prospectus that may be taken include the following:

- So-called "gating provisions" that limit redemptions—for example, in any one day, no more than 10 percent of the total value of a fund may be redeemed, and any redemption requests in excess of 10 percent would be deferred to the next business day and valued on that next business day;
- Extending the payment of redemption proceeds to a time not to exceed, for example, 30 business days during exceptional circumstances, including when the liquidity of the fund is not sufficient to meet the redemption request; and/or
- Temporarily suspending redemptions and deferring the calculation of the fund's NAV, during exceptional circumstances and when such an action is in the interests of shareholders.

These actions typically do not require prior regulatory approval, although regulators may need to be notified of the action. The circumstances must be exceptional, and a dominant principle guiding a manager's decision, or a board's approval if necessary, to invoke such provisions is the responsibility to consider the interests of the fund's shareholders, including weighing the interests of remaining shareholders against the actions of redeeming shareholders.[158]

We believe, and discussions with investors confirm, that these types of provisions generally may be perceived as placing too much discretion with the adviser and would not be widely accepted by U.S. money market fund investors. Further, we believe that even if such provisions should become available, the decision to exercise these rights must be exercised by the fund's board of directors, and particularly the fund's independent board members.

Instead, we put forth two recommendations, discussed below, designed to allow a money market fund's board of directors (or a committee thereof) to act quickly in response to unusually severe redemption requests to ensure fair treatment of all money market fund shareholders.

[156] *See* Appendix H.

[157] *Id*.

[158] *See, e.g.,* Autorité des marchés financiers Recommendations For Management Companies Managing French Funds that May Be Affected by the Madoff Affair (December 17, 2008) (noting actions to be considered by management companies and consideration of interests of remaining shareholders); September 2008 Lehman Brothers Press Release, *supra* note 122 (noting suspension of redemptions as a protective action in the best interests of shareholders); January 2009 Lehman Brothers Press Release, *supra* note 124 (lifting suspension with right to impose a gate limiting the aggregate amount of redemptions). *See also* Speech, "Current Regulatory Challenges: an Update from the FSA," Dan Waters, UK Financial Services Authority (FSA) (January 24, 2008) (noting that with respect to redemption issues arising from liquidity difficulties in the property fund sector (non-UCITS funds), the FSA's major consideration is to ensure customers are treated fairly; that is, that the interests of redeeming shareholders are balanced against those remaining in the fund).

RECOMMENDATIONS:

- **A money market fund's board of directors, including the fund's independent directors, or a committee thereof, under exigent circumstances should have the authority to suspend redemptions and purchases by the fund for a period of five business days in order to seek a "cure" for a fund that has either broken or reasonably believes it may be about to break a dollar. During that time, the fund could either seek credit support or otherwise address the NAV, or determine to permanently suspend redemptions and liquidate the fund. The fund should be required to provide prompt, nonpublic notice to the SEC staff when making this election.**
- **The SEC, prior to the expiration of Rule 22e-3T under the Investment Company Act of 1940, which permits a money market fund to suspend redemptions upon liquidation pursuant to the Treasury Department's Temporary Guarantee Program for Money Market Funds, should adopt a similar rule that is available to all money market funds preparing to liquidate. Within five business days of announcing a suspension and liquidation, the fund's board must approve and the fund must announce to shareholders its plan of liquidation.**

7.5.1 Authority to Temporarily Suspend Redemptions

The requirement to treat all fund shareholders fairly is one of the most significant underpinnings of the Investment Company Act of 1940 (Investment Company Act), and has been paramount in retaining investors' trust for almost 70 years. When drafting the Investment Company Act, David Schenker, who led the Investment Trust Study that was the foundation of the original Act, testified about past abuses when sponsors of mutual funds would suspend redemptions without clear disclosure to investors, in order to lock the investors in the fund to increase management fees. As Mr. Schenker noted, these were abusive practices clearly motivated by a conflict of interest. Mr. Schenker also stated, however, that "we are not prepared to say to this committee that you ought to prohibit the suspension [of redemptions]. You can never tell whether an emergency may arise. Suppose war is declared, with the result that the stock market 'fell out of bed' and you had a tremendous 'run.'"[159] When a run occurs, little time is available to obtain regulatory relief to suspend redemptions, and so the requirement to treat all investors fairly can be difficult to achieve.[160]

[159] Investment Trusts and Investment Companies: Hearings on S. 3580 before the Subcommittee of the Senate Committee On Banking and Currency, 76th Cong., 3d Sess. 291 (1940) ("1940 Hearings").

[160] As the credit market crisis began to unfold, ICI and its money market fund members developed a "checklist" of actions a fund should consider taking in the event a money market fund broke a dollar. *See* Appendix J for a copy of that checklist.

