OVERSIGHT OF THE MUTUAL FUND INDUSTRY: ENSURING MARKET STABILITY AND INVESTOR CONFIDENCE

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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OVERSIGHT OF THE MUTUAL FUND INDUSTRY: ENSURING MARKET STABILITY AND INVESTOR CONFIDENCE

Friday, June 24, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Manzullo, Biggert, Neugebauer, Pearce, Fitzpatrick, Hayworth, Hurt, Grimm, Dold; Lynch, Miller of North Carolina, Maloney, Perlmutter, Donnelly, Carson, Peters, and Green.

Also present: Representatives Renacci, Capuano, and Carney.

Chairman GARRETT. Good morning. This hearing of the Subcommittee on Capital Markets and GSEs is called to order. And before I recognize myself to give opening statements, let me welcome the panel and say a couple of housekeeping things.

We are going to do opening statements, and then, of course, we will hear the witnesses' statements. We understand that near the top of the hour, or a quarter after, or somewhere in there, we are going to be called for votes.

And so, we do not know how many votes, but if it is only one vote, then what we can probably do is just rotate through and have you all keep on testifying as I just pop in and out, and that sort of thing. We hope it goes that way.

If it is two votes, unfortunately, then we will probably have to just take a brief 15- or 20-minute recess to allow us all to go vote.

Okay. That is where we are.

I now recognize myself for 4 minutes. And, again, as I said, welcome, everyone, to the hearing. We are here to explore a series of issues impacting the mutual fund industry.

As you may know, it has been more than 6 years since this committee last held a hearing focused on mutual funds. This new Republican Majority has made it a priority to focus on oversight, not only of government regulators, but also of industries under its purview. Given that it has been over 6 years, this is a good opportunity now to reacquaint this committee with issues affecting this industry.

There has been some attention in the media this week regarding how the Greek debt crisis may affect money market mutual funds.

And while that is not why this hearing was scheduled, it certainly is going to be a topic worthy of exploring to some extent.

More broadly, though, there was the intent to focus today on different efforts and proposals to provide more certainty to policymakers, along with stability of the money market mutual funds.

I do think the SEC's recent 2a-7 reforms make significant progress in quelling systemic concerns about money market funds. But I also think it is worth discussing today, different ideas regarding potential so-called buffers for money funds.

As safe as money market funds generally have been, unfortunately, the proverbial genie was let out of the bottle back in 2008 when Treasury and the Fed stepped in to provide a temporary guarantee program for money market funds, potentially at the time putting taxpayers at risk.

So this type of action definitely needs to be avoided in the future. And I think representatives of the industry on the panel before me today would agree with that point of view.

As I said, I am interested in having a good discussion on some of what has already been done by the SEC in the past and what further could potentially be done going forward.

With all that being said, I have not been convinced that the floating NAV is a proper avenue to go down in order to address the perception by some that the money funds represent a systemic risk. For one, I am not convinced that replacing a stable NAV with a floating one solves the worry about runs on the bank, so to speak, or runs on money market funds.

Additionally, policymakers must take into account the impact that a floating NAV would have on the corporate and governmental issuers of debt and our broader economy, as well.

There is compelling evidence that such an action would lead to a loss of access to a significant source of short-term funding. A floating NAV would also impact investors, basically of all shapes and sizes.

And while I can understand some level of concern about money market funds, we can also ignore the concerns about banks, which is likely where much of that money now invested in money market funds would migrate over to, if you institute a floating NAV.

While on the one hand our money market funds were a source of undeniable problems back in 2008, hundreds of banks have failed in the last few years, and the TARP program pumped literally hundreds of billions of dollars into banks during the depth of the crisis.

So we cannot look at the potential victims of a floating NAV in a vacuum. That would be, I think, at considerable cost.

Another issue I hope the subcommittee can explore today is the potential for the Financial Stability Oversight Council (FSOC) to designate asset management firms, such as mutual fund companies, as systemically significant financial institutions, or SIFIs.

With the way that Dodd-Frank requires regulators to regulate SIFIs, there are a lot of questions as to how mutual fund firms, for instance, would be regulated under a regime largely set up, the same regime as the banks.

Furthermore, today's hearing may also touch on issues such as the 12b-1 fees, the Dodd-Frank Act derivative rulemaking issue and its impact on mutual funds, fiduciary standard proposals, as well as proposed amendments to CFTC Rule 4.5.

But more than anything else, I hope today's hearing affords us an opportunity to have a good and robust discussion on many of the issues affecting the mutual fund industry today. So I very much appreciate the panel being with us.

And with that, I turn—not to Ms. Waters—to Mr. Green for 2 minutes?

Mr. GREEN. Thank you. Thank you, Chairman Garrett.

And I also thank the full committee chairman, who is not with us, but I thank him, as well. And, of course, the Honorable Maxine Waters.

Mr. Chairman, I would like to commend you for holding this hearing. It is an important hearing. And I thank the witnesses for agreeing to participate.

You have indicated that it has been about 6 years since we examined this topic in the committee, and I agree and concur that it is time for us to have another opportunity to visit these issues.

I am eager to understand how we can adapt regulatory frameworks in governing the mutual money market funds such that we can avoid a run similar to the one that we experienced in the fall of 2008.

I understand that my constituents, and our constituents, hold a lot of savings and retirement funds and accounts heavily invested in money market mutual funds because of their safety. And I want to ensure that future generations can continue to depend on these financial instruments. They are important to our economic stability, and they have been of great benefit to us.

I am also interested in exploring the various options our witnesses bring to the table today, including industry-funded reserve buffers, a liquidity bank and two-tiered net asset value—that is NAV—classes for money market funds.

Additionally, the recent economic climate in Europe has raised some concerns over risk to U.S. money market funds. With the knowledge that millions of Americans depend on stable savings and retirement accounts, I am concerned about the ramifications of a Greek debt crisis with regard to these mutual funds.

This issue comes after particularly troubling times when retirement savings have already been severely diminished by the recent economic crisis.

Further, I would like to examine the potential for individual mutual funds, or their managers, to be considered systemically important. I am very interested to explore the arguments for or against designating mutual funds as systemically important, along with what the potential impacts would be for both retail and institutional investors.

So with all these issues—and they are all important to us—I am looking forward to this hearing, Mr. Chairman. I thank you, and I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

And I understand that Mr. Capuano and Mr. Carney would also like to participate in the hearing today.

Without objection, it is so ordered.

At this time, I yield 1½ minutes to the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Chairman Garrett.

When we look back at 2008, you had very little exposure to Lehman throughout the industry. But when Reserve Fund broke that dollar, broke the buck, you had a massive run on prime money market funds. And it really took some extraordinary steps by the government to put a halt to that run.

And I think we have some questions here as to whether the events in 2008 prove that the structure of money market funds makes the industry today susceptible to that kind of a run. That is up for interpretation.

What is not subject to interpretation, though, is that we are now left with an industry that is at least implicitly government-backed.

And given recent headlines, noting the potential exposure of a European bank debt crisis, there are other questions that are going to have to be kicked around in this committee.

We are going to have to ask, has the industry fundamentally changed since then? Is it in a better position to prevent an industry-wide run this time? Will the government be forced to intervene again in such a circumstance?

But I hope that the hearing not only answers those questions, at the end of the day, I think we have to remove the perception that money market funds are risk-free or government-backed. And I think reducing investors' incentives to redeem shares from distressed funds is going to result in more stable funds and a more stable financial system.

How that can be achieved is the subject of this hearing. We have various competing ideas here that are going to be presented to us in terms of the best way forward.

But I thank the chairman for holding this timely hearing. I think that these are subjects that need to be resolved. And I appreciate his leadership in trying to kick this off. Thank you.

Chairman GARRETT. And I thank the gentleman.

The gentleman from Massachusetts for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the witnesses for appearing before this committee today and helping us with our work.

As of April of this year, the combined assets of the mutual fund industry totaled about $12.5 trillion. From a systemic risk perspective, it is important that regulation maintain proper oversight of this industry.

It is also important to recognize that the money market funds that have been noted in earlier remarks have been the most stable sector of the mutual fund industry and represent about $2.7 trillion within the industry.

However, everyone does remember, as the gentleman from California mentioned, the event with the Reserve Fund breaking the buck back in 2008.

But since that event, the SEC and other market participants have studied the mutual fund industry, and significant reforms have already been implemented in response to the Reserve Fund event.

One of these measures, Rule 2a-7, imposes requirements for asset quality and liquidity. The Commission has also reduced the amount of money that market funds can invest in lower quality, illiquid securities from 5 percent of a fund's assets to 3 percent.

And the President's Working Group on Money Market Funds has also proposed requiring money market funds to allow their net asset value to float above or below $1 a share.

Now, the goal—the stated goal, at least—of the proposal would be to help remove the perception that money market funds are risk-free, and reduce investors' incentives to redeem shares from so-called distressed funds that break the buck. However, there is also countervailing evidence that allowing NAV to float would also undermine the value of those assets.

I would like to hear the panel's opinions on that point, how all of these reforms have affected the money market industry, and particularly how a floating NAV proposal might affect this financial tool, whether it would make it more or less attractive to investors, and how it improves safety and soundness.

But I want to thank you, Mr. Chairman, for your courtesy, and I look forward to the testimony from our witnesses. And I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Dold for 1½ minutes.

Mr. DOLD. Thank you, Mr. Chairman.

The mutual fund industry is a critical part of our economic system, and, I would argue, one of the most important investment vehicles millions of Americans use. With combined assets now exceeding $12 trillion, millions of Americans rely on the mutual fund industry for retirement funding, for college tuition funding, and for growing personal resources.

Despite the mutual fund industry's vital importance to so many Americans and to our economy as a whole, this committee has not held an oversight hearing since 2005. And since that last oversight hearing, we have seen the 2008 financial crisis, the Dodd-Frank regulation, the resulting rulemaking process and continuing dramatic industry growth, and so many other developments that impact the industry.

So today's hearing is very timely and important, and I want to thank the chairman for calling it.

I also look forward to hearing from our witnesses about several specific topics, including fee reforms, potential FSOC designations, corporate government reforms, and the SEC's effectiveness in regulating the industry.

Most importantly, I am interested in how we might improve the safety and stability of money market funds which now contain assets approaching $3 trillion.

As we have learned from the Reserve Primary Fund during the 2008 financial crisis, there can be some risk to investors in money market funds.

In that case, the Administration decided to expose taxpayers to trillions of dollars of potential liability by guaranteeing certain money market fund investments.

Fortunately, in that case, none of the guaranteed money market funds actually failed. But we must ensure that taxpayers are never again so badly exposed to such enormous potential losses.

We all want smart and cost-effective regulation of the mutual fund industry, and I look forward to hearing from the witnesses about how we can get closer to that objective.

And I yield back.

Chairman GARRETT. The gentleman yields back, thank you.

Mr. Carson for 3 minutes.

Mr. CARSON. Thank you, Mr. Chairman. I want to thank the chair and the ranking member for holding this hearing.

As the state of our financial markets and economy continue to be of utmost concern, as we will be specifically focusing on money market mutual funds today, I am very hopeful our witnesses will explain why or why not these funds are good for monies to be invested in.

I understand these funds do provide for short-term financing for businesses, banks, and governments at all levels. There is a certain stability, as well as convenience, that these funds bring to the table.

While a few money market funds have broken the buck or have gone below $1, the fund company or sponsor has stepped in to absorb the losses.

I do, however, have concerns. I have some questions regarding the net asset value and your opinions on money market funds, assuming they float an NAV structure.

I am interested in learning about what this change could do to not only the nature of a single investment vehicle, but also what further implications and consequences these would have for the entire system.

I also have some questions on whether or not these funds could potentially be under some scrutiny for holding any Greek debt or other euro zone investments. I am also curious as to how the faltering billion-dollar Greek financial bailout threatens the industry.

The money market fund industry has indeed, as you all know, come under heightened scrutiny in the wake of the financial crisis. It has brought to light concerns from both fund-specific and systemic risks associated with these funds.

We are curious as to how we could distinguish these different vehicles, from our distinguished panelists, and really getting your insights and critiques and thoughts on an issue that is within the regulatory system, really explaining systemic risk without damaging money market mutual funds' important role as a source of value to investors and funding to the short-term capital markets.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And the gentleman yields back.

I believe those are all the opening statements that we have up here, so we will now turn to our esteemed panel.

And as you, of course, know, your full written testimony has been already delivered to the committee. You are now recognized for 5 minutes to summarize your statements.

Mr. Stevens?

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE (ICI)

Mr. STEVENS. Chairman Garrett, Congressman Green, and members of the subcommittee, we welcome today's hearing because of the central role that mutual funds and other registered investment companies play in helping some 91 million Americans achieve their most important long-term financial goals.

Today, the assets of these funds actually total some $13.8 trillion, representing nearly one-quarter of the financial assets of U.S. households. As these figures suggest, the fund market is vibrant and highly competitive.

One leading indicator of that competition is the cost of fund investing. Since 1990, average fees and expenses paid by mutual fund shareholders have decreased by more than half as a percentage of assets for both stock and bond funds. Over the same period, the range of services investors receive has increased just as dramatically.

The key to the industry's success is the comprehensive framework of regulation in which funds operate. That framework grew out of the great financial crisis of the 1930s and has proven its worth for over 7 decades.

Its distinctive features include market valuation of fund assets each day, tight limits on leverage, unrivaled transparency, strict custody of fund assets, detailed prohibitions on transactions with affiliated parties, and strong governance overseen by independent fund directors.

Fund regulation and our fiduciary culture helped ensure that funds were not at the center of the latest crisis, nor were funds the focus of the Dodd-Frank Act. Nonetheless, funds and their advisers remain concerned about how the Financial Stability Oversight Council will exercise its authority under Dodd-Frank to designate non-bank financial institutions as systemically important and subject them to heightened bank-type regulation.

As we explain in detail in our written statement, funds are already among the most highly regulated and transparent financial companies in the country. They simply do not present the kind or extent of risks to financial stability that would merit SIFI designation.

Moreover, quite apart from designation, there is ample regulatory power in Dodd-Frank and under other existing laws to address risks identified by the FSOC or other regulators. And regulators, in our view, should use those tools first.

Money market funds are a good case in point. Regulators not only have the authority they need over these funds, they have already put that authority to use.

After the financial crisis, our industry supported, and the Securities and Exchange Commission adopted, comprehensive amendments to its rules governing money market funds.

Those amendments raised standards for credit quality. They shortened maturities. They improved disclosure. And for the first time, they imposed explicit minimum daily and weekly liquidity requirements.

As a result, prime funds today have a minimum of $660 billion in highly liquid assets available to meet redemptions on a daily and weekly basis. This far exceeds the $370 billion in outflows that we saw during the week of the Lehman Brothers failure.

In short, we have come a long way in making money market funds more resilient, and the industry remains open to ideas to strengthen these funds further, including ways to enhance liquidity and minimize the risks of a fund breaking a dollar.

Any further proposals, however, must preserve the utility of money market funds to investors. They also must avoid imposing costs that would make large numbers of additional advisers unwilling or unable to continue to sponsor these funds. Violating either of those two principles will undercut the important role that money market funds play in our economy.

Bear in mind that these funds hold more than one-third of all commercial paper issued by American companies and more than half of all the short-term municipal debt outstanding. The funding they provide is part of the life-blood of jobs and communities, and in today's economy especially, we can ill afford to disrupt it.

One disruptive idea is the notion of floating the value of money market funds' shares, forcing these funds to abandon their stable $1 per share price. Our investors, institutions and individuals alike, have stated clearly that they cannot or will not use funds that fluctuate in value for cash management purposes.

And as Treasury Secretary Timothy Geithner recently noted, any further changes to money market funds must be made "without depriving the economy of the broader benefits that those funds provide."

We agree.

Lastly, let me note our concerns about conflict and duplication that can arise when multiple regulators oversee the same entities. One compelling example is the CFTC's sweeping proposal to amend Rule 4.5 and potentially subject many hundreds of mutual funds to regulations that duplicate or even directly conflict with those of the SEC.

Why this is necessary, the CFTC has not adequately explained, in our judgment. Nor is it clear why the CFTC wants to so dramatically expand its regulatory reach now, when it says to Congress it does not have enough resources to do its basic job under Dodd-Frank.

This committee has addressed the need to promote regulatory coordination and avoid market disruption by passing H.R. 1573. ICI supports the policy goals of that regulation.

Mr. Chairman, members of the subcommittee, my written testimony touches on a wide variety of other issues, any of which I will be happy to discuss with you and your colleagues during the question-and-answer session.

Thank you.

[The prepared statement of Mr. Stevens can be found on page 106 of the appendix.]

Chairman GARRETT. Thank you very much.

From the University of Mississippi, Professor Bullard?

STATEMENT OF MERCER E. BULLARD, PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC, AND ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

Mr. BULLARD. Thank you, Chairman Garrett, Congressman Green, and members of the subcommittee. Thank you for the opportunity to appear before you today.

Recent events have provided useful lessons in the management of systemic risk, prudential regulation, and investor protection in the mutual fund industry. The performance of stock and bond mutual funds, for example, has demonstrated the remarkable resiliency of the investment company regulatory structure in times of extreme stress. As share values have plummeted, most shareholders in mutual funds have stood their ground.

This confidence in the investment company structure reduces the likelihood of the kind of panic selling that contributes to systemic risk. This is one of the reasons that true mutual funds that price their shares based on their net asset value do not pose material systemic risk and should not be treated, for example, as systemically important financial institutions.

Another reason is that they are already comprehensively regulated under the Federal securities laws by the SEC.

In contrast, money market funds are not true mutual funds. They are not required to redeem their shares at the current net asset value, or, more precisely, they are permitted to round their net asset value to the nearest dollar.

Money market funds' stable net asset value can contribute to systemic risk. And in the wake of the 2008 run on money market funds, there can be no dispute that this risk is real.

The question before regulators is, what steps, if any, should be taken to address this systemic risk?

Money market fund portfolios are safer than they were before the crisis. They are better able to handle operational and liquidity stress, and they are subject to improved regulatory oversight.

But they were safe before the crisis. The 2008 run did not result from shareholders' judgments about the safety of individual funds in which they were invested. They made an undiscriminating judgment about the safety of prime money market funds as cash management vehicles.

Any regulatory reform that seeks to address this kind of systemic run risk, therefore, must stand outside of the system for which the reform is intended to provide a backstop. In other words, it must retain the faith that the system it supports has lost.

For example, capital requirements would operate within the very system in which shareholders have lost faith. When it is the system that shareholders doubt, safety mechanisms that are viewed as operating within that system will not prevent a run. The only meaningful preventive mechanism for systemic run risk is a guarantee, like the Treasury's Temporary Guarantee Program, that shareholders believe to be derived from an external source.

The strongest source of such a guarantee is the full faith and credit of the United States, as reflected by deposit insurance. And it is my view that deposit insurance should be extended to money market funds in conjunction with weaning banks from investing insured deposits in anything other than short-term assets.

However, deposit insurance is not necessarily the only external guarantee that could provide an adequate source of independent confidence. For example, a liquidity bank with access to the Fed's discount window might be sufficient to quell the doubts of institutional money market fund shareholders who are likely to lead any money market fund run in a crisis such as that experienced in 2008.

In contrast, requiring money market funds to effect transactions at their net asset value—the so-called floating NAV proposal—would not mitigate systemic risk. This would, however, overrule the market preferences of tens of millions of money market fund shareholders.

If the SEC's money market fund roundtable is any indication, however, the preferences of these millions of small investors in money market funds appear to be an afterthought.

In conclusion, I am also concerned regarding the SEC's approach to being a prudential regulator. In January of 2008, I filed a rulemaking petition with a group of similarly concerned organizations to require money market funds to file their portfolios with the SEC on a monthly basis, to enable detailed monitoring of their portfolios.

This is what we wrote in that letter, 9 months before the Reserve Funds broke a dollar: "No retail fund has broken a dollar, but we believe that it may be inevitable that a money manager will one day decline to bail out its money market fund. To prepare for this eventuality, the Commission should take steps to ensure that the damage to faith in money market funds is minimized."

The Commission finally adopted this proposal years after we submitted our petition, and I am concerned that it is not doing what it should be doing with that data. In the last week, we have seen headlines claiming that money market funds are vulnerable to European exposure. I read in Wednesday's L.A. Times that Federal Reserve Chairman Bernanke said that he is keeping a "close eye on money market funds."

I found no public statements from the SEC on what it has found, leaving the rest of us to wonder whether banking regulators' repeated announcements that money market funds are at risk may actually be true.

Being a prudential regulator means proactively, directly, aggressively addressing concerns regarding the stability of money market funds. I hope that the SEC will set the record straight.

Thank you.

[The prepared statement of Mr. Bullard can be found on page 48 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Donohue?

STATEMENT OF ANDREW J. DONOHUE, PARTNER, MORGAN, LEWIS & BOCKIUS LLP

Mr. DONOHUE. Thank you, Chairman Garrett, and members of the subcommittee, for permitting me to testify before you.

My name is Andrew Donohue, and I am a partner at the law firm of Morgan Lewis & Bockius, and I was Director of the Division of Investment Management of the United States Securities and Exchange Commission from May 2006 until November of 2010.

Prior to joining the SEC, I held senior positions in the investment company industry, most recently as global general counsel for Merrill Lynch Investment Managers. I have been associated with the investment company industry since 1975, and I have recently been elected to the Board of the Mutual Fund Directors Forum, a nonprofit organization of independent fund directors.

The views I express today are my own and do not represent those of my firm, my firm's clients or any other organization.

Funds are subject to a comprehensive regulatory regime that has served fund investors well and played a significant role in the success of the fund industry. With the critical role that funds play in our economy and in the investment of American people's hard-earned money for savings and retirement, it is essential that this regulatory regime remain comprehensive, yet flexible enough to meet changing markets and investor needs, as well as to enable product innovation.

During the financial crisis, funds and their investors were subject to many of the same challenges as other financial institutions.

Funds performed quite well during this period with but a few exceptions. A few short-term bond funds had exposures to mortgage-backed securities that caused them to suffer unexpected losses. A number of closed-end funds had issued auction rate preferred securities that suffered auction failures in 2008, resulting in those securities becoming illiquid and losing value.

Money market funds had liquidity, pricing, and credit issues that affected them during this period. The industry was quite supportive of their money market funds, with over 25 advisers providing liquidity and other financial support to over 100 money market funds.

While only one money market fund broke the buck, some extraordinary steps were taken by the Treasury and the Federal Reserve to stabilize this area.

Since then, the SEC has adopted amendments to its rules, significantly strengthening the regulatory regime for money market funds, and is currently considering additional measures.

I am confident that the SEC and industry participants will be able to craft an approach that lessens the likelihood of a run on money market funds or a money market fund breaking the buck, while still preserving the benefits money market funds have historically provided to investors and the markets.

While mutual funds and mutual fund complexes are important participants in the U.S. financial system and provide many benefits to their investors, I believe that the nature of mutual funds, their operations, and the comprehensive regulatory regime within which they operate, argue quite forcefully for them not being considered systemically important financial institutions.

Mutual funds have regulatory requirements on the degree of leverage they can employ, the diversification and concentration of their portfolios, where and under what circumstances their assets are held, the valuation of their assets on a daily basis at market value, the requisite liquidity of their investments, and limits on transactions with affiliates.

These and other requirements have provided the sound structure for funds to operate in, in a manner that does not expose the U.S. financial system to the types of risk the Dodd-Frank Act was concerned with.

For somewhat different reasons, I do not believe that asset managers should be designated as significantly important financial institutions. The asset management industry is quite different from that of other financial institutions, and those differences should militate against them being considered significantly important financial institutions.

Asset managers do not put their balance sheet at risk, do not guarantee returns, and their clients bear the risk of the investments. The asset management industry is not concentrated, and it is quite competitive, and assets can be moved quite freely from manager to manager.

The SEC has played a critical role in the comprehensive regulatory regime for funds. It has used the flexibility provided in the Investment Company Act to adapt a 70-year-old statute to changing markets and investor needs, and to facilitate innovation in the fund industry, such as money market funds and exchange traded funds.

It has also used that flexibility to permit funds to engage in activities otherwise prohibited, by fashioning alternative means of achieving the safeguards intended by the statute.

I want to thank you for the opportunity to testify today, and I welcome any questions that you might have.

[The prepared statement of Mr. Donohue can be found on page 58 of the appendix.]

Chairman GARRETT. Thank you.

And before you go, Mr. Goebel, I will just indicate to the panel and the rest of the members here, we are just going to continue. There is only one vote. It is on right now, so members are encouraged to dash over to vote and then come back, so that we will proceed as you are voting.

Mr. Goebel?

STATEMENT OF SCOTT C. GOEBEL, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, FIDELITY MANAGEMENT & RESEARCH COMPANY

Mr. GOEBEL. Chairman Garrett, members of the subcommittee, thank you for the opportunity to testify today.

My name is Scott Goebel, and I am senior vice president and general counsel of Fidelity Management and Research Company. In this role, I am responsible for legal matters pertaining to Fidelity's investment advisory businesses, including the Fidelity mutual funds.

Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of $3.7 trillion, including managed assets of more than $1.6 trillion. We manage over 400 mutual funds across a wide range of disciplines.

As you might have assumed, we are strong advocates for the mutual fund model and the benefits mutual funds provide to individual investors. Mutual funds allow shareholders, at a low cost and for a small minimum investment, to obtain a professionally managed, liquid, diversified portfolio of securities, with the added safeguards of a robust regulatory regime and independent board oversight.

For example, mutual funds operate under strict statutory borrowing limits. And, as a result, the vast majority of mutual funds do not use leverage to generate investment returns.

Today, there are more than 7,500 funds, holding over $12.5 trillion in assets, offered by a host of financial services companies. We believe that these numbers illustrate the intense competition and low barriers to entry that have been the hallmarks of the mutual fund industry—forces that continue to drive mutual funds to innovate and improve product offerings.

The assets in mutual funds belong to our shareholders. They are not proprietary assets. They are not Fidelity's assets. And our mission each day is to put the interests of our shareholders first as we manage the assets of these funds.

I want to focus today in my oral testimony on money market mutual funds. Money market funds offer a convenient way for millions of investors and institutions to invest short-term cash. For 40 years, they have offered stability, liquidity, and income at a reasonable cost, and today provide an important source of funding for State and Federal governments and corporations.

In 2008, during the worst economic crisis since the Great Depression, the credit markets became stressed as uncertainty rippled through the financial markets.

As part of a broad range of efforts by the U.S. and foreign governments to stabilize the markets, the U.S. Treasury established a limited, fee-based insurance program to support money market funds. No money market fund drew upon this program, and the Federal Government actually earned $1.2 billion in fees.

At the height of the crisis in 2008, one money market fund, the Reserve Primary Fund, dipped below the stable $1 per share price that money markets strive to maintain.

In the aftermath of this financial meltdown, the SEC adopted a comprehensive set of amendments to Rule 2a-7, which have dramatically enhanced the resiliency of money market funds.

To take just one example, the SEC rules now require that each money fund be able to liquidate 10 percent of its assets in 1 day, and 30 percent in 7 days. This change alone has created, by one estimate, more than $800 billion of new liquidity in money market funds.

The question is, what comes next? Are there additional money market fund reforms that are necessary or appropriate?

Some reform options under consideration, such as the floating NAV, would cause shareholders to leave money market funds in large numbers. Based on client surveys, we believe that these shareholders would shift to other investment options, including banks, offshore products, and other unregistered institutional investment options, all of which pose greater systemic risks than do money market funds.

However, Fidelity understands that some Federal financial regulators, and others, believe that more needs to be done to increase the resiliency of money market funds. Therefore, we are working with others in the industry on a proposal that would strengthen money market funds by creating a buffer within each fund.

It is worth noting that this is a private market solution that does not rely on any government support.

The idea is pretty simple. Each fund would be required to hold back a portion of the yield shareholders would otherwise receive. And this amount would grow over time to create a buffer, or cushion, that would help absorb any potential losses and help ensure liquidity by enabling money market funds to sell securities at a loss to meet large redemptions.

Shareholders would continue to buy and sell shares at the $1 price, but each share would represent assets of slightly more than $1.

We arrived at this solution by asking ourselves, what is the problem that regulators are trying to solve? By and large, we believe that the issue is that some shareholders have—or think they have—an incentive to redeem first, in order to avoid paying for a portion of a potential loss in a money market fund.

The NAV buffer concept eliminates this incentive to get out first, because as shareholders redeem, the buffer amount is spread over a smaller investor base. In other words, a shareholder redeems $1, and leaves the value of the buffer behind in the fund, which helps to protect the remaining shareholders.

As regulators in the industry consider additional possible reforms, we submit that the question should not be, how do we prevent the next money market fund from breaking a buck; rather, the question should be, since so much has already been done to improve the resiliency of money market funds, how can we alter shareholder incentives to ensure that, if a money market fund breaks a buck in the future, shareholders and other funds are not affected.

I would like to thank the subcommittee and staff for their work on these issues that are important to mutual funds and our investors, and for holding this hearing.

I would be happy to answer any questions.

[The prepared statement of Mr. Goebel can be found on page 69 of the appendix.]

Chairman GARRETT. And I thank you.

Ms. Stam, please, for 5 minutes?

STATEMENT OF HEIDI STAM, MANAGING DIRECTOR AND GENERAL COUNSEL, VANGUARD

Ms. STAM. Thank you.

Thank you, Chairman Garrett, and members of the subcommittee. I appreciate being here today.

My name is Heidi Stam, and I am a managing director and general counsel of Vanguard and the Vanguard Mutual Funds.

Vanguard is one of the world's largest mutual fund firms. We offer more than 170 mutual funds with combined assets of approximately $1.7 trillion. We serve nearly 10 million shareholders.

About 95 percent of the assets we oversee are owned by individuals, whether they invest directly with Vanguard, indirectly through financial advisers, or as participants in retirement funds.

In short, we are a big company that serves many, many small investors.

We appreciate your interest in Vanguard's views about the current state of the mutual fund industry, and we hope to lend to this hearing the perspective of the average investor from Main Street, not Wall Street.

During the financial crisis, investor trust and confidence in the global financial system was severely damaged. Investor trust and confidence in mutual funds, however, was not. And this is a very important distinction.

Indeed, assets entrusted to mutual funds and ETFs reached an all-time high of nearly $13 trillion at the end of last year. This is a tremendous testament to the trust that millions of investors place—and have placed over many decades—in mutual funds.

Mutual funds are resilient. They have weathered every crisis from the Great Depression of yesteryear to the great recession of yesterday.

Mutual funds are the most efficient, effective, and intelligent way to invest in the securities markets. Compared to other financial products, they provide superior liquidity, transparency, professional management, and diversification—all at a reasonable cost.

We believe that strict regulatory oversight of mutual funds has played a vital role in their success. Mutual funds are subject to a comprehensive regulatory regime. And for more than 70 years, the SEC and the industry have shared an obligation to serve and protect the interest of investors. It is an obligation we do not take lightly.

This shared obligation came to the fore in 2008, when the money markets were rattled by the most significant liquidity crisis in our history. The industry and the SEC moved to solve the problem quickly and thoughtfully.

The industry formed a working group which began a thorough review of rules governing money market funds, and they developed a series of measures to address the funds' ability to withstand the extremely unusual market conditions that existed at the time.

Shortly thereafter, the SEC adopted enhancements to Rule 2a-7, which improved the liquidity, credit quality, maturity, and transparency of money market funds.

We believe that these enhancements addressed the need for greater liquidity in money market funds and significantly reduced the risk that a future systemic market disruption would threaten the liquidity of these funds.

If the SEC determines, however, that additional measures are needed, then we would encourage a solution that is tailored to address the remaining concern.

Specifically, more liquidity may be required for institutional money market funds that have demonstrated a heightened need to make large, same-day redemptions. And we think this could be achieved quite simply by increasing the liquidity requirements for these funds.

This approach, or other recent proposals that are discussed here today, are simply not required for mom-and-pop money market funds. The cost, complexity, and disruption that additional changes may cause small retail investors are not warranted, given the way these money market funds are used—to pay the mortgage, send a tuition check, or save for a rainy day.

We believe money market funds are well regulated and should remain solely under the SEC's jurisdiction. That said, Vanguard understands the need for the Financial Stability Oversight Council to monitor risk across markets, institutions, and segments.

It is important to emphasize, though, that none of the reckless lending, leveraging or financial engineering that led to the creation of FSOC related to mutual funds.

Mutual funds do not have leverage exposures or off-balance sheet liabilities. They mark their asset value to market every day. Their portfolio holdings are transparent and reported regularly.

Mutual funds do not engage in proprietary trading. They do not pose systemic risk. They do not have the attributes of systemically important financial institutions, based on the FSOC factors, and they should not be designated as such.

Vanguard has always been willing to discuss the interest of mutual fund investors with legislators and regulators. We respectfully caution against duplicative regulation that has the potential to limit innovation, raise the cost of investing, stretch the resources and time of fiscal constraint—unless there are clear benefits to investors.

We believe that mutual funds already benefit from multiple layers of investor protection in the form of strong securities laws, an effective regulatory agency, a keenly competitive industry, an educated consumer, and a vigilant news media.

Thank you very much for this opportunity to share our views. We would be happy to answer any questions.

[The prepared statement of Ms. Stam can be found on page 89 of the appendix.]

Chairman GARRETT. Thank you, Ms. Stam.

Professor Stulz?

STATEMENT OF RENE M. STULZ, REESE CHAIR OF BANKING AND MONETARY ECONOMICS, AND DIRECTOR OF THE DICE CENTER FOR RESEARCH IN FINANCIAL ECONOMICS, OHIO STATE UNIVERSITY

Mr. STULZ. Chairman Garrett and members of the subcommittee, I thank you for giving me the opportunity to testify at this hearing.

My name is Rene Stulz. I am a professor at the Fisher College of Business of the Ohio State University.

Systemic risk is used everywhere, all the time within the regulatory community. At the same time, it is rarely defined and almost never quantified, which makes possible a lot of mischief.

My definition of systemic risk is that it is the risk that the financial system becomes incapable of performing one or more of its key functions in a way that prevents normal economic activity.

To justify regulation in the name of preventing systemic risk, it is important to assess both the costs and the benefits of that regulation. Any systemic designation should be based on objective and quantifiable criteria.

On economic grounds, there is no reason to believe the specific mutual funds, mutual fund complexes or management companies should be designated as systemically important.

The asset management industry plays a critical role in our economy by managing the funds of investors. The failure of a player in that industry in performing its role does not create a systemic risk. If one player runs into trouble, another player can take its place.

There is no evidence that the asset management industry created systemic risk during the recent crisis, except in one segment: the money market fund segment.

Rather than designating money market funds as systemically important, it would make more sense to eliminate the features of money market funds that create systemic risk.

By their very nature, money market funds are prone to runs. When investors run from funds, this forces funds to sell assets and disrupts the provision of short-term funding in the financial system.

In 2008, the run was started by losses on Lehman investments at one fund, the Reserve Primary Fund, which was forced to redeem shares at less than $1.

In the 2 weeks following the bankruptcy of Lehman, more than $400 billion left prime money market funds. Further, money market funds sold assets to become more liquid to cope with further redemptions. Runs and anticipated redemptions led to chaos in the commercial paper market as well as in the repo market.

The point of reform of money market funds is not, therefore, to make investors in these funds safer; it has to be to make the financial system safer.

Some might argue that reforms that have already taken place have eliminated the problem. This is not correct. Money market funds are still vulnerable to runs.

Further, the large positions of the funds in European banks are a source of risk for these funds, as well as for the financial system. A recent study finds that the top 15 largest prime AAA funds have more than 50 percent of their assets invested in foreign banks—the lion's share of these investments in European banks.

The key reason why money market funds are prone to runs is that they allow investors to redeem at $1, when the market value of the fund's assets is worth less than $1. If the market value of a fund's assets is worth less than $1 a share, it can become rational for investors to run, since they receive $1 by redeeming immediately, instead of possibly receiving less if they do not.

To make runs much less likely, the Squam Lake Group, a group of 14 economists of which I am a member, has proposed that the money market funds either should have a floating NAV, or should have a buffer that could be used to prevent the NAV from falling below $1 a share.

By buffer, we mean resources committed by the management company, or by third parties, that absorb losses, so that the fund can keep redeeming shares at $1, even if it has made losses. The use of a buffer makes it possible to keep the stable value NAV mechanism, but largely eliminates the incentives for investors to run, since the buffer ensures that the mark-to-market value of the shares does not fall below $1, as long as the buffer is large enough to cover losses.

We proposed several mechanisms to create a buffer. Irrespective of how the buffer is implemented, we recommend that any buffer mechanism should have three important characteristics.

First, the mechanism should be such that, in the presence of losses, the buffer could be replenished quickly.

Second, a stable value fund should immediately convert to a floating NAV fund if the buffer is depleted, so that its value is below some minimum threshold.

Third, once losses have been made, the buffer should be replenished within a short period of time; and if it is not, the fund should convert to a floating NAV fund.

Thank you again, Mr. Chairman and committee members, for letting me testify. I would be happy to answer any questions.

[The prepared statement of Mr. Stulz can be found on page 205 of the appendix.]

Mr. SCHWEIKERT. [presiding]. Thank you, Mr. Stulz.

As a matter of fact, you are all very impressive. It is amazing how close you all came to hitting exactly the 5 minute-mark.

A couple of odds and ends. One, I just finished, earlier this morning, reading something from the Federated Investors. I would like to actually put that into the record.

And the Chair yields himself 5 minutes.

I would like to actually continue where you were going, Professor Stulz, regarding what you call a buffer. If an account or fund puts that buffer, what has that done to its yield?

Mr. STULZ. In the Squam Lake proposal, which is appended to my written testimony, we try to estimate the impact on the yield. And our conclusion is that the impact would be minimal. What would happen is that the funds would have incentives to be very transparent about the holdings.

Mr. SCHWEIKERT. My concern was actually—and I was actually going through your proposal this morning—I was trying to get some understanding. Particularly, I come from having once been an institutional investor in these types of accounts, and just managing lots and lots of cash.

Sometimes, I could only hold them for 45 days until I had to pay salaries for teachers or sheriff's deputies. But that yield sometimes was the salary for another teacher. And so, I am always very, very yield-centric, if that buffer does much damage on that rate of return.

Mr. STULZ. Our conclusion is that it would not do much damage to the rate of return.

Mr. SCHWEIKERT. Okay.

Professor Bullard, it is almost the same question. And then, you actually said something interesting in your testimony about access to the window. Could you also expand—first the question, and then expand on that?

Mr. BULLARD. It is partly just a flat disagreement with the view that a buffer can change the fundamental causes of systemic runs.

And to give you an example, I have read the Squam Lake proposal. They suggest that 3 percent might be a reasonable buffer.

If the Lehman Brothers holdings had been 4 percent, Reserve would have failed, the buffer would have been exceeded, and then we still would have had a run. And everyone in the institutional marketplace will know that. There is no relationship between that and what actually causes that kind of systemic failure of trust.

A liquidity bank that has access to the discount window has the potential to create that kind of change in attitude of institutional investors, who really are the only ones who would lead a run. I think retail investors would have followed in September, but they were the only ones who would lead a run, and they are the ones we should focus on.

But we cannot know that. And not being an economist, I am not willing to say that I do know the answer to that.

I do know the answer that full faith and credit solves the problem. But I think a liquidity window certainly has a high enough probability of changing their attitude that it would actually prevent precisely the kind of run that a buffer would fail to prevent.

Mr. SCHWEIKERT. And don't harp on not being an economist. Around here, if you are an economist, we get two or three answers.

Mr. BULLARD. I think it is a badge of honor.

Mr. SCHWEIKERT. Mr. Stevens, give me pros and cons on floating up and down over the net asset value.

Mr. STEVENS. I am harder pressed to do the pros than the cons.

I think many of the people who have suggested floating the NAV understand implicitly that, as a result of that, we won't have money funds as we know them any longer. And that would be just fine with them.

If that is a pro, that is, I think, what they have in their minds.

The con is that, as has been observed already, the money will go from institutions into unregulated parts of the financial system, and we will be replicating the same risks that are perceived here with respect to money funds. We will just be doing it elsewhere, where the SEC is not overseeing it and it is not as transparent.

Much more importantly, though, we will put at risk the whole mechanism that funds corporations, and State and local governments, individuals who are accessing the credit markets. For that matter, even the Treasury's auctions depend very substantially on money market mutual funds' participation.

So it would be a real shock to the current funding model, a real shock to those people who depend upon money market mutual funds for critically important financing. And it would not solve the systemic risk issue.

Mr. SCHWEIKERT. Okay. And we probably barely have time to touch on this.

Ms. Stam?

Ms. STAM. Yes.

Mr. SCHWEIKERT. In today's world, with one of these funds, what do you think your regulatory cost is, compared to what it may expand to with some of the discussions?

Ms. STAM. I have to say, interestingly enough, the Vanguard funds have been operating under very conservative money market regulations for some time.

And so, the enhancements to Rule 2a-7 that were adopted recently are very consistent with the way we have managed these funds historically. So there has been not much of an incremental cost to those changes.

When we think about the other suggestions that have been put on the table—buffers of different types, and so on—there is certainly a cost associated with them. And that is something that we will have to evaluate as to whether these are workable solutions.

We would hate to burden the money market fund investors with a cost that would essentially make the product unusable for them.

Mr. SCHWEIKERT. I am over my time. And you will have to forgive me, but having been a treasurer of a large county, I was always—the safety of principal return was always number one. But that constant concern, that little bit of yield is what helped employ that next teacher.

Five minutes to Mr. Green?