Section 22(c) of the Investment Company Act and Rule 22c-1 thereunder impose certain requirements for the daily pricing of redeemable securities offered by funds.[161] Section 22(e) of the Investment Company Act currently provides that a registered investment company may not suspend the right of redemption or postpone the date of repayment or satisfaction upon redemption of any redeemable securities for more than seven days, except:

- For any period (1) during which the New York Stock Exchange is closed other than customary weekend or holiday closings; or (2) during which trading on the NYSE is restricted;
- For any period during which an emergency exists as a result of which (1) disposal by the company of securities owned by it is not reasonably practicable or (2) it is not reasonably practicable for such company fairly to determine the value of its net assets; or
- For such other periods as the SEC may by order permit for the protection of security holders of the company.

The Section further states that the SEC shall "by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection."

To date, the only rule adopted by the SEC under its authority to define an "emergency" is Rule 22e-3T, a temporary exclusion for liquidation of certain money market funds.[162] This Rule, discussed in more detail below, was adopted in response to the Treasury Department's Temporary Guarantee Program for Money Market Funds (Treasury Guarantee Program), and will expire once that program terminates.

On rare occasions, the SEC has granted relief, either under Rule 22c-1 or Section 22(e), to funds experiencing "emergency situations" that make it difficult to calculate their NAVs in order to meet purchase or redemption requests. Snowstorms, power outages and similar events fall into this category.

These provisions, originally designed to ensure that investors are treated fairly, can have the opposite effect when markets are so frozen that redeemability is severely impaired. As squarely demonstrated by shareholders' experiences with Reserve Primary Fund (Primary Fund), when a fund breaks a dollar, it quickly may come under redemption pressures that the fund is unable to fulfill.[163] Those shareholders that first submit redemption requests stand a better chance to be paid faster, and a greater amount, than those that delay. Further, selling portfolio securities en masse to meet unusually high redemption requests further depresses the market as a whole, causing any subsequent sales by the fund to occur at increasingly lower prices. Remaining shareholders bear the full brunt of these lower prices. This dynamic serves only to fuel the pace of redemptions and to undermine the confidence of money market fund shareholders generally.

[161] Section 2(a)(32) of the Investment Company Act defines a "redeemable security" as "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer…is entitled…to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

[162] *Temporary Exemption for Liquidation of Certain Money Market Funds*, SEC Release No. IC-28487 (November 20, 2008), 73 FR 71919 (November 26, 2008) ("Rule 22e-3T Release").

[163] As previously discussed, the once $62 billion Primary Fund received redemption requests for approximately $60 billion of the fund's assets in just four days.

Addressing the possibility that a money market fund may be subject to a run should its NAV become, or likely soon would become, materially impaired is critical to the basic concepts of shareholder fairness upon which our industry has been built. Under such extreme circumstances, fairness dictates that other important principles, such as the ready redeemability of open-end fund shares, yield to the interest of ensuring that all shareholders are treated fairly. Protecting shareholders under these extreme circumstances requires ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

We recognize that this possible impairment of liquidity may be unacceptable to some investors, and that money market funds may lose some clients and assets as a result of these recommendations. But we are convinced that a stronger and more protective regulatory environment is in investors'—and therefore the industry's—best interests. From discussions with investors, we understand that many likely will diversify their portfolios among multiple money market fund sponsors to address this risk. Further, as discussed below in the disclosure section of this Report, this authority to suspend purchases and redemptions must be clearly disclosed.

We therefore recommend that the SEC adopt a rule under Section 22(e) providing, in essence, that an "emergency" would be deemed to exist at any time a majority of a money market fund's directors, including a majority of the fund's independent directors, or a committee thereof, determines the fund's NAV is, or is reasonably believed about to become, materially impaired. Depending on the circumstances, "materially impaired" could mean when a money market fund is shadow priced at less than $0.995 per share. In the event an emergency occurred, the fund's board, including the independent directors, would have the authority to suspend the fund's redemptions, and not accept new purchases, for a period not to exceed five business days. This rule would only apply to money market funds, and may only be exercised by an adviser on behalf of a particular fund once every five years.

This internal "circuit breaker" is designed to provide a brief period of breathing room for a fund under stress, while seeking to restore its NAV. The sole purpose for taking this action would be, in the directors' business judgment, to protect remaining shareholders from a possible run by those investors that may be faster to redeem, while the fund seeks credit support or otherwise restores its NAV to $0.995 or greater. In the event that the NAV cannot be restored within that time, the board would be required to permanently suspend redemptions and immediately begin liquidating the fund in an orderly manner, as discussed below.