Mr. GREEN. Thank you. I will yield to Mr. Lynch, and then I will proceed next in the rotation.

Mr. SCHWEIKERT. Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

Thank you, Mr. Green.

First of all, I want to agree heartily with the testimony of Mr. Stevens and Mr. Goebel in terms of the value and opportunity that mutual funds have created for working-class families that I represent in my district.

I have companies like Procter & Gamble, Gillette—and I came out of the ironworker industry myself, the building trades, and I know there are a lot of hard-working families out there who, at a very low cost, are now able to invest and, over their working lives, accumulate significant wealth because of the structure and stability of mutual funds. There is great support here for that.

I do want to talk about how most of the controversy here has been focusing on the Reserve Fund and breaking the buck. And I just know that there is less and less support in this body and in the Senate for government guarantees, where the good faith and credit of the American taxpayer is at risk.

That is what intrigues me about your testimony, Mr. Goebel, regarding this buffer for the money market mutual funds as a private sector response to this, where the taxpayer is not at risk, and that, over time, incrementally, a buffer would be created.

Could you go over that? I know that is an industry response. I think it is thoughtful. I think it is responsible. I think it could work.

I just need to hear a little bit more about it, if you would.

Mr. GOEBEL. Sure. Thank you, Congressman.

The fundamental premise that we have is that, to the extent there is additional residual risk in the product that has not been resolved—and I should pause and say, that is still an "if" for us, the significant liquidity.

One of the issues in Lehman and the crisis that followed from Lehman was that institutional investors did not know what was inside our portfolios. They did not have the visibility into what the actual holdings were.

It is very common now, in the institutional space in particular, to disclose full holdings within a day or two. So there is much greater transparency.

If there is an institutional investor out there who has questions or concerns about what is inside one of our funds, they can find out very quickly and very easily. The liquidity changes, the transparency changes have really been significant.

The idea of the buffer is to say that we do not think that the government should be standing behind these products. We recognize that there is some risk in them. They are an investment product. Shareholders are putting their dollars with us, and our job is to return stability of the principal, liquidity, and yield, in that order.

So what our approach is, to say that yield, a piece of that yield over time, shareholders, we think, will accept a reduction in that yield in order to enhance the stability of the product.

The question that was asked earlier of the panel was, how much of the yield, how much of a cost is this going to be? And the answer to that question is, you tell me how quickly you want to get to the buffer, and I will tell you how much it is going to cost. Because if it is 30 basis points, and you take 5 basis points a year, that is a 6-year issue.

One of the questions that we have with all of the issues with Basel III and banks increasing their capital liquidity is, how quickly can we get to the right level of protection? And we submit that this product is very safe and secure today. But the added idea of taking a little bit of the yield from time to time out of what shareholders would otherwise receive, fully disclosed, so shareholders can understand what they are getting, is a pretty elegant solution.

And the reason for that, the reason why we think it works in the marketplace, is that a shareholder can make a decision about the yield that it or he or she is receiving on that product. And if they do not like the yield, they can go to another product.

So over the last 20 years, roughly, money market—taxable money market funds have returned 150 basis points more than banks. We believe, in a normal rate environment, taking 5, 6, 7 basis points of that yield and diverting it into this buffer idea is a reasonable trade-off, and shareholders will continue to invest.

Mr. LYNCH. Okay. Thank you.

I do agree that the situation with Lehman, the death knell there was really the lack of transparency, the uncertainty. No one knew what kind of product exposure was. And that is a much different situation than what we have here today.

I know I am short on time, but Mr. Stevens, do you have anything you want to add to that?

Mr. STEVENS. I think it is an idea that is worth very serious consideration, and I would say it is among a number that the industry participants and the institute have developed.

And I would just reiterate the points that I made. As we consider these things, I think they need to be held up to two standards. Do they maintain the utility of the product to the investor, number one? And number two, are they going to still be consistent with maintaining a robust array of advisers who want to be in this market and to provide these funds?

I think those are the two criteria appropriate to begin thinking about what additional reforms should be.

Mr. LYNCH. Thank you.

Thank you, Mr. Chairman. I yield back.

Mr. SCHWEIKERT. Thank you, Mr. Lynch.

Mr. Dold for 5 minutes.

Mr. DOLD. Thank you, Mr. Chairman.

Professor Stulz, a question for you. In your testimony, you urged regulators to refrain from designating financial firms as systemically important until they can accurately set forth an objective and quantifiable criteria to define the term.

Can you give me some examples of some objective and quantifiable criteria Congress and the regulators can use to define a systemically important firm?

Mr. STULZ. Financial economists have developed models that look at the impact of a shock to one firm on the rest of the financial system. And so, the use of models of that type would provide an objective benchmark for whether an institution is systemically important or not.

So you would want to see, based on historical evidence or based on simulations, what would happen to the financial system if a particular institution runs into trouble. If such models were used, it is inconceivable to me that the asset management industry would show that it has a systemic impact.

Mr. DOLD. Can you give me just some sort of an idea of how many firms out there right now would get the SIFI designation, that you believe are systemically important financial institutions? Do you have a number?

Mr. STULZ. I do not have a number, but I believe that the number would not be in the hundreds; it would not be more than 50. I think we should be very careful in giving that definition, and we should make absolutely sure that there is enough objective evidence that the failure of the institution would have systemic consequences.

Mr. DOLD. Okay. Thank you so much. So you are basically at about 50; I have heard a couple of dozen would be the most.

Mr. Donohue, what is your assessment on that? How many firms do you think right now would qualify for an SIFI designation, or should be qualified?

Mr. DONOHUE. I am not sure I am well informed enough to make that judgment. I would say, as I have said in my testimony, that absent extraordinary circumstances, I do not see asset managers, traditional asset managers or mutual funds being within that class.

Mr. DOLD. Just continuing to follow up with you, sir. In your opinion, has the SEC oversight of mutual funds worked in the past? And what can be improved internally within the SEC to better regulate those funds?

Mr. DONOHUE. I am a strong supporter of the SEC's role in regulating mutual funds. I had an interesting seat during the financial crisis, heading up the Division of Investment Management.

The expertise that exists inside the SEC, the understanding of the mutual fund industry and how it operates, and the way that, in fact, the SEC has operated with regard to mutual funds over the years, I think is a testament to the right regulation of an industry. And I think the growth of the industry during that period is testament to that.

That does not mean that there are not challenges. It is a 70-plus-year-old statute that the Commission has to—they have a tool in order to adjust the statute, the ability to do exemptive and other type of relief. But that is time-consuming and does take resources that the Commission then has to have in order to adapt.

I think they have done it well. I think, if they do not have adequate resources in order to do it, then the robust regulatory regime that funds have had may be compromised.

Mr. DOLD. Thank you.

Professor Bullard, if I can ask you, in the absence of the government bailout under TARP, how many money market funds do you think would have failed?

Mr. BULLARD. I am not sure there is any evidence that suggests that the TARP bailout had an impact on the survivability of any particular money market fund. And that was quite a different kind of exercise in the socialization of risk that we see banking regulators engaged in.

So I would say, I do not think anyone can know the answer to that, but my guess is close to zero.

Mr. DOLD. Okay. In light of that, do you think it is necessary that the government be a backstop to money market funds?

Mr. BULLARD. There are a couple of different levels on which to answer that question.

As an overall systemic regulation question, money market funds should be regulated considering the context in which all short-term cash is regulated, which is why I couple my recommendation of deposit insurance necessarily with weaning banks from their overreliance.

Within the context of money market funds, I would probably say, "no." I have a somewhat iconoclastic view of what really happened in the crisis. Money market funds were safe before; they were safe after.

I would not have supported any of the improvements the SEC has made to the safety of the objective portfolios that have been done to-date. I support the operational changes, the liquidity changes.

But in terms of whether the product itself has actually become meaningfully safer, I think that is simply an incorrect assumption and has essentially been giving into political pressure.

And what you are going to find in a few years is, the ICI is going to tell us how many basis points that shareholders in money market funds have lost because of it, without any real meaningful change in safety.

On the other hand, systemic risk is a different thing. There is a good argument that there should be some kind of systemic risk management put into place. And for that purpose, as I said, it needs to be something that will force money market fund shareholders to think differently about money market funds as a structure.

And the only way you can actually do that is not a buffer, is not capital requirements, is not increased liquidity, is not greater safety. There is only one thing out there, and that is some kind of Federal guarantee.

And the discount window by itself probably would be sufficient to bring about that change in perception of money market funds, while costing the government as little as possible in terms of the costs of socializing risk as a general matter.

Mr. DOLD. Thank you so much.

Mr. Chairman, I yield back.

Chairman GARRETT. Thank you.

Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman.

And to the witnesses, thank you again for appearing.

The financial system depends greatly on confidence, and confidence depends greatly on transparency.

With reference to the money market system, is there sufficient transparency? Is there more that we can do to enhance transparency such that we enhance the confidence in the system as a whole?

So let me just ask such that I do not go down to every person, if you think there is more that we can do in the area of transparency, would you just kindly extend a hand into the air?

Anyone? All right.

Yes, sir, Mr. Stevens?

Mr. STEVENS. I would say, in the dialogue around this issue, there is a sense that some believe that shareholders do not understand the risks of money market mutual funds enough.

We are almost victims of our own success here. Our track record in maintaining that stable NAV per share is really quite extraordinary. It has gone on for 30 years. Only two money market mutual funds have ever broken a dollar.

In the case of the Reserve Primary Fund, shareholders lost a penny on a dollar under circumstances where many other investors would have thought that was a great day in the market for them.

To the extent that they do not understand it—even despite the fact that the prospectuses say these funds are not guaranteed, they are not insured by the FDIC or by the United States Government—we can try to make sure, in blaring headlines, we communicate that to people.

That might be a useful thing to remind everyone, that these are investment products. They have risks that are quite minimal. And people need to understand that as they invest in them.

I would like also just to mention something about the systemic risk issue. And you have to think about money market funds in September of 2008 in a context.

The context was essentially a paralysis in the short-term, fixed-income markets that affected every market participant, not money market mutual funds uniquely by any means. It was a crisis in the banking system that paralyzed the markets in which we invest.

What we needed then, Congressman, was not a Federal guarantee. In fact, we never asked Secretary Paulson for a guarantee. We were kind of appalled, because we knew the consequences when it was extended.

What we wanted was liquidity in the markets in which we invest, particularly the commercial paper market.

And we may have another crisis one day in that market. Fixing money market mutual funds is fine, and we think that is important. But we also ought to attend to the reality that we are going to need to have liquidity provisions in that market, as well. And there is no possibility of that at the moment.

Mr. GREEN. As we review and reflect, obviously, Lehman comes to mind and the cascading impact that it had on the entire economic system.

How do you avoid that, given that it generated a run? And once you get a run, it sometimes is difficult to stop the run.

So how do you do that, and under those economic circumstances?

I understand the liquidity argument. But how do you prevent, how do you stop the run or prevent it?

Mr. STEVENS. We spent—as a result of the Treasury Department's White Paper and the President's Working Group Report suggesting the desirability of exploring a liquidity facility—the institute and its members spent almost 2 years putting together a very detailed model of how such a facility might work, formed as a commercial bank, capitalized by sponsors of prime money market funds and by shareholders in prime money market funds, and as a commercial bank regulated by the Fed and overseen as a bank, but available as a dedicated market-maker in commercial paper should there be a liquidity crisis in that market.

It would be able to make a market for money market funds, prime money market funds, and in the worst circumstances, could access the discount window.

Mr. GREEN. I am going to let you continue, but let me intercede for just a quick second.

Is it anticipated that in the shadows, there will be the hidden hand of the government?

Mr. STEVENS. I was going to say, the only hand of government here, other than overseeing the institution, would be that it would, just as every other commercial bank, have access to the Fed's discount window in the worst kinds of circumstances. But it would do it with the haircut and at the expense of the institution and its participants, just as would be the case with every other commercial bank—so, no different than others.

Mr. GREEN. Thank you, Mr. Chairman.

Chairman GARRETT. And I thank you.

I will recognize myself.

Along those lines, first of all, as far as the glaring statements as to evidence that these things are not guaranteed by the government, of course, that was the case.

I have a little bit in a fund, and any time you call up to have a transaction and find out what is going on, the recorded message there is exactly that. Right? It is telling you that this is not guaranteed by the Federal Government, until after the fact, you found out that it really was.

Mr. STEVENS. And, Mr. Chairman, that is a circumstance that we would very much like to avoid ever again in the future. As an industry, we are not seeking a guarantee of any kind from the government.

Chairman GARRETT. Right.

Could you just elaborate a little bit as to what your protestation was at the time when this was going on, as far as to the Secretary. Were you saying, "Stay away, we do not want this?"

Mr. STEVENS. No. We thought the problem was liquidity. And if the markets in which we invest could be jump-started—as eventually they were through the Fed's facilities—then that would solve the problem.

The guarantee was perhaps an appropriate response to an extraordinary crisis, and it certainly did bolster confidence. I think most people did not understand how limited the guarantee was.

What the guarantee was, was if a fund is at risk of breaking $1, it would have to immediately suspend redemptions and liquidate its shares. The level of risk to the Treasury was intentionally very small.

All of our funds participated and paid $1.25 billion in premiums. There were no claims against the guarantee.

Chairman GARRETT. So one of the solutions out there that we talked about already is a floating NAV.

The question then is, let us say we did that. Would that preclude—and I will just open this to anyone—would that absolutely preclude basically what we are talking about here, a next run on the bank, so to speak?

Mr. GOEBEL. I would like to take a crack at that.

Chairman GARRETT. Sure. Okay.

Mr. GOEBEL. The floating NAV idea we have talked a little bit about. We do not think it works for several reasons. One is, we know shareholders do not want it.

We have surveyed our shareholders. Depending on the segment, between 70 and 90 percent prefer the stable NAV. The tax and accounting issue is more complicated.

If you believe that floating the NAV means that the product will go away, if that is the goal, then floating NAV may not be a bad policy choice. But if you believe that money market funds are an important vehicle for investor savings and an important element of the short-term funding that goes on for municipalities, then floating NAV is a bad idea.

Chairman GARRETT. Let me just stop you right there. Part of the answer of why you do not want it, or why they do not want it, is because of that dependency for short-term financing by corporations.

Is part of the problem then, maybe, that there is just too much reliance—you said municipalities, but others—on these funds for short-term financing?

Mr. GOEBEL. I think—first of all, the business model that was the poster child for overreliance on short-term funding no longer exists. There have been significant changes in the marketplace.

I know we are going to talk a little bit about European banks later, but as we get into that conversation, the lessons of overreliance on short-term funding have been learned by participants in the marketplace, as well. So there are very different approaches to liquidity, very different understanding of how much short-term funding ought to be used by a particular entity.

Money market funds are investors investing in the very shortest part of the market, trying to get our money back. And we do, like other very short-term investors, see the problems that occur in the marketplace and react quickly enough to protect our shareholders. That is an element of how these products work.

Chairman GARRETT. Okay.

Professor Stulz, there seems to be not much love for the floating NAV.

Mr. STULZ. I still think that it should be pursued and that we should study it very carefully.

The great advantage of the floating NAV is full transparency. The investors know exactly what the value of their investment is. Currently, they really do not

They can withdraw their money at $1, but that is not the value of the shares. It is not the fair value of the shares.

The floating NAV has the advantage of the transparency. It has the advantage of removing the free option that investors have under the current system that leads to runs.

The floating NAV has some advantages. I agree that it has operational difficulties, and I think the ICI report describes them extremely well.

Chairman GARRETT. I apologize, but I want to quickly get to you with regard to SIFIs and your comment that the regulators should not be declaring some of these financial institutions as SIFIs until they can accurately define what a systemically important institution is.

Are you able to help set forth what that criteria should be?

Mr. STULZ. Financial economists have come up with a number of models that are helpful in answering that question.

And so, yes, the answer is that I could help.

Chairman GARRETT. Okay, that has been one question we have grappled with here from the day that former Chairman Frank raised the issue, that we need to go after these systemically important institutions, to the time that we had Secretary Geithner here, and Chairman Bernanke.

And we could never quite ever get anyone to actually define exactly what we were talking about in this situation.

But I appreciate your answer.

The gentleman from North Carolina is recognized.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

One striking lesson from the financial crisis is that there were enormous aspects of the financial system that no one knew anything about. Americans in general did not know anything about it. And really, no one in Congress knew anything about it, I don't think, including members of this committee, including me.

And I do not think it was because we lacked diligence—not in every case. It was because there was nothing to call our attention to some of what was going on, some of the changes in the market, in the financial system.

And those who really did know about it did not see any percentage at all to calling our attention to it, one of which was the repurchase market, the repo market. At the time of the crisis, that was described in the press as a freeze in interbank lending. But it really was a traditional run.

The only proposal that seems to—and, as I understand it, the repo market was approximately the same size every night in daily lending as all deposits. So, it was enormous.

And no one knew the first thing about it, and there was no regulator even breathing on it. And the run in the repo market around the time of Lehman—and really before that, Bear Stearns—is what precipitated most immediately the crisis.

Has anything changed? There has certainly been no regulatory change. But is there any reason to think that the repo market is less vulnerable to a run? Is there any more market discipline in who financial institutions will lend to through the repo market?

Professor Bullard, you talked about the possibility of runs in the money market, money market funds. Have you given any thought to that?

Mr. BULLARD. I do not follow the repo market as such. But the problem with the repo market is that it gives a superficial sense of confidence, in that it looks like something that is almost immediate cash, and it is easy to forget that what stands behind it is a single counterparty, which presents a significant issue of risk.

The Rule 2a-7, which regulates money market fund holdings, has long regulated repos in, I think, the right way, by understanding that you have an issuer standing behind that repo. And I am not aware of any problems in the money market fund world that have stemmed from repo liquidity or value as such.

Mr. MILLER OF NORTH CAROLINA. Mr. Goebel?

Mr. DONOHUE. If I could jump in, actually, when 2a-7 was amended, actually, the repo positions—position—in 2a-7, which is the rule that governs money market funds, was strengthened with regard to what is called the look-through rule on whether or not you had to look just to the counterparty or whether you could look through for the underlying collateral. And you can only look through the underlying collateral if it is government securities now.

I think it has been strengthened inside money market funds, not because money market funds had issues, but rather looking forward to ensure that actually money market funds do not have issues going forward with regard to having to liquidate their collateral on repos.

Mr. MILLER OF NORTH CAROLINA. But not all the repo market was through money market funds. Money market funds may have been participants in the market, but there were mutual funds who were participants beyond the money markets. Isn't that correct?

Mr. GOEBEL. Yes, that is correct.

Mr. MILLER OF NORTH CAROLINA. Mr. Goebel?

Mr. GOEBEL. That is correct.

There is some work going on. The New York Fed has a tri-party repo commission. There was an understanding that there is a concentration of risk in certain aspects of the structure, the way repos are actually effected over the course of the day.

There is a group that has been working on greater transparency, removing that intra-day risk, understanding how the confirmation process works, so there is better understanding in the tri-party repo market. There is also work to create different liquidity sources in case there are issues within the repo market.

So there is definitely work under way to strengthen the way the repo market operates.

If your observation is that there is an investment decision made every day by money market funds and others to participate in the repo market, that is certainly true. There is cash that needs to be invested overnight. There are securities that are available for this market. And that is something that is important to the way the markets operate today.

Mr. MILLER OF NORTH CAROLINA. Okay, I think, actually, the concern by the critics of the repo market was that there were not really decisions being made every day, it really was reflexive, until it got to the point that Bear Stearns got to, or till it got to the point that Lehman Brothers got to.

Chairman Bair's concern, and the FDIC's concern, is that, instead of identifying a firm that was in trouble earlier when the resolution of that firm would not be quite so expensive or complicated, the run on the repos usually left—the collateral required and all the rest—left firms in a crater. They would hit Earth and leave a large crater, which made it very hard, much more expensive, and much more complicated, with much more systemic risk resulting from that.

Mr. GOEBEL. Can I just say that, when we think about repo, we ignore the collateral. We receive full collateral for the investments, but we assume that we have to look to that counterparty to make that investment good.

So we are very careful to evaluate the counterparty risk of every repo trade that we enter into.

Mr. SCHWEIKERT. [presiding]. Thank you, Mr. Miller.

Chairman Neugebauer?

Mr. NEUGEBAUER. Thank you very much.

I want to associate myself with some of my colleagues who spoke earlier about the fact that we have almost made an implied guarantee of money market funds by the fact that the government stepped in.

And that is something we have to fix, because we cannot let companies pick up the profits, and the taxpayers pick up the losses. And so, I think this is healthy discussion.

One of the things that—and I am not necessarily associating myself with the floating asset value concept at this particular point in time, but I do—we have to think about, if you are going to classify yourself as an asset manager, at that point where the value of the underlying securities is less than what you are obligated to pay, you are moving away from an asset manager to you have created a security that comes with an obligation to the firm managing those assets.

And so, I guess one of the questions I would have of the panel is, where am I missing the fact that creating that additional liability then brings into question, why wouldn't—if the taxpayers eventually pick that up, wouldn't that have some systemic implications to it?

Mr. STEVENS. Congressman, may I try to provide one part of the answer?

Mr. NEUGEBAUER. Sure. Absolutely.

Mr. STEVENS. We actually have looked very carefully at a group of money market funds and how the pricing of their portfolios has been done over time. While the funds transacted at $1 per share, they also marked their portfolios to market and carefully examined the extent to which the market value deviates from that $1 above or below.

We actually issued a paper, which I would be pleased to submit for the record here, and what we find historically is that the deviation up or down is extraordinarily minuscule, even if you bring several places to the right of the decimal.

And the reason for that is because the securities in which the fund is investing are very short-dated, so they do not have much interest rate risk. They are extraordinarily high quality, so they do not have much credit risk.

They are expected to be held to maturity and, therefore, can be valued at their amortized costs. And that is the accounting treatment that allows them then to maintain that $1 per share value.

Mr. NEUGEBAUER. Let me stop you there for just a second. You talk about maturity and credit quality. How about concentration?

Mr. STEVENS. Yes, the concentration is limited under the rule, as well, so you do not have exposure, overexposure in the fund to an individual name. There are new rules with respect to the weighted average maturity of the portfolio as a whole, the weighted average life of instruments in the portfolio.

The experience of the industry under Rule 2a-7 over time has been—with the exception of glaring circumstances of the sort that the Reserve Fund found itself in with the credit difficulties that Lehman Brothers presented—that the transacting at $1 really does represent, from a shareholder perspective, the value of its, or his, or her interest in the portfolio.

And the degree of success that was had is remarkable. There has actually been a third of a quadrillion dollars—we don't think about quadrillions much, even in the Congress—but a third of a quadrillion dollars that has gone in and out of money market funds over their history without the loss of any principal to the shareholder. It shows you the level of success that these rules and the industry have had over 30 years.

Mr. NEUGEBAUER. Yes, we try not to use that word around here, because we do not want the Congress to know that there is something after a trillion.

[laughter]

Mr. STEVENS. That is a thousand trillion.

Mr. NEUGEBAUER. Yes, I know.

I think the other question is, and when we go back and rewind the tape to 2008, what about the amount of underlying capital that an entity holds versus the amount of issue that they have and where they have the ability to maintain that commitment, if you are going to continue?

Does one of the other panelists want to dive into that?

Mr. GOEBEL. Just to clarify the question, are you asking about the size of capital that might be required to support any one of these ideas?

Mr. NEUGEBAUER. Yes.

Mr. GOEBEL. There are a couple of different theories. One that you heard was that there needs to be enough money set aside to avoid any fund ever breaking a buck again. In 2008, it was 3 cents on Lehman—in the Primary Reserve Fund, excuse me—and even though, eventually, shareholders received 99 cents.

Our approach is different. Our approach is to say that there is a cushion, there is an amount of money that is appropriate to set aside. And it is enough for shareholders to understand what is happening. It is enough to, over a period of a 10-day crisis—we have a chart in our attachment that explains what happens over a 10-day crisis, assuming certain lock-up in liquidity and diminution in value within the underlying securities and 60 percent of the fund leaves—you still have a dollar left for your shareholders.

With a relatively small buffer, what you really do is buy time. You buy a chance for the markets to resettle. You will buy a chance for investors to really understand what is happening.

And, ultimately, if a board, a mutual fund board and the adviser conclude that they have a product that is no longer viable, it should be okay, again, for a money market fund to shutter its doors and say, we are going to return your money to you, and the rest of the system can continue to operate.

Mr. BULLARD. If I could just add one point to that?

Mr. SCHWEIKERT. I hope you will forgive me. Any objections to another 30 seconds?

Please continue.

Mr. BULLARD. I just wanted to add that, thanks to a recent innovation, a really brilliant innovation that we have Mr. Donohue to thank for is that you can go online now. You can look historically at the NAV of these money market funds.

I have done that. The first one I looked at was 1.000. The second one I looked at was 1.0000. I guarantee you, the first one to start showing up at 0.9999 is going to start losing assets. And that is, in some ways, the best answer to the point that Mr. Stevens was making.

This is now very transparent. It is very obvious.

I can tell you, if you took bank balance sheets and you started forcing them to do that, we would see very different behavior in the bank sector, as well.

Mr. NEUGEBAUER. So you believe there is market discipline concepts built into the system?

Mr. BULLARD. Yes. Enterprising financial journalists cannot wait to write the article about the money market fund that is routinely falling under that 1.0000 number.

Mr. SCHWEIKERT. Thank you, Chairman Neugebauer.

Mrs. Maloney?

Mrs. MALONEY. Thank you, Mr. Chairman.

And welcome to all the panelists.

I would like to ask Mr. Stevens, you may recall during the Dodd-Frank markup that I offered an amendment, which was accepted, to include leverage as part of the criteria for deciding whether a non-bank should be designated an SIFI, a systemically important financial institution.

As major financial firms were failing during this crisis, it seemed that one of the main problems was the degree to which they were leveraged to really outrageous levels.

Mutual funds and their advisers are not highly leveraged. And I am wondering if you believe that the regulators are devoting enough attention to leverage.

Mr. STEVENS. Congresswoman, I do recall the efforts that you made in Dodd-Frank, and we appreciated them. And I think your insight was exactly correct. Excessive leverage in the system was one of the fundamental problems that visited upon us the financial crisis.

One of the reasons that funds came through it so well is that our portfolios do not reflect any leverage of that kind. Our maximum leverage ratio is 1.5-to-1. And any borrowing that a fund does has to be covered by assets so that its indebtedness would be, if you will, secured.

That has been in our DNA, if you will, since the Investment Company Act was passed in 1940. And I think it is a fundamental strength of our institutions.

I hope, frankly, that it will be among many factors that would persuade the FSOC that SIFI designation is not appropriate in our case.

Mrs. MALONEY. I would also like to ask you and Professor Bullard, I recently read an article in the Financial Times, which was written by Professor Robert Pozen, who is an economist and former mutual fund executive, and who is now a professor at Harvard University.

And I request unanimous consent to place this article in the record.

Mrs. MALONEY. So granted?

Thank you.

And in this article, Professor Pozen wrote that money market mutual funds that invest in tax-exempt, short-term instruments issued by States and municipalities offer investors an opportunity to invest in tax-exempt securities that banks cannot offer.

If regulators decide that money market funds cannot maintain a stable net asset value of a dollar, what would the impact be on the availability of these types of investments for consumers?

Mr. STEVENS. When we have talked to investors about this issue, they have told us, in essence, if it is not a dollar in and a dollar out, you do not get my dollar. That is true across-the-board.

But this is a particularly compelling case that you cite, because in the municipal finance area, it is not apparent who could pick up the shortfall in funding, if you did not have tax-exempt money market funds available.

There was a question earlier, why do people finance in the short-term end of the spectrum? And they do it because, in many instances, it is lower cost. And because they are refinancing on a regular basis, they can keep a current rate of interest, in many instances lower than if they are borrowing on a longer term basis.

For America's communities around the country, access to that financing is extraordinarily important. And I think Bob Pozen's piece, which I did read, is exactly right about what is at risk if we remove that funding from our State and local governments.

Mrs. MALONEY. Thank you.

Professor?

Mr. BULLARD. I agree 100 percent with those comments.

I would just add, Mr. Pozen is one of the smartest guys in the fund industry. I would listen carefully to what he has to say, and also reiterate that we are talking about people who are relying for their retirement on income that would be threatened by removing that product from the marketplace, especially as we inside the

Beltway know so clearly that exemption, just having been taken away from D.C. residents, I think, just in the last month.

Mrs. MALONEY. Ms. Stam, in your testimony, you noted that the SEC's recent amendments to money market fund rules have significantly improved the funds' safety, liquidity, and resiliency under extreme market conditions.

Do you believe that these recent reforms constitute a sufficient amount of reform to the money market fund industry? Or should the SEC pursue additional activities?

And Professor Bullard, if you would respond, as well.

Ms. Stam?

Ms. STAM. Yes, thank you. I believe that the enhancements to 2a-7 have gone an extremely long way to addressing many of the concerns that were mentioned here today by a number of the members commenting.

The amount of increased liquidity, improvements to credit quality, the transparency that a number of members talked about being so important to making sure that the marketplace understands the value of the money market funds' investments—we think really it has addressed in large measure the concerns that were faced in 2008.

To the extent that something is left yet to be done—and I think there are proposals worth considering, and we should consider them thoughtfully. But the problems that occurred in 2008 were really focused on the movement of large institutional investors who had a need for intra-day liquidity of their assets. And the run that precipitated at the Reserve Fund came from those investors.

To the extent that we look to put further constraints on this product, we ought to think about tailoring the response to that market.

Mrs. MALONEY. Could we have 30 seconds for Professor Bullard to respond?

Mr. SCHWEIKERT. Without objection, 30 seconds.

Mr. BULLARD. As I noted before, I agree as to the operational and liquidity reforms put in place by the SEC. But I disagree as to the need for those that go directly to the specific quality of the assets they held, with respect to which I do not think there was a good empirical argument that there were safety issues, with the possible exception of the treatment of auction rate securities.

Mr. SCHWEIKERT. Thank you, Mrs. Maloney.

Chairman Royce?

Mr. ROYCE. Yes, let me ask a quick question to Mr. Bullard.

You view the assertions as overstated in terms of the threat of a European debt problem reaching the point where it impacts money market funds here in the United States, in your report.

Could you walk us through that in terms of—I might agree with you, but I just want to hear your thoughts on that. You think it is overstated and there isn't that amount of debt in the money market fund system.

Mr. BULLARD. What is misleading about the representations we have been seeing this week is the characterization of those holdings as simple European bank exposure.

If you look at 2a-7 and the nature of the instruments that they would be allowed to hold, they would be essentially the safest, shortest-term obligations issued by those banks, many of which are a lot safer than some of the banks in the United States.

I think part of it is driven by a chauvinistic attitude toward anything that is offshore. Part of it is driven by banking regulators repeatedly making assertions about the quality of money market fund assets with respect to European banks, while at the same time their banks hold long-term obligations of those same European banks.

What we need, I think, is the SEC to come out and do what prudential regulators do and do best, which is to say, "We have looked at the innards of these funds. We have looked at what they hold, and this is what we can tell you about them. They are safe. They are extremely short term. And money market funds are not vulnerable."

Mr. ROYCE. Let me go to a question where I disagree with you, and that is your proposal for Federal insurance for money market funds.

It seems to me that moves in exactly the wrong direction, to do that explicit Federal backstop, to try to regulate these like a bank when they are not in that category. They do not have the leverage. They have very different terms of operation.

It just seems to me that, if you put that backstop in, what it is going to do is encourage a whole lot of additional short-term financing, which is the opposite of what we want.

And so, when economists talk about this moral hazard problem, why would we want to go down that path?

Mr. BULLARD. I agree I would not go down it alone. What I would do is go down it on a path that, as I described in an article I wrote more fully about this issue, down what I call "the path of least insurance."

We need to look at the entire market and look at the total picture of distortions caused by insurance. And while there is a distorting effect of insuring short-term lending, nothing compares to the distorting effect and the systemic risk created by insuring long-term obligations, which is the foundation of the insurance that we provide for deposits held by banks.

I agree with you. I would not do that by itself. I think that what we need is to move down a path where we are reducing the overall socialization of risk in the system, and that any insuring of money market funds and other short-term assets should be combined with a long-term attempt to reduce the scope of government insurance of private sector activity.

And what has happened in the last 3 years is the opposite of that. We have seen a huge expansion of the socialization of risk, and I think that we need to look at the big picture. But I agree completely with your point as to just money market funds.

Mr. ROYCE. Yes, I think the problem we have there is, you are explicitly expanding the safety net in one more area. And if it is 60 percent of the financial economy now, you are just ratcheting it up.

But I think, Mr. Donohue, you had something to say?

Mr. DONOHUE. I wanted to respond to a couple of points. One is, I think that the debate that is going on about the European exposure of money market funds is precisely because of the transparency that money market funds have about their portfolio holdings, that may not exist inside other areas of the financial system.

I think it is a healthy debate. One of the things that gives me a degree of comfort is that many institutional managers, many institutions that are very highly qualified, get to see those exposures on a frequent basis, and as my co-panelist had mentioned, in many cases daily.

They have not moved their money. They are comfortable with those exposures. They have kept them there.

Mr. ROYCE. Let me go to Mr. Goebel for a question.

Mr. Goebel, you mentioned that the net asset value buffer funded by the money market funds as an alternative would mitigate the potential for runs, without, of course, increasing taxpayer exposure.

And what I wanted to ask of you, Professor Bullard does not believe this is enough to prevent a run. What do you think? Explain that argument, if you will.

Mr. GOEBEL. I differ with the professor.

What we are trying to do is create an appropriate signal to shareholders that they do not need to leave.

If you imagine you have 30 basis points of extra benefit, extra buffer in a fund, the shareholder has a decision. If he or she believes that there is a risk in the fund that they want to get out of before that share price drops, they can go. But by going, they leave behind a bigger buffer for those who stay.

So it is both an incentive not to leave, because you can see every day that your share is worth more than a dollar. And if you choose to leave anyway, those who do not are protected.

Now, over time you could imagine a massive credit problem, a significant crisis in Europe or some region of the world, that swamps the buffer. And so, we concede that this is not a solution that solves every issue.

But we think that the buffer, coupled with an understanding by shareholders that the Federal Government is not a backstop and not a guarantee, this is a private order solution. And you need to decide where your dollar is going. Not all money market funds are equal.

We believe we have a very talented group of people who spend all day long, resources that are devoted to making sure the credit is correct, that we are doing the trading appropriately, that the portfolio management is working. And we think that people invest with the name of Fidelity, not just because there is a rule out there that says you get a dollar back, but because of what we offer.

And we think that is appropriate in the marketplace for shareholders to be able to make differentiations and really makes the whole industry work better.

Mr. ROYCE. And you think there is enough time to ramp up with that?

Mr. GOEBEL. In the current—

Chairman GARRETT. And that will be your last question, because we do have votes after this. I want to get all the questions in before the next vote series.

Mr. GOEBEL. Certainly. So briefly, we do not think that the—we need some time to build the buffer, just like we would need any sort of capital support, just like the banks need to get to Basel III.

We recognize that this is an approach that will take some time to build up, but we think that is appropriate.

We do not want to do something that is so precipitous that the product becomes uneconomical, or shareholders decide they do not want it.

One has to strike a balance as to what the end state is and how you get there.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman from Colorado?

Mr. PERLMUTTER. Thank you.

And I want to thank this panel. This is a very interesting conversation that we are having. And, several of us having lived through this, as did you, the 2008 collapse, experienced a little post-traumatic stress syndrome.

And to be 2, 2½ years out now, to look back, and try to be objective, Professor Stulz says, as objective as we can be in determining what are realistic, reasonable precautions to take to avoid something like this happening again.

But I guess, when this all occurred, and when it was starting to occur, terms came up that I had never heard of before, and I have been a litigator sort of in the financial arena for a long time.

And so, when you said we need to have objective, defined terms for what systemic is—and I agree with you, except that is easier said than done.

And now, it made me think of, do any of you know what the gastrocnemius is? Anybody suffered a gastrocnemius? It is a tear of the upper calf. I never knew what the heck it was until I did it a couple of days ago. But it sure changed my system. I cannot play in the baseball game. All right?

And I had no clue what auction rate securities were, or collateralized default swaps. You never know where it is going to come from. That is all I am saying.

As you try to come up with your objective criteria, be a little more expansive than narrow. That is all I wanted to say on that.

This is about confidence, and it is about fear. And when there is confidence—and Secretary Paulson, did that overnight guarantee, in effect, to bring confidence to the system, where there was a run on the system. That was my experience of that day or those weeks. FDR did a banking holiday.

Now, we are back to normal—as normal, I hope, as we can get—and continue to develop confidence in the system.

What I really want to understand—because people do look at this as cash. Out there on the street, it is cash.

Explain to me the difference, really, so I can understand it, between the buffer and the liquidity bank, if you would, Mr. Goebel and Mr. Stevens?

Mr. GOEBEL. Sure. The idea of the buffer is actual dollars that sit in the fund, that shareholders can see, that is subject to board oversight, that does not involve the Federal Government, to ensure that people understand that the incentive to leave does not need to be there, if there is one, in a stable NAV product.

Mr. PERLMUTTER. Is this a fund-by-fund-by-fund buffer?

Mr. GOEBEL. Yes.

Mr. PERLMUTTER. Okay.

Mr. GOEBEL. Every fund would have a buffer.

Mr. PERLMUTTER. All right.

Mr. GOEBEL. It would be mandated.

You could imagine different kinds of funds might have a different level of buffer. There are a lot of details to be worked out. But in essence, yes, every fund would have its own buffer.

And so, the real risk that we talk about in money market funds is this contagion effect, where somebody goes down across the street. I have to worry about what my money looks like over here.

If that happens, the idea is that there is no collective socialization of the risk. Every mutual fund and every complex has its own buffer.

Mr. PERLMUTTER. All right. So let me stop you, because Mr. Schweikert talked about being a treasurer. And I can tell you, a lot of treasurers in the State of Colorado—because they were in the primary fund. Okay? And we had to deal with the bankruptcy and all of that stuff.

Is the liquidity bank different? Is it a general backstop, Mr. Stevens?

Mr. STEVENS. Yes. And you can think about the two proposals in this way.

One is designed to make sure that there is not the first fund that breaks the dollar. The liquidity facility is designed to, if a fund breaks the dollar for credit reasons, to make sure that it does not have a knock-on effect by making the markets in which other funds invest illiquid as a result of massive redemptions.

It is a way of helping funds meet shareholders' demand to get their cash out of the fund. It socializes not credit risk, by any means; it socializes liquidity available to the industry—

Mr. PERLMUTTER. Okay.

Mr. STEVENS. —building it up over time, and essentially dedicating it as a market marker, particularly in the commercial paper markets, where there is no one else who serves that function.

That, it seems to me, was part of the lesson of the crisis, that we need to make sure that those markets function well, because they are so essential for American businesses.

The liquidity facility would allow, if you will, money market funds to have an opportunity to exchange money, good commercial paper, for U.S. Treasury obligations or cash that they then could, in turn, meet redemptions with, and it would be put together as a commercial bank under the normal supervisory arrangements with the banking regulators.

Chairman GARRETT. Will the gentleman yield back?

Mr. PERLMUTTER. I was just going to thank the panel, if I could.

Chairman GARRETT. You got it.

Mr. PERLMUTTER. Because this is a very good conversation. And I think we have to continue it, because now we can look back properly on what happened without just some knee-jerk reaction, and really do this, I think, in a good way. And I appreciate the testimony.

Chairman GARRETT. Thank you.

Mr. PERLMUTTER. Now, I yield back.

Chairman GARRETT. There you go.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I also want to thank the panel for your testimony this morning.

Professor Bullard, in a recent op-ed opinion piece, you wrote that the Department of Labor's fiduciary duty proposal, as it related to 401(k)s and pension plans, missed the mark. I think those were your words.

Can you elaborate on how Labor's rule is flawed and discuss for us how you would proceed, or what action we should take?

Mr. BULLARD. The proposal, I think, is right on the mark in the sense that the use of the term "fiduciary" has been unnaturally limited by the Department for decades.

Beyond that, however, the way that the Department approached the problem was to put the cart before the horse and expand the fiduciary definition that very many people in the industry would not be able to conform to in a reasonable period of time.

And this is because the Investment Company Act, actually, ERISA, which is the statute they are interpreting, has a kind of shadow set of statutes. There are exemptions. And those exemptions are actually the way that money managers who have ERISA clients operate. They live under those exemptions, for the most part, not under the actual statute.

And DOL went ahead and redefined the term "fiduciary" without laying out how it was going to modify those exemptions to accommodate the expanded category that it created.

Now, it may be, and I might agree with them, that some of them should not be expanded. But that is a debate that has to be had, and is functionally a debate that has to be had, before you expand the category. That is what you might call a pro-industry view of what is wrong with it.

The shareholder point of view is that, at the same time it put the cart before the horse, it created an exception to the prohibited transaction exemptions—prohibitions—that completely swallowed the rule.

It created what is known as a seller exemption that allows you essentially to say that, because I am a seller, I do not owe you a fiduciary duty.

And DOL already has a prohibited transaction exemption, I think it is PT–71, that covers exactly the kind of transaction. And the proposal it created swallows the exemption, greatly expanding that category, without any real thought as to whether it is appropriate, especially as to retail investors.

And to give you an example, it would mean that a mom-and-pop who goes and buys a municipal security from their broker would not be protected from ERISA, to the extent it should apply.

That is really just the beginning of the problems that a short op-ed can deal with. There are problems in the drafting of the rule. There is a fundamental problem of the Department's consideration of extending it to individual retirement accounts, which are, fundamentally, not really ERISA vehicles.