7.5.2 Rule Permitting a Fund to Suspend Redemptions Upon Liquidation

The SEC's new interim final temporary rule—Rule 22e-3T—permits money market funds that have elected to participate in the Treasury Guarantee Program to take advantage of the program and initiate the steps necessary to facilitate orderly liquidations that will protect the interests of all shareholders in the funds.[164] Specifically, Rule 22e-3T will permit money market funds that commence liquidation under the Treasury Guarantee Program to temporarily suspend redemptions of their outstanding shares and postpone the payment of redemption proceeds. The release adopting the rule notes that the temporary rule is designed to "facilitate orderly liquidations and help prevent the sale of fund assets at 'fire sale' prices."[165] The release goes on to say that "[s]uch a result could lead to substantial losses for the liquidating fund and further depress prices for short-term securities that may be held in the portfolios of other money market funds."[166]

We agree with the SEC's rationale for the temporary rule and also agree that the rule is consistent with the policy underlying Section 22(e). The purpose of Section 22(e) is to ensure that a redeemable security is, in fact, redeemable, and that funds do not institute barriers to redemption or suspend the right of redemption for improper purposes such as to preserve management fees by limiting redemptions.[167] As the release recognizes, however, liquidation of a money market fund under the program eliminates a source of advisory fees for the adviser, removing the "ulterior motives" for suspending redemptions.

We believe the same logic applies to any money market fund that liquidates, regardless of the Treasury Guarantee Program. Furthermore, when the NAV of a money market fund falls below $1.00 per share and the fund's board decides to liquidate the fund, redemption requests can outpace the fund's ability to sell its portfolio instruments, to the detriment of the remaining shareholders. These requests also can outpace the SEC's ability to grant a timely exemptive order. Under these circumstances, requiring individual applications for exemptive relief from Section 22(e) does not serve the public's interest. Accordingly, we urge the SEC, prior to the expiration of Rule 22e-3T, to adopt a similar final exemptive rule available to all money market funds preparing to liquidate.[168]

[164] For a description of the Treasury Guarantee Program, *see supra* note 46.

[165] *See* Rule 22e-3T Release, *supra* note 162.

[166] *Id*.

[167] *See* 1940 Hearings, *supra* note 159.

[168] *See*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (December 24, 2008) (commenting on Rule 22e-3T, and urging the SEC to make it permanent as described above). *See also* Letter from Stephen E. Roth and David S. Goldstein on behalf of the Committee of Annuity Insurers, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (December 23, 2008) (urging the Commission to extend the Rule 22e-3T to permit life insurance company separate accounts registered as investment companies to similarly rely on the rule).

7.6 Investor/Market Confusion About Money Market Funds

Money market funds traditionally have been viewed as such low risk investments that their risk disclosures have become viewed by investors as somewhat boilerplate. In light of our recent experiences, we recommend that money market funds reassess their risk disclosures, and provide more transparency into the holdings of money market fund portfolios. The goal would be to provide the marketplace with a better understanding of how performance may be linked to risk. Recent experience also demonstrates that members of the press and public confused failing enhanced cash funds and local government investment pools with money market funds, perhaps adding to investor concern. We offer three recommendations to address these issues.

RECOMMENDATIONS:

- **Money market funds should reassess and, if appropriate, revise the risk disclosures they provide to investors and the markets.**
- **The SEC should require money market funds to provide monthly website disclosure of portfolio holdings.**
- **The SEC should adopt a rule under the Investment Advisers Act of 1940 applicable to advisers to unregistered funds, designed to reduce investor and market confusion about funds that appear to be similar to money market funds, but do not comply with the risk-limiting provisions applicable to money market funds.**

7.6.1 Enhanced Risk Disclosure

Form N-1A, the registration form used by mutual funds, requires that mutual funds provide narrative risk disclosure "summarizing the principal risks of investing in the [f]und, including the risks to which the [f]und's portfolio as a whole is subject and the circumstances reasonably likely to affect adversely the [f]und's NAV, yield and total return."[169]

Money market funds in particular must disclose that "an investment in the [f]und is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the [f]und seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the [f]und."[170] Some money market funds have provided additional risk disclosures, but because the risk of such a fund's breaking a dollar has largely been viewed as remote, much of this disclosure, while accurate and complete, may have come to be viewed by investors as boilerplate.

In light of recent events, many money market funds have provided additional disclosures as various market risks have unfolded. We recommend that all money market funds review and revise their disclosures, including advertising and marketing materials, and in particular their risk disclosures, to evaluate whether they fully capture the risks that money market funds may present and the effects those events may have on funds and their

[169] *See* Item 2 of Form N-1A.