And then finally, a significant problem that is really what caught my interest is that the DOL proposal is now interfering with what I think should be a primary agenda item for this committee, and that is the issue of the fiduciary duty as applied to broker-dealers when providing retail, personalized investment advice.

Mr. FITZPATRICK. How would you suggest that we deal with the flawed rule then? Any recommendations?

Mr. BULLARD. I think that the committee should go ahead and narrowly focus on the SEC's role and use as much persuasive power as possible to get DOL not just to delay, but essentially put its process on hold until we see how that unfolds.

The SEC's fiduciary will overlap precisely with a large percentage of those Commission-based brokers who will become—who may become—fiduciaries under the SEC rule and become fiduciaries under ERISA.

And that double whammy is not an appropriate way to go about extending regulation, especially when the way the law is structured, it is much more appropriate for the SEC to go first to see how that system works before you attack the industry with ERISA, which has far many more restrictions, and is far more difficult to comply with, than the Federal securities laws.

Mr. FITZPATRICK. Do any of the other panelists wish to comment on that?

Ms. STAM. I would say that, we have paid a lot of attention to this rule. And I think that one of the concerns of the fiduciary standard as proposed is that it has the unintended effect of interfering with key services that may be provided to plan participants or holders of IRAs.

And I think it is something that, actually, DOL could address quite simply with some thoughtful re-proposal of the provision. We are hoping that they could address that. It would be a pity to cut off some of the types of services just because there are sort of technical problems with the definition of "fiduciary."

Mr. FITZPATRICK. Ms. Stam, my district is Bucks County and Montgomery County, so I have quite a few constituents who are employees of Vanguard.

As a significant sponsor of mutual funds, aside from this fiduciary duty issue, what do you think the Congress should be focusing on?

Ms. STAM. One of the things that we said in our written testimony is that mutual funds have really fared quite well. And when we think about what is important to us going forward, we really think about the strength and the efficiency and the transparency of the market.

It is why—we are in the financial markets every day on behalf of our clients. We expect those markets to be strong and transparent. And we would spend our time looking to make sure that those conditions continue to exist.

It is why we care deeply about the derivatives markets and strong regulation of those markets. It is why we care about transparency in municipal markets. It is, frankly, why we care that the regulatory activities of the various regulatory agencies are consistent and not duplicative, so that we can deliver efficient and effective returns to our clients.

Mr. FITZPATRICK. Thank you for your testimony. I appreciate it.

Chairman GARRETT. The gentleman yields back.

Mr. Peters?

Mr. PETERS. Thank you, Mr. Chairman.

And thank you, panel, for being here with some very interesting discussions.

First off, I want to thank the mutual fund industry for what you do. The products that you provide for middle-income Americans allow them to save efficiently and invest in important lifetime objectives that we all have, like retirement and saving for our children's education. And that would not be possible without the variety of products that the mutual fund industry offers. So I appreciate what you do in that regard.

I want to change gears a little bit in some of the questions that have been asked to a different subject, but I know you are all very involved in this area.

Along with one of my colleagues, John Campbell, from the other side of the aisle, we have introduced legislation to reform the housing finance market, the GSEs, and unwind Freddie Mac and Fannie Mae. There are a number of proposals that have been floating around here in Washington right now to deal with that.

But as an industry, you invest hundreds of billions of dollars in GSEs with your products. I just want to get a sense of some of your principal concerns that you have as an industry, as Congress is looking at reforming the GSEs. And so, I would open that up.

It is a wide discussion, but I am just kind of curious as to some of your principal concerns that we need to be focused on as we reform the GSEs.

Mr. STEVENS. Congressman, maybe I can begin the answer. I think one important realization is that there are a lot of legacy securities out there that are held very widely in the marketplace.

And while we very much support the Congress' direction of unwinding or significantly limiting the GSEs and moving the Federal guarantee, or limiting it in some fashion, I think it is very important that we not do anything that disturbs the guarantees that exist with the outstanding legacy securities. That is something that we have been seriously concerned about.

I know that there has been interest in the committee in the development of a covered bond market, and the dealer firms have expressed some very serious interest in that. That is a conversation we are currently having with our membership, and look forward to acquainting the subcommittee with our findings.

But I do applaud you and your colleagues here for looking at alternatives that would remove what perhaps is the largest of the moral risks that we experienced as a result of the recent crisis.

Mr. GOEBEL. I guess I would add that, by merely asking the question, you have gone a long way toward answering our concern, which is that we think that this is obviously a very important market to us. And we are sensitive to whatever the changes are that come about, that they are transparent and signaled in advance, so we can make appropriate portfolio management decisions.

We also—I would echo Mr. Stevens' comments that there are a great deal of legacy assets out there, and particular evaluations were made of those securities based on the terms as they exist today and at the time.

So we are very interested in making sure that there are limited disruptions to that and an understanding going forward of exactly what the changes will look like and how that will happen, so we can make sure that we minimize any impact on our shareholders.

Mr. PETERS. Anybody else?

As far as concerns about the legacy and the guarantees that are in that, there is a question going forward as to whether or not there still is a government role when it comes to securities.

The proposed bipartisan legislation that I have with Mr. Campbell still has a government role, although there is considerable private capital ahead of any sort of government guarantees. But the idea is that some sort of government guarantee is necessary to attract investors into those securities, particularly if they are long-term securities.

Do you share that view as an industry, generally?

Mr. GOEBEL. The types of investors and the decisions about what portfolios those securities are appropriate for certainly depends on the existence of the guarantee. So whether there is another market, or different types of investors, or different types of rates that might be required in order to incent the purchasers, I guess the answer is, it sort of depends on what that looks like.

Mr. PETERS. Right. Okay.

The other point that I think bears repeating, and I have heard it over and over again today, is the concern about the net asset values and if you are off that dollar.

I spent 20-some years in my private sector career in the investment business dealing with private clients, and I can assure you that they all wanted the $1 NAV. And I know that your studies show that 70 percent of people will not invest. I think it was probably close to 100 percent of my clients who would have said that is the product they want, to make sure that they have that $1 value.

So I think it is very important that we preserve that and I will continue to work with you to preserve that, because it is a necessary part of not only financing, as you mentioned, the government short-term securities to our municipalities, but also to our other companies and manufacturers.

I am in a manufacturing State. I am from Michigan. We have Chrysler and the auto companies that go in for short-term financing, and commercial paper in particular.

Maybe, if someone could just elaborate for us, too. If money is pulled out of the money market funds—you have already talked, Mr. Stevens, about the impact on our municipalities and how difficult it will be to fund—what about corporations? Where will they go for that short-term money? And if there are not adequate places, what sort of consequences does that have?

This NAV is more than just investors not wanting to invest; the NAV breaking that dollar will have an impact on the economy and on jobs, I presume. Is that accurate?

Mr. STEVENS. There is no question in my mind about that, Congressman.

The commercial paper market represents funding for payrolls, represents funding for inventories, represents funding that is essential to maintain employment.

And if that market constricts greatly, and the corporation's cost of financing goes up, their ability to tap the short-term markets is compromised, it is going to have a real impact on their operations. It is an example of how embedded money market funds have become in the broad economy.

And what we have said over and over again in meeting after meeting is, fine, let us address whatever reforms are needed here, but let us not throw the baby out with the bathwater.

Mr. PETERS. Thank you.

Mr. DONOHUE. I would, if I could, just interject two things. One is that I think many of the institutional investors that are in money market funds may themselves do one of two things, which is, either they will pull the money out of the money market funds, if that is their selection, and they may directly go into the commercial paper market, which is what they had done 15, 20 years ago.

Alternatively—and this is something that I think would not be a very good result for anyone—is that they can go into unregulated pools, where there is no transparency, where there is no 2a-7, there is no regulatory regime around that, and obtain many of the same benefits that they believe they are getting from money market funds, but actually not. But I think that is the worst answer.

Chairman GARRETT. All right. Thank you. I thank you for the follow-up question.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman. I will be brief.

I think Mr. Fitzpatrick asked the question that I have the most concern with, because many of your companies' representatives have come in to me and have raised the concerns about the Department of Labor's proposed rule changing about fiduciary when advising, particularly, retirement plans.

I have asked the question to both the SEC and to the Department of Labor, at various hearings that we have already had, whether they were working together, so that there would not be a difference as far as what each of these agencies would come up with.

And both of them said that they were working together. But it does not appear that really is the case.

I think that the SEC has already came out with a study, and it kind of, I think, gives us an idea of what their rule will be. And the Department of Labor has now come out with a rule, a proposed rule, although we have not really seen it. And I do not think that they are the same.

So I wondered, how are we going to solve that problem, if there are different rules?

And I think we could have headed it off, but I would assume that the Department of Labor wants to get the rule right. And what can we do, then, to further bring those two back together?

Maybe, Mr. Bullard, you seem to be the most knowledgeable.

Mr. BULLARD. I certainly would not say I am necessarily the most knowledgeable.

But I was actually in the office under Mr. Donohue's predecessor who was responsible for that communication with DOL. And I assure you, the communication is going on, but there is undoubtedly disagreement between the two.

And there is also a limitation to the extent they can work together, because the effects of being a fiduciary under ERISA are so different and so much more onerous than under the Federal securities laws.

Another reason is that, to a great extent, broker-dealers' conduct is in many contexts already subject to a fiduciary duty. The SEC's proposal really goes primarily to the public enforcement mechanism; whereas, DOL's proposal is very much a private liability issue, and predominantly a private liability issue.

Those are just two examples of the way in which those simply are not processes that necessarily can be coordinated. But that does not mean that you should not see the outcome of the SEC's sort of more fundamental, ground-level approach before you go ahead and subject ERISA to many of exactly the same people whose activities under the SEC standard may solve a lot of DOL's concerns.

Mrs. BIGGERT. And I would agree. It seems to me, though, who is going to get it out first? And I think that will cause problems. But I appreciate what you are saying.

And I yield back.

Chairman GARRETT. The gentlelady yields back.

The gentlelady from New York?

Dr. HAYWORTH. Thank you, Mr. Chairman.

Of course, we have talked a bit about SIFI designation. And for banks, of course, SIFI carries with it potential advantages in terms of how creditors might view that guarantee. And, of course, there are costs, as well, to SIFI designation. And indeed, I am skeptical of that designation in its entirety.

But in terms of the proposal that perhaps SIFI designation should also be applied to mutual funds, could any of our panelists elaborate on—and perhaps we can start with Mr. Stevens—the implications more specifically of SIFI designation on our mutual funds?

Mr. STEVENS. If a fund, or a fund complex, or a fund adviser were designated as a systemically important financial institution, under Dodd-Frank there would be two consequences: one, they would be targeted for heightened prudential supervision by the Federal Reserve; and two, they would be subject to capital and other kinds of requirements.

Prudential supervision is an alien concept in our world. While Professor Bullard has talked about the SEC perhaps becoming a bit more prudential, the fact of the matter is, its regulatory model has never been of a nature that is omnipresent in our businesses and telling us how to operate them in the way that the Federal Reserve and other banking regulators do with respect to depository institutions.

The implications of that are unknown, perhaps unknowable. And I have heard Federal Reserve officials say that they are kind of puzzled by it, too, if they had to move in that direction.

The capital issue is even more murky, because, to a very large degree, advisers, while they need capital to assure that they have sufficient robustness to fund ongoing operations, do not have capital requirements of the sort that banking institutions do. And mutual funds, you can either look at as having zero capital or 100 percent capital.

So it is a question, I think, that I am not exactly sure what the answer is. And I would tell you, Congresswoman, I hope we do not have to find out.

Dr. HAYWORTH. Agreed.

Any of our other panelists?

Ms. STAM. Yes, I could add to that. I think that, interestingly enough, the reasons why there was a determination that there should be the designation of systemically important financial institutions are the type of issues that occurred in 2008.

But if you think about mutual fund structure and regulation, it is sort of the antidote to all of those concerns, so you do not have the leverage, you do not have the lack of transparency and a lot of the questions that were raised that cause the attention to the sort of unregulated or uncovered segment of the industry.

Clearly, I think we all agree on this panel that mutual funds or their advisers were not intended. But it is really important to understand that the mutual funds themselves are separate entities, and there is no bleeding over between the funds and the adviser. And so, difficulties with an adviser would not impact a mutual fund.

And the other thing, I think it is really important to note that size is indicated as a factor to be considered. But in the mutual context or in a mutual fund complex, the fact that you have assets under management are really irrelevant, because of the mutual fund structure that oversees those assets, and they are individually owned by millions of individual investors, and the adviser has no ownership rights to those assets.

So we are hoping that reason will prevail when the designations are made.

Mr. GOEBEL. I just want to expand. I think that Ms. Stam got exactly the right point, which is, as I mentioned, we have over 400 mutual funds. We think that the designation would be required on a fund-by-fund basis. Each entity is a different entity. Some of them are organized as trusts, so it would not be 400 designations. But it would be more than a dozen, more than a couple of dozen.

You could designate it an adviser. But are you designating the adviser, and then turning around and worrying about the capital in the funds in another place?

What is a capital standard that applies to an adviser that has a particular balance sheet that looks very different, because it does not own the assets of the fund?

That relatively basic structural point of mutual funds makes it very hard for any of us to answer questions about how these rules apply, because they just were not designed for the way we operate.

Mr. BULLARD. Yes, if I could just add to that. I think that the SIFI question really has two parts: first, whether there is an inherent systemic issue raised by a structure; and second, if there is, do we already have a comprehensive regulatory regime in place dealing with that?

As to both one and two, the answer for non-money market funds is clearly that they should not be SIFIs. If you ask—any question you ask that someone thinks represents systemic risk, the answer for non-money market funds is "no."

But I strongly disagree with Mr. Stevens that the SEC is not a prudential regulator as to money market funds. If Rule 2a-7 is not prudential regulation, I do not know what it is.

The answer for money market funds, to the first question, is clearly that it is systemically important in some respects.

I think that the second question, though, is the one we really need to deal with, whether the current regime and the current regulator is the right one to do it. If Mr. Stevens' point about the SEC not being a prudential regulator goes that deeply into its structure that it cannot do the job for money market funds, then we need to re-think whether it is a good idea to have what is essentially a free market regulator also being a prudential regulator.

But we cannot lose sight of the fact that money market funds are prudential regulation, and their regulator needs to act like one.

Mr. STEVENS. I think this is a definitional squabble more than anything else.

But from where I sit, it makes no sense to designate 642 money market mutual funds as systemically important financial institutions and saddle them with Federal Reserve oversight and capital requirements. If there is a deficiency here, if there are reforms that are needed, they should not be arrived at through the designation process. That is my key point.

Dr. HAYWORTH. Thank you all. It sounds as though that kind of designation would take an awful lot of energy out of our money market funds, etc., when we desperately need more energy in the marketplace.

And I yield back my time. Thank you, Mr. Chairman.

Chairman GARRETT. The gentlelady yields back her time.

I want to extend another 30 seconds to the gentleman from Colorado. He indicated that he had the most salient and poignant question of the day.

[laughter]

Thank you.

Does the gentlelady have anything? Okay.

Before I dismiss the panel, we have, without objection, several letters with regard to the hearing to be entered into the record: from the New Jersey State Chamber; from the New Jersey Business and Industry Association; from the New Jersey State League of Municipalities; from the Chamber of Commerce of the United States of America; from the Greater Boston Chamber of Business; from the Association of Financial Professionals; from the Dallas Regional Chamber; from the Association of Commerce and Industry; from the Fort Worth Chamber; from the National Association of Corporate Treasurers; from Davenport and Company; and from the American Public Power Association.

And I guess from all the rest, and among others: the Council of Development Finance Agencies; the Council of Infrastructure Financing Authorities; the Government Finance Officers Association; the International City Council Management Association; the International Municipal Lawyers Association; the National Association of Counties; the National Association of Local Housing Finance Agencies; the National Association of State Auditors; the National Association of State Treasurers; the National League of Cities; and the U.S. Conference of Mayors.

And without objection, those letters with regard to today's hearing will all become a part of the record.

And speaking of the record, the record will remain open for 30 days for additional questions for members who are here, or other salient and pointed questions from the gentleman from Colorado, which he should make, as well. And your responses will also be made a part of the record.

On that point, I think there was only one question which I did not use additional time for, which was Professor Stulz. And you said you had some comments that you wish to make. If you would so kindly, I would appreciate getting a note back with you. That was on the point before we were raising about as far as defining our criteria for systemically important institutions like that.

If you would like to submit that in writing, that would be most beneficial.

And to the rest of the panel, we very much appreciate it. It was an interesting and informative panel. And where do we go from here? We will just begin to digest everything that you have said.

Thank you so very much. I appreciate it.

And the hearing is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

A P P E N D I X

June 24, 2011

Testimony of Mercer E. Bullard

President and Founder
Fund Democracy, Inc.

and

Associate Professor of Law
University of Mississippi School of Law

before the

Subcommittee on Capital Markets
and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

on

Oversight of the Mutual Fund Industry:

Ensuring Market Stability and Investor Confidence

June 24, 2011

Chairman Garrett, Ranking Member Waters, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss market stability and investor confidence in relation to the mutual fund industry. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Associate Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified before various Congressional committees, and published articles on regulatory issues. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the CFP Board's Public Policy Council; and a co-founder of and faculty advisor to the Self-Regulatory Organization for Independent Investment Advisers. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee;[1] an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

I. Introduction

The Subcommittee's interest in a wide range of issues related to mutual funds is timely, particularly as to the resiliency and security of money market funds ("MMFs"). It is now generally accepted that MMFs, in certain scenarios, pose systemic risk. Regulators and industry members should be applauded for their efforts to determine what reforms, if any, are needed to address this risk.

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[1] The SEC's Investor Advisory Committee considered the floating NAV issue at its May 2010 meeting. *See* memorandum from Investor as Purchaser Subcommittee to Investor Advisory Committee (May 3, 2010) *available at* http://www.sec.gov/spotlight/invadvcomm/iacmemo-mmf.pdf.

However, the debate surrounding MMF risk has veered dangerously from the realm of reality into the realm of rhetoric. To believe certain critics of MMFs, one would think that there has been run on MMFs every year for the last decade, that a few dozen funds failed last week, and that more are likely to fail this afternoon. My testimony focuses on correcting some of the misconceptions about the nature of MMFs and their regulation that threaten to undermine reasonable efforts to improve MMF regulation. In particular, the misguided proposal to prohibit MMFs from using a stable net asset value ("NAV") would unnecessarily eliminate an investment vehicle that has been chosen for decades by tens of millions of Americans as a safe place for their cash holdings. As is so often the case, retail investors' interests will have been virtually ignored, as pointedly illustrated by the participant list and discussion at the SEC's recent MMF roundtable.

II. Money Market Fund Regulation

a. Money Market Funds: The Historical Record

The evaluation of MMF systemic risk should be based on actual facts and events and not false generalizations.

The current MMF debate has been replete with misleading characterizations of the actual performance of MMFs during their thirty-year history. For example, statements that MMFs are "prone" or "susceptible" to runs are patently false. There have been dozens of instances of market stress during the last three decades that have affected MMFs, but only two MMFs have failed. One failure was extremely small (and did not trigger a run). The other occurred during the most extreme financial crisis since the Great Depression. To characterize MMFs as being "prone" (*i.e.*, having a natural tendency to an action) or "susceptible" (*i.e.*, being especially vulnerable to a particular influence) to runs directly contradicts the historical record. The empirical evidence demonstrates unequivocally that MMFs are *not* "prone" or "susceptible" to runs.

Nor is it accurate to describe MMFs as "prone" or "susceptible" to runs in times of crisis. The MMF run in 2008 was a single event from which no responsible statistician would derive reliable predictive value. The causes of the run were complex and numerous. However one defines "crisis," MMFs have performed perfectly during 9 of the 10, 99 of the 100, or 999 of the 1,000 largest crises of the last three decades. The one crisis that MMFs did not successfully navigate was arguably a perfect financial storm that might never be repeated. Yet some MMF critics appear to view MMFs' performance in the 2008 "crisis" as reflecting how they have performed in every crisis and would perform in every future crisis.

The recent claims that MMFs are at risk because of their holdings of short-term European banks are similarly misleading. There is no empirical basis for the assertion that these holdings pose a threat to MMFs' NAVs. The data on which these claims have been made are stale and inadequate to reach a reasonably informed judgment about the safety of MMFs individually or as a group.

For example, a Federal Reserve Bank of Boston President Eric Rosengren recently stated publicly that,

> [d]espite the regulatory changes that have occurred, MMMFs still remain vulnerable to an unexpected credit shock that could cause investors to doubt the ability to redeem at a stable net asset value.[2]

Mr. Rosengren had no empirical basis on which to evaluate the effect of "regulatory changes that have occurred," such as greatly enhanced liquidity requirements, greater redemption suspension rights, and increased portfolio monitoring by the SEC. The claim that MMFs are vulnerable to "unexpected credit shocks" is belied by the fact the MMFs have experienced frequent unexpected credit shocks and survived

[2] Statement of Eric Rosengren, President, Federal Reserve Bank of Boston (June 3, 2011) *available at* http://www.bostonfed.org/news/speeches/rosengren/2011/060311/index.htm.

all but one.[3] His related comments about MMFs' exposure to short-term European bank obligations was not based on any empirical analysis of the actual risk posed to MMFs by these holdings.[4]

The most insidious aspect of Mr. Rosengren's comments is the statement that these shocks "could cause investors to doubt the ability to redeem at a stable net asset value." Unwilling to make the objective claim that a credit shock could cause an MMF to break a dollar, presumably because that claim would have no historical or current empirical basis, he chose the subjective claim that shareholders could "doubt" their MMFs. The irony, of course, is that it is such pronouncements by banking regulators that can themselves cause shareholders to doubt their MMFs, even if there is no objective basis on which to do so. His comment generated substantial press coverage, including the headlines: *Fed's Rosengren: Money Market Funds Remain Vulnerable To Shocks*[5] and *Rosengren Warns on Vulnerability of Funds.*[6]

Effective reforms to address MMF systemic risk should not be based on assumptions about the safety of MMFs that have no basis in fact. The scenario in which MMFs failed – the *only* scenario in which they have failed – was a financial crisis the likes of which has been experienced only twice in the last 100 years. This is not to downplay the need to address the very real systemic risk posed by MMF failure. Rather, it is to emphasize the need to design regulatory reforms that are

[3] See *Sponsor Support Key to Money Market Funds*, Moody's Investors Service at 4 (Aug. 9, 2010) (majority of MMF sponsor support events triggered by credit quality issues).

[4] Statement of Rosengren, *supra* ("some MMMFs are potentially sensitive to a disruption in the European banking system, should one arise from the fiscal and sovereign-debt problems we are seeing in some European countries."); *see* Sean Collins and Chris Plantier, *Money Market Funds and European Debt: Setting the Record Straight*, Investment Company Institute (June 20, 2011) *available at* http://www.ici.org/viewpoints/view_11_mmfs_european_debt;
U.S Money Fund Exposure to European Banks Remains Significant, Fitch Ratings (June 21, 2011) *available at* http://www.politico.com/static/PPM191_moneyfundexposure621.html

[5] Michael Derby, WSJ.com (June 3, 2011).

[6] Boston.com (June 4, 2011).

actually based on the historical record. That record is conclusive. Under any reasonable definition of "safe," money market funds are safe.

b. Safety Regulation and Infinite Liquidity

Only a form of infinite liquidity guarantee ultimately can prevent an MMF run; the MMF reforms being considered generally do not address the central question of the optimal structure of such a guarantee.

The systemic risk posed by MMFs is not created by the potential failure of a single MMF. Rather, it is created by the potential that an MMF failure could trigger a run on a large number of MMFs. The MMF reforms that have been adopted or proposed generally would not have had a material effect on the behavior of shareholders who fled MMFs in September 2008. Granted, the reforms have reduced or would reduce the likelihood that any given MMF will break a dollar. But almost none of the reforms would have a material, direct effect on the likelihood of a post-failure run.

For example, buffers and other forms of capital requirements are designed to reduce the likelihood that an MMF's NAV will decline below $0.995 per share. They do so by increasing the amount by which an MMF's portfolio would have to decline in value before breaking a dollar. They also reduce failure risk by directly or indirectly imposing costs on risk-takers for taking risks (*i.e.*, by reducing moral hazard). Either the sponsor's implied promise to rescue the fund is made contractually binding, or some alternative mechanism is used to transfer the costs of the buffer to shareholders and MMF sponsors. Capital requirements would undoubtedly make MMFs safer and reduce failure risk.

Capital requirements do not, however, address run-risk that has a systemic impetus. The 2008 MMF run resulted from systemic run-risk, that is, fears *not* about whether particular MMFs' portfolios posed a relative risk of loss, but about whether

MMFs as a group would hold their $1.00 NAV. Institutional shareholders decided *indiscriminately* that the prime MMF as a cash management vehicle was no longer a structure that provided adequate safety of principal.

Recent reforms undoubtedly have enhanced the perceived safety of MMFs.[7] However, it is in the nature of systemic shocks that market participants revert to simplistic evaluative tools and make quick decisions based on limited information. While the idea that shareholders would stop to ponder that MMFs now have shorter maturities, greater liquidity, enhanced regulatory oversight[8] and a public record of shadow $1.00 NAVs is theoretically comforting, it is not consistent with the dynamics of financial contagion. If the purpose of MMF reform is to prevent a run like that of 2008, it will not be achieved by capital requirements and other changes that are essentially internal to the very systemic structure in which a run demonstrates a loss of confidence. It can only be achieved by a source of confidence that stands outside of that systemic structure, such as the full faith and credit of the United States.

The addition of some form of buffer to reduce the likelihood of an MMF failure might reduce run-risk at the margins, but it is unlikely to affect the kind of dynamics that dominated MMF shareholders' actions in September 2008. In response to a buffer proposal made at the SEC roundtable, a fund industry executive said that it was too complex. Indeed, it is too complex. It is not too complex to make failure less likely, but it is far too complex to be relied on to have a material effect on

[7] There are also persuasive arguments that safety reforms have not achieved any material safety improvements and will themselves accomplish the elimination of MMFs that some critics seek. Each reform provides an additional increment of safety – as would adding a rubber bumper to the nose of a commercial jet – while stripping away another basis point of yield. Eventually, MMFs will reach the tipping point at which they collapse under the weight of safety rules.

[8] In 2010, the Commission adopted rules requiring the monthly reporting of money market fund portfolios. *See SEC Approves Money Market Fund Reforms to Better Protect Investors* (Jan. 27, 2010). *available at* http://www.sec.gov/news/press/2010/2010-14.htm. Fund Democracy and a number of other parties had filed a rulemaking petition in early 2008 asking that the Commission impose such a requirement. *See* Letter from Fund Democracy, *et al.* to Securities and Exchange Commission (Jan. 16, 2008) *available at* http://www.funddemocracy.com/MMF%20Rulemaking%20Petition.pdf.

systemic run-risk. There is simply no substitute for an infinite liquidity guarantee as a means of substantially mitigating systemic run-risk. Virtually all other reforms and reform proposals are reducible to a relative position on MMF portfolio safety, as opposed to run-risk that arises apart from objective portfolio safety.

c. The Floating NAV and Expectations of Safe Money

The systemic risk posed by MMFs reflects the intrinsic expectations of safe money, not the structure of MMFs, and these expectations and the systemic risk they create will follow safe money wherever it goes, including floating NAV funds.

Some commentators have suggested that the systemic risk created by MMFs would be eliminated by requiring that MMFs permit their NAVs to float. The floating NAV proposal is, however, fatally acontextual. Critics assume that the expectations of safe money, which expectations are the seeds of systemic risk, will disappear if MMFs' NAVs are required to float. This argument misunderstands the nature of safe money and its attendant expectations.

The safe money currently invested in MMFs is money with respect to which shareholders have an expectation of safety (that is what makes it "safe money" as that term is used here). If MMFs are no longer available, safe money will move to the investment option that the MMF shareholder determines to be the next best safe investment vehicle. The shareholder's expectation of safety will move with it. The move will not affect shareholders' expectations regarding their safe money. The cash for which safety is a priority will still be cash for which safety is a priority. They will no longer be able to invest it in the vehicle that they deem to best serve their needs – MMFs – but that would not change their need for safety. If their safe money did not simply move to a new "safe home," it would not be the safe money that it is.

Thus, safe money MMF assets that move to floating NAV funds will do so because shareholders believe that floating NAV funds are safe. And these funds probably will, in fact, be safe. It is not entirely clear what form these funds would take, but they would likely maintain a constant per share NAV of $10.00, with sales and redemptions almost always occurring at precisely that value. Occasionally, transactions will be effected for a few cents more or less than $10.00 per share, but the funds will manage their portfolios in order to maintain a stable NAV consistent with their shareholders' expectations of safety of principal. Those expectations will be reinforced by experience, and the circle of trust will have been re-established in the form of the floating NAV fund (again, assuming that floating NAV funds win the competition for safe money formerly held by MMFs).

At some point, a floating NAV fund will break this circle of trust. An ensuing run on floating NAV funds will confront regulators with the same dilemma that confronted them during the 2008 run – only the systemic risk is likely to be much greater. Floating NAV funds may not be subject to rule 2a-7's portfolio restrictions, which will greatly expand the size of potential losses of any given floating NAV fund. The funds' directors will not be subject to any of rule 2a-7's monitoring requirements. The Commission will not have the authority to enforce safety-based regulations. The only mechanism serving to keep the actual investment of the funds' portfolio in line with the expectations of safe money will be the funds' prospectus disclosure. One need only review some of the recent litigation involving short-term bond funds to appreciate the flimsy discipline that this mechanism imposes. Alternatively, if rule 2a-7 requirements are imposed, safety will be enhanced, but the expectation of safety will have been strengthened. Eliminating the vehicle in which safe money expectations are housed does nothing to eliminate safe money expectations.

In short, requiring MMFs to float their NAVs would eliminate an investment option chosen by tens of millions investors as the best option for their safe money, only to re-create precisely the same problem in floating NAV funds that these funds were intended to solve. This problem will follow safe money wherever it goes, including banks, where the systemic risk is far greater than that posed by MMFs. It is banks that historically have been and continue to be the primary source of runs and systemic risk. During a period in which two MMFs have failed, *thousands* of banks have failed. To the extent that institutional MMF shareholders move their safe money into banks, they will have exchanged a diversified pool of safe, short-term money market securities for an uninsured investment in a single issuer whose assets include high-risk, long-term assets.[9] To the extent that safe money moves to unregulated hedge funds and/or offshore funds, the systemic risk that is necessarily attendant upon the expectations of safe money will have moved underground.[10]

A truly contextual analysis of MMF systemic risk would approach the question of infinite guarantees of liquidity as one of finding the path of least insurance.[11] Money market funds have been and continue to be the lowest overall cost mechanism for providing a safe investment vehicle for cash. Federally insuring MMFs while weaning banks from the use of insured deposits to invest in high-risk, long-term assets would result in a net reduction in systemic risk and improve financial stability.

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[9] *See Reforming Money Market Funds*, Squam Lake Group at 3 (Jan. 14, 2011) ("Because the bank deposits of large institutional investors are uninsured, this could simply move the threat of runs from money market funds to the banking sector. Given that banks are less transparent than money market funds, the likelihood of a damaging run could theoretically increase as a result of this shift.").

[10] *See Money Market Fund Reform Options*, President's Working Group on Financial Markets at 21 – 22 (Oct. 2010) *available at* http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

[11] *See generally* Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (Mar. 2, 2009) *available at* SSRN: http://ssrn.com/abstract=1351987; Mercer Bullard, *Will Obama Kill Money Market Funds?* Morningstar.com (Oct. 2, 2009) *available at* http://news.morningstar.com/articlenet/article.aspx?id=310677; *Enhancing Investor Protection and the Regulation of Securities Markets*, Hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, at 4 - 10 (Mar. 11, 2009) (testimony of Mercer Bullard) *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a22c0391-db89-4e18-a40c-e9e6caddabae.

Testimony of

Andrew J. Donohue

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U. S. Securities and Exchange Commission (May 2006 to November 2010)

Regarding

"Oversight of the Mutual Fund Industry:

Ensuring Market Stability and Investor Confidence"

Before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

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* * * * * * * * * *

Thank you, Chairman Garrett, Ranking Member Waters, and members of the Subcommittee for permitting me to testify before you today regarding "*Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence*". My name is Andrew J. Donohue. I am a partner in the law firm of Morgan, Lewis & Bockius LLP and was the Director of the Division of Investment Management of the U.S. Securities and Exchange Commission (the "SEC") from May 2006 until November 2010. Prior to joining the SEC I held senior positions in the investment company industry most recently as Global General Counsel for Merrill Lynch Investment Managers. I also was recently elected to the Board of the Mutual Fund Directors Forum, a non-profit organization for independent mutual fund directors. The views I express today are my own and do not represent those of my firm, my firm's clients or any other organization.

When I entered the fund industry in 1975 there were less than 500 funds with about $45 billion in net assets. Today, some 35 years later, the fund industry has grown to over 10,000 funds (including open-end funds, closed-end funds and exchange-traded funds) with over $ 13 trillion in net assets owned by over 90 million shareholders in over 51 million households. Funds own over 25% of U.S. stocks, 33% of municipal securities, 45% of commercial paper and 10% of U.S. government securities. Funds represent the investment of choice for almost one-quarter of household financial assets and for over $4.5 trillion of IRA and defined contribution plan assets.

I do not cite these statistics to praise funds, the fund industry or their federal regulators. Rather, I want to emphasize the critical role that funds play in our economy and in the investment of the American people's hard earned money for their savings and retirement.

I will limit my remarks today to my personal reflections and observations on investment company regulation, the performance of funds during the financial crisis (including short-term bond funds, auction rate preferred securities, money market funds and securities lending pools), the potential designation of mutual fund complexes or asset managers as systemically important financial institutions, the challenges facing funds and their investors, the role of the SEC, and some areas for consideration to enhance the competitiveness of funds in the U.S. and globally.

Investment Company Regulation

Funds are subject to regulation under the Investment Company Act of 1940 (the "1940 Act") as well as the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), Sarbanes-Oxley Act of 2002 ("SOX") and Subchapter M of the Internal Revenue Code of 1986 ("Subchapter M"). Funds are also subject to state corporate or trust laws, as is typical for ordinary operating companies. Investment advisers to funds must be registered with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act") and fund underwriters must be broker-dealers subject to the Exchange Act and members of FINRA.

This regulatory regime is quite comprehensive, and is designed to protect investors and insure that the fund is operated for the benefit of the fund's investors. These laws and the regulations adopted by the SEC and the IRS and FINRA's rules provide for, among others:

- Prospectus disclosure to investors of the important information regarding the fund (recently improved by the SEC with the adoption of the Summary Prospectus);
- Annual and semi-annual shareholder reports with annual reports audited by PCAOB registered and inspected independent auditors;
- Investment diversification requirements and limitations on the use of leverage;
- Limitations on transactions with affiliates;
- Advertising standards;
- Inspections and examinations of funds, their investment advisers and underwriters by the SEC (and FINRA for underwriters);
- Enforcement by the SEC for violations;
- Requirements for a comprehensive compliance program for the fund and its investment adviser including the appointment of a chief compliance officer;
- Requirements for daily valuation and liquidity;
- Limitations on fund issuance of multiple classes of securities and on the issuance of senior securities;
- Sales practices requirements;
- Fund shareholder vote requirement for certain fund changes;
- Required fund distribution of income and capital gains; and

- Custody requirements.

A key additional requirement under the 1940 Act and the SEC rules addresses the critical role of independent fund directors. Independent directors act as watchdogs for fund investors, and among other things, oversee potential conflicts of interest, oversee valuation, and approve fund investment advisory and underwriting agreements.

The authority that 1940 Act gives to the SEC to exempt funds from certain prohibitions has been a critical factor in providing flexibility to adapt the 70 plus year old statute to address changing markets and instruments and encourage innovation (such as money markets funds and exchange-traded funds).

This regulatory structure has served investors well and has played a critical role in the success of the fund industry.

The Performance of Funds during the Financial Crisis:

While funds and their investors were subject to many of the same challenges that other institutions faced during the financial crisis, funds performed quite well during this period. With a few notable exceptions, funds were able to price their portfolio securities, invest their assets and meet redemptions in a timely manner. This was due, I believe, in no small part to the comprehensive regulatory regime described above.

The areas that exhibited strain during the financial crisis were the following:

Short-term Bond Funds: A few short-term bond funds had exposure to mortgage backed securities and other instruments that suffered significant unexpected losses;

Auction Rate Preferred Securities: Closed-end funds used a type of security often referred to as *auction rate preferred securities* or *ARPS* to provide leverage to their portfolios. In 2005 for the over $275 billion in closed-end fund assets $60 billion was represented by *ARPS*. *ARPS* were securities that were re-auctioned at periodic intervals providing *ARPS* investors with liquidity and an adjusted market rate of return for their investment. *ARPS* had worked well for many years benefiting the funds, the fund's common shareholders and the fund's *ARPS* holders. In February 2008 *ARPS* auctions began to fail. This failure resulted in a significant decrease in liquidity and value for the ARPS. Recently available information indicates that of the $33 billion in *ARPS* issued by taxable closed-end funds $28 billion had been redeemed or had their redemption pending. Of the $31 billion in *ARPS* issued by tax-exempt closed-end funds, $15 billion had been so redeemed.

Money Market Funds: In the late summer of 2007 money market funds, which represented about $3 trillion in assets and which strive to maintain a steady value of $1.00 per share, started to encounter difficulties with the commercial paper owned by some of them.

These securities were issued by certain structured investment vehicles ("*SIVs*"). Several funds encountered credit and liquidity challenges arising from their *SIV* investments that required the financial assistance of the fund's adviser or its affiliate. In September 2008 with the bankruptcy of Lehman the Reserve Fund "*broke the buck*" and there was a run on certain institutional money market funds. With the assistance of several government programs, including the Treasury Temporary Guarantee Program for Money Market Funds, The Federal Reserve Board Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and financial assistance provided by many investment advisers to their own money market funds only the Reserve Fund "*broke the buck*" and no losses were incurred by the government in its programs. I understand that Reserve Fund investors may ultimately suffer a 1% loss on their investment receiving back $0.99 for each share they owned. During this period money market fund advisers from some 25 plus complexes provided financial support to over 100 money market funds to provide them with necessary liquidity or to keep them from "*breaking the buck*".

In early 2010 the SEC amended its money market fund rule, rule 2a-7. Among other things, these amendments: (1) reduced money market fund portfolios exposure to interest rate risk by decreasing the maximum weighted average maturity ("*WAM*") from 90 days to 60 days, and imposing a new weighted average life requirement ("*WAL*") of 120 days; (2) decreased money market fund portfolio exposure to credit risk by decreasing the permissible exposure to Second Tier Securities; (3) reduced the money market funds dependence on the market for liquidity by adopting minimum liquidity requirements of 10% a day and 30% a week; (4) enabled fund directors to close a money market fund immediately if it was in danger of "breaking the buck"; (5) mandated periodic stress testing and monthly disclosure of portfolio information for investors and the SEC along with publication of the "*shadow nav*" and (6) expanded the ability of affiliates of money market funds to purchase distressed assets from money market funds in order to protect the fund from losses. These amendments significantly enhanced the regulatory regime for money market funds.

In October 2010 the *Report of the President's Working Group on Financial Markets Money Market Reform Options* was issued (the "*PWG Report*"). The *PWG Report* explored a number of potential options for reform including:

- Floating *nav*;
- Private emergency liquidity facility;
- Mandatory "Redemption in Kind";
- Money market fund insurance;
- Two tier system of money market funds with enhanced protections for stable *nav*;
- Two tier system of money market funds with stable *nav* for retail investors only;

- Regulating stable *nav* money market funds as "*Special Purpose Banks*"; and
- Enhanced constraints on unregulated money market fund substitutes.

The *PWG Report* provided a well balanced assessment of the potential options for money market reform. The SEC sought comments on the *PWG Report* and received a number of comment letters suggesting potential avenues for further reform. The SEC held a *Roundtable on Money Market Funds and Systemic Risk* on May 10, 2011 along with other members of the Financial Stability Oversight Council ("*FSOC*"). On May 16, 2011 the Investment Company Institute held a *2011 Money Market Funds Summit* which explored a number of topics relating to money market funds.

There does not appear to be a unified approach from the money market fund industry regarding the next step in money market reform. Approaches advanced in comment letters from firms varied and ranged from:

- do nothing
- institute a private emergency liquidity facility
- impose a mandatory reserve "buffer" in the fund
- require money market funds to be managed by special purpose entities with reserve requirements

Groups from outside the industry have proposed requiring:

- a floating *nav*
- special purpose bank for stable *nav* funds
- a mandatory "buffer" in the form of committed capital

The next step in money market reform is extraordinarily important as the wrong choice might have considerable unforeseen consequences for the money market funds, the investors and the capital markets. Yet not doing anything might leave money market funds vulnerable to runs and the increased potential for "*breaking the buck*". I believe that commentators have provided the SEC with a wide range of choices from which an optimum solution might be crafted. One possibility is for there to be a required "buffer" provided by the manager assuring that there are assets dedicated to maintaining the stable *nav*. That "buffer" could be in the form of a special share class ("*Capital Shares*") funded by the adviser that must be maintained at a certain prescribed level and which is designed to absorb any realized or unrealized losses or gains to enable the other share class (the "*Income Shares*") to maintain a stable *nav*. This approach could be augmented with requirements for greater transparency from omnibus accounts and a limit on the maximum fund ownership by any one investor or group of investors (such as 5%). This approach might make explicit the implicit guarantee that investors and the industry seem to operate under and the increased transparency and ownership limits would enable money market funds to better assess and manage their vulnerability to runs.

The money market fund industry, the SEC and money market fund investors should have a common goal. No one wants to see a repeat of what occurred during the financial crisis. The approach outlined above is but one possible approach for consideration by the SEC. I am confident that the SEC and the industry participants will be able to craft an approach that significantly lessens the likelihood of a run on a money market fund or of a money market fund "*breaking the buck*" while still preserving the benefits market funds have historically provided to investors.

***Securities Lending Pools*:** While I am not aware of any securities lending pools registered with the SEC as money market funds (or otherwise) that encountered difficulties during the financial crisis (other than as discussed above for money market funds), some funds did utilize other pooled investment vehicles for the investment of the cash collateral they received from lending securities. I understand that certain of these pooled investment vehicles did encounter some challenges relating to the financial crisis leading to loses in those pools and the possible loss of liquidity to the funds.

Potential Designation of Mutual Fund Complexes or Asset Managers as Systemically Important Financial Institutions

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") provides the Financial Stability Oversight Council (the "FSOC") the authority to require that a nonbank financial company be supervised by the Board of Governors of the Federal Reserve System ("Board of Governors") and be subject to the prudential standards in accordance with Title 1 of the Dodd-Frank Act if FSOC determines that material financial distress at such a firm, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the firm, could pose a threat to the financial stability of the United States. The Dodd-Frank Act provides that in making that determination, FSOC shall consider:

- The extent of leverage of the company;
- the extent and nature of the off-balance-sheet exposure of the company;
- the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

- the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, inter-connectedness, and mix of the activities of the company;
- the degree to which the company is already regulated by 1 or more financial regulatory agencies;
- the amount and nature of the financial assets of the company;
- the amount and types of liabilities of the company, including the degree of reliance on short-term funding; and
- any other risk-related factors that the *FSOC* deems appropriate.

While mutual funds and mutual fund complexes are important participants in the U.S. financial system and provide many benefits to their investors, I believe that the nature of mutual funds, their operations and the comprehensive regulatory regime within which they operate argue quite forcefully for them not being considered *systemically important financial institutions ("SIFIs")* absent extraordinarily unusual circumstances. Mutual funds have regulatory requirements on the degree of leverage they can employ, the diversification and concentration of their portfolios, where and under what conditions their assets are held in custody, the valuation of their assets on a daily basis at market value, the requisite liquidity of their investments and limitations on transactions with affiliates. The enduring strength of this regulatory regime was demonstrated most recently during the recent financial crisis as well as during other financial crises that have occurred since the adoption of the Investment Company Act in 1940.

The one subset of mutual funds which some might believe appropriate for *FSOC* to review whether *SIFI* consideration might be appropriate is money market funds. I believe, however, that *FSOC* should conclude that money market funds should not be considered for designation as *SIFIs* in light of the important steps the SEC, as their primary regulator, has taken and is considering to significantly improve the regulatory regime money market funds are subject to.

For somewhat different reasons I do not believe that asset managers should be designated as *SIFIs* either. Asset managers, while themselves subject to a somewhat less rigorous regulatory regime than mutual funds, manage other people's money. They are often also subject to the regulatory regime applicable to the client or the assets being managed. (mutual funds, pension assets, etc). The asset management industry is quite different from that of other financial institutions and those differences should militate against asset managers being considered *SIFIs*. Asset managers do not put their balance sheet at risk, do not guarantee returns and their clients bear the risk of the investment of the client's assets. While there are some significant participants in the asset management arena, the asset management industry is not concentrated, is quite competitive, and assets can be moved by clients quite freely from manager to manager. For these and other reasons I believe that a careful consideration of the characteristics of an asset manager, the asset management industry and of the factors enumerated in the Dodd-Frank Act will, except in an exceptional case, lead to a determination by *FSOC* that the asset manager does not pose a threat to the financial stability of the United States.

Challenges Facing Funds and Their Investors:

Despite the success they have enjoyed, funds and their investors are facing a number of challenges. While some of these challenges are inherent in the fund structure or the types of securities in the funds invest in, I believe it is important to be mindful of them.

Pricing and nav Determination: As funds invest in an increasing array of more sophisticated investments the ability of the fund to accurately value its investments every day within the tight time frames required becomes more challenging.

Use of Derivative Instruments and Complex Financial Instruments: The comprehensive regulatory regime described earlier was not designed with derivatives and complex financial instruments in mind. The SEC is currently studying how best to address this area and has provided some guidance to the fund industry regarding disclosure obligations in prospectuses and shareholder reports for these instruments. While I am confident that the SEC, with industry input, will provide appropriate guidance in this area it will still be a challenge for funds to be able to craft meaningful, understandable disclosures for fund investors regarding the fund's use of these instruments.

The IRA and 401k Retirement Market and Advice: The IRA and 401k retirement market is one that has been extremely important to the fund industry and its investors. $4.7 trillion of fund assets consist of money invested by IRA and 401k participants. As 401k plan participants and IRA owners increasing devote their resources towards their retirement goals it is important that they have access to the funds as an investment option and advice from qualified professionals to assist them in achieving their goals. This area is subject to an array of requirements from the Department of Labor, the Internal Revenue Service and the SEC and these can present quite a challenge.

Distribution Practices: Funds are encountering a range of challenges relating to the distribution of their shares through the various distribution channels. Many of these challenges are not new but they do need to be considered. These challenges range from *revenue sharing* payments (which I understand has been a particular challenge for small fund complexes) to operating within the current strictures of rule 12b-1 under the 1940 Act. In addition, Section 22(d) of the 1940 Act currently acts as an impediment to increased competition in the pricing of shares of funds for investors. The SEC has proposed amendments to its rule 12b-1 that address some of these challenges but change, even if beneficial to investors and the industry in the longer term, can be a challenge in the near term.

The Role of the SEC:

The SEC has played a critical role in comprehensive regulatory regime for funds. It has utilized the flexibility provided to it in the 1940 Act to facilitate many innovations in the fund industry including money market funds and exchange-traded funds. It also has used that authority to permit funds to engage in certain actions or transactions otherwise prohibited by the 1940 Act but conditioned such permission on substantive requirements (often involving the independent directors' oversight) that achieve the purpose of the restriction. The SEC has improved disclosures to fund investors with the recently adopted Summary Prospectus and I am hopeful they can improve the usefulness of shareholder annual and semi-annual reports in a similar manner. The SEC has also played a critical role in its inspection and examination program of funds as well as its enforcement actions against those that abuse their positions. The SEC has not traditionally had the role of a merit regulator for funds. I believe that is the correct approach.

I am concerned that budgetary constraints may compromise the SEC's ability to continue the critical role it has played for funds in the past. By way of example, let's look at the ability of the SEC to keep pace in its inspections and examinations of funds. In 1985 the SEC examined 23% of the funds, in 1990 28%, in 1995 51%, and in 2000 32%. In 2010 the SEC examined 10% of the funds and the target for 2011 and 2012 is only 15%. This is certainly not intended as a criticism of the SEC or the inspection staff as I know how difficult their jobs are but rather recognition that without adequate resources to conduct examinations of funds the comprehensive regulatory regime which has benefited funds and fund investor alike may be compromised. In a similar vein, the resources for the Division of Investment Management and for the Commission as a whole may not keep pace with the regulatory challenge of continually adapting the seventy plus year old statute to the modern world.

I am confident, however, that given the proper level of resources, the SEC and my former colleagues in the Division of Investment Management are more than capable of doing the job.

Competitiveness of Funds:

Worldwide mutual fund assets are about $25 trillion with the US representing about $12 trillion of that amount. Accordingly, the US continues to have the preeminent fund regulatory regime. The US fund industry has grown some 33% over the past five years about the same pace that European funds have. The Far East, however, grew 58% during that same period. The European regulatory regimes *UCITs* have been quite active in promoting the use of *UCITs* in the Far East and have been meeting some success. US funds have not able to compete effectively there (or elsewhere outside the US) primarily because of US tax law. I doubt these tax laws generate any tax revenue since investors outside the US merely select an investment vehicle outside the US to invest in. I would really like to see the funds in the US able to compete for foreign investors on a level playing field with *UCITs* in the Far East and elsewhere.

Inside the US, funds have been subject to increased competition from private funds that are not subject to all the strict regulatory requirements of the 1940 Act. Now I think that competition from differing structures and products can be quite healthy for everyone. I do believe, however, that it would be worthwhile to explore what impediments there may be to importing some of the successful private fund strategies into the fund regulatory regime that might be addressed without compromising investor protection.

Conclusion:

I want to thank you for this opportunity to testify today regarding mutual funds. Mutual funds have provided significant benefits to investors and the markets. It is incumbent on us all to insure that they continue to do so.

Testimony of

Scott C. Goebel

Senior Vice President and General Counsel

Fidelity Management & Research Company

Before the Financial Services Subcommittee on Capital Markets and Government Sponsored Entities

June 24, 2011

Chairman Garrett, Ranking Member Waters and Members of the Subcommittee, thank you for the opportunity to testify today on the topic of oversight of the mutual fund industry. My name is Scott Goebel and I am Senior Vice President and General Counsel of Fidelity Management & Research Company. In this role, I am responsible for legal matters pertaining to Fidelity's investment advisory businesses, including the Fidelity mutual funds.

Fidelity Management & Research Company and its affiliated companies are more commonly known as Fidelity Investments. Founded in 1946, Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of \$3.7 trillion, including managed assets of more than \$1.6 trillion, as of May 31, 2011. The firm is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

Fidelity Investments is a market leader in asset management, offering over 400 mutual funds across a wide range of disciplines, including equity, investment grade bond, high income bond , asset allocation, and money market funds. In addition, Fidelity Investments offers comprehensive investment management solutions for institutional investors, such as defined benefit and defined contribution plans, insurance accounts, endowments and foundations. Fidelity is also a leading provider of asset allocation solutions for retail and institutional clients.

Overview of Existing Regulatory Oversight

Mutual funds are the preferred vehicle for saving and investing for millions of American investors. Each fund is organized under state law as a separate legal entity such as a corporation or a business trust. The fund offers for sale shares that are priced daily based on the market value of the fund's investments. By investing in a fund that pools their assets, individual investors are able, at a low cost and for a small low minimum investment, to obtain a professionally managed, liquid, diversified portfolio of securities, with the added safeguards of a robust regulatory regime and independent oversight.

Each fund is overseen by a board of directors or trustees, the majority of whom are independent from the fund's investment adviser. The fund's board has a fiduciary duty to act in the best interests of the fund's shareholders and is responsible for, among other matters, reviewing and approving the investment advisory agreement that the fund enters into with the fund's investment adviser. This agreement covers many of the critical services needed to operate a mutual fund, including portfolio management, research, trading and compliance services. Most investment advisers provide these services to a complex of mutual funds. For example, each of the over 400 Fidelity mutual funds has entered into a separate agreement with Fidelity for investment advisory services.

While the investment adviser is responsible for day-to-day management of the fund, each fund is legally separate and distinct from the investment adviser. Each fund is also legally separate and distinct from any other funds that may obtain services from the same investment adviser. The assets of each fund (i.e., the securities in which the fund invests) are owned by the fund and, thus, by its shareholders, and not by the fund's adviser. The adviser receives fees for its services, which are governed by the terms of the investment advisory agreement, but otherwise has no interest in the assets of the fund. Like the fund's board, the adviser has a fiduciary duty to act in the best interests of the fund when providing these services.

This structure is derived from the robust body of laws and regulations that cover mutual funds and their investment advisers. The regulatory scheme is principally embodied in two statutes: the Investment Company Act of 1940, which governs the operations of mutual funds, and the Investment Advisers Act of 1940, which regulates the operations of investment advisers. In each case, the Securities and Exchange Commission has supplemented the relevant statutes with a robust set of rules.

Under this regulatory regime, a fund and its investment adviser must abide by a number of requirements that are intended to serve the interests of the fund's shareholders. These include, but are not limited to, comprehensive disclosure obligations, transparency with respect to the fund's investments, limits on the types of investments that may be made, limits on borrowing and leverage, restrictions on entering into certain transactions with affiliates, including a fund's investment adviser, and rules governing the safekeeping of the fund's assets.

Value to Shareholders

The value of this regulatory structure is evident in the popularity, stability and longevity of mutual funds. Since 1940, the mutual fund industry has experienced tremendous growth. As of April 30, 2011, more than 7,500 funds held over $12.4 trillion in assets offered by a number of different financial services companies.[1] The number of available funds highlights the intense competition and low barriers to entry that have been hallmarks of the mutual fund industry, forces that continue to drive mutual fund sponsors to innovate and improve product offerings.

Mutual funds are owned by a wide spectrum of investors, including individuals of all ages, defined contribution and defined benefit retirement plans, corporations and government entities. The substantial benefits offered by mutual funds to each of these investors include:

- A convenient, low-cost tool for investment diversification;
- Access to the services of experienced investment professionals who draw upon significant bodies of research;
- Access to various types of funds designed to fit investors' different investment needs with low investment minimums;
- Comprehensive disclosure of fund investments, policies, risks and strategies; and

[1] *See* Investment Company Institute Trends in Mutual Funds Investing - April 2011, available at http://ici.org/research/stats/trends/trends_04_11.

- The security and comfort of a robust regulatory regime.

The strength of this regulatory regime was evident during the recent financial crisis as mutual funds on the whole weathered the crisis well. Despite suffering through the worst economic crisis since the Great Depression, the mutual fund industry continued to provide investors with a full suite of investment products and services. Investors who sought to liquidate their investments or to shift between different funds generally were able to do so without issue.

It is true that many funds experienced significant declines in value, as did the funds' underlying investments. However, other than in one notable instance involving a money market fund discussed below, this did not endanger the existence of the funds themselves. Mutual fund prospectuses must disclose to investors that their investments involve an element of risk and that it is possible to lose money by investing in a fund. Other than limited one-time support for money market funds, the federal government had no need to draw on taxpayer funds to support the mutual fund industry.

Money Market Mutual Funds

Money market mutual funds are a specialized type of mutual fund that provides investors a convenient means to invest their short-term cash. Money market funds invest in short-term debt obligations such as U.S. Treasury bills and certificates of deposit. Under the SEC's Investment Company Act Rule 2a-7, money market funds may value their shares (i.e., the fund's net asset value per share or "NAV") at amortized cost (typically $1.00 per share) provided a number of conditions are met. These conditions include requirements with respect to the maturity, quality, liquidity and diversity of a fund's assets. The stable $1.00 NAV offers investors investment stability with low risk while also allowing money market funds to provide liquidity and a market rate of return to shareholders. That said, as with all mutual funds, a money market fund's value is not guaranteed by the government and each fund discloses prominently that shareholders may lose value by investing in the fund.

In addition to offering substantial benefits to shareholders, money market funds provide critical low-cost, short-term, stable funding for the federal government, corporations, and financial institutions, as well as state and local governments and non-profits, including universities and hospitals. As shown in Attachment 1, money market funds are significant buyers across a wide spectrum of short-term securities. In particular, more than $320 billion of short-term municipal securities are purchased by money market funds.[2] Money market funds also provide an important source of low-cost funding to businesses, by purchasing short-term debt securities issued by companies.

Unlike other types of mutual funds, money market funds came under pressure during the crisis as short-term credit markets became stressed and the creditworthiness of many trading counterparties was uncertain. In light of this strain, the federal government instituted, through the U.S. Treasury Department, its fee-based Temporary Guarantee Program for Money Market Funds. This program was instituted after concerns with the health of money markets arose in the wake of the collapse of the Reserve Primary Fund, which dipped below the stable $1.00 per share price that money market funds strive to maintain. This was only the second instance in the 40-year history of money market funds in which a fund "broke the buck." Ultimately the shareholders of the Reserve

[2] BOARD OF GOVERNORS OF THE FEDERAL RESERVE, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, FIRST QUARTER 2011 79 (2011), *available at* http://www.federalreserve.gov/releases/z1/Current/z1.pdf.

Primary Fund received 99 cents on the dollar. No other money market mutual fund experienced principal losses, and no funds drew upon the Temporary Guarantee Program, which resulted in $1.2 billion in revenue for the federal government. However, the government's intervention in the money markets to bolster confidence may have introduced an element of moral hazard. Fidelity believes that any remaining moral hazard concerns can be adequately addressed by reaffirming to investors that the government will not again support money market mutual funds, perhaps in conjunction with adoption of the NAV buffer concept discussed below.

Money Market Fund Reform

Recent Amendments to Rule 2a-7

In response to the liquidity pressures that money market funds faced during the financial crisis, the SEC amended Rule 2a-7 in 2010. The amendments to this rule, in combination with other significant changes to the regulatory structure of U.S. capital markets, have dramatically increased the ability of money market funds to absorb large, unexpected redemptions. Specifically, the changes to 2a-7 targeted:

- *Liquidity* – New one-day and seven-day liquidity requirements have resulted in money market funds holding $812 billion in liquidity, which dwarfs the $50 billion made available under the Treasury Guarantee Program.
- *Maturity* – Decreasing the Portfolio Weighted Average Maturity (WAM) from 90 days to 60 days, introducing a new weighted average life test of

120 days, and placing limits on the amount and maturity of investments has decreased interest rate and credit risk in money market funds.

- *Risk* – Money market fund boards have significantly more information about potential risk as a result of new stress test requirements.
- *Transparency* – Monthly holdings information is now available on the web. More detailed portfolio and security data is also provided to the SEC and is available publicly on a delayed basis.
- *Ability to Suspend Redemption* – Money market fund boards now have the ability to suspend redemptions in a fund to help ensure an orderly sale of assets once the board has made an irrevocable decision to liquidate the fund.

Oversight of money market fund investments has also improved since the crisis. New Basel III rules increase the capital requirements and liquidity thresholds as well as reduce leverage for banks, which issue instruments that are widely held by money market funds. Significant work is also underway to reduce potential risk in the tri-party repo (or repurchase agreement) market. A Task Force on Tri-Party Repo Infrastructure Reform has produced a number of recommendations meant to increase tri-party repo market transparency and help repo buyers, including money market funds, better prepare for the possibility of a repo counterparty default.

In October 2010, the President's Working Group on Financial Markets published a report regarding Money Market Fund Reform Options ("PWG Report"). We strongly agree with the observation in the report that the changes to Rule 2a-7 have directly addressed liquidity risks associated with maturity transformation and elements of money market fund portfolios' exposures to credit and interest rate risks. Nevertheless, we also recognize that questions about money market funds remain, and that some financial regulators believe that additional reforms to money market funds are needed. It is critical, however, that any next phase of money market fund reform that may emerge not undermine the viability of the product, exacerbating rather than mitigating systemic risk by making banks bigger and driving assets to other products that are less stable and less well regulated than money market funds.

Floating NAV

One option the President's Working Group considered is having money market funds abandon the stable $1.00 share price and instead offer their shares at a floating NAV each day. While some believe that shareholders might be less inclined to redeem shares during market turmoil under a floating NAV model, recent history shows just the opposite. During the financial crisis, ultra-short-term funds with floating share prices experienced significant outflows and lost a significant portion of their assets, just as money market funds did.

If a floating share price were adopted, many investors have told Fidelity that they would shift their money market investments to federally-insured bank products, among others, narrowing the landscape of choices for investors, increasing risks to our economy and taxpayers, and increasing systemic risk by concentrating short-term assets in the banking system. The banking system is significantly larger today than it was prior to the start of the financial crisis in 2007 with more than $8 trillion in deposits as of March 31, 2011,[3] compared to $2.7 trillion in money market fund assets as of June 15, 2011.[4] We believe that pressure on the Federal Deposit Insurance Corporation, which is still dealing with bank collapses stemming from the events of 2008, would increase significantly if a floating share price were adopted. This would raise serious questions about whether there is sufficient capital in the banking system to avoid a government bailout in a market environment similar to 2008. Such an expansion of the federal safety net is unwarranted.

A shift to banks could also significantly change the makeup, cost, transparency, and availability of stable, liquid, reasonably-priced investments relied on by millions of individuals, institutions, and governments for short-term funding and cash. Banks typically prefer to own longer-dated assets and may not want to purchase a significant amount of short-term securities. This change would be exacerbated by new banking regulations that are forcing banks to extend their liabilities into longer term markets. Banks would likely charge more than money market funds do. In addition, unlike banks, money market funds are required to disclose periodically the investments they make, which provides mutual fund shareholders with much greater insight into and control over their mutual fund investments than bank deposits. Shifting assets away from money market funds to banks would reduce transparency for investors. Short-term financing for corporations, financial institutions and governments will therefore be more expensive and less available if money market funds are forced to float the NAV.

Higher borrowing costs would ultimately be passed through to U.S. taxpayers and consumers, leading to negative impacts across the U.S. and global economies.

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[3] *See* Federal Deposit Insurance Corporation Quarterly Banking Profile Balance Sheet, available at http://www2.fdic.gov/qbp/index.asp.
[4] *See* Investment Company Institute Money Market Mutual Fund Assets, dated June 16, 2011, available at http://ici.org/research/stats/mmf/mm_06_16_11.

Companies would be required to pay more, which could lead to other cost cutting and job reductions, hindering economic growth. Likely increases in tax, accounting, and record-keeping requirements due to a floating NAV would also result in higher investor costs. In addition, some municipalities and insurance companies would no longer be able to invest in money market funds because their state laws and regulations limit their ability to invest in funds that do not maintain a stable NAV.

NAV Buffer

Fidelity believes that there is another alternative that would preserve many of the benefits and attractive features of money market funds while also addressing the liquidity and credit concerns that federal financial regulators have raised. Fidelity has worked with others in the industry to develop the concept of a NAV buffer, whereby each money market fund would be required to retain a portion of the fund's income in order to build a buffer within the fund to absorb potential realized or unrealized future losses. When combined with the recent amendments to Rule 2a-7, which better position money market funds to withstand heavy redemptions, this mandatory buffer (which would grow over time) would strengthen the ability of money market funds to maintain the stable $1.00 NAV. The transparency and protection afforded by the NAV buffer also would increase investor confidence and reduce the likelihood of runs – or large unexpected redemptions - by investors on money market funds in the event of market volatility. Furthermore, the

NAV buffer idea addresses all five features of money market mutual funds that the PWG Report argues create an "incentive to redeem shares before other shareholders."[5]

The NAV buffer would apply to all money market funds and would be funded over time by withholding a small portion of the income paid to shareholders. This buffer would be an asset of each money market fund and therefore would belong to the fund's shareholders, not the investment adviser. Each fund would disclose to its shareholders exactly how much income was held back to fund the buffer and what impact the holdback had on the net yield of the fund. The buffer would grow over a period of years to minimize disruption to short-term markets that could result if money market mutual funds were required to fund the buffer all at once. Current and prospective fund shareholders would be able to evaluate the yield impact over time and decide whether to invest in a particular money market fund, or some other investment option.

Money market funds would have the ability to sell securities at a loss in times of market stress in order to meet redemptions. Attachment 2 illustrates how a fully-funded NAV buffer creates significant resiliency for money market funds by showing the large percentage of a fund that is able to be liquidated over a short period of time before even approaching a market NAV of $0.9950, the which point at which a fund is considered to have "broken the buck." Moreover, trades in money market securities transacted at market prices should have the effect of allowing turbulent markets to reset more quickly in times of stress. The NAV buffer would also allow money market funds to withstand price volatility of securities held in the portfolios caused by credit concerns in the market.

[5] Report of President's Working Group on Financial Markets, Money Market Fund Reform Options, October 2010, at 9, available at http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

Because money market funds would operate at a net asset value higher than today, funds would be able to tolerate greater realized and unrealized losses due to credit issues.

Another key feature of the NAV buffer is that a fund's market value per share would typically increase as shareholders redeem. This would greatly reduce any incentive for shareholders to run on the fund. With a NAV buffer in place, each fund would typically operate at a per share market value of greater than $1.00, but all purchases and redemptions of shares would take place at $1.00. Thus, as shareholders redeem at $1.00, the per-share market value for the remaining shareholders would increase because the buffer amount above $1.00 is shared across a smaller shareholder base. This increase in market value would greatly reduce the incentive to redeem shares of a money market fund, as the likelihood of not receiving $1.00 per share is significantly reduced – and each shareholder that exits the fund actually would improve the position of the shareholders who remain in the fund.

Finally, the NAV buffer has the advantage of simple implementation. The SEC could mandate a NAV buffer with some minor changes to Rule 2a-7. No other legislative or regulatory actions would be required -- though, we remain open to discussion of any implementation challenges or questions that may arise. The buffer would be an asset of the fund, subject to board oversight. The investment adviser would invest the buffer as directed by the board just like every other asset of the fund.

Systemic Designation

Fidelity has also been asked to address the potential designation of one or more mutual fund complexes as systemically important financial institutions ("SIFIs") by the

Financial Stability Oversight Council ("Council"). I would like to start by noting that we interpret the statute to require that any designation decision be entity specific. Fidelity does not believe, therefore, that a mutual fund complex could be designated as a whole, but it would be possible for the Council to designate the entities comprising a complex individually.

As to whether designation of such entities would be appropriate, Fidelity believes that these entities are highly unlikely to present systemic risk and that designation is equally unlikely to be an appropriate tool for mitigating any risk that they may present in light of many factors, including:

- The high substantive threshold and procedural hurdles established by Congress for designating nonbanks,
- The low risk profile of the mutual fund industry and its constituent entities generally,
- The strength, scope and flexibility of the existing regulatory regime, and
- The legal structures and business models employed by mutual funds and their advisers.

Fidelity welcomes the opportunity to address this issue as well as the Council's ongoing efforts to elucidate the process for identifying SIFIs. We believe that these endeavors have the potential to provide clarity to (i) financial institutions that are concerned about the possibility that their designation or the designation of other companies could affect their business plans or business models, (ii) those institutions' customers and investors, and (iii) the market as a whole. In general, greater clarity regarding implementation and attendant effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") should help the economy to the extent that it reduces the uncertainty that has dampened investment and economic activity. With respect to the Council's designation authority, however, the benefits of clarity are far outweighed by the importance of using the authority effectively and efficiently while encouraging diversity in the financial services sector and seeking to minimize the unintended and inappropriate consequences.

To that end, Fidelity believes that designation of an entity as a SIFI can only be effective and cost efficient in mitigating a likely threat to the financial stability of the United States if the Council first specifically identifies that threat, the interconnections, types of activities and business models that could give rise to such threat, and the supervision and prudential standards that can most effectively and efficiently mitigate it. Accordingly, when considering whether to exercise its authority to designate an institution a SIFI, Fidelity believes that the Council should:

- Clearly identify the threat that the institution could pose to the financial stability of the United States;

- Consider all of the tools available to the Council and individual financial regulators that could be used to mitigate the threat;

- Identify other entities and business models that create risks that have historically warranted consolidated prudential supervision (e.g., banks) and consider whether the institution in question presents (or is likely to present) similar risks that would most effectively and efficiently be mitigated by that supervisory model;

- Articulate the supervisory approach, including the specific prudential standards and supervisory tools that would be applied to the company, if designated; and

- Consider the cost of designation.

Such a comprehensive approach to potential systemic risks would both help to ensure that risks are addressed by the most effective and efficient of the existing regulatory mechanisms and those mechanisms newly provided by the DFA and, by doing so, best position the financial system and the United States for future economic growth.

Fidelity has addressed each of these points in greater detail in its comment letter responding to the Council's advanced notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies, dated November 5, 2010.

Other Issues of Concern to Fidelity

This testimony has focused on the strength of the mutual fund industry, the dangers of instituting a floating NAV, the benefits of the Rule 2a-7 reforms already adopted since the crisis, the possibility that our proposed NAV buffer could address any remaining concerns about money market funds, and the limited utility and high costs of the designation authority with respect to the mutual fund industry. However, Fidelity devotes significant attention to many other issues that impact the mutual fund industry. Among those issues are the following: the potential repeal of Investment Company Act Rule 12b-1, the DFA derivatives regulatory regime and its potential impact on the mutual fund industry, the proposed amendments to CFTC rule 4.5, target date fund disclosure, fiduciary duty issues, and credit ratings. We have been monitoring regulatory changes associated with these and other issues and have actively participated in the comment process for many of the related rule proposals.

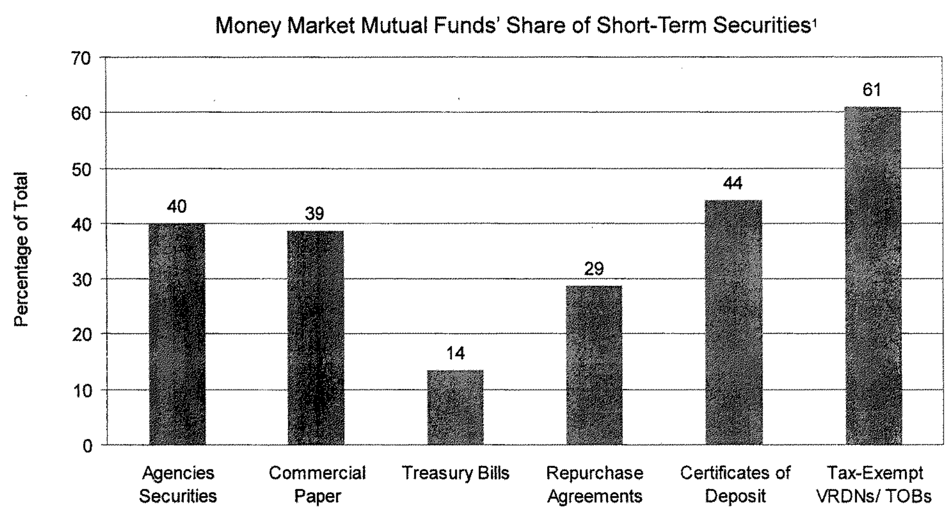
We note that the financial services industry is enduring a historic period of increased regulatory activity and uncertainty. Fidelity, as an entity already subject to robust regulatory oversight, is struggling with the interplay of rule proposals and potential conflicts among multiple regulators. We urge the regulators to be thoughtful in the sequence in which they issue rule proposals and to work with one another to harmonize their rulemakings. This collaborative approach will achieve far more efficient and effective rulemaking, and avoid irreconcilable regulatory conflicts in the final rulemaking efforts.

Conclusion

In closing, I would like to reiterate that the mutual fund industry is fundamentally strong and well regulated, having weathered the financial crisis well; and it provides enormous benefits to investors and the U.S. economy as a whole. A principal reason for the success of this industry has been the strong and effective body of regulation first enacted by Congress and now overseen by the SEC.

Any assessment of or proposed improvements to the mutual fund regulatory regime should begin with an understanding of its strengths. These strengths, many of which I have discussed, have enabled the mutual fund industry to provide valuable services to mutual fund shareholders, to endure and flourish through financial crises, and to serve as stable, reliable participants in the capital markets by helping to encourage capital formation and job creation. In seeking to strengthen further the money market fund industry, therefore, it is imperative that financial regulators appreciate the value that money market funds have brought to investors as well as federal, state and local governments, corporations and banks. Additional reform of the money market fund industry must avoid changes that would undermine and potentially eliminate entirely, a product that has played a part in the success of the U.S. capital markets over the last 40 years. With respect to the rest of the mutual fund industry, a similar analysis is warranted in connection with any discussion of SIFI designation or the application of other new regulatory tools to the industry as a whole or to individual entities or firms within it. Accordingly, we thank you for the Subcommittee's focus on these issues and for the opportunity to testify today.

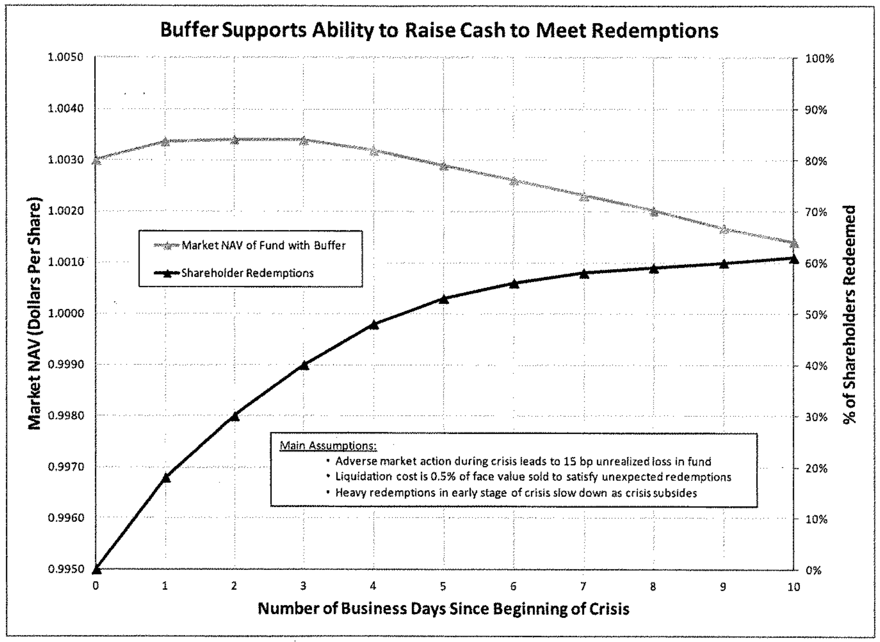
Attachment 1: Money Market Mutual Funds are Significant Buyers of Short-Term Securities



[1]Short-term securities include money market instruments as well as longer-term securities with a remaining maturity of 1-year or less.
As of 12/2010 Sources: Investment Company Institute, Federal Reserve Board, U.S. Treasury Department, Fannie Mae, Freddie Mac, Federal Housing Finance Agency, and Federal Reserve Bank of New York

Fidelity INVESTMENTS

Attachment 2: Buffer Supports Ability to Raise Cash to Meet Redemptions



Fidelity INVESTMENTS

Written Testimony On

Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence

Before the U.S. House Financial Services Subcommittee on Capital Markets

Heidi Stam

Managing Director and General Counsel

Vanguard

June 24, 2011

Mr. Garrett, Ranking Member Waters, and Members of the Subcommittee, my name is Heidi Stam. I am a Managing Director and General Counsel of Vanguard and the Vanguard Funds. I appreciate the opportunity to speak with you today about the state of the mutual fund industry and issues of importance to mutual fund investors.

Vanguard, headquartered in Valley Forge, Pennsylvania, is one of the world's largest mutual fund complexes. We offer more than 170 U.S. mutual funds with combined assets of approximately $1.7 trillion. Individual investors, whether directly on Vanguard's retail fund platform, indirectly through financial intermediaries, or as participants in defined contribution or defined benefit retirement plans, hold upwards of 95% of our assets under management.

Vanguard's highest priority is to serve the interests of our clients, namely, the investors in our mutual funds. We believe that we bring a unique and important perspective to the industry and to our investors because of our mutual ownership structure. Vanguard is a "*mutual*" mutual fund company – that is, Vanguard is owned by the Vanguard mutual funds and therefore owned indirectly by our mutual fund shareholders. All of Vanguard's corporate management and shareholder services are provided "at cost" with "profits" returned to mutual fund shareholders in the form of lower expenses. Given this mutual ownership structure, all of Vanguard's management policies, practices, and incentives are aligned with the growth and safety of investors' assets and the long-term interests of our mutual fund shareholders.

So I speak today not only as a representative of Vanguard but also as a direct representative of millions of American workers, retirees, their families and their businesses, who entrust their assets to Vanguard. Our retail shareholders rely on mutual funds, including money market funds, to save for a down payment on a house and maintain a rainy-day fund. They save for retirement through mutual funds offered in their employer's 401(k) retirement plan or an individual retirement account, and for their children's education in 529 college savings plans. Institutions use mutual funds to manage pensions, endowments and foundations. Small businesses look to money market funds as a source of capital to finance their payrolls and for safety in their cash management needs. Municipal (widely known as tax-exempt) money market funds play a significant role in financing short-term debt for state and local governments, hospitals, school districts, and sewer authorities. Without tax-exempt money market funds, borrowing would become less efficient and more expensive, further stretching government budgets that are already trying to do more with less.

We appreciate your interest in Vanguard's views about the current state of the mutual fund industry, market stability, investor confidence, and regulatory matters, and we hope to lend to this Congressional oversight hearing today the perspective of the retail investor from Main Street, not Wall Street.

Key Advantages of the Mutual Fund Product

Mutual funds are the most efficient, effective and intelligent way to invest and they have a long history of integrity and success. They are superior in terms of liquidity, transparency, professional management, and diversification as compared to other financial products.

Mutual funds have democratized investing. By pooling the money of many investors, mutual funds allow people of ordinary means to get broadly diversified, professionally managed portfolios of stocks, bonds, and money market instruments. Investors own an equity security in the form of mutual fund shares, representing economic exposure to all the portfolio securities in the fund and receiving their proportionate share of the dividends, interest, and capital gains produced by those securities. Thus, the shareholder who has $5,000 in a fund receives the same investment return per dollar as someone who invests $5 million in the fund. Competition has continued to lower the costs of investing in mutual funds and to broaden the services available to fund investors.

Mutual funds provide superior transparency and disclosure to most alternative products. Those who place money in bank deposits or insurance products often don't know how their assets are invested. Mutual funds, by contrast, provide regular, detailed information on their holdings. They calculate and publish the net asset value (NAV) of fund shares at least daily, and are required to sell and redeem their shares at their current NAV. This daily mark-to-market requirement ensures that investors know the value of their shares, and imposes discipline on mutual funds to which other financial products are not subject.

Money invested in mutual funds is subject to many legal safeguards. Importantly, a fund is a separate legal entity and therefore its assets cannot be used to satisfy any obligations owed by the fund's adviser or any other funds. Fund assets are physically held in safekeeping by a custodian that is independent of the fund and the adviser. Funds are subject to oversight by boards of directors that are independent of the adviser, and fund advisers have a fiduciary duty to manage the fund's assets in the best interests of shareholders.

Mutual funds are registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and mutual fund shares are publicly offered securities that are registered with the SEC under the Securities Act of 1933. The Investment Company Act, the framework for comprehensive regulation of the fund industry, remains one of the most successful pieces of legislation enacted by Congress.

These characteristics of mutual funds have served Main Street investors extremely well for more than 70 years and provide investor protections that differentiate them from many other financial and investment products in the market.

Our Mutual Fund Investors' Recent Experience

Mutual funds remain the investment and savings product of choice for U.S. investors. Today, 44% of U.S. households own mutual funds, compared with less than 6% in 1980.[1] An estimated 90 million individuals own funds, covering a broad spectrum of age, education and income characteristics.

Investors in mutual funds, including participants in employer-sponsored retirement plans, weathered the recent financial crisis surprisingly well. Most investors came through the financial crisis, perhaps not unscathed but substantially intact. According to our research, retirement plan account balances over the five-year period through 2010 actually have risen as a result of ongoing contributions, a recovery in stock prices, and the diversification of participant portfolios (most participants do not hold all-equity portfolios).[2] In 2010, median account balances rose by 16% and average balances rose by 14% from 2009 levels as a result of improving markets and the impact of ongoing contributions.[3] Over the three-year period from the fall of 2007 through 2010, one of the most volatile markets in history, only 3% of retirement plan participants sold out of equities entirely.[4]

Long-term investors rode out the financial storm by remaining calm, staying the course, and tuning out the market noise. Storms inevitably will occur. Vanguard has always encouraged investors to take a long-term view of investment return, pay attention to cost, and diversify within and across different asset classes. Prudent asset allocation, broad diversification, and long-term investing using low-cost funds including exchange-traded funds (ETFs), are sustaining principles that serve the investing public well in all types of market conditions, including during the most recent economic crisis that some now refer to as the Great Recession.

Mutual funds proved to be strong and resilient in the face of extreme market volatility and duress. Continued public confidence in, and success of, the mutual fund product is due in large part to the comprehensive investor protections and detailed, substantive federal securities law and regulatory requirements to which mutual funds are subject.

To be sure, mutual fund investors and the industry faced some challenges during the financial crisis. Markets were illiquid and bank credit was frozen. The Reserve Primary Fund, a money market fund that was heavily invested in commercial paper issued by Lehman, "broke the buck" in 2008 and returned 99¢ per share to its shareholders instead of $1.00. Vanguard's money market funds, which followed stricter internal policy controls on credit and liquidity than regulatory minimums, were well positioned to address the challenging conditions when the markets seized. But the industry felt the consequences of The Reserve Primary Fund's failure, and regulators and the Investment Company Institute's Working Group on Money Market Reform began to review rules governing money market funds, looking for ways to improve the funds' ability to withstand extremely unusual market conditions. The SEC responded swiftly and soundly by strengthening money market fund rules governing liquidity, credit quality, maturity and transparency, and concerns have subsided despite the fact that these funds are mired in the lowest yielding environment in their four-decade history.

In the 40 years since they were introduced to the marketplace, money market fund assets have grown to over $2.7 trillion, representing over 25% of all mutual fund assets.[5] And over this 40-year history, only two money market funds ever have failed to return $1.00 per share: Community Bankers Fund, an institutional money market fund that paid out 96¢ per share in 1994, and The Reserve Primary Fund in 2008. Yet despite money market funds' well-earned reputation for safety over a long period of time, some commentators have called for an end to money market funds as we know them, either by having money market funds regulated as banks or by requiring them to float their net asset values, that is, turn them into short-term bond funds. We urge these commentators to maintain some perspective and carefully weigh the substantial benefits that money market funds offer to individual investors and small businesses, and the costs that would be imposed on those investors and the economy if money market funds were to disappear.

Enduring Principles of Mutual Fund Regulation

Mutual funds are subject to a comprehensive regulatory regime and are regulated under four federal securities laws: the Securities Act of 1933; the Securities Exchange Act of 1934; the Investment Advisers Act of 1940; and, most importantly, the Investment Company Act of 1940.