[170] *Id.*

shareholders. To assist money market funds in developing this disclosure, we provide examples of the types of disclosure that funds may wish to consider; as with all risk disclosure, these disclosures should be tailored to the fund providing the disclosure:

- Disclosure that money market funds can break and have in the past broken a dollar, and may do so in the future;
- Disclosure that shareholders should not rely on or expect a fund's affiliate to purchase distressed assets from a money market fund, make capital infusions, enter into capital support agreements, or take other actions to prevent the fund from breaking a dollar;
- Disclosure about how a money market fund's portfolio securities' credit quality can change rapidly in certain market environments, and that the default of a single holding could have the potential to cause significant NAV deterioration;
- Disclosure concerning how a money market fund's NAV can be affected by forced selling during periods of high redemption pressures and/or illiquid markets;
- Disclosure that the actions of a few large investors in the fund may have a significant adverse effect on other shareholders;
- If the SEC adopts rules as recommended in this Report concerning the ability to suspend redemptions, disclosure that the fund's board of directors, including a majority of the independent directors, has the ability to temporarily or permanently suspend redemptions in order to protect the interests of remaining shareholders;[171] and
- For Treasury money market funds, disclosure about the effect a low-interest rate environment may have on a fund's return, including that it may prevent the fund from providing a positive yield, paying expenses out of fund assets, or maintaining a stable $1.00 NAV.

7.6.2 Website Disclosure of Monthly Portfolio Holdings

Currently, mutual funds must publicly file with the SEC their complete portfolio holdings on a quarterly basis, no more than 60 days after the close of the quarter. Funds cannot "selectively disclose" portfolio information to certain individuals absent a confidentiality agreement that provides that the recipient will not trade on the data, but instead, must make this information available to all investors at the same time.[172]

During the recent market volatility, some money market fund shareholders wanted to know, sometimes on a daily basis, the portfolio holdings of their funds. To avoid selectively disclosing this information, many money market funds began posting their holdings on their websites at periodic intervals, depending largely on what their clients desired.

[171] Additionally, we would expect money market funds to prominently disclose their ability to suspend redemptions as recommended in this Report, the lack of liquidity that such an action would impose, and that in weighing whether to suspend redemptions, that the fund's board would value treating all shareholders fairly as having greater importance than providing immediate liquidity.

[172] *See* Item 4(d) of Form N-1A.

During our discussions with investors, we learned that while views varied, most investors, whether institutional, broker sweeps, or advisers to individuals, did not see great value in having daily access to money market fund portfolio holdings information. Some believed, however, that being able to assess this information periodically would be beneficial.

Mutual funds are very sensitive to frequent disclosure of portfolio holdings information.[173] The confidentiality of this information is of critical importance to mutual funds. Any improper disclosure of this information can lead to frontrunning of a fund's trades, adversely impacting the price of a security that a fund is buying or selling to the detriment of fund shareholders.

Because of the specific characteristics of money market funds and their holdings, however, the Working Group believes that the frontrunning concerns are far less significant for this type of fund. For example, money market funds' holdings are by definition very short-term in nature and therefore would not lend themselves to frontrunning by those who may want to profit by trading in a money market fund's particular holdings. Rule 2a-7 also restricts the universe of Eligible Securities to such an extent that frontrunning, to the extent it exists at all, tends to be immaterial to money market fund performance.

As a result, the Working Group recommends that money market funds be required to post on their websites their entire portfolio holdings each month after a two-day lag. During times of market volatility, some funds may wish to post their holdings on a more frequent basis. This requirement also would *only* apply to money market funds.

We recognize that most investors will not, under normal market conditions, monitor their funds' holdings; the disclosure, however, may allow third-party analysts and commentators to compare money market funds and flag certain aspects of money market fund portfolios—positive or negative—that would be of interests to investors or the market. It is hoped that these third-parties will use this, and the other disclosure recommendation discussed in this Report, to help guide the investing public about the risk characteristics of particular money market funds.

[173] *See* Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission (September 14, 2005, August 29, 2006, and September 19, 2008); *see also* Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission (December 16, 2008).

7.6.3 Anti-Fraud Rule to Address Investor and Market Confusion

Cash management vehicles that are not required to register under the Investment Company Act currently are not held to any specific standard concerning how their sponsors hold them out to investors.

Section 206 of the Investment Advisers Act of 1940 contains general antifraud provisions that reach any investment adviser, whether or not registered with the SEC.[174] In relevant part, Section 206 makes it unlawful for an investment adviser, directly or indirectly:

(1) To employ any device, scheme, or artifice to defraud any client or prospective client;

(2) To engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client;

* * * * *

(4) To engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.

In addition to the provisions of the Advisers Act, the Supreme Court, in *SEC v. Capital Gains Research Bureau*,[175] held that the purpose of Section 206 is to eliminate conflicts of interest, and to prevent an adviser from overreaching or taking unfair advantage of a client's trust. The Court characterized this as a fiduciary duty of the adviser to its client.

The SEC has adopted a number of rules under that section, providing detail on particular practices that it would deem to be false or misleading. The Working Group recommends that the SEC adopt another rule, providing that it would be a fraudulent or deceptive practice to advise a fund that is not registered under the Investment Company Act that either (1) uses the word "cash" (or any variant of the word, such as "money," "liquid," etc.) in its name; or (2) holds itself out as seeking to maintain a non-fluctuating NAV of $1.00 per share, unless the fund also complies with the risk-limiting provisions of Rule 2a-7.