The federal securities laws are designed to protect investors primarily through disclosure, but the Investment Company Act also substantively regulates the structure and day-to-day operations of mutual funds and ETFs. The Act protects and requires independent safekeeping of a fund's assets; prohibits conflicts of interest and other forms of self-dealing; restricts complex capital structures; requires daily mark-to-market valuation of fund shares for price transparency in purchases and redemptions; and imposes a corporate governance framework in which independent directors (who must constitute at least a majority of the board) play a key role in protecting mutual fund shareholders from overreaching by their management companies. The role of mutual fund directors is central to protecting the interests of fund shareholders in conflict of interest situations.

Useful and usable fund disclosure

Current disclosure rules ensure that mutual fund investors receive comprehensive, accurate information about a fund. In recent years, Vanguard supported the widespread use of a summary prospectus for mutual funds, which provides key information about the fund including its investment objective and strategies, risks, and fees and expenses, in a standardized format allowing investors to more readily compare similar funds. The SEC adopted the summary prospectus for mutual funds in 2009. Vanguard also supported online disclosure of a money market fund's complete portfolio holdings in connection with amendments to SEC Rule 2a-7, which the SEC adopted in 2010. In both cases, we believe that improved transparency and greater understanding by investors of relevant fund information benefits the mutual fund industry as a whole. We also support moving to a more streamlined shareholder report for mutual fund investors to provide them the most helpful information in a usable format.[6]

Improving transparency

Importantly, mutual fund sponsors and financial advisors are adapting disclosure tools and techniques to better educate investors about mutual funds and ETFs as well as to improve investors' financial literacy. Transparency in disclosure for investors' protection has always been a key goal of the SEC. At Vanguard, we have a long history of educating investors with "Plain Talk" on a wide variety of investment topics in an easy-to-read format. We have remained focused on investor education with progressive methods for delivering content to investors, including podcasts, videos, live webinars, interactive graphics, and blogs. We encourage the SEC to continue to apply its regulatory oversight over mutual fund disclosure judiciously and effectively to embrace positive innovation that historically has served investors well.

Effective regulator

The strict regulatory regime to which mutual funds are subject has played a vital role in the growth and endurance of the mutual fund industry and continued investor protections. The SEC has served as an effective regulator of mutual funds and their investment advisers for 70 years through a variety of disruptive and unstable markets, and should continue to serve as their primary regulator in the future.

The Dodd-Frank Act gives the SEC new responsibilities in addition to its traditional market oversight and investor protection responsibilities, including oversight of derivatives trading; hedge fund advisers; municipal advisers; asset-backed securities; and NRSROs (nationally recognized statistical rating organizations). The SEC's expanded authority cannot compromise its responsibilities with respect to mutual funds and other more traditional investment products.

Current Issues Facing the Mutual Fund Industry and Investors

Vanguard understands the need for the Financial Stability Oversight Council (FSOC) to monitor risk across markets, institutions, and sectors. However, we do not believe that mutual funds, which are already highly regulated by the SEC, should be subject to oversight by that

Council. Frankly, we at Vanguard are perplexed when the words "systemic risk" and "mutual fund" are uttered in the same sentence. During the Congressional debate on the Dodd-Frank Act, it seemed clear that mutual funds were not relevant to the discussions about systemic risk.

The financial crisis demonstrated that markets can be vulnerable when certain interconnected financial companies engage in risky lending and financial engineering involving highly complex transactions coupled with the use of leverage. But none of that risky lending or financial engineering with leverage related to mutual funds. Mutual funds don't have leveraged exposures or non-transparent, off-balance sheet liabilities. They don't engage in short-term risk-taking through proprietary trading. They are extensively and comprehensively regulated by the SEC. Neither mutual funds nor their advisers are systemically risky under the criteria of the Dodd-Frank Act.

Mutual Funds Should Not Be Designated As SIFIs

Under Dodd-Frank, FSOC has authority to designate certain non-bank financial companies as systemically important financial institutions (SIFIs), subject to regulation by the Board of Governors of the Federal Reserve System and heightened prudential standards.

Mutual funds do not pose systemic risk and they do not exhibit the characteristics of a SIFI under FSOC's articulated relevant factors, which include: extent of leverage; extent and nature of off-balance sheet exposures; extent and nature of transactions and relationships with other significant nonbank financial companies and significant bank holding companies; importance as a source of credit for households, businesses, and governments as a source of liquidity for the financial system; importance as a source of credit for low-income, minority, or underserved communities; size, scale, concentration, interconnectedness, and mix of activities; the degree to which the company is regulated by a primary regulator; amount and nature of financial assets; and amount and types of liabilities, including degree of reliance on short-term funding.

Vanguard submitted a comment letter to FSOC on its Advanced Notice of Proposed Rulemaking[7] in which we explained that mutual funds, by their very structure and regulation, do not pose systemic risk and should not be designated as SIFIs. Among other things, we pointed out the following:

- The SEC limits the amount of leverage mutual funds may use and requires funds to segregate assets to cover future or contingent payments. Therefore, mutual funds do not have leveraged exposures.
- The SEC requires regular and timely financial reporting and transparency by mutual funds both to the regulator and to investors. Lack of transparency, such as off-balance sheet accounting, can exacerbate hidden problems until they surprise the market. Mutual funds do not have off-balance sheet liabilities and do not engage in leveraged trading activities with systemically important financial companies.
- Mutual funds perform daily valuations of fund assets and disclose such valuations in the form of an NAV. The requirement to value securities daily, coupled with disclosure of such information, makes it difficult to mask risk.
- SEC rules require mutual funds to maintain highly liquid portfolios in order to ensure that mutual fund shares may be redeemed daily by investors. The market-wide illiquidity that occurred in 2008 did not result from mutual fund activity. It resulted from banks' unwillingness to accept each others' credit risk.

- Historically, returns from credit risk have a bias toward small frequent gains and large infrequent losses, which can be destabilizing to a financial system in a time of market crisis. Companies that have large and leveraged exposures to credit risk could magnify financial system risk. Mutual funds and their investors may experience losses, but those losses do not infect the broader financial markets.
- The SEC has been a highly effective primary regulator of mutual funds and their investment advisers. Mutual funds and their advisers are comprehensively and substantively regulated under the federal securities laws.
- Mutual fund advisers do not engage in proprietary trading for their own accounts with mutual fund assets. Mutual fund assets are owned, *pro rata*, by the fund's shareholders; each fund is its own corporate entity, separate and distinct from its adviser and all other mutual funds; fund assets are recorded on the fund's balance sheet, not the adviser's balance sheet; fund assets are subject to strict custody requirements; fund assets cannot be used to satisfy the obligations of the adviser or other funds managed by the adviser; fund advisers manage assets as fiduciaries; and investment activity of mutual fund advisers is limited by each fund's distinct objective and strategy.

Money Market Fund Reform

Money market funds are well-regulated by the SEC and should remain solely under the SEC's jurisdiction. To the extent that the debate about money market reform continues, and regulators determine that additional protections are necessary, the SEC, not FSOC, should be tasked with developing any rules governing money market funds.

During the fall of 2008, many institutional money market funds experienced large-scale redemptions, and some retail money market funds experienced reduced liquidity in terms of finding buyers and sellers for their commercial paper and other portfolio securities. The SEC's recent amendments to money market fund rules have significantly improved the funds' safety, liquidity, and resiliency under extreme market conditions. The money market fund rules now impose daily and weekly liquidity minimums, maximum weighted-average maturity and weighted-average life requirements, regular portfolio stress testing and board reporting, additional limits on second tier securities, and portfolio holdings disclosure requirements. Collectively, these changes are designed to make money market funds self-provisioning for liquidity, reducing the likelihood that a future systemic market disruption would threaten the liquidity of these funds and require government support.

Institutional money market funds experienced the greatest cash demand for redemptions and therefore the greatest need for enhanced liquidity. From September 9 through September 23, 2008, investors in the 25 largest institutional prime money market funds withdrew 30% of those funds' assets, on average. By contrast, investors in the 25 largest retail prime money market funds withdrew an average of only 3% of fund assets.[8]

Institutional money market funds typically have significantly large percentages of fund assets concentrated in the hands of a few large and highly sophisticated shareholders. These sophisticated institutional shareholders, such as hedge funds, private equity and sovereign wealth funds, often insist on same-day liquidity, meaning that they purchase fund shares in the morning and redeem fund shares on the same day, earning interest for the time that their money is in the fund.

Retail money market funds serve the cash management needs of retail investors, individuals who need to save cash to make an upcoming purchase, manage their cash, or save for retirement. Retail money market funds tend to have a very small percentage of fund assets held by any one or few shareholders, and generally do not provide for same-day liquidity. Instead, these funds permit shareholders to purchase shares on any given day, but will not accommodate a same-day request for redemption of those shares. Redemption requests in retail funds are generally performed on a one-day delay.

These two types of money market funds serve different investor needs and operate somewhat differently. If more needs to be done to enhance money market funds' resiliency under extreme market conditions, then it may be appropriate for the SEC to impose a customized set of rules including, importantly, additional liquidity requirements on the institutional money market funds. Imposing additional liquidity will result in slightly lower yields for those institutional fund investors. This is an appropriately tailored regulatory solution. Institutional investors who are likely to demand the greatest liquidity should pay for it, rather than the retail investor who occasionally writes a check out of his or her money market fund account.

We hope that FSOC will defer to the SEC on this topic and we urge the SEC to consider distinguishing retail versus institutional money market funds in the event it determines that money market fund regulation requires further reform.

Municipal bond markets

Vanguard manages over $120 billion in tax-exempt money market and tax-exempt municipal bond funds. Although much has been reported lately about the financial difficulties facing municipal governments, Vanguard believes that predictions by certain analysts of massive municipal bond defaults in 2011 do not reflect reality.

Municipal bonds trade in a large, fragmented market with a long history of repayment, and the credit and transaction structure of municipal bonds have been favorable to investors. These credit structures have stood up well in times of stress, making municipal bankruptcies extremely rare. Nonetheless, state and local governments face ongoing financial pressures that should not be ignored. These pressures could lead to some future downgrades in credit ratings, and some isolated defaults or restructurings of smaller projects in the future. That said, we do not see these pressures leading to major municipal bond defaults.

We support the efforts of the SEC and the Municipal Securities Rulemaking Board to improve disclosure and price transparency in the municipal market. We remain concerned, however, about the differences in disclosure practices between the taxable and tax-exempt municipal bond markets. Timely and updated financial information is not provided to the market on a consistent basis by all municipal issuers. We also are concerned when issuers refuse to make available to the market information that they otherwise provide to rating agencies or their governing boards. As long-term investors in the municipal markets, Vanguard supports additional measures to improve disclosure by municipal issuers on an ongoing basis, including repeal of the Tower Amendment.

Credit ratings

Vanguard supports the SEC's efforts to improve information about credit rating agencies and their methodologies, and to address conflicts of interest. Given recent problems encountered with credit rating agencies, the Dodd-Frank Act requires the SEC to remove references to credit ratings from all of its rules, including SEC Rule 2a-7. In the context of money market fund regulation, however, credit ratings have served an important investor protection role by providing a "floor," or a minimal credit rating, below which a money market fund adviser could not acquire securities.

Earlier this year, the SEC proposed a rule to remove from Rule 2a-7 all references to credit ratings and substitute the credit ratings with subjective thresholds of eligibility. The

SEC's subjective standard could permit a fund adviser to become more aggressive in its credit analysis. Although credit ratings alone do not render a security eligible for purchase by a money market fund, removing the credit risk rating as a floor could lead to imprudent management. We believe that more can be done to protect investors. Thus, should Congress re-open certain provisions of Dodd-Frank to modification, we recommend that SEC rules relating to money market funds be permitted to retain references to credit ratings.

Derivatives regulation

Vanguard supports better regulation and transparency of the derivatives markets, including centralized clearing of derivatives and posting margin to back derivatives trades. These measures will benefit mutual funds as investors in the derivatives markets and restore integrity of the markets and investor confidence.

Many of the changes coming out of the Dodd-Frank Act relate to the lightly regulated derivatives markets. In contrast, mutual funds' use of derivatives is highly regulated. Specifically, derivatives use by mutual funds is highly regulated by substantive provisions of the Investment Company Act that regulate capital structure and leverage. In addition to statutory prohibitions on leveraged structures, the SEC has issued guidance that requires mutual funds to segregate highly liquid assets to cover future or contingent payments, such as through derivatives transactions.

Vanguard has used derivatives in its mutual funds as part of prudent portfolio management for more than 25 years. Derivatives, such as futures and options, enable funds to hedge portfolio risk, lower transaction costs, and achieve more favorable execution compared to traditional investments. These uses are highly beneficial to investors. We continue to work with regulators to clarify misconceptions about derivatives use in "plain vanilla" funds, including

ETFs. Product innovation and investor choice should not be stifled where concerns do not exist, such as funds and ETFs that use derivatives as a portfolio management and cost efficiency tool.

Conclusion

Today, the fund industry overall has over $13 trillion[9] in assets under management, which serves as a testament to the trust that investors continue to have in the mutual fund product. Despite the severe market pull back and a decade of mundane stock returns, the mutual fund industry is the healthiest of all the financial industries.

There are a few critical reasons for the relative good health that we, as industry members, never take for granted. Diversification of our underlying assets; absence of proprietary trading and therefore no incentive to take on risk for short-term reward; daily valuations, which force us to "take our medicine" in down markets daily; tight controls on leverage; and, finally, the nature of our client base, which also is diversified and balanced.

Mutual funds continue to help investors reach their most important financial goals in a lifetime, including a secure retirement, a college education, a home, and a safety net. Competition in the mutual fund industry is a great regulator and also a great source of humility. We thank you for the opportunity today, on behalf of our investors, to share the view from Main Street.

ENDNOTES

[1] *2011 Mutual Fund Fact Book*, Investment Company Institute, p. 79.

[2] *The Great Recession and 401(k) Participant Behavior*, Stephen P. Utkus and Jean A. Young, March 2011.

[3] *How America Saves 2011*, A Report on Vanguard 2010 Defined Contribution Plan Data, June 2011.

[4] *Supra*, note 2, at 11.

[5] Source: Investment Company Institute.

[6] *Comment Request on Existing Private and Public Efforts to Educate Investors*, Vanguard Comment Letter, June 21, 2011.

[7] *Advanced Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, Vanguard Comment Letter, November 5, 2010.

[8] Source: iMoneynet.

[9] *Supra* note 1, at 9.

INVESTMENT COMPANY INSTITUTE

TESTIMONY OF PAUL SCHOTT STEVENS

PRESIDENT AND CEO

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

ON

"OVERSIGHT OF THE MUTUAL FUND INDUSTRY: ENSURING MARKET STABILITY AND INVESTOR CONFIDENCE"

JUNE 24, 2011

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Executive Summary

Today, U.S. registered investment companies – including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts ("UITs") (collectively, "funds") – help over 91 million investors achieve both long- and short-term financial goals. These millions of investors have entrusted funds with more than $13 trillion in assets, giving funds a significant role as institutional investors in the U.S. economy and world financial markets.

In serving the interests of its investors, the fund industry has proven innovative, competitive, and, most importantly, accountable. It operates under a remarkably comprehensive framework of regulation, including the Investment Company Act of 1940, which emerged out of the last great financial crisis. That framework has been enhanced over the years by Congress and the Securities Exchange Commission ("SEC"). Its major features – strict limits on leverage, daily mark-to-market valuation, exceptional transparency, and strong governance, among others – again proved their worth by protecting fund investors through the turmoil of recent years.

Taking stock of the state of industry regulation in mid-2011, in the wake of the financial crisis and in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), three important issues present themselves: first, regulatory reforms of money funds; second, uncertainties about the application to funds and their investment advisers of the extraordinary regulatory powers over "systemically important financial institutions" ("SIFIs") granted under the Dodd-Frank Act; and third, the burdens and potential for conflicts posed by the multiplicity of regulatory regimes to which funds are now subject.

Money Market Funds. For thirty years, money market funds have served as a unique and highly effective cash management tool for investors. They also have been an indispensable source of short-term funding for American corporations, municipalities and other issuers, helping to finance payrolls and inventories and build communities.

Since fall 2008, the ICI and its members have dedicated enormous effort, in collaboration with regulators, to preserving the benefits that money market funds provide to the economy and to investors, while making them more resilient in the face of severe market stress such as that which followed the collapse of Lehman Brothers. During this period, both the SEC and the money market fund industry have made a great deal of progress toward this objective. Importantly, all money market funds now manage interest rate, credit and liquidity risks under stricter new SEC standards. In the event a money market fund proves unable to maintain a stable $1.00 net asset value ("NAV") per share, the fund's board is able to take prompt action to assure an orderly liquidation of the fund and equitable treatment for all shareholders.

Notwithstanding the importance of these and other reforms to date, however, both regulators and the industry have continued to weigh additional measures to make money market funds even better prepared to weather the worst conditions, including ways to the enhance liquidity available to prime money market funds investing in the commercial paper market and to minimize the risks of a fund being unable to maintain a stable NAV.

We remain committed to working with regulators on these and other policy options. We submit that this process should be guided by two principles. First, we should preserve those features of money market funds (including the stable $1.00 per share NAV) that have proven so valuable and attractive to investors. Second, we should avoid imposing costs of a nature that will undercut the willingness or ability of large numbers of investment advisers to continue to sponsor these funds. Otherwise, we will put at risk the enormous benefits that money market funds provide to the economy.

SIFI Designation. The Dodd-Frank Act gives the new Financial Stability Oversight Council ("FSOC") the authority to designate systemically important nonbank financial companies, or "SIFIs," for heightened prudential regulation and consolidated supervision by the Federal Reserve Board. This is an extraordinarily potent legal authority, and one that, in our judgment, should be exercised only in exceptional circumstances. Registered investment companies and their advisers do not present risks to the financial system remotely justifying the application of such regulatory controls.

Congress intended SIFI designation only for those nonbank financial companies that could pose a threat to U.S. financial stability, either because of material financial distress at the company or because of the "nature, scope, scale, size, concentration, interconnectedness or mix" of its activities. Funds are among the most comprehensively regulated and transparent financial institutions in the United States—and they simply do not pose such threats. Accordingly, neither individual funds nor fund complexes warrant SIFI designation, nor do asset management firms in their capacity as advisers to funds.

Some have suggested that money market funds should be designated as SIFIs. We strongly disagree. In our judgment, it simply makes no sense to designate each of the 642 money market funds or even the 237 prime money funds offered in the U.S. market today as a SIFI, thereby subjecting each to ongoing prudential supervision by the Federal Reserve Board and discrete capital requirements. Nor does it make sense to pick and choose among money market funds or fund complexes for this purpose. Quite apart from SIFI designation, there is ample regulatory authority to craft further reforms if deemed necessary for these funds. This includes both the wide-ranging authority accorded the SEC under the securities laws as well as other powers entrusted to the FSOC under the Dodd-Frank Act.

Dealing with Multiple Regulators and the Potential for Regulatory Conflict. A third broad area of concern to funds is the potential for regulatory conflict and the compliance burdens posed by the multiplicity of regulators to which they are subject. Increasingly, funds face regulation, or the potential for regulation, from multiple agencies. At its worst, this dynamic could result in irreconcilable regulatory conflicts, where funds are subject to rules imposed by different regulators that simply are at odds with one another. More frequently, the result is a regulatory hodgepodge – when one agency pursues its perceived regulatory mandate without regard to closely related actions underway at another agency or to the implications of divergent standards; or when an agency addresses regulatory policy concerns only with respect to a specific product without regard to the way in which identical concerns arise with respect to other, competing products. Four recent examples highlight these problems:

- The proposed amendments to CFTC Rule 4.5, which if adopted would subject funds (or their advisers) to directly conflicting requirements by the CFTC and SEC;

- The ongoing debates over fiduciary duties at the Department of Labor (DOL) and the SEC, which are proceeding on completely separate tracks;

- Disclosure initiatives at the SEC and FINRA relating to potential broker conflicts, where one agency (FINRA) has acted before another (the SEC) with a narrow rule applicable only to the sale of mutual funds; and

- Multiple areas in the international arena, where regulators increasingly are adopting regulations that may conflict with or reduplicate those that global firms face in the United States.

In the written testimony that follows, we address other current regulatory issues of concern to funds. Some of these issues primarily affect **funds as issuers of securities.** These include, for example, the proposed repeal of Rule 12b-1 governing the use of fund assets to pay for distribution expenses; substantial U.S. tax impediments to foreign investment in U.S. funds; the SEC's moratorium on product applications for certain new ETFs; the need for further improvements in disclosure and greater flexibility to use electronic media for required disclosures; the vexing issue of how to apply antiquated rules on recordkeeping to the dynamic new use of social media; and the potential for investor confusion with less regulated alternatives to funds, such as exchange-traded notes.

Others issues primarily affect **funds as investors in the markets**. These include the implementation of Title VII of the Dodd Frank Act, establishing a new regulatory framework for the swaps markets and their participants; trading and market structure issues, such as the need for increased transparency of market information and the role of liquidity providers and high frequency trading; municipal securities market reform;

housing finance reform; and the need for across-the-board proxy voting disclosure by institutional investors.

Appropriate resolution of these issues is important to funds and their investors. So, too, is the **effective functioning of the SEC**, our primary regulator. Funds and their shareholders stand to benefit if the SEC is both well resourced and well managed. We continue to urge intensive, high-level, and sustained attention to improving the agency's internal operations, including its ability to conduct empirical research to inform its rulemaking and oversight activities. Effective cost-benefit analysis is not just a good idea—it is a statutory mandate. Several recent rulemaking efforts have been found to be seriously deficient in this regard.

Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs") (collectively, "funds").[1] Members of ICI manage total assets of $13.41 trillion and serve over 90 million shareholders.

I very much appreciate the opportunity to appear before this Subcommittee and offer our perspectives on the state of the fund industry. As both issuers of securities (fund shares) to investors and purchasers of securities in the market, funds have a strong interest in the ongoing consideration by policymakers and other stakeholders of how to improve the functioning of our capital markets and strengthen our financial regulatory system, both generally and specifically with respect to the regulation of funds.

The fund industry is a vibrant, innovative, and competitive industry that helps millions of American investors meet their long-term financial goals. As of April 2011, more than 91 million investors have entrusted funds with more than $13.8 trillion of their investment dollars. As a result, funds are among the largest investors in U.S. companies—they hold, for example, about 27 percent of those companies' outstanding stock, approximately 45 percent of U.S. commercial paper (an important source of short-term funding for corporate America), and about 33 percent of tax-exempt debt issued by U.S. municipalities. The fund marketplace is also fiercely competitive, with nearly 700 fund families offering more than 7,000 funds to investors.

Taking stock of the state of industry regulation in mid-2011, in the wake of the financial crisis and in light of the Dodd-Frank Act,[2] three important issues present themselves: first, regulatory reforms of money funds; second, uncertainties about the application to funds and their investment advisers of the extraordinary regulatory powers over "systemically important financial institutions" ("SIFIs") granted under the Dodd-Frank Act; and third, the burdens and potential for conflicts posed by the multiplicity of regulatory regimes to which funds are now subject.

We discuss these and other issues below in detail. Section 1 describes the state of the industry from an economic perspective and outlines some of the major trends we are seeing. Section 2 describes the three principal regulatory issues facing the industry mentioned above. Section 3 describes a number of other regulatory issues of concern to

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[1] Throughout this testimony, references to "funds" and the "fund industry" refer only to those funds registered with the SEC. Many of our statistics relate specifically to mutual funds, which are by far the most prevalent type of fund in the U.S.

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) (the "Dodd-Frank Act").

the industry, some that affect funds as issuers of securities and some that affect funds as investors in the markets. Section 4 comments on our experiences with oversight by the Securities and Exchange Commission ("SEC"), the primary regulator for the industry.

Section 1: State of the Industry

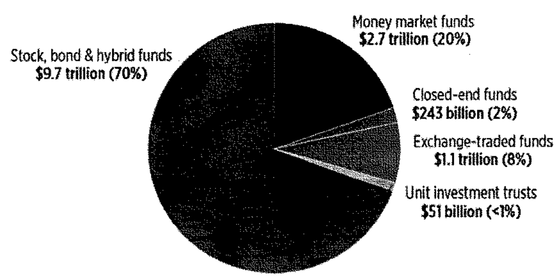
The fund industry is a vibrant, innovative, and competitive industry that helps millions of American investors meet their short- and long-term financial goals. These millions of investors have entrusted funds with more than $13 trillion in assets, giving funds a significant role as institutional investors in the U.S. economy and world financial markets. This section of the testimony provides an economic overview of the fund industry, including a look at some of the major trends shaping it. More specific details and a comprehensive review of the trends and activity in the fund industry are contained in ICI's 2011 Investment Company Fact Book.[3]

A. Overview of U.S. Funds

As of April 2011, U.S. funds managed $13.8 trillion in assets for over 91 million U.S. investors. Long-term mutual funds (stock, bond and hybrid funds) accounted for 70 percent of investment company total net assets (Figure 1). Money market funds made up 20 percent of assets and exchange-traded funds comprised 8 percent.

Figure 1

Over Two-Thirds of Investment Company Assets in Long-Term Mutual Funds*



Total = $13.8 Trillion

**Data for long-term funds, money market funds, and exchange-traded funds are for April 2011. Data for closed-end funds are for March 2011. Data for unit investment trusts are for December 2010.*

[3] 2011 Investment Company Fact Book (51st Edition), available at http://www.icifactbook.org ("ICI Fact Book").

Total net assets of U.S. mutual funds were $12.5 trillion as of April 2011. Equity mutual funds accounted for $6.2 trillion or half of U.S. mutual fund assets. Domestic equity funds (those that invest primarily in shares of U.S. corporations) held $4.6 trillion or 37 percent of total mutual fund assets. World equity funds (those that invest primarily in foreign corporations) accounted for $1.6 trillion or 13 percent. Bond mutual funds accounted for $2.7 trillion or 22 percent of total mutual fund assets. Money market funds ($2.7 trillion or 22 percent of total assets) and hybrid funds ($816 billion or 7 percent of total assets) held the remainder of total U.S. mutual fund assets.

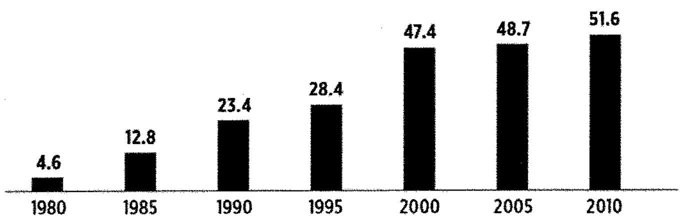
B. Fund Shareholders

In 2010, an estimated 90 million individual investors owned mutual funds and held 87 percent of total mutual fund assets at year-end. Altogether, 51.6 million households, or 44 percent of all U.S. households, owned mutual funds (Figure 2).

Figure 2

44 Percent of U.S. Households Owned Mutual Funds in 2010

Millions and percentage of U.S. households owning mutual funds, selected years



	1980	1985	1990	1995	2000	2005	2010
Percentage of U.S. households	5.7	14.7	25.1	28.7	44.5	43.0	43.9

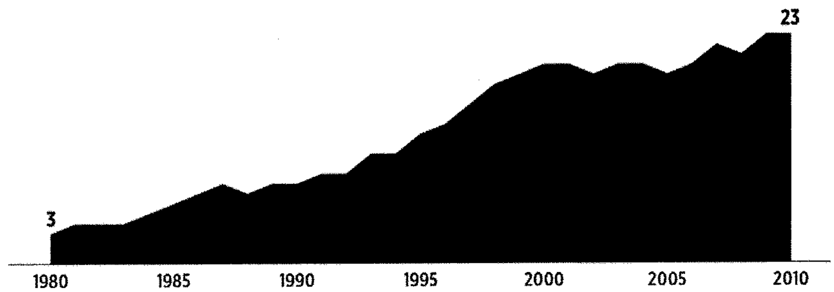
Sources: Investment Company Institute and U.S. Census Bureau. See ICI Fundamentals, *"Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010."*

Mutual funds represented a significant component of many U.S. households' financial holdings in 2010. Among households owning mutual funds, the median amount invested in mutual funds was $100,000. One-quarter of mutual fund-owning households had household incomes of less than $50,000; 20 percent had household incomes between $50,000 and $74,999; 19 percent had incomes between $75,000 and $99,999; and the remaining 36 percent had incomes of $100,000 or more. The median household income of mutual fund-owning households was $80,000.

Households are the largest group of investors in funds, and funds managed 23 percent of households' financial assets at year-end 2010, up from only 3 percent in 1980 (Figure 3).

Figure 3

Share of Household Financial Assets Held in Investment Companies
Percent, year-end, 1980–2010



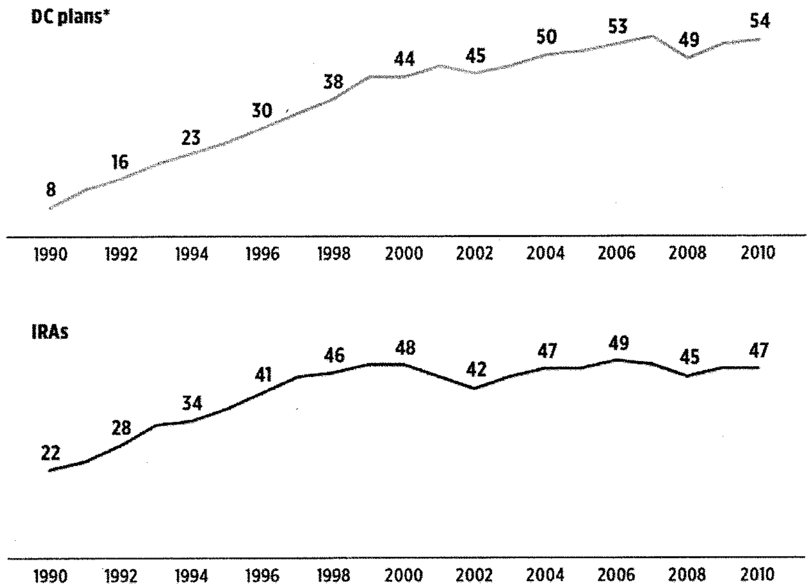
Note: Household financial assets held in registered investment companies include household holdings of ETFs, closed-end funds, and mutual funds. Mutual funds held in employer-sponsored DC plans, IRAs, and variable annuities are included.
Sources: Investment Company Institute and Federal Reserve Board

The growth of individual retirement accounts (IRAs) and defined contribution (DC) plans, particularly 401(k) plans, in conjunction with the important role that mutual funds play in these plans explains some of households' increased reliance on funds during the past two decades. At year-end 2010, 9 percent of household financial assets were invested in 401(k) and other DC retirement plans, up from 6 percent in 1990. Mutual funds managed 54 percent of the assets in these plans in 2010, up from 8 percent in 1990 (Figure 4). IRAs made up 10 percent of household financial assets, and mutual funds managed 47 percent of IRA assets in 2010. Additionally, outside of retirement accounts, mutual funds are investment options in $1 trillion in variable annuities, which have tax-deferred status.

Figure 4

Mutual Funds in Household Retirement Accounts

Mutual fund percentage of retirement assets by type of retirement vehicle, 1990–2010



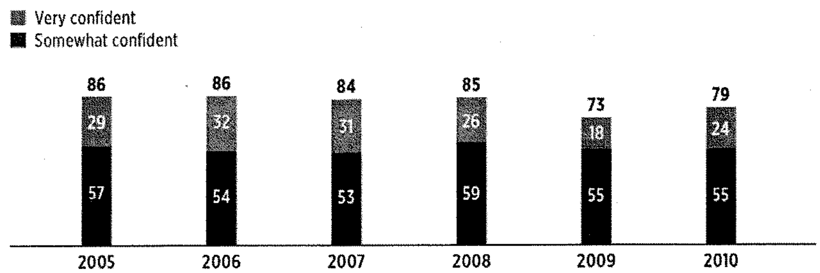
**DC plans include 403(b) plans, 457 plans, and private employer-sponsored DC plans (including 401(k) plans).*
Sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

Investors' confidence that mutual funds are helping them reach their financial goals declined a bit in the wake of the financial market crisis. In 2009, 73 percent of fund shareholders said they were confident in mutual funds' ability to help them achieve their financial goals, compared to 85 percent in 2008 (Figure 5). In 2010, confidence rose: 79 percent of all fund shareholders said they were confident in mutual funds' ability to help them achieve their financial goals. Indeed, nearly one-quarter of fund investors in 2010 were "very" confident that mutual funds could help them meet their financial goals.

Figure 5

Shareholder Confidence Rose in 2010

Percentage of all mutual fund shareholders by level of confidence that mutual funds can help them meet their investment goals, 2005–2010



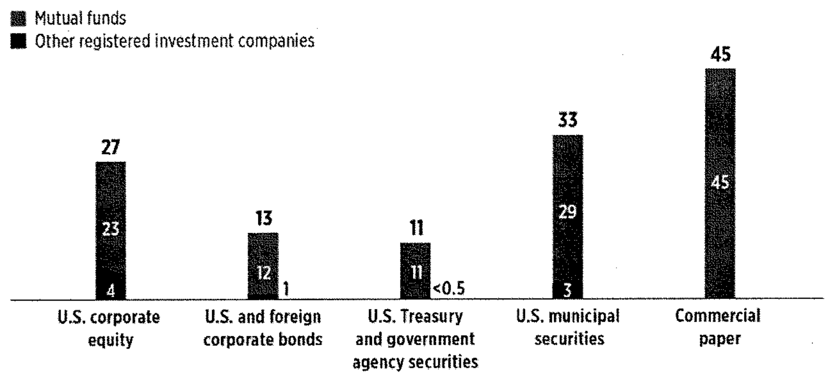
Note: This question was not included in the survey prior to 2005. The question has four choices; the other two possible responses are "not very confident" and "not at all confident."
Source: ICI Fundamentals, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010"

C. Funds as Investors

Funds have been among the largest investors in the domestic financial markets for much of the past 20 years and held a significant portion of the outstanding shares of U.S.-issued stocks, bonds, and money market securities at year-end 2010 (Figure 6). Funds as a whole were one of the largest group of investors in U.S. companies, holding 27 percent of their outstanding stock at year-end 2010. Funds continued to be the largest investor in the commercial paper market—an important source of short-term funding for major U.S. and foreign corporations—and held 45 percent of outstanding commercial paper. At year-end 2010, funds held 33 percent of tax-exempt debt issued by municipalities. Funds' share of the tax-exempt market has remained fairly stable in the past several years despite changes in the demand for tax-exempt funds and the overall supply of tax-exempt debt. Funds held 11 percent of U.S. Treasury and government agency securities and 13 percent of U.S. corporate and foreign bonds.

Figure 6

Investment Companies Channel Investment to Stock, Bond, and Money Markets
Percentage of total market securities held by investment companies, year-end 2010



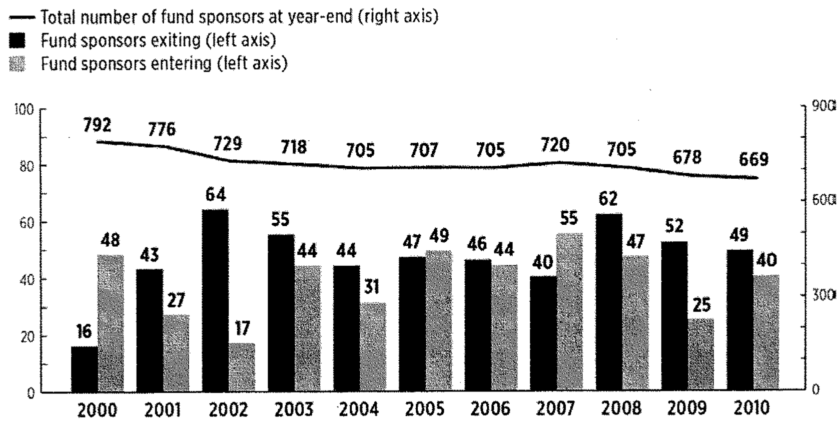
Note: components may not add to the total because of rounding.
Sources: Investment Company Institute, Federal Reserve Board, and World Federation of Exchanges

D. Competition in the Fund Industry

In 2010, there were 669 financial firms that competed in the U.S. market to provide investment management services to fund investors. Historically, low barriers to entry have attracted a large number of fund sponsors to the fund marketplace in the United States. These low barriers to entry led to a rapid increase in the number of fund sponsors in the 1980s and 1990s. However, competition among these sponsors and pressure from other financial products reversed this trend over the past decade. From year-end 2000 to year-end 2010, 502 fund sponsors left the fund business (Figure 7). In the same time, 379 new firms entered. The overall effect has been a net reduction of 16 percent in the number of industry firms serving investors. The decrease in the number of advisers has occurred with larger fund sponsors acquiring smaller fund families and with some fund sponsors liquidating funds and leaving the business. In addition, several other large sponsors of funds sold their fund advisory businesses.

Figure 7

Number of Fund Sponsors
2000–2010



Source: Investment Company Institute

Competitive dynamics have prevented any single firm or group of firms from dominating the market. For example, of the largest 25 fund complexes in 1985, 13 remained in this top group in 2010. Another measure of market concentration is the Herfindahl-Hirschman Index, which weighs both the number and relative size of firms in the industry. Index numbers below 1,000 indicate that an industry is unconcentrated. The mutual fund industry had a Herfindahl-Hirschman Index number of 465 as of December 2010.

In this past decade, however, the percentage of industry assets at larger mutual fund complexes has increased (Figure 8). The share of assets managed by the largest 25 firms increased to 74 percent by 2010 from 68 percent in 2000. In addition, the share of assets managed by the largest 10 firms in 2010 was 53 percent, up from the 44 percent share managed by the 10 largest firms in 2000.

Figure 8

Share of Assets at the Largest Mutual Fund Complexes
Percentage of industry total net assets, year-end, selected years

	1985	1990	1995	2000	2005	2009	2010
Top 5 complexes	37	34	34	32	37	39	40
Top 10 complexes	54	53	48	44	48	53	53
Top 25 complexes	78	76	71	68	70	74	74

Source: Investment Company Institute

Several factors likely contributed to this development. One factor is the acquisition of smaller fund complexes by larger ones. Second, total returns on U.S. stocks averaged only a little over 1 percent annually from year-end 1999 to year-end 2010 and likely held down assets managed by fund complexes that concentrate their offerings primarily in domestic equity funds—many of which tend to be smaller fund complexes. Third, in contrast, total returns on bonds averaged 6 percent annually in the past 11 years. Strong inflows over the decade to bond mutual funds, which are fewer in number and have fewer fund sponsors than equity mutual funds, helped boost the share of assets managed by those large fund complexes that offer bond funds.

E. Trends in Mutual Fund Fees and Expenses

Investing in funds involves two primary types of fees and expenses: sales loads and ongoing expenses. Sales loads are one-time fees—paid directly by investors either at the time of share purchase (front-end loads) or, in some cases, when shares are redeemed (back-end loads). Ongoing expenses are paid from fund assets, and thus investors pay them indirectly. A fund's expense ratio reflects all of its annual ongoing expenses, expressed as a percentage of fund assets. Ongoing fund expenses can cover portfolio management, fund administration, daily fund accounting and pricing, shareholder services (such as call centers and websites), distribution charges known as 12b-1 fees, and other miscellaneous costs of operating the fund.

ICI studies trends in fund fees and expenses by adding a fund's annual expense ratio to an estimate of the annualized cost that investors pay for one-time sales loads. This measure is reported as an asset-weighted average, which gives more weight to those funds that have more assets.

Mutual fund fees and expenses that investors pay have trended downward since 1990 (Figure 9). In 1990, investors in stock funds, on average, paid fees and expenses of 2 percent of fund assets. By 2010, that figure had fallen by more than half to 0.95 percent. Fees and expenses paid on bond funds declined by 61 percent from 1.85 percent of fund assets to 0.72 percent over the same time period.

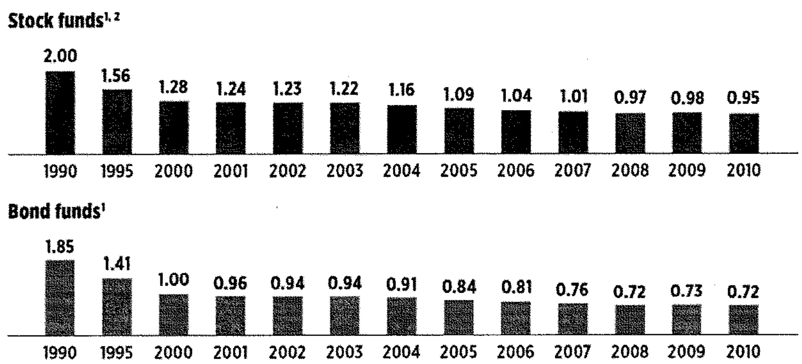
There are a number of reasons for the dramatic drop in fees and expenses incurred by mutual fund investors. First, in general, investors pay much less in sales loads than they did in 1990. For stock funds, for example, the average front-end sales load actually paid fell from 3.9 percent in 1990 to 1.0 percent in 2010. A key factor contributing to the steep decline in loads paid has been the growth of mutual fund sales through employer-sponsored retirement plans. Sales charges are often waived for purchases of fund shares through such retirement plans.

Another reason for the decline in fees and expenses has been growth in the sales of no-load funds. Much of the increase in sales of no-load funds has occurred through the employer-sponsored retirement plan market. In addition, sales of no-load funds have also expanded through mutual fund supermarkets, discount brokers, and full-service brokerage platforms that compensate financial advisers with asset-based fees paid outside of funds.

Figure 9

Fees and Expenses Incurred by Stock and Bond Mutual Fund Investors Have Declined by More Than Half Since 1990

Percent, selected years



[1]Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds. Figure reports year-end asset-weighted average of annual expense ratios and annualized loads for individual funds.

[2]Stock funds include equity and hybrid funds.

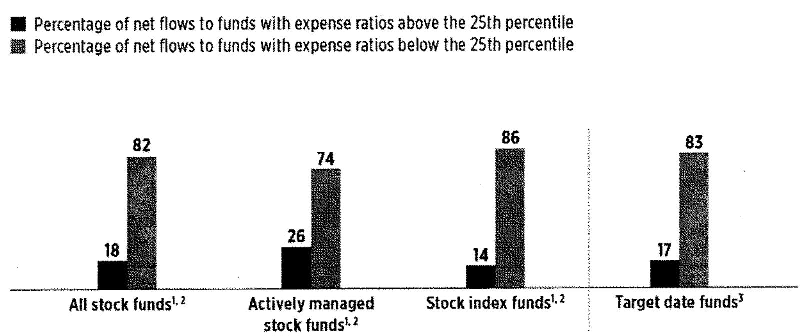
Sources: Investment Company Institute and Lipper

Mutual fund fees also have been pushed down by economies of scale and competition within the mutual fund industry. For example, the number of households owning mutual funds has more than doubled since 1990, going from 23.4 million in 1990 to 51.6 million in 2010. Over the same period, the number of shareholder accounts rose from 61.9 million to over 290 million. Ordinarily, such a sharp increase in demand, coupled with an increased demand for services, could tend to raise fund expense ratios. Any such effect, however, was more than offset by the downward pressure on fund expense ratios from competition among existing fund sponsors, economies of scale from the growth in fund assets, and shareholder movement to lower-cost funds.

Finally, all else equal, ICI research shows that mutual fund shareholders invest predominantly in lower expense ratio funds. During the 11-year period 2000 to 2010, stock funds with expense ratios in the lowest quartile received 82 percent of all net new cash flow, while the remaining 75 percent of funds received only 18 percent of net new cash flow (Figure 10). This pattern holds for actively managed stock funds, stock index funds, and target date funds.

Figure 10

Least Costly Stock Funds Attract Most of the Net New Cash
Percent, 2000–2010



[1]Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.
[2]Stock funds include equity and hybrid funds.
[3]Target date fund data are for 2005–2010; includes target date funds that invest primarily in other mutual funds.
Sources: Investment Company Institute and Lipper

Section 2: Principal Regulatory Issues Facing the Industry

In the wake of the financial crisis and in light of the Dodd-Frank Act, three important issues face the fund industry: first, regulatory reforms of money funds; second, uncertainties about the application to funds and their investment advisers of the extraordinary regulatory powers over SIFIs granted under the Dodd-Frank Act; and third, the burdens and potential for conflicts posed by the multiplicity of regulatory regimes to which funds are now subject. This section of the testimony describes each of these issues in detail.

A. Money Market Funds

1. Overview

Money market funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool for investors, and as an indispensable source of short-term financing for the U.S. economy. ICI and its members are committed to working with policymakers to bolster money market funds' resilience to severe market stress so as to assure their continued ability to serve these purposes.

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

This section of ICI's testimony provides a discussion of the money market itself, including its structure and participants; key characteristics of money market funds; and the development and growth of these funds. It then describes how money market funds are regulated, including important SEC amendments to the rule governing these funds that make them more resilient to extreme market stresses. Finally, it discusses ongoing efforts by both the industry and regulators for further strengthening these funds. In particular, we explain why requiring that money market funds "float" their share price (*i.e.*, have an NAV that fluctuates based on the current market prices of portfolio instruments, rather than maintain a stable $1.00 NAV through the use of the amortized cost valuation method) would be unlikely to reduce systemic risk and may, in fact, increase it.

2. The U.S. Money Market

The money market is a huge, complex, and significant part of the nation's financial system, and one in which many different participants interact each business day. This section describes: the structure of the market; the different vehicles through which investors can access money market instruments (many of which compete directly with money market funds); the unique characteristics of money market funds; and the role and growth of money market funds as financial intermediaries in the money market.

a. Structure of the U.S. Money Market

In the United States, the market for debt securities with a maturity of one year or less is generally referred to as "the money market."[4] The money market is an effective and lower cost mechanism for helping borrowers finance short-term mismatches between payments and receipts. For example, a corporation might borrow in the money market if it needs to make its payroll in 10 days, but will not have sufficient cash on hand from its accounts receivable for 45 days.

The main borrowers in the U.S. money market are the U.S. Treasury, U.S. government agencies, state and local governments, financial institutions (primarily banks, finance companies, and broker-dealers), and nonfinancial corporations. Borrowers in the money market are known as "issuers" because they issue short-term debt securities.

Reasons for borrowing vary across the types of issuers. Governments may issue securities to temporarily finance expenditures in anticipation of tax receipts. Mortgage-related U.S. government agencies borrow in the money market to help manage interest-rate risk and rebalance their portfolios. Banks and finance companies often use the money market to finance their holdings of assets that are relatively short-term in nature, such as business loans, credit card receivables, auto loans, or other consumer loans.

Corporations typically access the money market to meet short-term operating needs, such as accounts payable and payroll. At times, corporations may use the money market as a source of bridge financing for mergers or acquisitions until they can arrange or complete longer-term funding. In addition, all types of borrowers may seek to reduce interest costs by borrowing in the money market when short-term interest rates are below long-term interest rates.

Borrowers use a range of money market securities to help meet their funding needs. The U.S. Treasury issues short-term debt known as Treasury bills. Government sponsored agencies such as Fannie Mae and Freddie Mac issue

[4] Securities that have final maturities of more than one year but whose yields are reset weekly, monthly, or quarterly also are generally considered part of the money market.

Benchmark and Reference bills, discount notes, and floating rate notes (agency securities). Municipalities issue cash-flow notes to provide short-term funding for operations, and bond anticipation notes and commercial paper to fund the initial stages of infrastructure projects prior to issuing long-term debt. They also issue variable rate demand notes to gain access to the short end of the yield curve. Banks and other depositories issue large certificates of deposits ("CDs") and Eurodollar deposits.[5] Banks and broker-dealers also use repurchase agreements, a form of collateralized lending, as a source of short-term funding.

Corporations, banks, finance companies, and broker-dealers also can meet their funding needs by issuing commercial paper, which is usually sold at a discount from face value, and carries repayment dates that typically range from overnight to up to 270 days. Commercial paper can be sold as unsecured or asset backed.[6] One alternative to issuing commercial paper is to obtain a bank line of credit, but that option is generally more expensive.[7]

Although the size of the U.S. money market is difficult to gauge precisely (because it depends on how "money market" instruments are defined and how they are measured), it is clear that a well-functioning money market is important to the well-being of the macro-economy. We estimate that the outstanding values of the types of short-term instruments typically held by taxable money market funds and other pooled investment vehicles (as discussed below)—such as commercial paper, large CDs, Treasury and agency securities, repurchase agreements, and Eurodollar deposits—total roughly $11 trillion.

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[5] In addition, U.S. banks (including branches of foreign banks in the United States) can lend to each other in the federal funds market. Banks keep reserves at Federal Reserve Banks to meet their reserve requirements and to clear financial transactions. Transactions in the federal funds market enable depository institutions with reserve balances in excess of reserve requirements to lend to institutions with reserve deficiencies. These loans are usually made overnight at the prevailing federal funds rate. Also, banks worldwide can provide funding to each other via the interbank lending market for maturities ranging from overnight to one year at the prevailing London Interbank Offered Rate.

[6] Unsecured commercial paper is a promissory note backed only by a borrower's promise to pay the face amount on the maturity date specified on the note. Firms with high quality credit ratings are often able to issue unsecured commercial paper at interest rates that are less than bank loans. Asset-backed commercial paper ("ABCP") is secured by a pool of underlying eligible assets. Examples of eligible assets include trade receivables, residential and commercial mortgage loans, mortgage-backed securities, auto loans, credit card receivables, and similar financial assets.

[7] The expense of these credit lines is expected to increase, and their availability may decrease, as the Basel Committee on Banking Supervision's endorsement of capital and liquidity reforms for banks (known as "Basel III") are implemented and banks are required to include credit commitments in their liquidity, net stable funding, and other calculations. *See* Basel III: A global regulatory framework for more resilient banks and banking systems, Annex 4 (Basel Committee on Banking Supervision, December 2010).

While these money market instruments fulfill a critical need of the issuers, they also are vitally important for investors seeking both liquidity and preservation of capital. Major investors in money market securities include money market funds, banks, businesses, public and private pension funds, insurance companies, state and local governments, broker-dealers, individual households, and nonprofit organizations.

b. Financial Intermediaries for Money Market Instruments

Investors can purchase money market instruments either directly or indirectly through a variety of intermediaries. In addition to money market funds, these include bank sweep accounts, investment portals, and short-term investment pools, such as enhanced cash funds, and ultra-short bond funds.[8] Investors also can purchase money market instruments through offshore money funds. Offshore money funds are investment pools domiciled and authorized outside the United States. There is no global definition of a "money fund," and many non-U.S. money funds do not maintain a stable NAV.[9] European money funds historically were not bound by Rule 2a-7-like restrictions; however, CESR[10] issued guidelines in May 2010 with criteria for European money funds to operate as either of two types of funds, depending on their risk tolerance. Europe also has an established and strong market of stable NAV money funds, including a large number of dollar-denominated money funds.[11]

[8] A description of these financial intermediaries is available at *Report of the Money Market Working Group*, Investment Company Institute (March 17, 2009) ("MMWG Report") at 16-17, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[9] In Europe, floating NAV money funds may use amortized cost accounting for securities up to 90 days in remaining maturity as long as there is no material difference between the amortized cost value and the market value. *See* Committee of European Securities Regulators ("CESR"), Guidelines on a Common Definition of European Money Market Funds (CESR/10-049), May 19, 2010, paragraph 21(valuation), available at http://www.cesr.eu/popup2.php?id=6638; CESR, A Consultation Paper: A Common Definition of European Money Market Funds (CESR/09-850), October 20, 2009, paragraph 8 (valuation), available at http://www.cesr-eu.org/data/document/09_850.pdf. *See also* CESR, Guidelines Concerning Eligible Assets for Investment by UCITS, CESR/07-044, March 2007, at 8 (article reference 4(2), amortization and valuation of money market instrument), available at http://www.cesr-eu.org/popup2.php?id=4421. In addition, while U.S. mutual funds must annually distribute their income and capital gains, many offshore funds tend to roll-up their income and capital gains. Offshore funds with this "roll-up" treatment therefore provide two advantages over investments in comparable U.S. funds: (1) tax deferral, and (2) conversion of ordinary income into capital gains, which are taxed at a lower rate.

[10] On January 1, 2011, CESR became the European Securities and Markets Authority.

[11] The dollar-denominated stable NAV money funds are used by multinational institutions and others seeking dollar-denominated money funds. The principal providers of these money funds formed a trade association, the Institutional Money Market Fund Association ("IMMFA"). IMMFA members adopted a Code of Practice in February 2003 that aims to ensure that members offer a high quality product and service to investors. All IMMFA funds are triple-A rated by one or more of the credit rating agencies. IMMFA funds also operate under the regulatory requirements of each fund's domicile. According to IMMFA, the

c. Characteristics of Money Market Funds

Investors expect to purchase and redeem shares of money market funds at a stable NAV, typically $1.00 per share. Investors view a stable $1.00 NAV as a crucial feature of money market funds, because it provides great convenience and simplicity in terms of its tax, accounting, and recordkeeping treatment. Investment returns are paid out entirely as dividends, with no capital gains or losses to track. This simplicity and convenience are crucial to the viability of money market funds because, in contrast with other mutual funds, they are used primarily as a cash management tool. In money market funds that allow check-writing, the $1.00 NAV gives investors assurance that they know their balance before they draw funds. Without a stable $1.00 NAV, many, if not most, investors would likely migrate to other available cash management products that offer a stable $1.00 NAV, such as those listed above, as they seek to minimize tax, accounting, and recordkeeping burdens.

In addition to a stable $1.00 NAV, money market funds seek to offer investors three primary features: return of principal; liquidity; and a market-based rate of return. Other important characteristics of money market funds include: high-quality assets; investment in a mutual fund; diversification; professional asset management; and economies of scale.

As of April 2011, 642 money market funds had a combined $2.7 trillion in total net assets under management, up from $180 billion as of year-end 1983, the year the SEC adopted Rule 2a-7 under the Investment Company Act of 1940 (the "Investment Company Act").

By investing across a spectrum of money market instruments, money market funds provide a vast pool of liquidity to the U.S. money market. As of February 2011, money market funds held $2.2 trillion of repurchase agreements, CDs, U.S. Treasury and agency securities, commercial paper, and Eurodollar deposits. Taxable money market funds invest primarily in these short-term instruments[12] and their holdings represent about 20 percent of the total outstanding amount of such money market instruments, underscoring the current importance of money market funds as an intermediary of short-term credit. In comparison, we estimate that money market funds held less than 10 percent of these same instruments in 1983.

Money market funds also are major participants within individual categories of taxable money market instruments. As of February 2011, these funds held 37 percent

market for the European triple-A rated stable NAV money funds has grown from less than $1 billion in 1995 to approximately $675 billion as of June 3, 2011, with approximately $308 billion of those assets in dollar-denominated money funds (both prime and government money funds).

[12] As of February 2011, approximately 90 percent of all taxable money market funds' total net assets were invested in these instruments. The remaining 10 percent of assets were invested in bank and corporate notes, bankers' acceptances, cash reserves less any liabilities, and other miscellaneous assets.

of outstanding short-term U.S. agency securities, 37 percent of commercial paper, 12 percent of short-term Treasury securities, 18 percent of repurchase agreements, 24 percent of large CDs, and 7 percent of Eurodollar deposits.

Tax-exempt money market funds are a significant source of funding to state and local governments for public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. As of May 2010, tax-exempt money market funds had $352 billion under management and accounted for an estimated 56 percent of outstanding short-term municipal debt.

For nearly 40 years, financial intermediation has developed outside of banks—a phenomenon that has benefited the economy by providing households and businesses more access to financing at a lower cost. Growth in money market fund assets has helped to deepen the commercial paper market for financial and nonfinancial issuers. Many major nonfinancial corporations have come to rely heavily on the commercial paper market for short-term funding of their day-to-day operations at interest rates that are typically less than rates on bank loans. The need for financial issuers to comply with Basel III, such as the new short-term liquidity ratio, will make the ready availability of money market funds to supply liquidity more necessary than ever.

In 1983, the year the SEC adopted Rule 2a-7, the commercial paper market had only about $185 billion outstanding—about one-fifth of the $990 billion in non-mortgage loans then on the books of banks and finance companies. At its peak in mid-2007, prior to the start of the financial crisis, the commercial paper market provided a total of $2.1 trillion in financing—equivalent to over half of the $3.6 trillion in on-balance sheet non-mortgage bank and finance company loans.

In August 2007, outstanding commercial paper, particularly ABCP, began to contract as reports of defaults in commercial paper issued by structured investment vehicles ("SIVs") started to surface. While money market funds shied away from buying additional paper issued by SIVs, they continued to supply credit to other financial and nonfinancial corporations in the commercial paper market. Over the next two years, even as the commercial paper market as a whole contracted, money market funds' share of financing in this market grew steadily, reaching a peak of 46 percent ($520 billion out of a total of $1.1 trillion) at the end of 2009. As of April 2011, money market funds held $414 billion (36 percent of the market) in outstanding commercial paper.

3. Regulation of Money Market Funds

Money market funds, like all mutual funds, are subject to a comprehensive regulatory scheme under the federal securities laws that has worked extremely well for over 70 years. Their operations are subject to all four of the major federal securities laws administered by the SEC, including the Securities Act of 1933 , the Securities Exchange

Act of 1934, the Investment Advisers Act of 1940, and, most importantly, the Investment Company Act.[13]

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) provide for a high degree of oversight and accountability; (2) ensure that investors receive sufficient information about the fund, including its fees and expenses, and that the information is accurate and not misleading; (3) protect the physical integrity of the fund's assets by having explicit rules concerning the custody of portfolio securities; (4) prohibit or restrict affiliated transactions and other forms of self-dealing; (5) prohibit unfair and unsound capital structures (by, for example, placing constraints on the use of leverage); and (6) ensure the fairness of transactions in fund shares.

One defining feature of money market funds is that, in contrast to other mutual funds, they seek to maintain a stable NAV or share price, typically $1.00 per share. As a result, money market funds must comply with an additional set of regulatory requirements in Rule 2a-7 under the Investment Company Act. Rule 2a-7 exempts money market funds from the valuation provisions generally applicable to all mutual funds and permits them to determine their NAV using the amortized cost method of valuation,[14] which facilitates money market funds' ability to maintain a stable NAV. The basic premises underlying money market funds' use of the amortized cost method of valuation are these: (1) high-quality, short-term debt securities held until maturity will return to their amortized cost value, regardless of any temporary disparity between the amortized cost value and market value; and (2) while held by a money market fund, the market value of such securities ordinarily will not deviate significantly from their amortized cost value. Thus, Rule 2a-7 permits money market funds to value portfolio securities at their amortized cost so long as the deviation between the amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current NAV per share of the fund. In practice these risk-limiting conditions generally keep deviations between money market funds' per share market value and amortized costs small.[15] Data from a sample of taxable money market funds covering

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[13] Mutual funds also are subject to most of the requirements that apply to U.S. corporate issuers under the Sarbanes-Oxley Act of 2002.

[14] Under this method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount.

[15] *See Pricing of U.S. Money Market Funds*, Investment Company Institute (January 2011), available at http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf ("*Pricing of U.S. Money Market Funds*").

one-quarter of U.S. taxable money market fund assets show that the average per-share market values varied between $1.002 and $0.998 during the decade from 2000 to 2010.[16]

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, Rule 2a-7 contains a number of conditions designed to limit the fund's exposure to certain risks by governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments.[17] These risk-limiting conditions include requirements that money market funds:

- only invest in high-quality securities that mature in 13 months or less (with exceptions for certain types of securities including variable and floating rate securities that have an interest rate reset of no more than 397 days or a demand feature), which a fund's board of directors (or its delegate) determines present minimal credit risks, and a requirement that at least 97 percent of a fund's assets be invested in securities held in government obligations or other securities that either received the highest short-term rating or are of comparable quality;

- maintain a sufficient degree of portfolio liquidity necessary to meet reasonably foreseeable redemption requests, including a requirement that all taxable funds maintain at least 10 percent of assets in cash, Treasury securities, or securities that convert into cash within one day ("daily liquid assets"), and that all funds maintain at least 30 percent of assets in cash, Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week ("weekly liquid assets");

- maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk; and

- maintain a diversified portfolio designed to limit a fund's exposure to the credit risk of any single issuer.

In addition, Rule 2a-7 includes certain procedural requirements overseen by the money market fund's board of directors. One of the most important is the requirement that the fund periodically compare the amortized cost NAV of the fund's portfolio with

[16] *Id.* at 26.

[17] Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.

the mark-to-market NAV of the portfolio.[18] If there is a difference of more than ½ of 1 percent (or $0.005 per share), the fund's board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) $1.00 per share, an event colloquially known as "breaking the dollar." Regardless of the extent of the deviation, Rule 2a-7 also imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Moreover, all funds must dispose of a defaulted or distressed security (*e.g.*, one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.

Money market funds also must prominently disclose on the first page of their prospectus 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."

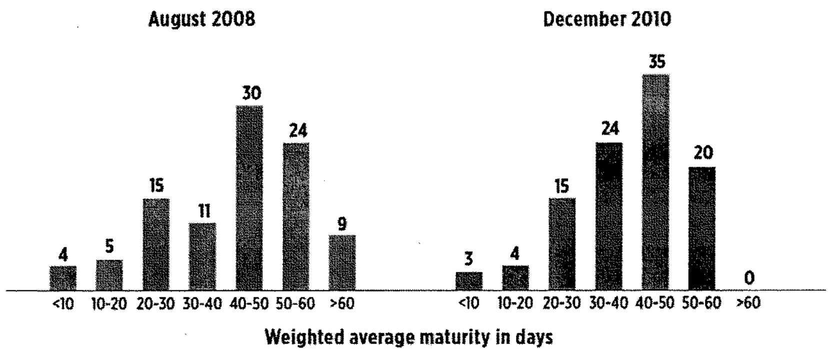
Building upon the lessons of the financial crisis, the SEC's 2010 rule amendments raised credit standards and shortened the maturity of money market funds' portfolios—further reducing credit and interest rate risk.[19] For example, the reduction in funds' weighted average maturity ("WAM") from 90 days to 60 days lowered the average maturity of taxable money market funds (Figure 11). It also reduced "tail risk" by preventing funds from holding a portfolio with a WAM in excess of 60 days; this is seen in Figure 14 as a "lopping off" of the right-hand tail of the distribution of WAMs across taxable money market funds. Reducing money market funds' WAM so that a higher percentage of their assets mature sooner than was the case before the onset of the financial crisis, makes them more resilient to changes in interest rates that may be accompanied by other market shocks, and puts money market funds in a better position to meet shareholder redemptions.

[18] Indeed, as a result of Rule 2a-7's risk-limiting conditions, money market funds' underlying per-share market price deviates by only a few basis points from $1.00 in all but the most extreme market conditions. For example, the SEC's decision to reduce the maximum allowable weighted average maturity of money market funds' portfolios significantly reduces volatility in per-share market prices arising from changes in interest rates. *See Pricing of U.S. Money Market Funds, supra* note 16.

[19] *See* SEC Release No. IC-29132 (February 23, 2010) ("SEC 2010 amendments"). A chart comparing money market fund regulations before and after the recent amendments is available on ICI's website at http://www.ici.org/policy/regulation/products/money_market/_11_mmf_reg_summ.

Figure 11

WAMs for Taxable Money Market Funds
Percent of funds

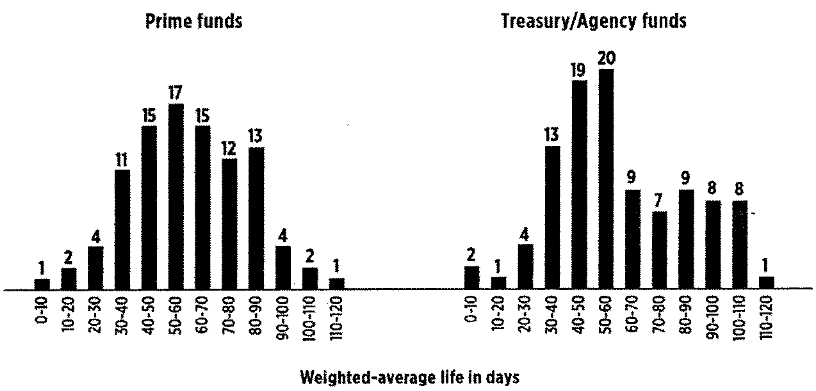


Source: Investment Company Institute

The introduction of a limit on money market funds' weighted average life ("WAL") also has strengthened the ability of money market funds to meet redemption pressures. Unlike a fund's WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although publicly available data on WALs do not exist before November 2010, the available data since then suggest that the new WAL requirement likely will bolster funds' ability to absorb market shocks. Figure 12 depicts the distribution of WALs for taxable money market funds as of December 2010. According to Figure 12, a very small proportion of funds have WALs in excess of 100 days. Indeed, the great majority of funds have WALs ranging from 30 to 90 days, in part reflecting the fact that money market securities (including Treasury and agency securities) are issued with maturities in essentially the same range.

Figure 12

WALs for Taxable Money Market Funds
Percent of funds, December 2010



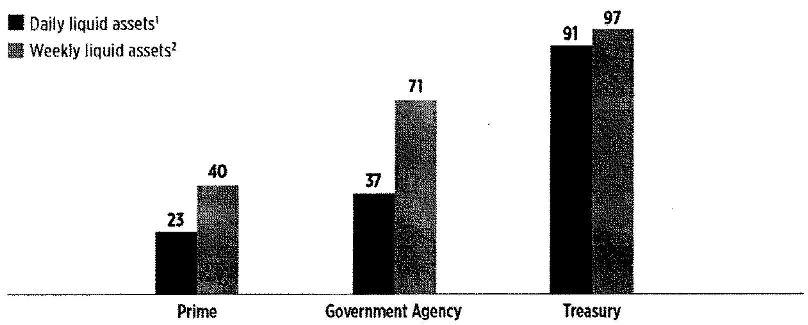
Note: Excludes money market funds that invest primarily in other money market funds (e.g., master/feeder structure).
Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website

In addition, the SEC 2010 amendments directly addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. The amendments further require funds to have "know your investor" procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly. As Figure 13 shows, as of December 2010, funds' assets exceeded the minimum daily and weekly liquidity requirements by a fair margin; 23 percent of the assets of taxable money market funds were in daily liquid assets and 40 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated \$1.4 trillion in highly liquid assets, which includes \$660 billion held by prime money market funds.[20] In comparison, during the business week of Monday, September 15 to Friday, September 19, 2008 (the week Lehman Brothers failed), prime money market funds experienced estimated outflows of \$370 billion.

[20] "Prime" money market funds are funds that may invest in high-quality, short-term money market instruments including Treasury and government obligations, CDs, repurchase agreements, commercial paper, and other money market securities. They do not include tax-exempt, government, or Treasury money market funds.

Figure 13

Liquid Assets for Taxable Money Market Funds
Percent of total assets, December 2010



[1]*Daily liquid assets include securities with a remaining maturity of one business day, Treasury securities of any maturity, and securities with a demand feature that is exercisable within one business day. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for daily liquid assets.*

[2]*Weekly liquid assets include securities with a remaining maturity of five business days, Treasury securities of any maturity, government agency securities with a remaining maturity of 60 days or less (regardless of whether those securities were initially issued at a discount), and securities with a demand feature that is exercisable within five business days. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for weekly liquid assets.*

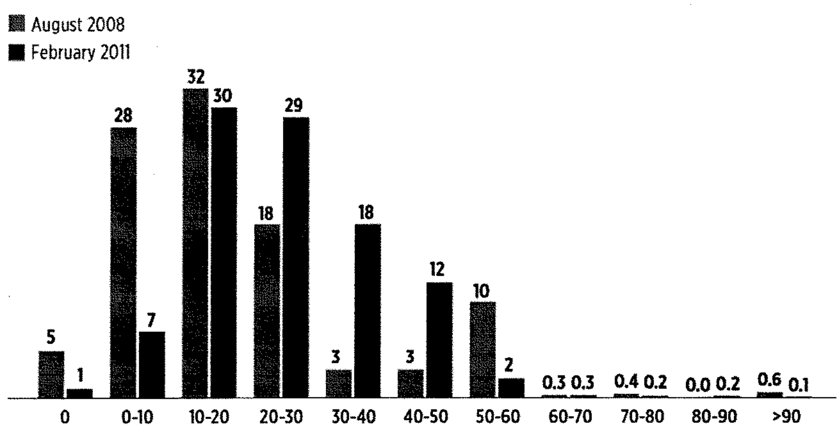
Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website, and Bloomberg

Prime money market funds appear, in part, to be meeting the minimum liquidity requirements by altering their portfolio holdings toward repurchase agreements and Treasury and agency securities. Figure 14 compares the concentration of prime money market funds' holdings of these securities in August 2008 to February 2011. From August 2008 to February 2011, the distribution shifts right, indicating that more prime money market fund assets are now in repurchase agreements and Treasury and agency securities. Indeed, money market funds often use one or seven day repurchase agreements to maintain liquidity to meet redemptions. Under Rule 2a-7 (as amended in 2010), Treasury securities automatically satisfy the daily and weekly liquidity requirements, while certain agency securities automatically satisfy the weekly liquidity requirement.

Figure 14

Concentration of Prime Money Market Funds Assets by Holdings of Repo, Treasury, and Agency Securities

Percent of prime fund assets



Source: Investment Company Institute

The rule changes also require more frequent disclosure of money market funds' holdings, so both regulators and investors will better understand funds' portfolios. In addition, the SEC took an important step to help bolster money market funds' resilience to severe market stress and redemption pressures. The SEC gave money market fund boards of directors, upon a determination of the board, including a majority of members who are independent of fund management, the ability to suspend redemptions if a fund has broken or is about to "break the dollar"—a powerful tool to assure equitable treatment for all of the fund's shareholders, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund. Indeed, this capability, which is available only if the board has determined to liquidate the fund, protects shareholders under extreme circumstances by ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

4. Making Money Market Funds Even More Resilient

Since September 2008, both the SEC and the fund industry have made a great deal of progress toward making money market funds more resilient under extreme market conditions. In March 2009, ICI issued the *Report of the Money Market Working Group*, an industry study of the money market, of money market funds and other participants in that market, and of recent market circumstances.[21] The MMWG Report included wide-ranging proposals to address weaknesses in money market fund regulation. When that report was issued, ICI's members pledged to adopt those recommendations voluntarily.

As previously described, early last year, the SEC approved far-reaching rule amendments that enhance its already-strict regime of money market fund regulation.[22] The SEC indicated that the amendments are designed to strengthen money market funds against certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable NAV per share.[23]

The search for ways to make money market funds even more secure under the most adverse market conditions did not stop, however, with the adoption of the SEC's reforms. For example, ICI and several of its members are actively engaged in a task force sponsored by the Federal Reserve Bank of New York to strengthen the underpinnings of a vital portion of the money market—tri-party repurchase agreements. These reforms are significant not only to money market funds, which provide about one-fifth of the lending in the repurchase agreement market, but to all participants in that market.

Regulators also are actively evaluating other proposals to make money market funds less susceptible to market stresses. In a June 2009 Treasury Department paper on financial regulatory reform,[24] the Treasury recommended that the President's Working Group on Financial Markets ("PWG") prepare a report assessing whether more

[21] *See* MMWG Report, *supra* note 8.

[22] *See* SEC 2010 amendments, *supra* note 19.

[23] *Id.* at 10060.

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

fundamental changes were necessary to supplement SEC money market fund reforms.[25] The paper called for, among other things, exploring measures to require money market funds "to obtain access to reliable emergency liquidity facilities from private sources."[26] In response, ICI and its members have developed a detailed framework for such a facility, including how it could be structured, capitalized, governed, and operated.

Last October, the PWG issued its report discussing several options for further reform of money market funds and recommending that the FSOC examine those options.[27] These options range from measures that could be implemented by the SEC under current statutory authorities to broader changes that would require new legislation, coordination by multiple government agencies, and the creation of private facilities, including a private emergency liquidity facility for money market funds as mentioned in the Treasury paper. In response to a request for comments on the report,[28] ICI, along with more than 90 other commenters, provided its views on the reform options outlined in the report.[29] There we described how an industry-sponsored emergency liquidity facility for prime money market funds[30] could address policymakers' remaining concerns by serving as a liquidity backstop for those funds during times of unusual market stress. In contrast, we explained how the other options presented in PWG's report, including forcing money market funds to abandon their objective of maintaining a stable $1.00 share price, would not solve the problem at hand, could increase rather than decrease systemic risk, would adversely impact the market, or would result in some combination of the foregoing. In many cases, transitioning to a new approach in and of itself would have systemic risk implications.

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[25] Notably, the Treasury paper urged caution in this effort. In particular, it recommended that the PWG carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as investor flight from these funds into unregulated or less regulated money market investment vehicles.

[26] Treasury paper, *supra* note 24, at 38.

[27] The PWG's report is available on the Treasury Department's website at http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

[28] *See* SEC Release No. IC-29497 (November 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. More recently on May 10, 2011, the SEC hosted a roundtable on money market funds and systemic risk that consisted of SEC officials, representatives of the FSOC, and participants from academia, the business community, the fund industry, and state and local governments. Information about this roundtable is available on the SEC's website at http://sec.gov/news/otherwebcasts.shtml.

[29] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011), available on ICI's website at http://www.ici.org/pdf/11_sec_pwg_com.pdf.

[30] Based on our study of money market funds, we strongly believe that any further reforms should be limited to prime funds, as their role in the broader money market can directly affect the commercial paper market. We do not believe that other types of money market funds pose the same concerns and, in fact, government and Treasury funds saw substantial inflows during the last market crisis.

Nevertheless, the fund industry remains open to exploring additional forums that will strengthen money market funds even further against adverse market conditions and enable them to meet extraordinarily high levels of redemption requests. Given the tremendous benefits money market funds provide to investors and the economy, however, it is imperative that any additional money market fund reform measures preserve this product's essential characteristics.

5. Requiring Money Market Funds to "Float" Their NAVs

Some commentators have suggested that the incentive for investors to exit money market funds rapidly during market stress would be eliminated if money market funds were forced to "float" their NAVs. Indeed, at various times, the SEC has requested public comments on the possibility of eliminating the ability of money market funds to use the amortized cost method of valuation. Out of more than 200 comment letters filed with the SEC during those comment periods, the ones that favored floating NAVs could be counted on one hand. By contrast, scores of letters opposed this idea.[31] Also included among those letters were many from individual investors who strongly opposed changing the fundamental nature of money market funds. Indeed, the SEC's own Investor Advisory Committee has before it a resolution that calls upon the SEC to preserve the stable NAV as a core feature of money market funds.[32] We are highly skeptical that such a requirement would reduce risks in any meaningful way. There is compelling evidence that a substantial portion of money market fund investors either would be unable or unwilling to use a floating NAV money market fund. As a result, the primary effect of requiring money market funds to float their NAVs would be a major restructuring and reordering of intermediation in the short-term credit markets, which would not reduce—and might well increase—systemic risk.

a. Impact of a Floating NAV on Preventing Investor Runs

Those urging that funds float their NAVs believe that doing so will prevent investor runs. Requiring funds to float their NAVs, however, is unlikely to achieve this goal. Under normal conditions, the shadow prices of money market funds' portfolios generally deviate very little from $1.00. This is simply a reflection of the fact that money

[31] These letters came from a broad spectrum of businesses, governments, schools, retirement plans, consumer groups, and financial services firms.

[32] The resolution states: "Money market funds should not be required to use a floating NAV. Money market funds play a vital role as cash management vehicles for millions of Americans and as liquidity facilities for short-term borrowers. They have an extraordinary history of stability, with only two instances of failure in three decades of regulation under Rule 2a-7. If the Commission believes that the stability of money market funds can be improved, then it should consider appropriate prudential measures. Mandating a floating NAV, however, would put the continued viability of money market funds at risk and be detrimental to the interests of America's retail investors." The resolution and corresponding memorandum are available on the SEC's website at http://sec.gov/spotlight/invadvcomm/iacmemo-mmf.pdf.

market funds invest in very short-term, high-quality, fixed-income securities and the price of these securities deviates little from their amortized cost value absent a large interest rate movement or credit event.[33] In the event, however, of a severe market crisis brought on or associated with a sharp, unexpected change in interest rates or a major credit event, risk intolerant investors who invest in these funds would typically flee to the safest investments (*i.e.* Treasury securities) and away from other investments, regardless of whether these other investments have fixed or floating NAVs.

Indeed, the money market itself historically is susceptible to liquidity pressures. Lenders in this market typically need ready access to their cash and have a low tolerance for financial risk. Borrowers depend on these markets to meet their immediate funding needs. Rollover issuances are a very high percentage of the outstanding short-term securities. During periods of financial stress, risk intolerant investors can and do move quickly out of the markets, leaving large supply and demand imbalances, which can cause volatility in short-term interest rates. These patterns existed long before money market funds developed in the 1970s.

The combination of these factors results in the money market and money market funds operating for long periods of time in relative tranquility punctuated by stress events. Investors' desire to have exposure to the money market, either directly or through money market funds, declines during these periods of stress. Opponents of stable NAV money market funds argue that floating the NAV would reduce the likelihood of investors wanting to move away from the money market during these events. We disagree.

Assuming, for the sake of argument, that a floating NAV money market fund would attract a substantial base of investors,[34] the same motivations to shift away from certain areas of the market would remain and could lead to investor withdrawals in a future widespread financial crisis. As discussed in the MMWG Report, ultra-short bond funds illustrate how this can occur outside of money market funds. While ultra-short bond funds are not required to follow Rule 2a-7, they do invest in a portfolio of relatively short-dated securities. In contrast with money market funds, however, the NAV of an ultra-short bond fund fluctuates. Beginning in the summer of 2007, the average NAV on these funds began to fall (Figure 15). By the end of 2008, assets of these funds were down more than 60 percent from their peak in mid-2007.

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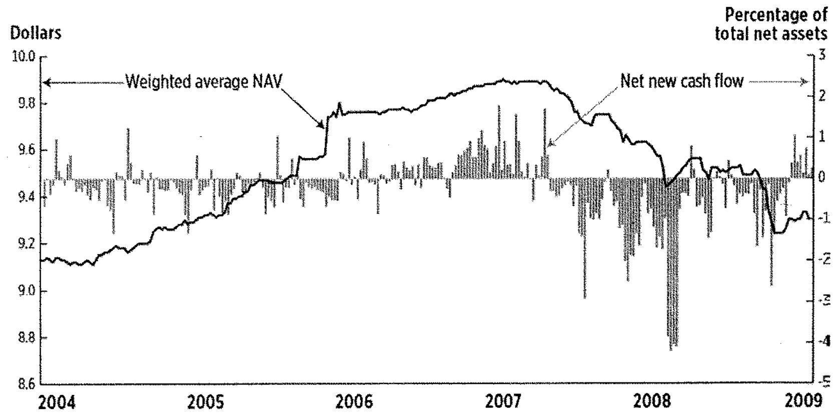
[33] *See Pricing of U.S. Money Market Funds, supra* note 15.

[34] As discussed below, we strongly believe that the vast majority of money market fund investors would reject outright, or substantially reduce their holdings in, a floating-NAV money market fund.

Figure 15

Weighted Average NAV and Net New Cash Flow of Ultra-Short Bond Funds
Weekly



Sources: Investment Company Institute and Morningstar

The experience in Europe of certain money funds likewise demonstrates that floating NAV funds also can face strong investor outflows during periods of market turmoil. For example, French floating NAV dynamic money funds (or *trésorerie dynamique* funds), lost about 40 percent of their assets over a three-month time span from July 2007 to September 2007.[35]

For these reasons, we remain doubtful that floating the NAV on money market funds would reduce risks in any meaningful way. Also, as we discuss below, prohibiting money market funds from maintaining a stable NAV would likely lead to the demand for less regulated products that seek to maintain a stable NAV, and would therefore simply shift the risk to a more opaque and less regulated part of the market.

b. Investor Demand for a Stable NAV Fund Would Remain

The elimination of a stable NAV would be a dramatic change for money market funds. One very significant concern is whether investors would continue to use such a product. For a substantial number of investors, the answer is no.

[35] For a more detailed discussion of the experience of certain money and bond funds in Europe, *see* MMWG Report, *supra* note 8, at 106-107.

Many institutional investors that use money market funds would be unable to use a floating NAV fund. These investors often face legal or other constraints that preclude them from investing their cash balances in pools that do not seek to maintain a stable NAV. For example, corporations may have board-approved policies permitting them to invest operating cash (balances used to meet short-term needs) only in pools that do not fluctuate in value. Indentures and other trust documents may authorize investments in money market funds on the assumption that they seek to maintain a stable NAV. Many state laws and regulations also authorize municipalities, insurance companies, and other state regulated entities to invest in stable NAV funds, sometimes explicitly including funds operating in compliance with Rule 2a-7. Thus, absent a stable NAV, many state and local governments would no longer be able to use money market funds to help manage their cash.[36]

Even those investors who do not face such constraints nevertheless may be unwilling to invest in a floating NAV product. A stable NAV offers significant convenience in terms of tax, accounting, and recordkeeping. For example, all of a money market fund's returns are distributed to shareholders as income. This relieves shareholders of having to track gains and losses, *including* the burden of having to consider the *timing* of sales and purchases of fund shares (*i.e.*, wash sale rule considerations). To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors make fewer purchases and sales from long-term mutual funds and, in any case, many such purchases (or exchanges) are made within tax-advantaged accounts (*e.g.*, 401(k) plans), where such issues do not arise.

A floating NAV also would reduce the value and convenience of money market funds to individual retail investors. For example, brokers and fund sponsors typically offer investors a range of features tied to their money market funds, including checkwriting and ACH and fedwire transfers. These features are generally only provided for stable NAV products. Thus, elimination of the stable NAV for money market funds would likely force brokers and fund sponsors to consider how or whether they could continue to provide such services to money market fund investors.

The current rate environment has proven to be an important test of investor demand for stable NAV funds. Currently, yields on money market funds are 150 basis points below short-duration bond funds, and 300 to 500 basis points below longer term bond funds. Yet, outflows from money market funds have slowed sharply, and since July 2010, assets in money market funds have hovered between $2.7 trillion and $2.8 trillion, *greater* than the assets held in money market funds in July 2007, prior to the start of the financial crisis.

[36] *See generally* MMWG Report, *supra* note 8, at Appendix D.