The Investment Company Act contains two provisions that preclude registered investment companies from using names that could mislead investors into thinking that a fund is a money market fund when in fact it does not comply with the risk-limiting provisions that govern such funds. Rule 2a-7(b) provides generally that it is an untrue statement of material fact for a registered investment company to hold itself out as a money market fund or the equivalent of a money market fund, unless it meets the risk-limiting provisions of the rule. Rule 35d-1 under the Investment Company Act (often referred to as the "names rule") also provides that a fund's name would be deemed to be materially deceptive and misleading if the name suggests that the fund focuses its investments in a particular type of investment or investments, unless the fund has a policy to invest, under

[174] *See, e.g., In re Thayer Capital Partners*, SEC No. Release IA- 2276 (August 12, 2004).

[175] 375 U.S. 180 (1963).

normal circumstances, at least 80 percent of the value of its assets in that type of investment. Subsection (d)(1) of the rule provides that the term "fund," as used in the rule, means a *registered* investment company.

There is no corresponding prohibition on an *unregistered* fund, such as an enhanced cash fund, a bank collective fund, or other type of fund that holds itself out as maintaining a non-fluctuating NAV 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, or something that was designed to provide the same safety and stability as a money market fund. We believe that this gap could cause investors to be misled about the exact nature of their investments. As discussed in Section 6 of this Report, a number of enhanced cash funds dissolved, even before the events of September 2008. Securities lending pools similarly have experienced difficulties maintaining a market value of $0.995 per share or better, as money market funds are required to do under shadow pricing provisions.[176] Our recommendation is designed to bridge the gap, to the extent possible under current law,[177] between the protections afforded investors in money market funds under the Investment Company Act, which has clear limitations on how registered funds can represent themselves to the public, on the one hand, and the ways advisers to unregistered pools can represent their activities on behalf of the pool, on the other.

7.7 Government Oversight

The roughly $12 trillion in money market instruments in which money market funds and other pooled investment vehicles primarily invest is of tremendous importance to all participants in that market—indeed, to the economy as a whole. The Working Group realizes that any entity charged with overseeing the financial markets may require detailed and timely data about the money market and institutional investors in that market, including money market funds, and offers recommendations to that end. We also believe that government oversight of money market funds could be enhanced if the SEC were to formalize a program to monitor money market funds that have performance (after adjusting for fees) that clearly exceeds that of their peers.

RECOMMENDATIONS:

- **The money market industry should work with the appropriate government entity to develop a nonpublic reporting regime for all institutional investors in the money market.**
- **The SEC should formalize a program such that agency staff would monitor any money market funds that, by category and excluding fees, have performance that clearly exceeds that of their peers during any month, to determine the reasons for such performance, and monitor an additional 10 randomly selected funds each month.**

[176] *See, e.g.,* State Street Corporation, Form 8-K (January 16, 2009), *supra* note 55.

[177] We recognize that even this proposed rule would not completely mitigate investor confusion, as banks and bank holding companies are excluded by statute from the definition of investment adviser (*see* Section 202(a)(11)(A) of the Advisers Act), and the SEC has no authority over state employees managing state funds (*see* Section 202(b) of the Advisers Act). Congress may wish to consider whether managers of these pools similarly should be subject to this antifraud standard.

7.7.1 Nonpublic Reporting

There have been many hearings and even more reports and suggestions for regulatory reform, most having as a key component some type of "systemic risk regulator" or similar body. We do not view any one money market fund to be systemically significant. Undoubtedly, however, the orderly operation of the money market does have systemic importance. The Working Group strongly believes that the recommendations advanced in this Report, when fully implemented, will make money market funds even more resilient than they have proved to be for nearly 40 years. Because of the importance of the money market, however, we realize that any entity charged with managing systemic risks to the financial system as a whole may require detailed and timely data about the money market and institutional investors in the money market—even from entities that on their own may not trigger systemic concerns.

We recommend that money market funds and other institutional investors provide the appropriate government body with nonpublic data designed to assist that entity in fulfilling its important mission of overseeing the markets as a whole. For many years, the Institute has provided the Federal Reserve Board and the SEC with a variety of data on the mutual fund industry on an aggregated basis. Our proposal would enhance the government's access to money market fund data by having these funds provide data directly (*e.g.*, on a non-aggregated basis). Possibilities for these data feeds include portfolio holdings information, client concentration levels, and notification when a money market fund's mark-to-market price decreases to less than $0.9975.[178] We also recommend that other cash management vehicles that are not required to register under the Investment Company Act be required to provide similar types of data. This would ensure that the appropriate government entity receives data about a substantial portion of the money market. We pledge to work with appropriate federal officials to implement such a regime for nonpublic reporting and monitoring.

7.7.2 SEC Staff Surveillance of Certain Money Market Fund Performance

Funds that materially outperform their peers (when the effect of fees are excluded from the analysis) may do so by assuming more risk. Primary Fund's yield, in the weeks before it broke a dollar, was in the 99th percentile of all prime money market funds. Had Reserve Management Company, Inc., Primary Fund's investment adviser, been on notice that it might have had to explain the rapid change in its portfolio strategy to the SEC, it may have adopted a more conservative approach to its investing. We therefore recommend that each month, the SEC staff monitor the performance of all money market funds by category (*e.g.*, Treasury funds, prime funds) and take such action as it may deem appropriate to understand the reasons for unusually high performance, including contacting fund groups. We also suggest that this program include an element of random evaluation, and that the SEC staff also monitor 10 money market funds randomly selected each month.

[178] This proposal is modeled on the provision of the Treasury Guarantee Program that requires a participating money market fund to notify the Treasury and the SEC when its NAV declines to less than $0.9975.

7.8 Government Resources

As previously noted in this Report, some money market funds advisers (or their affiliates), in an effort to protect their shareholders from potential losses of principal, elected to provide support for their funds. This support took a number of forms, including purchasing Eligible Securities from a fund. This action, however, required prior SEC staff approval, and while the staff was extremely prompt and helpful in providing the relief, the requests became fairly standard and used valuable staff resources. Further, the SEC staff currently does not have to be notified of purchases by an affiliate of securities that no longer qualify as Eligible Securities, because these purchases can occur without prior approval under Rule 17a-9 under the Investment Company Act. We recommend that this rule be expanded, and that the staff receive nonpublic notification whenever the rule is used.

RECOMMENDATIONS:

- **The SEC should amend Rule 17a-9 to allow a money market fund affiliate to purchase an Eligible Security from a fund.**
- **The SEC should amend Rule 2a-7 to require nonpublic notice to the SEC of any affiliated purchase in reliance on Rule 17a-9.**

7.8.1 Rule 17a-9 Transactions

In its comment letter discussing Rule 2a-7, the Institute recommended that the SEC propose an amendment to Rule 17a-9 under the Investment Company Act to expand its availability.[179] Currently, the rule only permits a fund's affiliate to purchase a security that is no longer an Eligible Security.[180] Our experience during the recent credit market turmoil has taught us that fund shareholders may be better protected if an affiliate could exercise its ability to purchase a portfolio security at other times (*e.g.*, when market conditions have caused the security to be illiquid but still an Eligible Security) and SEC staff resources could be allocated to other important tasks if not required to assess requests for these transactions. Expanding Rule 17a-9 in this manner also may enable affiliates to better provide money market funds with needed liquidity to meet redemptions during times of market stress.[181] We therefore recommend that the SEC amend Rule 17a-9 to expand the securities eligible to be purchased by an affiliate under the rule (*e.g.*, to include situations in which a portfolio security has defaulted, has been determined to no longer present minimal credit risks, or when the issuer of the security experiences an insolvency event).

[179] *See* September 5 ICI Letter, *supra* note 135.

[180] Absent an SEC exemption, Section 17(a)(2) of the Investment Company Act prohibits an affiliated person of a fund from knowingly purchasing a security from the fund.

[181] Any such expansion, however, should in no way suggest that affiliated persons of funds have any legal obligation to enter into such transactions.

Last summer, the SEC proposed an amendment to Rule 2a-7 that would require that money market funds provide the SEC with prompt notice via electronic mail when an affiliate of a money market fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an Eligible Security, pursuant to Rule 17a-9.[182] The release states the SEC's belief that the current notice provision in Rule 2a-7, which is triggered only when a portfolio security defaults, provides the SEC with incomplete information about money market funds holding distressed securities, particularly those funds that have engaged in a transaction with an affiliated person under Rule 17a-9. We support this proposal (provided the electronic notice is nonpublic) and believe that it would enhance the SEC's oversight of money market funds, especially during times of market stress.[183]

7.9 Government Programs

During the credit market crisis, the federal government undertook several extraordinary measures to provide needed liquidity to the money market and one program designed to calm the fears of money market fund investors in the aftermath of Lehman Brother Holdings Inc. bankruptcy. Our recommendations regarding one of those actions, the Treasury Guarantee Program, as well as certain guidance provided by the SEC staff, are described below.

RECOMMENDATIONS:

- **The Treasury Department should extend the Treasury Guarantee Program until the program expires by its terms on September 18, 2009.**
- **The SEC should delegate to its staff the authority to reinstate the no-action letter permitting money market funds to use amortized cost for shadow pricing certain securities, under specified market conditions, at the staff's own motion or upon request by the industry.**

7.9.1 Extension of Treasury Guarantee Program

The Treasury Guarantee Program, which applies to publicly offered money market funds, has worked as intended to bolster confidence among money market fund investors and to contribute to greater stability for the U.S. money market industry overall. The Treasury Guarantee Program is scheduled to expire on April 30, 2009, after which the Treasury Secretary has the option to extend the program up to the close of business on September 18, 2009.[184] There has been—and we are hopeful that there will be—no occasion for the Treasury Guarantee Program to pay a claim. We nonetheless believe that it could compromise progress achieved in stabilizing the money market if the program is not extended at this time. Financial markets continue to experience substantial strains. Indeed, citing similar concerns, on February 3 the Federal Reserve announced

[182] *See* Rule 2a-7 NRSRO Release, *supra* note 135.