Indeed, a diverse range of investors in money market funds previously have communicated their opposition to floating NAVs directly to the SEC. The stable $1.00 NAV, as the Association of Public and Land-Grant Universities told the SEC in September 2009, provides a "low-cost, convenient, and reliable cash management tool."[37] Investors, added the American Bankers Association in its comment to the SEC, "understand and appreciate the accounting treatment offered by stable NAV funds."[38]

The State of Rhode Island's General Treasurer has told the SEC that "[a] floating NAV will likely reduce investment yields as it increases complexity and drives up administrative costs."[39] His comment was echoed by a letter to the SEC from the Pennsylvania School District Liquid Asset Fund, which said that a floating NAV would lead to "needless complication of the reporting systems of public schools and local government entities to reflect variations of value that are inconsequential."[40] Similarly, a floating NAV, in the words of the National Association of State Treasurers, could "potentially destabilize financial markets for both investors and debt issuers."[41] More recently at the SEC's May 10, 2011 roundtable on money market funds and systemic risk, Harford County, Maryland's Treasurer (representing the Government Finance Officers Association) called the stable NAV for money market funds "extremely important" to her department's mission of maintaining principal for operating cash and noted that "[i]f we have fluctuating NAV, my government won't be in it."[42] The Senior Vice President and Treasurer of CVS Caremark echoed this point by stating that she "will not invest in a floating NAV product" and noted that her treasury systems are not equipped to mark assets to market on a day-to-day basis.[43]

Furthermore, surveys of money market fund investors indicate clearly that most investors do not want and would not use a floating NAV product. For example, a survey of institutional cash managers indicated that more than half would decrease *substantially*

[37] *See* Letter from Peter McPherson, President, Association of Public and Land-Grant Universities, to Elizabeth M. Murphy, SEC, available at http://www.sec.gov/comments/s7-11-09/s71109-48.pdf.

[38] *See* Letter from Lisa J. Bleier, Vice President and Senior Counsel Center for Securities, Trust and Investments, American Bankers Association, to Elizabeth Mr. Murphy, SEC, available at http://www.sec.gov/comments/s7-11-09/s71109-107.pdf.

[39] *See* Letter from Frank T. Caprio, General Treasurer, State of Rhode Island and Providence Plantations, to Elizabeth M. Murphy, SEC, available at http://www.sec.gov/comments/s7-11-09/s71109-147.pdf.

[40] *See* Letter from Thomas R. Schmuhl, Duane Morris LLP, on behalf of the Board of Trustees of the Pennsylvania School District Liquid Asset Fund, to Elizabeth M. Murphy, SEC, available at http://www.sec.gov/comments/s7-11-09/s71109-109.pdf.

[41] *See* Letter from James B. Lewis, New Mexico State Treasurer and President, National Association of State Treasurers, to Timothy Geithner, Secretary of the Treasury (July 2, 2010).

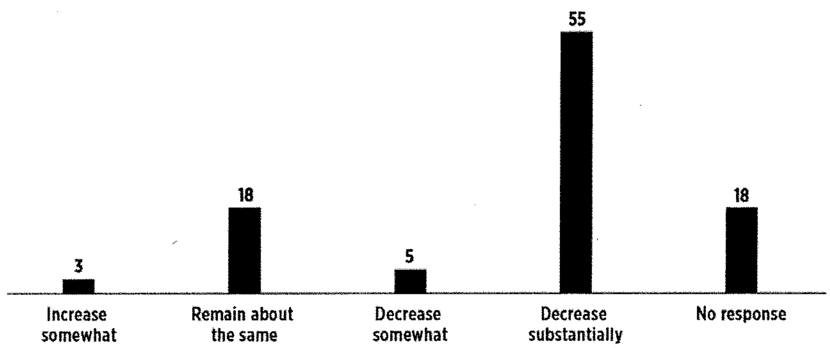
[42] *See* SEC Roundtable discussion at http://sec.gov/news/otherwebcasts.shtml.

[43] *Id.*

their use of money market funds if money market funds are required to have a floating NAV (Figure 16).

Figure 16

Institutional Cash Managers' Expected Usage of Floating NAV Money Market Funds



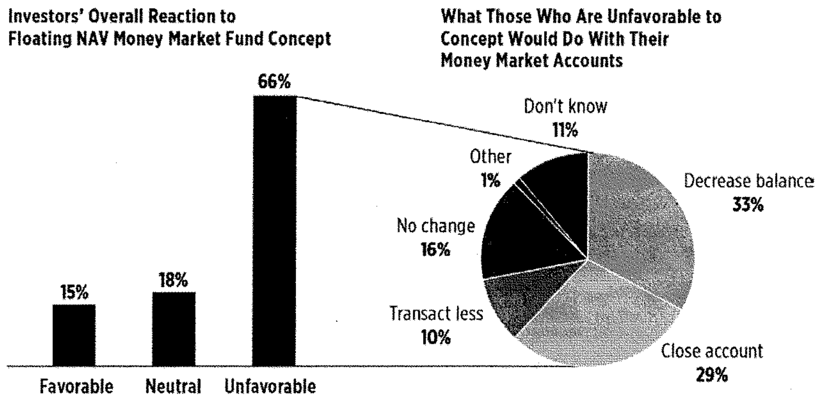
Note: Percentages do not add to 100 percent because of rounding.
Source: Treasury Strategies Inc. flash survey of 78 institutional cash managers on January 30, 2009. Of the 78 institutional cash managers, 43 were commercial, 13 were education-related, 13 were private, four were state and local governments, four were financial institutional, and one was unclassified.

A recent survey of retail money market fund investors commissioned by T. Rowe Price and conducted online by Harris Interactive indicated much the same response (Figure 17).[44]

[44] Based on a study commissioned by T. Rowe Price and conducted online by Harris Interactive from August 31 to September 7, 2010 of 413 adults aged 35-75 who own money market funds outside of a retirement plan, who also own at least one long-term mutual fund, who invest directly with a mutual fund company, do not rely solely on the advice of an investment adviser, and have $100,000 or more in investable assets. The data are weighted to be representative of the adult population with $100,000 or more in investable assets. A full methodology is available upon request.

Figure 17

Retail Investors' Reaction to Floating NAV Money Market Funds



Source: Harris Interactive / T Rowe Price

Two thirds of retail investors surveyed found the idea of a floating NAV money market fund unfavorable. Among those who found the concept unfavorable, 72 percent indicated that they would use the product less, and that their most likely response would be to close their money market fund accounts (29 percent), decrease their money market fund balances (33 percent), or execute fewer money market fund transactions (10 percent). A third survey, conducted among both retail and institutional shareholders by Fidelity Investments, found much the same result. This survey found that institutional investors overwhelmingly (78 percent) disliked the idea of a floating NAV product and would use money market funds less or not at all (69 percent of 78 percent) if faced with the prospect of a floating NAV. Retail investors also disliked the floating NAV concept. Forty percent of the retail investors surveyed disfavored the floating NAV concept; however, when informed of the adverse tax consequences, the percent disfavoring jumped to over sixty percent.[45] In short, there is good reason, backed by data, to believe that investors do not want and will likely reject a floating NAV money market fund.

[45] The Fidelity survey of retail investors and institutional investors was coordinated by Northstar Research Partners in conjunction with Fidelity Consulting Group in August 2009.

c. Floating the NAV Would Harm the Market

The primary, and perhaps only, effect that floating the NAV of money market funds would have on the financial system would be a major restructuring and reordering of intermediation in the short-term credit markets. This would not reduce systemic risk and might well increase it.

Assets in money market funds now total $2.7 trillion. As indicated, money market fund investors of all types are unlikely to use a floating NAV product. Requiring money market funds to float their NAVs thus would risk precipitating a vast outflow of assets from money market funds to other products. This transition, in and of itself, could be systemically risky. It would require money market funds to shed hundreds of billions of dollars of commercial paper, bank CDs, Eurodollar deposits, repurchase agreements, and other assets. Even under the calmest of financial market conditions, this would be a highly tricky process. During a period of stress in the money market, such a transition could well set off the kind of systemic event that advocates of a floating NAV seek to avoid.

Requiring money market funds to float their NAVs will merely shift credit intermediation from one type of product to others; it will not reduce systemic risk. There are a number of alternative products that money market fund investors could use, including, as listed above, enhanced cash pools, offshore money funds, and other vehicles that seek to maintain a stable unit price but are not regulated under the Investment Company Act. Regulatory changes that push assets from regulated products (*e.g.*, money market funds) to less regulated products arguably would serve to increase systemic risk. Moreover, these products had their own difficulties during the financial crisis.[46]

Indeed, investors have the ability through banks to select among various sweep arrangements that seek to offer a stable unit value, such as money market fund sweeps, repurchase agreement sweeps, commercial paper sweeps, and, importantly, sweeps into offshore (non-money market fund) accounts (*e.g.*, Eurodollar sweeps).[47] If a stable NAV is eliminated for money market funds, investors can migrate to these other kinds of sweep accounts, which in some cases (*e.g.*, Eurodollar sweeps) are largely beyond the jurisdictional reach of domestic regulators.

Such an exodus from money market funds would not reduce systemic risk, but simply transfer it elsewhere and may, in fact, serve to increase systemic risk. Institutional investors that use these money market fund substitutes would likely exit them quickly in a crisis, seeking the safety of Treasury securities. The end result would still be a freeze in the commercial paper, repurchase agreement, or Eurodollar markets.

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[46] *See* MMWG Report, *supra* note 8, at 62-64.

[47] For a general discussion of overnight sweep arrangements, *see* MMWG Report, *supra* note 8, at 43-44.

Opponents of stable NAV money market funds suggest that requiring money market funds to float their NAVs could encourage investors to shift their liquid balances to bank deposits. We believe that this effect is overstated, particularly for institutional investors. Corporate cash managers and other institutional investors would not view an undiversified holding in an uninsured (or underinsured) bank account as having the same risk profile as an investment in a diversified short-term money market fund. Such investors would continue to seek out diversified investment pools, which may or may not include bank time deposits.

To the extent that investors would hold deposits in conventional banks , unless these deposits were fully insured, either explicitly or implicitly, institutional investors would likely run during a serious crisis. Insuring these deposits would entail a major increase (perhaps as much as $2 trillion) in the federal government's potential insurance liability and would result in a vast increase in moral hazard, a development that would simply increase systemic risk. To protect against a run, banks would then need to hold more liquid and higher quality assets in order to meet the requirements of this funding source, especially if institutional investors became concerned about counterparty risk and sought to withdraw their deposits during periods of financial stress. To the extent that banks did not increase their liquidity, systemic risk could increase.

In addition, a shift to traditional banks would result in a significant reduction in the supply of short-term credit to corporate America unless banks raised significant amounts of capital to be able to support their expanded balance sheets. Even if they could raise the capital to support this expansion, the market would be less efficient and the cost of short-term credit would rise. Furthermore, municipalities would lose an important source of financing in the short-term markets because banks cannot pass through tax-exempt income and simply could not replace tax-exempt money market funds.

Not surprisingly, issuers of money market securities have expressed serious concerns about the disruptive effects in the market for their securities should regulatory reforms diminish the role played by money market funds.[48] In sum, investors will

[48] For example, in its letter to the SEC in September 2009, the National Association of College and University Business Officers has warned the SEC that loss of a stable NAV investment option "could alter both the number of investors and the amount of capital that could be invested in debt issued by colleges and universities, potentially raising the cost of capital for our members." *See* Letter from John D. Walda, President and CEO, National Association of College and University Business Officers, to Elizabeth M. Murphy, SEC, available at http://www.sec.gov/comments/s7-11-09/s71109-127.pdf. More recently, a diverse group of 16 companies that rely on money market funds to support their capital raising and investment needs, as well as six associations, wrote to the SEC to express their view that "American business will lose one of its most important sources of short-term funding if money market funds are forced to abandon their stable per-share value." *See* Letter from Agilent Technologies, Inc., Air Products & Chemicals, Inc., Association for Financial Professionals, The Boeing Company, Cadence Design Systems, CVS Caremark Corporation, Devon Energy, Dominion Resources, Inc., Eastman Chemical Company, Eli Lilly & Company,

continue to demand a stable NAV money market fund or money market fund-like product. And one way or another, financial markets will find a way to deliver it.

6. Money Market Fund Reform—Next Steps

ICI and its members have devoted much effort since fall 2008 to identifying ways to strengthen money market funds against future market shocks. Much progress has been made, including the SEC's extensive amendments to its rules in early 2010. We are committed to continuing to work with regulators as they consider additional ways of achieving this objective. We submit that any such reforms should first, preserve those features of money market funds (including the stable $1.00 per share NAV) that have proven so attractive and valuable to investors; and second, avoid imposing costs that will undercut the ability or willingness of large numbers of investment advisers to continue to sponsor these funds.[49] Otherwise, we will put at risk the enormous benefits that money market funds provide to the economy.

We, of course, will keep the Subcommittee apprised as the industry and regulators continue to examine issues related to one of our country's most successful financing vehicles.

B. Systemic Risk Regulation

A second major area of concern to the fund industry relates to systemic risk regulation and the potential that some funds or advisers could be designated as systemically important. Since the beginning of the debate over the shape and scope of financial services regulatory reform, ICI has been a strong proponent of improving the U.S. government's capability to monitor and mitigate risks across our nation's financial system.[50] As both issuers of securities and large investors in U.S. and international

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Financial Executives International's Committee on Corporate Treasury, FMC Corporation, Institutional Cash Distributors, Kentucky Chamber of Commerce, Kraft Foods Global, Inc., National Association of Corporate Treasurers, New Hampshire Business and Industry Association, Nissan North America Inc., Pacific Gas and Electric Company, Safeway Inc., Weatherford International, Ltd., U.S. Chamber of Commerce to Elizabeth M. Murphy, Secretary, SEC (January 10, 2011) (letter in connection with SEC's request for comment on the PWG's report), available at http://www.sec.gov/comments/4-619/4619-32.pdf.

[49] The current environment of near-zero short-term interest rates—which stems from the Federal Reserve pursuing a target federal funds rate of 0 to 25 basis points in order to bolster the economy—is already posing a significant financial cost on fund advisers. In this environment, yields on money market funds before fees have been virtually zero. In order to keep fund yields above zero *after* fees, about 90 percent of the share classes of money market funds have recently waived some or all of the funds' operating expenses. These waivers, which are absorbed by funds' advisers, cost advisers an estimated $3.6 billion in 2009 and another $4.5 billion in 2010.

[50] *See, e.g.*, Investment Company Institute, Financial Services Regulatory Reform: Discussion and Recommendations (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf; Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of

financial markets, ICI member funds are keenly interested in policies that promote a well-functioning financial system able to withstand the periodic shocks that are an inevitable part of our complex, global marketplace.

As a starting point, we wish to emphasize that all financial market activities involve some degree of risk. Indeed, the ability of market participants to spread, share, or take on risk through the financial markets is a prime characteristic of vibrant and innovative economies. Thus, the goal of systemic risk regulation should be to eliminate the abuses and excessive risk taking that can endanger the financial system, while at the same time encouraging acceptable levels of the risk taking that are disclosed and necessary for innovation and economic growth.

1. SIFI Designations Should Be Made Deliberatively

The Dodd-Frank Act provides regulators many new tools to address abuses and excessive risk taking by financial market participants. These include tools that will affect financial institutions generally (*e.g.*, comprehensive regulation of the OTC derivatives market, stress tests) and those targeted either to eliminate excessive risk taking in, or to improve regulatory oversight over, specific sectors (*e.g.*, regulation of private fund advisers, swaps push-out rule).

Our financial system and its participants are nothing if not dynamic, however, and the rules set in place today, no matter how well crafted, will not necessarily prevent all of the unforeseen problems of tomorrow. The Dodd-Frank Act therefore gives the new Financial Stability Oversight Council ("FSOC") the authority to identify gaps in regulation and make recommendations to financial regulators, standard-setting bodies and Congress. Further, the critical monitoring function of the FSOC, with the help of the new Office of Financial Research, is intended to provide the capability to detect new buildups of risk in the financial system, allowing regulators to address changing circumstances before systemic problems develop.

The most well known—and controversial—of the FSOC's powers is its authority under Section 113 of the Dodd-Frank Act to designate systemically important nonbank financial companies, or "SIFIs," for heightened prudential regulation and consolidated supervision by the Federal Reserve Board. The FSOC's ability to determine that an individual company poses potential risk to the entire U.S. financial system—and the additional regulatory scrutiny that would flow from that determination—is an extraordinarily potent legal authority. Accordingly, it is one that should be used with great care. Specifically, ICI believes that the designation of individual companies for heightened supervision should be reserved for those circumstances, presumably quite

Representatives Committee on Financial Services on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" (July 17, 2009), available at http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny ("Stevens July 2009 Testimony").

limited, when the FSOC has determined that a specific company poses significant risks to the financial system that clearly cannot otherwise be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act.

As discussed more fully in our comments to the FSOC, there are several reasons why ICI believes that SIFI designations should be limited in number.[51] First, it will be very difficult for regulators to determine *in advance* which nonbank institutions are, or may prove to be, systemically significant. Second, the heightened requirements to which SIFIs would become subject largely reflect banking regulation concepts. Even if a nonbank financial company were to present some of the characteristics of being systemically risky, applying prudential standards that are not tailored to the specific risks presented by that company would have little actual value and may even be detrimental to the financial system and macroeconomy.

Third, from a systemic perspective, there is a high level of uncertainty as to how the markets and market participants may react to the designation of a company as systemically significant. Such a designation could signal that the government views the company as unsafe and might increase the company's cost of financing if market participants become reluctant to transact with it. Alternatively, because the designation would result in heightened oversight, this could make the company appear to be a safer bet than its non-designated competitors and provide a competitive advantage in terms of access to lower cost financing. Fourth, the designation could increase moral hazard as it might carry with it a dangerous expectation by market participants that the Federal Reserve Board and the FSOC will be able to mitigate any risks that a designated company may pose to the broader markets.

Finally, there are other potential costs and unintended consequences associated with using this authority too broadly, such as reduced competition and consumer choice. It is also possible that financial companies might be tempted to shift to less regulated jurisdictions and products.

Given these challenges and possible negative consequences, we reiterate our view that the FSOC should reserve this authority for situations that cannot be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act.

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[51] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010, available at http://www.ici.org/pdf/24696.pdf ("November 2010 FSOC Letter").

2. Funds and Their Investment Advisers Do Not Present the Risks That SIFI Designation is Intended to Address

Pursuant to Section 113 of the Dodd-Frank Act, SIFI designation is intended only for a nonbank financial company that could pose a threat to U.S. financial stability, either because of material financial distress at the company or the "nature, scope, scale, size, concentration, interconnectedness or mix" of its activities. For the reasons discussed below, ICI firmly believes that funds simply do not pose such threats, and accordingly, SIFI designation is neither warranted nor appropriate for an individual fund. The same can be said for investment advisers in their capacity as advisers to funds.

Funds are among the most highly regulated and transparent financial companies in the United States. They are subject to all four of the major federal securities laws, including the Investment Company Act. Although that Act was designed to protect shareholders, it also contains strong systemic risk-limiting provisions. These include:

- **Limits on Leverage and Capital Structure**: The Investment Company Act prohibits complex, unfair, or unsound capital structures. Mutual funds are subject to significant limitations on their ability to use leverage. Under the Investment Company Act, the maximum ratio of debt-to-assets allowed by law for a mutual fund is 1-to-3, which translates into a maximum allowable leverage ratio of total assets-to-equity of 1.5 to 1.

- **Disclosure and Transparency**: The Investment Company Act ensures that the market and investors have access to extensive information about each fund, including its strategy and investment risks as well as information on its current activities. In contrast, the marketplace simply does not have access to anything even approaching this degree of transparency about banks and their holdings. In fact, some believe that the opacity of banks' balance sheets contributed to the spread and severity of the recent financial crisis.[52]

- **Valuation and Liquidity**: Funds provide their investors with liquidity and an objective, market-based valuation of their investments. Mutual fund shares are redeemable on a daily basis at a price that reflects the current market value of the fund's portfolio securities, which value must be determined in accordance with Investment Company Act requirements. Further, the SEC takes the position that mutual funds should not invest in illiquid securities if doing so would cause the fund to have less than 85 percent of its assets in liquid securities. These requirements are essential to promoting investor and market confidence, and

[52] *See, e.g., The Financial Crisis of 2008 in Fixed Income Markets*, Gerald P. Dwyer and Paula Tkac, Working Paper 2009-20, Federal Reserve Bank of Atlanta (August 2009).

serve to ensure that investors, counterparties, and others are able to understand easily the actual valuations of funds' portfolios.

- **Transactions with Affiliates:** The Investment Company Act contains detailed prohibitions on transactions between a fund and its insiders or affiliated persons (such as the corporate parent of the fund's adviser). These prohibitions are intended to prevent over-reaching and self-dealing. In so doing, they serve to protect investors and promote investor confidence in funds.

- **Diversification:** Both the Internal Revenue Code and the Investment Company Act provide diversification standards for mutual funds. In contrast, for example, a bank deposit (over any insured amounts) is subject to the single counterparty risk that the bank may fail.

- **Custody of Fund Assets:** The Investment Company Act has specific custody rules requiring strict care of a fund's assets. These provisions protect investors from theft or misappropriation of their investments.

In our view, these characteristics of funds should be a sufficient basis on which to conclude that SIFI designation is not warranted or appropriate for an individual fund. Nevertheless, Section 113 is written broadly and could conceivably be applied to any type of nonbank financial company. For this reason, ICI has provided extensive written comment to the FSOC as it seeks to develop the process by which it will designate certain nonbank financial companies for heightened supervision.

Central to an inquiry under Section 113 are the various criteria that Congress directed the FSOC to consider. In our November 2010 letter to the FSOC, ICI analyzed the criteria in detail, focusing on those we believe to be the greatest indicators of the potential to pose systemic risk.[53] We were pleased that the FSOC, in its release proposing rules under Section 113, described an analytical framework that largely comports with ICI's analysis. This framework—which we have urged the FSOC to incorporate into its final rule—maps each of the specific criteria in Section 113 to one of six broad categories. As the release indicates, the six categories identified by the FSOC (size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) reflect different dimensions of a company's potential to pose risk to the financial system.

Summarized below are ICI's primary observations about the six FSOC categories, with particular emphasis on how they should apply specifically to funds and their investment advisers:

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[53] *See* November 2010 FSOC Letter, *supra* note 51.

- **Size**: A company's size alone reveals very little about its potential to pose risk to the financial system and, consequently, could be highly misleading if considered in isolation. In assessing a company's size as part of its overall analysis, the FSOC should focus on the size of the company's potential on- and off-balance sheet risks, and the impact on the U.S. financial system of potential losses. In the case of a company that manages assets owned by others, there are several clear reasons why the managed assets should not be attributed to the company. With regard to a fund's investment adviser, these reasons include: (1) the fund is a separate legal entity; (2) shareholder recourse for losses is solely with respect to the fund, absent wrongdoing on the part of the adviser; (3) the adviser cannot pledge the fund's assets to advance its own interests; (4) the adviser does not take on leverage to manage the fund's portfolio; and (5) the adviser must manage the fund's assets as a fiduciary and in accord with the fund's own investment objectives and restrictions.

- **Lack of Substitutes**: Captured within this category is a company's importance as a source of credit (*e.g.*, for households, businesses, and state and local governments). A company is more likely to pose systemic risk if it is a single or primary source of credit for such purposes and no other financial intermediaries can step in as alternate sources of financing. A crucial additional consideration is whether the credit is funded through debt or equity, with the latter posing considerably less risk to the financial system. While funds are significant providers of credit—to state and local governments, U.S. financial and operating companies, the U.S. Treasury, Fannie Mae and Freddie Mac—no one fund is a primary or sole source of credit to any of these markets and the vast majority of this credit is funded by paid-in capital (equity) from fund shareholders.

- **Interconnectedness**: The key issue appears to be whether a financial firm's failure could force a disorderly unwinding of the firm's on- and off-balance sheet positions and spark a cascade of failures among the firm's counterparties that then spread to the counterparties of those firms. Interconnectedness poses the greatest risk when it is coupled with leverage, either of the firm itself or its counterparties. Funds' interactions with shareholders and participation as counterparties in financial transactions pose very modest risks because funds have little or no leverage.

- **Leverage**: As history amply demonstrates, companies that are highly leveraged pose greater potential risk to the financial system. For example, when one highly leveraged firm holds the debt of another highly leveraged firm, losses can mount exponentially and spread quickly. As required by law, most mutual funds operate with little if any leverage and segregate liquid assets (or maintain offsetting positions) in order to meet their obligations in leverage transactions. This has the effect of tightly constraining the risks a fund might pose to the financial markets.

- **Liquidity Risk and Maturity Mismatch**: Generally speaking, financial institutions holding assets that can be sold quickly at a price approximating fundamental value are more resilient to economic shocks. Such assets give those institutions the flexibility to respond quickly to the kinds of rapidly changing economic circumstances that are common during financial crises. By contrast, institutions holding assets that do not trade in deep secondary markets may tend to pose more of a systemic concern. As noted above, in order to maintain liquidity for ordinary redemptions, mutual funds must hold at least 85 percent of their portfolios in "liquid securities," which are defined as any assets that can be disposed of within seven days at a price approximating market value. As a result, mutual funds can—and do—routinely handle large flows (purchases, exchanges, and redemptions) without perceptible consequences to the broader financial system.

- **Existing Regulatory Scrutiny**: A financial company that already is highly regulated is more likely to have robust internal controls and compliance procedures. Moreover, its primary regulator is the "subject matter expert" regarding the applicable regulatory scheme, and will be knowledgeable about the industry of which the company is a part, industry best practices, areas of regulatory concern, and the markets in which the company operates. These circumstances may militate against the need for imposing additional regulation by the Federal Reserve Board, as is required for any company designated by the FSOC under Section 113. Further, the FSOC should look specifically at the degree to which the regulatory requirements already applicable to that company serve to limit or control risk. As a general matter, a financial company that must already adhere to risk-limiting requirements is less likely to warrant a SIFI designation. As discussed above, funds are subject to comprehensive regulation, including risk-limiting requirements, under the Investment Company Act. Fund investment advisers also are highly regulated.

We understand that the FSOC is continuing to refine its thinking and may seek further comment before adopting final rules under Section 113. We recognize the difficulty inherent in fashioning an appropriate analytical framework to guide the FSOC's decision making in this area and we are hopeful that, with the benefit of additional public input, the FSOC will be able to develop rules that give market participants greater clarity as to how the SIFI designation process is likely to work.

3. SIFI Designation is Not Appropriate for Money Market Funds

In comments to the FSOC, some have suggested that certain (presumably larger) money market funds should be designated for heightened supervision pursuant to Section 113. In response, ICI has explained to the FSOC that such designation would *not* be an appropriate regulatory tool for further strengthening the resilience of money market funds to severe market distress.

The six broad categories identified in the proposed FSOC framework (size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) apply to money market funds in a manner that is similar to mutual funds generally, as outlined above. In fact, money market funds must comply with an additional set of regulatory requirements beyond the comprehensive requirements of the Investment Company Act to which all registered investment companies are subject. These legal requirements include stringent credit quality, liquidity, maturity, and diversification standards. The basic objective of money market fund regulation is to limit a fund's exposure to credit risk, interest rate risk, liquidity risk, and the risk that certain shareholders may act precipitously to seek large redemptions.

As discussed in Section 2.A.3 above, the SEC has adopted significant enhancements to these requirements. Reflecting the lessons learned from the recent financial crisis, these regulatory enhancements are designed to better enable money market funds to withstand certain short-term market risks.

As noted above, ICI and its members are committed to working with regulators to identify an appropriate way to bolster money market funds yet further against severe market stress. Designating each of the 642 money market funds, or even each of the 273 prime money market funds, offered in the U.S. market as a SIFI and subjecting each to ongoing prudential supervision by the Federal Reserve Board is not the way to accomplish this. Nor does it make sense to pick and choose among money market funds or complexes for this purpose, or to designate a fund adviser solely on the basis of its money market fund activities.

Last October, the PWG issued its report discussing several options for further reform of money market funds and recommending that the FSOC examine those options.[54] Nowhere in its detailed and thoughtful analysis of money market funds, however, did the PWG even suggest that the FSOC consider taking a fund-by-fund, complex-by-complex, or adviser-by-adviser approach under Section 113. Indeed, quite apart from SIFI designation, there is ample regulatory authority to craft additional reforms if deemed necessary. This includes both the wide-ranging authority accorded the SEC under the securities laws as well as other powers entrusted to the FSOC under Sections 112 and 120 of the Dodd-Frank Act.[55] To the extent the FSOC has any remaining

[54] *See supra,* note 27.

[55] Section 112 of the Dodd-Frank Act gives the FSOC the authority to, among other things: (1) facilitate information sharing and coordination among the FSOC member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions; (2) recommend to the member agencies general supervisory priorities and principles; and (3) identify gaps in regulation that could pose risks to the financial stability of

concerns with respect to money market funds, we urge it to evaluate and implement any additional reforms (whether to prime money market funds or money market funds generally) on an industry-wide basis.

C. Dealing with Multiple Regulators and the Potential for Regulatory Conflict

A third broad area of concern to funds is the potential for regulatory conflict and the compliance burdens posed by the multiplicity of regulators to which they are subject. Increasingly, funds face regulation, or the potential for regulation, from multiple agencies. At its worst, this dynamic could result in irreconcilable regulatory conflicts, where funds are subject to rules imposed by different regulators that simply are at odds with one another. More frequently, the result is a regulatory hodgepodge – when one agency pursues its perceived regulatory mandate without regard to closely related actions underway at another agency or to the implications of divergent standards; or when an agency addresses regulatory policy concerns only with respect to a specific product without regard to the way in which identical concerns arise with respect to other, competing products. Four recent examples highlight these problems:

- The proposed amendments to CFTC Rule 4.5, which if adopted would subject funds (or their advisers) to directly conflicting requirements by the CFTC and SEC;

- The ongoing debates over fiduciary duties at the Department of Labor (DOL) and the SEC, which are proceeding on completely separate tracks;

- Disclosure initiatives at the SEC and FINRA relating to potential broker conflicts, where one agency (FINRA) has acted before another (the SEC) with a narrow rule applicable only to the sale of mutual funds; and

- Multiple areas in the international arena, where regulators increasingly are adopting regulations that may conflict with or reduplicate those that global firms face in the United States.

Each of these is discussed in this section of our testimony.

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the United States. Section 120 provides that the FSOC may issue recommendations to one or more primary financial regulatory agencies to apply "new or heightened standards and safeguards" upon determining that the conduct of a financial activity or practice "could create or increase the risk of significant liquidity, credit, or other problems spreading among back holding companies and nonbank financial companies or the financial markets of the United States." The primary regulator(s) must impose the recommended standards or similar standards acceptable to the FSOC, or explain in writing why the regulator has determined not to follow the FSOC's recommendation.

1. Proposed Amendments to CFTC Rule 4.5

Rule 4.5 under the Commodity Exchange Act currently excludes certain "otherwise regulated entities," including funds, from regulation by the CFTC as commodity pool operators ("CPOs"). In late January, the CFTC approved a sweeping proposal to revise Rule 4.5 solely as applied to funds, revise or rescind other exclusionary rules, and adopt new disclosure requirements in an effort to "more effectively oversee its market participants and manage the risks that such participants pose to the markets."[56] This proposal is not required or even contemplated by the Dodd-Frank Act, although the CFTC attempts to describe it as being "consistent with the tenor" of that Act.[57] For the reasons summarized below, ICI and its members strongly object to the proposal's narrowing of the Rule 4.5 exclusion. We have provided extensive written comment to the CFTC,[58] and have met with CFTC Commissioners and agency staff, in order to highlight our concerns with the proposal. In addition, our April 12 Letter provided detailed recommendations as to how the Rule 4.5 proposal could be revised consistent with the CFTC's regulatory goals.

a. Background

The term CPO is broadly defined in the Commodity Exchange Act and generally includes, among other things, any person engaged in a business that is in the nature of an investment trust who receives funds from others "for the purpose of trading in any commodity for future delivery on or subject to the rules of a contract market or derivatives transaction execution facility."[59] CFTC Rule 4.5 recognizes the breadth of this definition, and provides an exclusion from CPO registration for certain persons operating "qualifying entities" that are subject to a different regulatory framework, including funds.[60] Prior to 2003, the Rule 4.5 exclusion was conditioned upon the entity satisfying certain conditions relating to its trading in commodity interests and the marketing of shares/participations in the entity.

After lengthy consideration in 2002-03, which included an advance notice of proposed rulemaking and a public roundtable on the regulation of CPOs and commodity trading advisors, the CFTC determined to eliminate the trading and marketing conditions

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[56] *See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 Fed. Reg. 7976 (Feb. 11, 2011) ("Rule 4.5 Proposing Release").

[57] *Id.* at 7977.

[58] Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated April 12, 2010 ("April 12 Letter"), available at http://www.ici.org/pdf/11_cftc_rule4.5_exclude.pdf.

[59] Section 1a(5) of the Commodity Exchange Act.

[60] Qualifying entities include funds, insurance company separate accounts, bank trust and custodial accounts, and retirement plans subject to ERISA fiduciary rules.

from Rule 4.5. In so doing, it cited, among other things, the fact that many qualifying entities avoided participation in the markets for commodity futures and commodity options because the Rule 4.5 conditions were "too restrictive for many [of them] to meet." The CFTC further determined that facilitating participation in the commodity markets by additional collective investment vehicles and their advisers would have "the added benefit to all market participants of increased liquidity."[61]

b. Proposed Amendments

The proposed amendments would condition eligibility for the Rule 4.5 exclusion on a fund's compliance with certain trading and marketing restrictions that are based upon those in the rule prior to 2003, but in fact are much broader in scope. These restrictions were first proposed in a rulemaking petition filed last summer by the National Futures Association ("NFA"). Although NFA's petition was prompted by concerns about the marketing practices of three funds offering so-called "managed futures strategies," it recommended imposing these restrictions (and thus substantially narrowing the Rule 4.5 exclusion) for *all* funds. The CFTC published the NFA petition for public comment and received considerable feedback from individual companies and trade and bar associations. Many of the comment letters, like that filed by ICI, expressed serious concerns about the scope of the NFA's proposed language, and identified for the CFTC the difficulties that funds would face if they were subject to the overlapping and conflicting requirements of the SEC's and CFTC's regulatory regimes.

Regrettably, the CFTC appears to have issued its proposal to amend Rule 4.5 without having fully analyzed the comments it received on the NFA rulemaking petition. The CFTC drew its proposed rule text almost verbatim from the NFA petition, but then proposed to narrow the Rule 4.5 exclusion even further by applying the proposed trading and marketing restrictions to a fund's positions in swaps. The CFTC's proposing release contains little explanation for the proposed language, except to describe it as "an appropriate point at which to begin discussions regarding the Commission's concerns."[62] The proposing release also fails to address the concerns and difficulties that were identified by commenters, except to the extent it asks for further public comment in the identified areas.

Funds unable to satisfy the proposed trading and marketing restrictions would be subject to regulation and oversight by the CFTC and the NFA. This would impose a second layer of regulation, primarily related to disclosures to investors, on such funds,

[61] *See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors*, 68 Fed. Reg. 12622, 12626 (March 17, 2003); *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors: Past Performance Issues*, 68 Fed. Reg. 47221 (Aug. 8, 2003).

[62] Rule 4.5 Proposing Release, *supra* note 56, at 7984.

which already must comply with similar comprehensive regulatory requirements under the Investment Company Act and other federal securities laws, administered by the SEC.

c. ICI Objections to the Proposed Amendments

As noted above, ICI and its members strongly object to the Rule 4.5 proposal in its current form. While we respect the CFTC's authority to "reconsider the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets,"[63] we do not believe the CFTC has demonstrated the need for a second level of regulation on funds. We further believe that the Rule 4.5 proposal is insufficiently developed. It does not appear to reflect thorough consideration by the CFTC of many critical issues raised by the proposal, which are discussed below and in more detail in our April 12 Letter.

The CFTC asserts that the proposed amendments to Rule 4.5 are intended to "stop the practice of registered investment companies offering futures-only investment products without Commission oversight . . ."[64] The agency has failed to explain, however, why the proposed amendments are troublingly broader in reach. Specifically, the sweeping language of the proposed trading and marketing restrictions would implicate a large number of funds that use futures, options and swaps simply as a means to efficiently manage their portfolios, rather than as part of operating a "futures-only" fund. It is particularly difficult to justify this result at a time when the CFTC Chairman has stated that current funding levels for the agency are "simply not sufficient" and has requested substantial additional resources from Congress.[65]

Furthermore, in its proposing release, the CFTC provides no evidence that a "futures-only" fund – not to mention a fund using futures, options or swaps for purposes *other than* providing exposure to the commodities markets, such as risk management – is currently subject to inadequate regulation, or that investors or the commodity markets generally have been harmed by their practices.

In fact, funds are already extensively regulated.[66] In addition to regulating their disclosures to investors, imposing limitations on their use of leverage, and otherwise regulating their daily operations, the federal securities laws subject funds and their

[63] *Id.* at 7977.

[64] *Id.* at 7984.

[65] *See, e.g.*, Testimony of Gary Gensler, Chairman, CFTC, Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, United States House of Representatives, on the CFTC's budget request for FY2012 (March 17, 2011) (stating that the Commission's current funding level is "simply not sufficient for the CFTC's expanded mission to oversee both the futures and swaps markets").

[66] *See* ICI Fact Book, *supra* note 3, at 191 for a description of how these securities laws apply to funds.

advisers to antifraud standards, and provide the SEC with inspection authority over funds and their investment advisers, principal underwriters, distributing broker-dealers and transfer agents. The Financial Industry Regulatory Authority (FINRA) also has oversight authority with regard to funds' principal underwriters and distributing broker-dealers. As a result, ICI questions why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily regulated entities.[67]

It is not even possible at this time for the fund industry and other stakeholders—or even for the CFTC itself—to assess the full impact of the proposed amendments to Rule 4.5. This is because one of the key restrictions would relate to margin levels on derivative positions held by funds, and the regulators have not yet made critical determinations that relate to swap margin levels. Specifically, the CFTC and SEC have not finalized rules regarding which swaps will be subject to central clearing requirements. In addition, margin requirements have not been established for cleared or uncleared swaps, which could end up varying significantly based on the type of swap. It is our strongly held view that the new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* the CFTC can propose any amendments to Rule 4.5 that implicate the use of swaps.[68]

Nonetheless, the CFTC provides in its proposal a cursory analysis of the costs and benefits of the proposed amendments to Rule 4.5. We believe this analysis is wholly inadequate to justify the costly, duplicative, and burdensome regulation that the amendments would impose on a large portion of the fund industry.[69] We question whether it is possible for the CFTC to conduct an adequate analysis of the costs and benefits of the proposal until the above-mentioned margin issues regarding swaps have been resolved, as the resolution of those issues could vastly impact the number of funds that may be swept into the CFTC's jurisdiction. The CFTC does identify a few costs, which it does not detail or quantify, but it fails to identify many of the major costs the proposal would impose on funds, some of which would inevitably get passed on to shareholders. The CFTC's analysis of benefits is even more abstract and does not appear to be focused on the proposed amendments to Rule 4.5 but instead on other, unrelated, parts of the proposal. Importantly, the CFTC fails to acknowledge in its analysis that any benefits that fund shareholders may receive as a result of the amendments to Rule 4.5 would largely duplicate many protections that shareholders currently enjoy as a result of the Investment Company Act and other federal securities laws. We have deep concerns

[67] We note that, at a recent hearing before the House Committee on Agriculture, Representative Glenn Thompson asked Chairman Gensler why "your recent 4.5 rule proposal would capture large swaps [sic] of mutual funds and subject them to duplicative and potentially conflicting CFTC regulation, when mutual funds are already highly regulated by the SEC." Testimony of Gary Gensler, Chairman, CFTC, Before the House Committee on Agriculture (March 31, 2011).

[68] *See* Section 3.B.1, *infra*.

[69] For our view on the importance of a robust cost-benefit analysis, *see* Section 4.A.2, *infra*.

whether the CFTC's cost-benefit analysis would satisfy the applicable requirements of the Commodity Exchange Act,[70] and we believe that the agency should not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis.

ICI is not alone in its concerns. This spring, Representative Frank Lucas, Chairman of the House Agriculture Committee, and Representative K. Michael Conaway, Chairman of the Subcommittee on General Farm Commodities and Risk Management, raised very similar concerns in requesting that the CFTC's inspector general undertake an investigation of the adequacy of the Commission's cost-benefit analysis.[71] We particularly agree with their observations that:

> The CFTC is failing to adequately conduct cost-benefit analysis – either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . [p]articularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.

The inspector general's report, issued on April 15, concluded that "[a] more robust process is clearly permitted under the [existing] cost-benefit guidance issued by the [CFTC's] Office of General Counsel and the Office of Chief Economist, and we believe a more robust approach would be desirable, with greater input from the Office of Chief Economist."[72]

Finally, even if the trading and marketing restrictions in the Rule 4.5 proposal are appropriately scaled back, there are likely to be cases in which funds and their advisers would be unable to rely on the amended rule and thus would become subject to regulation by both the CFTC and the SEC. The proposing release specifically

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[70] Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

[71] *See* Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC, dated Mar. 11, 2011.

[72] *See* Office of the Inspector General, CFTC, *Report of Investigation: An Investigation Regarding Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act* (April 15, 2011). Even the CFTC's own commissioners have raised concerns about the manner in which the agency conducts its cost-benefit analysis. *See* Jill E. Sommers, Commissioner, CFTC, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011).

acknowledges that funds may have difficulty complying with some of the CFTC's regulations, yet it does not propose any solutions. As part of our analysis of the CFTC's proposal, ICI and its outside counsel compared the CFTC and SEC regulatory regimes under the Investment Company Act and the Commodity Exchange Act, respectively. This analysis is summarized in a detailed appendix to our April 12 Letter.[73] As this appendix demonstrates, many of the CFTC's requirements would be duplicative of the requirements to which funds and their advisers are already subject under the Investment Company Act or other federal securities laws. Other of the CFTC's requirements would be fundamentally inconsistent with the requirements to which funds and their advisers are subject.