[183] *See also* September 5 ICI Letter, *supra* note 135.

[184] *See* Press Release, U.S. Department of the Treasury (November 24, 2008), available at http://www.treasury.gov/press/releases/hp1290.htm.

the extension through October 30, 2009, of its existing liquidity programs that were scheduled to expire on April 30, 2009.[185]

We do not believe that all funds will elect to renew under the program. Indeed, during the last renewal period, several large money market funds that invested only in U.S. Treasury securities declined to renew, with virtually no shareholder concern. Because of the uncertain state of the markets, however, we believe it best for each fund's board of directors to make the determination whether to renew. We also look forward to working with Treasury Department and other government officials to develop an exit strategy from the program, so that the termination of the program itself does not cause market volatility.

We believe that the measures outlined in this Report, if implemented promptly, will strengthen money market funds such that when the Treasury Guarantee Program expires by its terms in September, money market funds will be well positioned for an orderly transition out of the program.

7.9.2 Amortized Cost No-Action Letter

In times of extraordinary illiquidity in the markets, it may be helpful for the SEC staff to be able to reissue the no-action letter it issued to the Institute last fall. That letter stated that the staff would not recommend enforcement action to the Commission if a money market fund complies with Rule 2a-7 by shadow pricing certain of its portfolio securities by reference to their amortized cost value (unless the particular circumstances suggest that amortized cost is no longer appropriate), rather than using available market quotations.[186] While the directors of mutual funds other than money market funds may determine that the value of debt securities with remaining maturities of 60 days or less is their amortized cost,[187] money market funds generally are not permitted to rely on this position.

The staff granted the relief in reliance on the Institute's representations that under the market conditions existing at the time the letter was granted, the shadow pricing provisions of Rule 2a-7 were not working as intended. In particular, the market for short-term securities, including commercial paper, in many instances were not resulting in the discovery of prices that reflected the fair value of securities, even of issuers that were reasonably likely to pay upon maturity. The pricing vendors customarily used by money market funds at times were not able to provide meaningful prices because inputs used to derive those prices had become less reliable indicators of price. The relief was limited to portfolio securities that (1) had a remaining maturity of 60 days or less, (2) were First Tier Securities, and (3) the fund reasonably expected to hold to maturity. The letter expired by its terms on January 12, 2009, as the market turmoil that preceded its issuance had abated.

[185] *See* Press Release, Board of Governors of the Federal Reserve System (February 3, 2009), available at http://federalreserve.gov/newsevents/press/monetary/20090203a.htm.

[186] *Investment Company Institute*, SEC No-Action Letter (pub. avail. October 10, 2008).

[187] See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, SEC Release No. IC-9786 (May 31, 1977).

The amortized cost no-action letter was extremely successful in removing many of the valuation difficulties experienced by money market funds that accompanied the disrupted and illiquid market for very short-term instruments. We understand that obtaining this letter, however, required the staff of the Division of Investment Management, the division within the SEC primarily responsible for regulating mutual funds, including money market funds, to notify each of the Commissioners prior to issuance. The Working Group recommends that the SEC now delegate to the staff, under specified market conditions, the ability to reinstate the letter at the staff's own motion or upon request by the industry. Having this authority in advance will save valuable time, and will allow the staff to use its limited resources during a time of crisis to deal with matters that do not have such precedent.

Much of the valuation strain that necessitated the amortized cost letter stemmed from a breakdown in the reliability of vendor pricing models during periods of severe market dislocations. Recognizing this, the Institute has begun discussions with several pricing vendors to consider ways to improve and enhance the transparency of their evaluation of short-term commercial paper in challenging markets. We are focusing our efforts on improving the so-called "challenge process," through which funds can provide real-time feedback and additional market color to vendors that may improve the quality of evaluations.

7.10 Forward-Looking Enhancements

During our analysis of money market funds, we identified two aspects of their regulation that many in the Working Group believe could be strengthened or modernized, even if the provisions in question did not play a role in the recent market volatility. One, to prevent future possible problems, would be to eliminate Second Tier Securities from the definition of an Eligible Security. The other, to modernize money market regulation, would be to update the responsibilities of money market fund boards of directors to better reflect the appropriate oversight role of fund boards.

RECOMMENDATIONS:

- **The SEC should amend Rule 2a-7 to eliminate Second Tier Securities from the definition of an Eligible Security.**
- **The SEC should modernize Rule 2a-7 to reflect the appropriate oversight role for money market fund boards of directors.**

7.10.1 Second Tier Securities

Currently, Rule 2a-7 permits taxable funds to invest up to 5 percent of their assets in Second Tier Securities (*e.g.*, securities that have been rated A-2 or P-2). For Tax Exempt Funds, this 5 percent test applies only to Second Tier Conduit Securities (municipal securities whose payment is ultimately backed by a non-municipal issuer). If a Tax Exempt Fund purchases a non-Conduit Security, that security is not subject to the 5 percent limit on aggregate exposure to Second Tier Securities. In today's fast-moving financial markets, however, rapid quality deterioration or default risk is a possibility for all securities, and especially those that have not been

rated by an NRSRO in the highest short-term rating category. Compared to First Tier Securities, Second Tier Securities tend to have weaker fundamental credit profiles. In addition, Second Tier Securities represent only 6 percent of the $1.2 trillion U.S. Rule 2a-7 commercial paper market (or $63 billion).[188] As a result of their weaker credit profiles, smaller overall market share, and smaller issuer program sizes, Second Tier Securities tend to be less liquid than First Tier Securities.

In determining the quality standards for money market fund portfolio securities, the exclusive focus must be on the protection of money market fund shareholders, who seek safety by investing in funds whose objective is the maintenance of a stable NAV. The Working Group believes that Second Tier Securities may involve future risks imprudent for funds seeking to maintain a stable NAV. We therefore believe that money market funds should be limited to holding only First Tier Securities. Similar to the liquidity requirements discussed above, however, this would be a time-of-purchase test. Specifically, if a First Tier Security is downgraded to Second Tier after an adviser has purchased the security for the fund, the fund may still hold the security.

7.10.2 Board Oversight

Rule 2a-7 recognizes that money market fund boards should not be involved in management-level determinations and permits fund boards to delegate some of the specific responsibilities imposed on them. As the SEC stated when adopting Rule 2a-7, "the rule does not require that the board personally become involved in the day-to-day operations of the fund, nor does the rule require the board to be an insurer of the fund or the fund's investment adviser."[189] The SEC also acknowledged in Rule 2a-7's proposing release that fund boards "typically rely on the fund's adviser" through the delegation provisions of the rule.[190]

Even if a board can delegate the responsibility for making specific determinations, however, it still is ultimately responsible for the determinations that are made. The Working Group recommends that, rather than impose responsibilities on fund boards that are expected to be delegated, Rule 2a-7 be revised to reflect the appropriate oversight role of fund boards.[191]

Specifically, we recommend updating Rule 2a-7 by revising provisions of the rule that involve boards at an inappropriate level in the investment process. For example, rather than limit investments to securities that the "fund's board of directors determines present minimal credit risks," the rule should be revised to simply limit investments in securities "that present minimal credit risks."[192] The adviser, who has the technical expertise in this area, would make the credit quality determination (as it does currently), subject to fund board oversight.

[188] *See* February 2009 Federal Reserve month-end levels for commercial paper holdings, available at http://www.federalreserve.gov/releases/cp/outstandings.htm.

[189] *See* Rule 2a-7 Adopting Release, *supra* note 40.

[190] *See* Rule 2a-7 Proposing Release, *supra* note 39.

[191] The Working Group's recommendations are consistent with those made by the Independent Directors Council. *See* Letter from Robert W. Uek, Chair, Independent Directors Council Governing Council, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission (August 29, 2008).

[192] *See* Rule 2a-7(c)(3)(i).

Similarly, the provision relating to ratings downgrades should be revised to eliminate the specific responsibilities imposed on fund boards and to permit fund boards to exercise oversight over the responses to ratings downgrades through, for example, the adoption and oversight of policies and procedures.[193]

On the other hand, the Working Group believes that boards should retain the following responsibilities, which appropriately involve fund boards in determinations essential to the operation of a money market fund:

- the initial determination that it is in the best interests of the fund and its shareholders to maintain a stable NAV by virtue of either the amortized cost method or the penny-rounding method (Rule 2a-7(c)(1));
- the establishment of required procedures under the amortized cost or penny-rounding method (Rule 2a-7(c)(7)(i), (c)(8) and (c)(9));
- determinations made in response to defaults of portfolio securities (Rule 2a-7(c)(6)(ii)); and
- establishment and review of shadow pricing procedures (Rule 2a-7(c)(7)(ii)(A-C)).

[193] *See* Rule 2a-7(c)(6)(i). Other provisions that inappropriately involve boards in the investment process include, but are not limited to, paragraphs (c)(3)(iv) (determination that there is minimal risk that the circumstances that would result in a Conditional Demand Feature not being exercisable will occur); (c)(4) (certain determinations with respect to money market funds in which the fund invests); (c)(5) (determination that certain Demand Features will not be relied upon); and (c)(6)(i)(C) (determination that disposal of certain securities subject to Demand Features that are downgraded would not be in the best interest of the fund).