For example, the SEC significantly limits the ability of a fund to include in its prospectus performance information about other funds or accounts managed by the fund's adviser.[74] The CFTC rules, by contrast, *require* disclosure of such information in certain circumstances. A fund could not comply with the CFTC's requirements without likely violating the SEC's (and FINRA's) requirements.

This is just one example of why we believe it is absolutely critical that the CFTC, before imposing an *additional* regulatory requirement on funds, evaluate its regulatory purpose in doing so and consider why a regulation to which funds and their advisers are *already* subject would be insufficient to satisfy that purpose. More broadly, it is essential that the CFTC work closely with the SEC before amending Rule 4.5 in order to reconcile the many duplicative and conflicting regulations to which a fund and its adviser could become subject.

If, after reviewing the public comments on its proposal, the CFTC nevertheless determines to proceed with amending Rule 4.5, ICI believes it is imperative for the agency to develop and issue a new proposal to amend the rule. Such proposal should fully address the issues outlined above, as well as the concerns voiced by other commenters. In particular, any new proposal must outline in detail how funds would be expected to comply with the CFTC's regulations, and how conflicting or inconsistent regulations would be reconciled. To proceed otherwise would deprive funds (and the broader public) of a meaningful opportunity to comment on the new regulatory requirements that would be placed on funds, as is required by the Administrative Procedure Act.[75]

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[73] *See supra* note 58.

[74] FINRA, which has oversight over fund advertising, similarly prohibits funds from advertising the adviser's other fund or account performance.

[75] Section 553 of the APA requires that an agency provide the public with adequate notice of the substance of a proposed rule and an opportunity to provide meaningful comment. If it fails to do so, the resulting rule may be struck down by courts on the basis that it is not a "logical outgrowth" of the agency's proposal. *See Kooritzky v. Reich*, 17 F.3d 1509, 1513 (D.C. Cir. 1994) (court stated that "agencies must include in their notice of proposed rulemaking 'either the terms or substance of the proposed rule or a description of the subjects

2. Resolving the Fiduciary Debates at DOL and SEC

Another context in which two regulators are dealing with similar issues is the application of fiduciary duties. Last fall, the DOL proposed a major rewrite of the fiduciary duty rule under the Employee Retirement Income Security Act (ERISA) that could result in fiduciary status for ordinary business interactions, discourage basic educational materials like newsletters that do not provide personalized investment advice, and make it difficult for firms to help workers preserve their savings at job change through an IRA rollover. On a completely separate track, the SEC is contemplating the results of a Dodd-Frank Act mandated study on the standard of care for broker-dealers providing investment advice to retail customers, in which its staff recommended a universal fiduciary duty be applied to broker-dealers and investment advisers.

DOL and SEC proceed from different statutory frameworks. While there are similarities in ERISA and the securities laws about the general obligations that attach to fiduciaries, there are also important differences. For example, an ERISA fiduciary is subject to strict prohibited transaction rules that apply only to ERISA fiduciaries. Because of these rules, compensation arrangements that are common and legal from SEC's perspective could become illegal, absent an exemption, if a person or firm is deemed an ERISA fiduciary.

The separate debates at DOL and SEC do not necessarily pose a regulatory conflict. Indeed, in both contexts, the Institute supports assuring that individual investors are protected by an appropriate legal duty *when receiving personalized investment advice*, as long as that duty is crafted such that investors do not lose access to the investment products and services that meet their needs. Rather, the ongoing debates are an example of the potential for regulatory hodgepodge.

a. DOL Fiduciary Duty Rulemaking

As noted in Section 1 above, savings held and invested for retirement in defined contribution plans like 401(k)s and IRAs represent an important part of our capital markets. Since 1974, ERISA and the associated excise tax rules in the Internal Revenue Code that govern DC plans and IRAs have provided that persons who provide "investment advice" for a fee are fiduciaries. An ERISA fiduciary not only must act prudently and for the benefit of participants – as virtually all fiduciaries must do – but is subject to unique duties under the prohibited transaction rules, including restrictions on compensation that apply only to ERISA fiduciaries.

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and issues involved' . . . [a]nd they must give 'interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.' The [agency] did neither." (internal citations omitted)); *Shell Oil Co. v. EPA*, 950 F.2d 741, 751 (D.C. Cir. 1992) ("an unexpressed intention cannot convert a final rule into a "logical outgrowth" that the public should have anticipated. Interested parties cannot be expected to divine the [agency's] unspoken thoughts.").

This is relevant to the Subcommittee because ERISA's regulation of financial service firms that deal with employee benefit plans overlaps with the securities laws administered by the SEC. Congress made clear when it enacted ERISA that it did not intend to disrupt the functioning of the securities markets, prevent employee benefit plans from accessing investments, or turn the "ordinary functions of consultants and advisers" into fiduciary functions.[76] In 1975, DOL released regulations drawing an important legal boundary – *i.e.*, the line between *commonplace financial market interactions* in which plan sponsors and participants of ERISA-governed plans can freely obtain information or suggestions to consider in making their investment decisions, on the one hand, and *advisory relationships* in which those plan sponsors or participants engage providers to act on their behalf in evaluating or making investment decisions, on the other. By restricting application of the ERISA definition of advice and the fiduciary duties it triggers to actual advisory relationships, that 1975 rule gives the clarity to the regulated community necessary for retirement savers to gather a range of market input into their decision making process and for other parties in the marketplace to avoid crossing into fiduciary activities.

Assuring that overlap between the securities laws and ERISA does not cause dysfunction in the securities markets or constrain the ability of retirement savers to get help in their decisions and access products that meet their needs remains critically important. DOL's rule defining what constitutes investment advice that makes one an ERISA fiduciary is important to mutual funds, and to this Subcommittee, because the clarity of the rule allows firms to offer plans and individuals investments they need and want and to provide financial and investment information to plans and IRA investors.

In October 2010, DOL proposed a major rewrite of the rule that could result in fiduciary status for ordinary business interactions, discourage basic educational materials like newsletters that do not provide personalized investment advice, and make it difficult for firms to help workers preserve their savings at job change through an IRA rollover.[77]

Extensive comments to DOL in letters and during an administrative hearing show the text of the proposal is confusing, its scope is unclear, and its policy implications are controversial. The comments include letters from members of Congress from both

[76] *See* ERISA Conference Report, P.L. 93-406, at 323 ("...the ordinary functions of consultants and advisers (other than investment advisers) may not be considered as fiduciary functions..."), *id.* at 309 (some otherwise prohibited transactions "nevertheless should be allowed in order not to disrupt the established business practices of financial institutions" and directing the Secretaries of Labor and Treasury to grant an administrative exemption for brokerage services).

[77] See 75 Fed. Reg. 65263 (Oct. 22, 2010).

parties expressing concern with the proposal and urging DOL to move carefully.[78] Even investor advocates have urged DOL to go "back to the drawing board."[79]

- The Institute's comments to DOL[80] emphasized that the proposal should be revised to meet the following principles:
- Persons who deal with plans or IRA investors must know whether or not they are fiduciaries.
- Fiduciary status should attach only to genuine advisory relationships where a position of trust and confidence exists.
- Simply selling an investment product cannot be a fiduciary act.
- The rule should not discourage the assistance that recordkeepers engaged to administer plan accounts provide to help fiduciaries prudently select and monitor plan menu investments.

We provided DOL with specific suggestions for improving the proposal to meet these principles and urged DOL to issue a reproposal of its fiduciary definition rule before moving to a final rule. We made this recommendation because the retirement services and investment industries, plan sponsors, and retirement savers, all have a shared interest in getting this rule right.

b. IA-BD Harmonization and the SEC Fiduciary Duty Debate

On a completely separate track from the DOL, the SEC staff recently completed its study, required by Section 913 of the Dodd-Frank Act, on the effectiveness of existing standards of care for providing personalized investment advice to retail customers and

[78] *See, e.g.*, Letter to Secretary Solis and Chairmen Gensler and Shapiro from Chairmen Bachus, Kline, and Lucas (May 15, 2011); Letter to Secretary Solis from 6 Members of the Blue Dog Coalition (May 10, 2011); Letter to Secretary Solis and Chairmen Gensler and Shapiro from 29 Members of New Democrat Coalition (May 10, 2011); Letter to Secretary Solis from Chairman Rehberg (June 3, 2011). This is only a partial list.

[79] *See* Mercer Bullard, President and Founder of Fund Democracy, "DOL Fiduciary Proposal Misses the Mark", Morningstar.com (June 14, 2011), available at http://news.morningstar.com/articlenet/article.aspx?id=384065.

[80] *See* Letters from Mary Podesta, Senior Counsel - Pension Regulation, Investment Company Institute, to Office of Regulations and Interpretations, Employee Benefits Security Administration, Department of Labor (February 3, 2011), available at http://www.ici.org/pdf/24941.pdf and (April 12, 2011), available at http://www.ici.org/pdf/25084.pdf; Testimony of Paul Stevens before Department of Labor Hearing on Fiduciary Definitions Proposal (March 1, 2011), available at http://www.ici.org/401k/statements/11_dol_fiduciary_tmny; ICI Letter to The Honorable Phyllis Borzi, Assistant Secretary, Employee Benefits Security Administration, Department of Labor (May 20, 2011), available at http://www.ici.org/pdf/25210.pdf.

whether there are gaps, shortcomings, or overlaps in such standards that should be addressed by rule or statute.[81]

The staff recommended establishing a uniform fiduciary standard for advisers and brokers that provide advice about securities to retail customers, consistent with the current standard under the Advisers Act.[82] We agree with this recommendation. For many years, the strong, fiduciary standard that applies to investment advisers has worked well to protect the interests of their customers and clients, and it should be preserved. This standard, which the U.S. Supreme Court articulated in *Capital Gains* nearly half a century ago, puts the interests of advisory clients and customers above those of their advisers. We believe this higher fiduciary standard should be applied to both advisers and brokers when they are providing substantially similar services to retail clients—namely personalized investment advice about securities.

We particularly appreciate that the SEC staff's recommendation would not alter the fiduciary duty articulated by the Supreme Court in *Capital Gains*. That standard has been widely interpreted in court cases and SEC enforcement actions, and a clear body of law has developed that has guided advisory conduct for the protection of investors for many years. We strongly believe that the SEC should not adopt any standard for broker-dealers that would weaken the existing fiduciary duty applicable to advisers.

The staff's report went beyond the issue of fiduciary duties and made a number of other recommendations to rationalize the IA-BD regulatory regime in certain respects. These recommendations are important as well, and should be carefully considered by the SEC. Our current system regulates broker-dealers primarily under the Securities Exchange Act and investment advisers primarily under the Advisers Act. This bifurcation of oversight had its roots in real distinctions in the businesses of broker-dealers and advisers at the time the relevant statutes were developed; those distinctions, in many cases, have become almost indiscernible over time, making it imperative that steps be taken to rationalize the regulatory systems for financial intermediaries who perform similar roles but are subject to differing legal standards. It also is imperative from the perspective of retail investors, who may not appreciate the distinct legal standards applicable to advisers and broker-dealers engaging in activities that are virtually indistinguishable; these investors should not have to peruse lengthy disclosures to

[81] *See* U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* (January 21, 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[82] There is no express fiduciary duty in the Advisers Act. The most commonly cited source of the federal fiduciary duty under the Investment Advisers Act is the Supreme Court's 1963 *Capital Gains* decision. *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S. Ct. 275 (1963) (holding that Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers by operation of law).

determine where the legal differences may lie.[83] The SEC staff's recommendations aim to create a level regulatory playing field that is functionally related to the financial service provided. This is precisely the type of approach we support.

Overall, we see the SEC's IA-BD rulemaking initiative as important to lay a proper foundation for many other distribution-related initiatives. While we encourage the SEC to move forward with this rulemaking, we also recognize that an overly broad application of a fiduciary duty could chill legitimate business practices. To avoid that result, the SEC should remain cognizant of the differences between investment adviser and broker-dealer business models. For example, broker-dealers may conduct commission-based transactional business that does not involve the provision of personalized advice, execute unsolicited trades, offer the use of financial calculators or similar investment tools or information, or service orphaned accounts. These activities should not be subject to a fiduciary duty standard when they entail no personalized advice or recommendations.

The SEC also clearly should recognize that the uniform fiduciary duty is not unlimited in scope. Both investment advisers and broker-dealers must be able to disclose any material limitations on the range of investment products about which they advise clients, and whether similar products are available outside that range; this disclosure should address concerns by many in the brokerage community about the ability to offer proprietary products. Similarly, both investment advisers and broker-dealers should be permitted to disclose any limitations on the nature and anticipated duration of the relationship with the client/customer.

3. Disclosure Initiatives Relating to Potential Broker Conflicts

A third context where multiple regulators are acting on related topics is in the area of disclosures of a broker-dealer's potential conflicts of interest. The SEC is studying new point of sale disclosure rules pursuant to mandates in the Dodd-Frank Act. At the same time, FINRA is seeking to impose new revenue sharing disclosure rules on broker-dealers that sell funds, while also contemplating a broader conflicts disclosure document that brokers could provide customers at the beginning of their relationship. While we strongly support many of these initiatives in concept, we question those that single out mutual funds.

ICI has long supported enhanced disclosure to help investors assess and evaluate a broker's recommendations.[84] Certain compensation structures have the potential to

[83] *See* RAND Corporation, "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers" (Jan. 3, 2008), available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf (version finalized Mar. 19, 2008).

[84] *See, e.g.*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated May 31, 2011, available at http://www.ici.org/pdf/25232.pdf; and Letter from

influence financial intermediaries' recommendations to their clients, such as by creating incentives to inappropriately favor some products over others. To enable investors to assess these incentives and make better informed investment decisions, we believe financial intermediaries should be required to provide relevant disclosure for *all* retail investment products they sell, including variable annuity contracts and separate accounts – not just mutual funds.[85]

We recognize that developing such disclosure is a substantial undertaking, and requires careful consideration of a number of issues. For example, regulators must understand how disclosures could be made most efficiently and with minimal disruptions to the sales process. To the extent that disclosures may be made orally to investors transacting over the telephone, mechanisms for tracking compliance must be considered. And, the appropriate substance of the disclosure, possibly including information about broker compensation and conflicts of interest, must be determined.

We are pleased that the Dodd-Frank Act directs the SEC to consider these issues.[86] We also support the product-neutral approach of Section 919 of the Act, which expressly affirms the SEC's authority to require broker-dealers to provide information to retail investors with respect to *any* product or service the investor may purchase.

We urge Congress to continue to view broker disclosure as a critical need for retail investors across *all* products, and to discourage regulatory initiatives that would single out mutual funds. Requiring prior disclosures only prior for selling mutual funds would create incentives for broker-dealers and other intermediaries to sell products not subject to the same requirement, even when those products are potentially less suitable for and do not offer the same level of regulatory protection and other benefits for investors. Regulators and consumer advocates have expressed concerns about this impact. For example, in discussing earlier point of sale disclosure initiatives, former NASD Chairman

Karrie McMillan, General Counsel, Investment Company Institute, to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, dated Aug. 3, 2009, available at http://www.ici.org/pdf/23677.pdf.

[85] *See, e.g.*, Stevens July 2009 Testimony, *supra* note 50

[86] Section 917 requires the SEC to conduct a study regarding financial literacy among investors, and to identify, among other things: 1) "methods to improve the timing, content, and format of disclosure to investors with respect to financial intermediaries"; 2) "the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors"; and 3) "methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products." Section 913 required the SEC to study potential harmonization of the obligations of broker-dealers and investment advisers. A report was delivered to Congress in January 2011. The report recommended that the Commission "facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest" and "consider the utility and feasibility of a summary disclosure document containing key information on a firm's services, fees, and conflicts and the scope of its services."

Robert Glauber stressed the need to consider this consequence, explaining that "[a]n investor should be sold a security because it's right for him or her, not because it's easier to sell than something else."[87] On a related point, Barbara Roper of the Consumer Federation of America stated that by considering fee disclosures as "a mutual fund issue, instead of a broker compensation issue, sort of more holistically, you run the risk that you make mutual funds less attractive to sell. And I think that would be a very bad thing."[88]

4. Potential International Regulatory Conflict

Increasingly, harmonizing international regulatory regimes is of large and growing importance for our funds and their advisers, an increasing number of which are global investment fund managers. Cooperation among standard setters is necessary to avoid regulatory arbitrage and to encourage efficiencies as funds pursue an increasing cross-border presence in the interest of their shareholders.

One current example among others of the need for harmonization concerns securities market structure. The issues surrounding the trading of securities by funds and other institutional investors are no longer purely a domestic matter.[89] Many funds utilize intricately linked global trading desks and must be concerned not only about the regulation and structure of the financial markets in the United States but also in other jurisdictions in which they trade.[90] Jurisdictions around the world also are starting to, or are already facing, many of the market structure issues being examined in the United States. As U.S. regulators review their current, and consider further, initiatives relating to the reform of the regulation of the U.S. securities markets, we urge them to work closely with foreign regulators to create consistent and sensible cross-border regulations.[91]

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[87] *See* Remarks by Robert Glauber, Chairman, NASD, at the Investment Company Institute's 2006 General Membership Meeting (May 18, 2006), available at http://www.finra.org/PressRoom/SpeechesTestimony/RobertR.Glauber/p016642.

[88] *See* Remarks by Barbara Roper, Director of Investor Protection, Consumer Federation of America, at the Securities and Exchange Commission 12b-1 Roundtable, Unofficial Transcript, p. 196, available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf.

[89] For our views on many of the major domestic market structure issues, *see* Section 3.B.2, *infra*.

[90] *See, e.g.*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Directorate General, Internal Market and Services, European Commission, dated February 2, 2011 (Consultation on the Review of the Markets in Financial Instruments Directive (MiFID)), available at http://www.ici.org/pdf/24946.pdf.

[91] In particular, we stress the need for U.S. regulators to implement the Dodd-Frank Act in a way that minimizes any negative impacts on the global asset-management operations of U.S.-owned firms. For example, if activities related to the foreign equivalent of a U.S. mutual fund (*e.g.*, highly regulated funds primarily intended for retail investors) are limited by the Volcker Rule, U.S. firms could be placed at a disadvantage to foreign firms.

We also strongly encourage U.S. regulators to recognize the importance of global cooperation and coordination and to commit ample resources (*e.g.*, time and personnel) to the development of regulatory recommendations for financial markets and participants at the international level. Specifically, given the complexity and importance of the issues, the brightest and most knowledgeable that the U.S. has to offer should represent the interests of U.S. mutual funds and their investors in these global discussions.

Section 3: Other Regulatory Issues Facing the Industry

In addition to the principal issues affecting the mutual fund industry described in Section 2, there are a number of other significant regulatory issues that the Subcommittee should note. Some of these, such as the repeal of Rule 12b-1, primarily affect funds as issuers of securities. Others, such as the implementation of Title VII of the Dodd Frank Act, primarily affect funds as investors in the markets. The remainder of our testimony is devoted to these significant issues.

A. Issues Affecting Funds as Issuers of Securities

1. Repeal of Rule 12b-1

Last year, the SEC proposed sweeping changes to its rules governing the use of fund assets to pay for distribution expenses. The proposal would repeal Rule 12b-1, the principal rule in this area, and replace it with an entirely new regulatory framework centered around fee caps on distribution fees taken over time.[92] The SEC's proposal attracted more than 2,400 comment letters, the vast majority of which were highly negative.[93]

Rule 12b-1 is an integral part of the structure and strength of the mutual fund industry. The rule and its associated fees allow investors to pay distribution costs over time, to access funds that otherwise might not be available to them, and to compensate financial intermediaries, on whom so many fund investors depend. Accordingly, this rulemaking is of critical importance to the fund industry and its millions of investors.

We recognize that the SEC has legitimate reasons to revisit Rule 12b-1. We too have advocated changes to Rule 12b-1 to provide better disclosure of 12b-1 fees and clarify

[92] SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010) (the "12b-1 Release").

[93] ICI made two submissions. We filed a lengthy comment letter on November 5 reacting to the substance of the proposal, and a supplemental submission on December 1 providing a full economic analysis of the rulemaking based on a detailed survey of the most affected ICI members. Our comment letters and other materials related to ICI positions on Rule12b-1 are available at www.ici.org/rule12b1fees.

the role of the fund board under the rule.[94]

In our judgment and that of the overwhelming majority of commenters, however, the SEC's 2010 proposal is unworkable. It would place the agency in the inappropriate role of a ratemaker and be far more extensive and intrusive than necessary. It could fundamentally alter the way intermediaries use funds in various distribution channels, significantly affect the lineup of share class options currently available to investors, necessitate major systems changes, and require the renegotiation of thousands of dealer agreements. As noted earlier in this testimony, ICI performed our own independent economic analysis of the proposal and concluded that the SEC significantly understated the operational and transitional costs on funds and intermediaries of the proposal, which would be reflected in higher expenses borne by shareholders. It also overstated the benefits, which in our view are uncertain and quite possibly illusory. As a result, we urged the SEC to take a further and more careful look at its economic analysis before proceeding with this rulemaking.[95]

We also firmly believe that this Rule 12b-1 reform proposal is the proverbial cart before the horse, given the ongoing debates over the rationalization of the IA-BD regulatory regime discussed above. A thoughtful and deliberate approach to that rulemaking would lay the foundation for appropriate reforms to Rule 12b-l. Moreover, while it is impossible to predict exactly how IA-BD regulatory harmonization or a new fiduciary duty will affect the sale of fund shares, it is fair to suggest that broker-dealers will adjust their business models to suit the new standard, and in so doing may render parts of the SEC's 12b-1 proposal unnecessary or outdated. It makes little sense to fundamentally alter Rule 12b-1 with the virtual certainty that the SEC's new framework would need to be revisited once the new IA-BD regulatory regime is adopted.

Certain elements of the confirmation statement disclosure proposed as part of the 12b-1 rulemaking would require confirms to include the types of information about ongoing fees and expenses found in a fund prospectus. These changes are misplaced and premature, as they would clearly be more appropriate for a point of sale disclosure document.[96] Confirms should serve as a record of a transaction and allow the investor to verify that the transaction was processed correctly and that whatever fees are associated with the transaction were properly assessed. Point of sale disclosure, in contrast, is meant to provide the investor with certain key information that highlights potential conflicts that he or she should consider *before* making the investment decision. As the SEC itself recognizes, confirms cannot do this – "[i]n making this proposal, we are mindful that...customers do not receive confirmations until after completing their purchases of

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[94] *See, e.g.*, letter from Mary S. Podesta, Acting General Counsel, ICI, to Nancy M. Morris, Secretary, SEC (June 19, 2007) ("2007 ICI Roundtable Submission").

[95] *See* Section 4.A.2.a, *infra*.

[96] *See* Section 2.C.3, *supra*.

mutual funds."[97] The SEC has legitimate concerns over the potential conflicts of interest a broker may have in recommending a particular investment or share class to an investor, but these conflicts are best addressed through the combination of point of sale disclosure and a fiduciary standard. The confirm simply is a belated and inappropriate means to convey this important information.

We also are concerned that the SEC looks to a fund-specific confirm to address potential conflicts that exist with respect to all investments – not just funds. As we noted above, we have repeatedly said that point of sale disclosure must be product-neutral to be effective and Congress appears to have agreed.[98] We are understandably concerned, therefore, that the confirm disclosure requirements proposed by the SEC run the risk of establishing unique disclosure requirements applicable solely to the sale of mutual funds, and not other products. As such, not only are they misplaced, they run counter to the mandate in the Dodd-Frank Act.

2. Ability of U.S. Funds to Compete Globally

U.S. fund managers lead the world in offering funds to investors. Forty-eight percent of global mutual fund assets ($11.8 trillion out of $24.7 trillion) are held by funds that are organized in the U.S. and managed by firms located here.[99] Several of these U.S. fund managers also are among the largest fund companies in countries (e.g., Luxembourg and Ireland) with globally-sold funds.

Notwithstanding the U.S. fund managers' preeminent role in the global fund business, our funds are held almost exclusively by U.S. persons. Substantial U.S. tax impediments to foreign investment in U.S. funds are a primary reason why U.S. managers have been forced to go overseas to create foreign funds for distribution outside the United States.

The most significant U.S. tax impediment to foreign investment in U.S. funds involves the effective requirement on our funds to distribute each year essentially all of their income.[100] These distributions can have two negative effects on foreign investors in

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[97] 12b-1 Release at 68.

[98] *See* Section 2.C.3, *supra*.

[99] *See*, ICI Fact Book, *supra* note 3, at Table 60. These funds are treated under the Internal Revenue Code as regulated investment companies ("RICs").

[100] To eliminate an excise tax (under Code section 4982) on "under-distributions," a RIC must distribute by December 31 an amount equal to the sum of: (1) 98 percent of its ordinary income earned during the calendar year; (2) 98.2 percent of its net capital gain earned during the 12-month period ending on October 31 of the calendar year; and (3) 100 percent of any previously-earned amounts not distributed during the prior calendar year. A tax of 4 percent is imposed on the amount, if any, by which the RIC's required distribution exceeds the amount actually distributed.

U.S. funds. First, these distributions cause foreign investors to incur tax currently in their home (resident) countries; in contrast, many foreign investors are not taxed in their home countries if they invest instead in a fund that retains, rather than distributes, its income. Second, the favorable tax treatment that most foreign countries provide for capital gains is lost when capital gains realized by U.S. funds are distributed to foreign investors as capital gain dividends. Instead of favorable capital gains treatment, these distributions are taxed in the foreign investors' home countries like any other dividend from a U.S. company. These tax disadvantages play a significant role in forcing U.S. mutual fund managers to go offshore to create funds for foreign investors.

These negative effects would be addressed by legislation supported by the ICI to create the International Regulated Investment Company ("IRIC") for foreign investors.[101] The IRIC would be a U.S. vehicle that invests in a single U.S. fund. The IRIC would not distribute the income it receives from the fund – thus addressing the foreign investors' home-country tax issues. To preserve U.S. tax revenues, however, the IRIC would pay U.S. tax equal to the amount that would be collected from foreigners investing directly in the underlying U.S. fund. The IRIC would improve the international competitiveness of U.S. funds.

Jobs are created in the United States when foreigners invest in a U.S. fund – but not when U.S. managers must go overseas to attract foreign investment. Removing the U.S. tax impediments to foreign investment in U.S. funds will help create jobs in the United States.

3. Stifling Innovation in Exchange-Traded Funds

As of March 2011, ETFs registered under the Investment Company Act held $947 billion in assets under management, comprising 68 percent of the global ETF market. Growth in this market is likely being slowed, however, by the SEC's deferral of certain new product applications.[102] Specifically, in March 2010, the SEC announced the deferral of new applications for ETFs that make significant use of derivatives pending a review of

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To qualify for the tax treatment provided to RICs by Subchapter M of the Internal Revenue Code, a fund must distribute with respect to its taxable year at least 90 percent of its income (other than net capital gain). Any retained income is taxed at regular corporate tax rates. Because a RIC that incurs corporate tax provides a lower return than one that does not incur such tax, RICs generally attempt to distribute all of their income.

[101] International Competitiveness Act of 1991, S. 1748, 102nd Cong. (1991).

[102] Because they operate differently from a traditional mutual fund in certain respects, ETFs must receive exemptive relief from the SEC from specific provisions of the Investment Company Act. This process entails the filing of a detailed application by an ETF's sponsor with the SEC and the granting of an exemptive order that establishes conditions or requirements with which the ETF must comply in exchange for the relief granted.

the use of derivatives by mutual funds, ETFs, and other investment companies.[103] While we support the Commission's review of funds' use of derivatives and have offered our assistance to the SEC staff as they conduct their examination, we believe this protracted moratorium on new ETF applications unfairly disadvantages new entrants to the ETF market, and is unwarranted from a regulatory perspective.

With respect to derivatives use, ETFs registered under the Investment Company Act must comply with the same rigorous regulatory framework as traditional mutual funds. Because mutual funds do not need to undergo the application process in order to launch, however, the SEC's deferral of applications does not apply to them, and therefore innovative products may be created as mutual funds that may not currently be done in the ETF format. Perhaps more importantly, prior to the SEC's announcement certain ETF sponsors received permission to create funds, including new funds, that make significant use of derivatives. This has given some market participants a substantial advantage as new entrants are prohibited, and has even placed an acquisition premium on those sponsors that have obtained such relief.[104] We believe such an unlevel playing field is inappropriate and unnecessary.

We recognize that a number of international regulators and watchdogs have recently expressed concerns about rapid growth and innovation in the ETF market.[105] As detailed in a recent Note by the Financial Stability Board ("FSB"), these concerns largely surround one specific ETF structure – what the Note terms a "synthetic" ETF – one that utilizes a single swap, typically entered into with an affiliated entity, to achieve its investment exposure. The Note acknowledges that this structure by and large does not exist in the United States, and makes reference to the SEC's moratorium. In fact, even absent the moratorium, there would be no synthetic ETFs in our market. As we explained in detail in our comment letter to the FSB, the Investment Company Act, along with its attendant regulations and guidance, establishes a framework under which such a structure could not operate.[106]

[103] *See* SEC Press Release: SEC Staff Evaluating the Use of Derivatives by Funds, March 25, 2010, available at http://www.sec.gov/news/press/2010/2010-45.htm.

[104] *See, e.g.*, Ignites, "Grail drawing interest from major institutional managers," Jan. 12, 2011 ("The asset manager that ultimately buys Grail Advisors' active ETF business is likely more interested in the firm's expansive regulatory exemptions than in its existing product lineup.").

[105] *See, e.g.*, Financial Stability Board Note, "Potential financial stability issues arising from recent trends in exchange-traded funds," April 12, 2011, available at http://www.financialstabilityboard.org/publications/r_110412b.pdf.; Bank for International Settlements Working Paper No. 343, "Market structures and systemic risks of exchange-traded funds," April 2011, available at http://www.bis.org/publ/work343.pdf.

[106] Letter from Karrie McMillan, General Counsel, Investment Company Institute, to the Secretariat of the Financial Stability Board, May 16, 2011, available at http://www.ici.org/pdf/25189.pdf. It is unfortunate that

Because its current position creates an unlevel playing field between mutual funds and ETFs as well as among ETFs themselves, and because the Investment Company Act structure offers substantial protections against the risks outlined by international regulators and watchdogs, we believe the SEC should be urged to lift its moratorium on applications for ETFs that may make substantial use of derivatives.

4. Use of Electronic Media to Improve Disclosure

Funds are subject to more extensive disclosure requirements than any other comparable financial product, such as separately managed accounts, collective investment trusts, and private pools. The goal of disclosure should be to provide information that is easily accessible, understandable and useful to investors. ICI research, as well as research by the SEC and consumer groups, finds that providing simplified, streamlined disclosure of essential information results in better-informed investors, because investors are far more likely to read a summary document than lengthy disclosures.[107]

In recent years, the SEC and the DOL—which regulates disclosure to participants in employee benefit plans such as 401(k)s—have made great strides in improving the quality of disclosure to investors, in part by authorizing the use of electronic media for certain disclosure purposes.[108] Indeed, electronic delivery—*e.g.*, using the Internet to

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by and large the media did not grasp this distinction, and unfairly painted all ETFs with the same "systemic risk" brush.

[107] *See, e.g.*, Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders* (Summary of Research Findings) (May 1996), available at http://www.ici.org/stats/res/arc-rpt/rpt_profprspctus3.pdf; Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders* (Volume 1) (May 1996), available at http://www.ici.org/stats/res/arc-dis/rpt_profprspctus.pdf; Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders* (Volume 2) (May 1996), available at http://www.ici.org/stats/res/arc-dis/rpt_profprspctus2.pdf; Investment Company Institute, *Understanding Shareholders' Use of Information and Advisers* (April 1997), available at http://www.ici.org/stats/res/arc-dis/rpt_undstnd_share.pdf; Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (2006), available at http://www.ici.org/stats/res/rpt_06_inv_prefs_full.pdf (2006 Preferences Study"); ICI Research Fundamentals, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010" (September 2010), available at http://www.ici.org/pdf/fm-v19n6.pdf; *see also* Barbara Roper and Stephen Brobeck, Consumer Federation of America, *Mutual Fund Purchase Practices* (June 2006), available at http://www.consumerfed.org/pdfs/mutual_fund_survey_report.pdf.

[108] For example, in 2009 the SEC adopted a rule revising the mutual fund prospectus—the cornerstone of fund disclosure—to require a summary section that contains the key information investors need, and permitting funds to send investors a "summary prospectus" in lieu of the full prospectus, so long as they provide additional information on the Internet and in paper upon request. *See* SEC Release Nos. 33-8998 and IC-28584 (Jan. 13, 2009), available at http://www.sec.gov/rules/final/2009/33-8998.pdf. Similarly, in 2010, DOL adopted new "layered" disclosure regulations to require that key information about all plan investment options be presented concisely and that plans have a website where participants can get more information, such as information about the risks associated with each investment and updated performance

provide disclosure to investors—is uniquely suited to facilitate investor understanding and response to information. It can enhance the effectiveness of communications by highlighting key information, making additional information readily available for those that desire it, and enabling recipients easily to take action on the information.

In the past, regulators have expressed reluctance to rely too heavily on technology that may not be available to some investors.[109] Today, however, Internet access among mutual fund investors is almost universal.[110] Indeed, a recently-released white paper filed with DOL demonstrates that working American families are almost as likely to have Internet access as they are to own a telephone.[111] For these reasons, we urge regulators to place increased emphasis on regulatory initiatives designed to utilize technology to improve delivery and utility of disclosure to investors, including in the areas discussed below.

a. Electronic Disclosure by Employee Benefit Plans

DOL recently issued a request for information on whether and how, in light of developments in technology, to revise the rules it adopted in 2002 that constrain e-delivery in employee benefit plans.[112] Given the many advantages electronic delivery can offer—as detailed in our comment letter to DOL—and the favorable statistics regarding working Americans' access to the Internet, ICI strongly supports amending these rules to allow plans to deliver the required information electronically.[113] We have recommended that DOL exercise leadership by adopting rules that make it easy, not hard, to use electronic delivery mechanisms that Americans are familiar and comfortable with, while preserving the ability of those participants who need or prefer paper to obtain it.

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information. *See* 75 Fed. Reg. 64910 (Oct. 20, 2010), available at http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24323.

[109] *See, e.g.*, SEC Release Nos. 33-7856, 34-42728, IC-24426 (April 28, 2000), at notes 100 and 101 and related text, available at http://www.sec.gov/rules/interp/34-42728.htm#p284_83646.

[110] In 2010, approximately nine in ten households owning mutual funds had Internet access. *See* ICI Research Fundamentals, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010," *supra* note 107.

[111] *See* Peter P. Swire and Kenesa Ahmad, Delivering ERISA Disclosure for Defined Contribution Plans: Why the Time Has Come to Prefer Electronic Delivery (June 2011), available at http://www.ici.org/pdf/ppr_11_disclosure_dc.pdf.

[112] *See* Request for Information Regarding Electronic Disclosure by Employee Benefit Plans, 76 Fed. Reg. 19285 (Apr. 7, 2011), available at http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24850.

[113] *See, e.g.*, Letter from Mary S. Podesta, Senior Counsel-Pension Regulation, Investment Company Institute, to Office of Regulations and Interpretations, Employee Benefits Security Administration, dated June 6, 2011, available at http://www.dol.gov/ebsa/pdf/1210-AB50-041.pdf.

b. Shareholder Report Reform

The SEC's summary prospectus initiative, which ICI Strongly supported over many years, has proved to be of enormous benefit to our investors.[114] ICI and SEC research indicates that similary recrafting funds' annual and semi-annual reports to shareholders would do likewise.[115] Also, the information shareholder reports currently must contain (including, for example, various narrative disclosures, financial data, a graphic depiction of portfolio holdings, and a schedule of investments) would seem to lend itself well to a layered disclosure approach.

We urge the SEC to turn its attention to improving fund shareholder reports at the earliest possible opportunity. Given the nearly universal access to the Internet among mutual fund investors, any such reforms should seek to take fullest advantage of the benefits that electronic technology can provide. In this regard, we note that while we supported the requirement that the summary prospectus be delivered in paper (unless an investor consented to electronic delivery), we expressed our expectation that, over time, investors would become accustomed to seeking investment information on the Internet. We recommended that in the future the Commission revisit whether the provision of information solely on the Internet may be sufficient. We believe the evidence is mounting that for many investors electronic delivery may now be superior to paper delivery. For these reasons, we recommend that the SEC continually reexamine the changing technology landscape—including benefits, costs, and risks—as it contemplates future improvements to investor disclosure, such as reform of fund shareholder reports.

5. Regulatory Challenges With Social Media

Many members of the fund industry utilize social media, and others are exploring the possibility of doing so.[116] Social media presents funds with an opportunity to communicate with shareholders and the public in a more dynamic way than was previously possible. For example, in the past, a fund typically would publicize a research report by means of a press release and posting on the firm's website. Social media provides the opportunity to additionally post the report on Facebook, tweet about it over Twitter, and have a portfolio manager discuss his or her findings on YouTube. Third parties may seize on this information and disseminate it even more broadly. The benefits

[114] *See, e.g.,* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated February 28, 2008, available at http://www.sec.gov/comments/s7-28-07/s72807-92.pdf.

[115] *See* 2006 Preferences Study, *supra* note 107; Mandatory Disclosure Documents Telephone Survey, Submitted to the Securities and Exchange Commission, July 30, 2008, at 78, 80, available at http://www.sec.gov/pdf/disclosuredocs.pdf.

[116] *See e.g.,* kasina, *Harnessing Social Media To Drive Business Results* (2011) showing that of the asset managers responding to the kasina survey, the percentage active in at least one social media channel rose to 80% in 2011 from 48% in 2010.

of social media include shareholder education, branding, enhancing relationships with customers, increasing the visibility of portfolio managers, and assisting in sales efforts.

Funds typically participate in social media through their affiliated broker-dealers or investment advisers. The SEC and FINRA regulate broker-dealer communications with the public, including the use of social media. The SEC also regulates investment adviser communications with the public, including the use of social media.

We commend FINRA's interest in reviewing issues relating to broker-dealers' use of social media. It established an industry task force, the Social Networking Task Force, in 2009 that assisted it in providing guidance early last year.[117] The guidance was intended to help broker-dealer firms in applying FINRA's rules on communications with the public to their use of social media sites. FINRA supplemented that guidance with two webinars, to provide industry with additional clarity regarding the guidance. Since then, FINRA has reconvened its Social Networking Task Force to assist in its efforts to provide still further guidance. The task force should provide FINRA greater insights to enable it to better align the existing rigid regulatory requirements with the fast and ever-evolving media used to communicate with the public.

Indeed, the most vexing issue is how to apply antiquated rules on recordkeeping to this dynamic communications medium. In particular, the regulations that govern broker-dealers' use of social media are based on a statutory provision written in 1934. When one considers how much has changed since 1934, it quickly becomes obvious that the regulatory framework has not kept pace with the technological advances and current means of communication.

While some firms have been able to establish policies and procedures that adequately oversee their participation in social media, strict application of current recordkeeping rules based on the 1934 law has inhibited greater use of social media, particularly with respect to broad usage of interactive features. We believe that the securities regulators should work with the industry to develop a reasonable framework for public communications and related recordkeeping requirements that provides firms with enough flexibility to allow them to communicate more broadly using today's and tomorrow's technologies consistent with investor protection. The ICI is working closely with its members on these issues, and stands ready to assist regulators in this important endeavor.

[117] *See* FINRA Regulatory Notice 10-06, (January 2010) ("2010 Guidance"). We were pleased that the task force included representatives from the fund industry.

6. The Potential for Investor Confusion with Less Regulated Alternatives to Funds

A final issue facing funds as issuers that we would like to call to the Subcommittee's attention involves exchange traded notes ("ETNs"), which, like funds, are marketed widely to retail investors. Many have touted ETNs as better than funds because they take advantage of gaps in the tax law to provide investors with superior tax treatment. Investors have been listening. The ETN market has grown in the past year from $9.8 billion to $16.6 billion.[118]

ETNs are forward contracts with unique features. The return of an ETN, typically, is measured by an assumed (notional) investment, or a series of assumed investments and reinvestments, in a basket of commodities or securities. Unlike the typical forward contract, which is settled at maturity, the investor in an ETN pays up-front; consequently, these derivatives are known as "prepaid" forwards. Moreover, unlike the typical forward contract, which is short-lived, the ETN does not mature for up to 30 years. The prepayment feature and 30-year maturity, with no interim payments, create two tax advantages not obtained by investors in comparable financial instruments.

The first tax advantage involves deferring all taxable income until either the ETN matures or the investor sells it. The second tax advantage involves treating all income arising from the investment as (tax-favored) capital gain. These advantages arise because the tax laws do not treat the ETN for what it is: a loan to the issuer for a return based upon constructive ownership of a basket of commodities or securities.

ETNs and funds both provide important investment opportunities – including gaining investment exposure to a diversified pool of securities – but with different risks. The ETN investor's return is based both on the return of the securities and the credit risk of the issuer. The fund investor's return, in contrast, is based solely on the return of the securities.

Comparable products should be treated comparably. Financial services firms should not be incentivized to create derivatives that take advantage of tax law gaps to provide unintended advantages while subjecting investors to unnecessary risk. The investors in Lehman's ETNs, having lost their investments when the bank filed for bankruptcy, surely agree.

B. Issues Affecting Funds as Investors in the Securities Markets

A second set of significant issues concern the fund industry primarily as investors in the markets. As institutional investors that held 27 percent of the value of publicly traded U.S. equity outstanding at the end of 2010, and that invest over $13.8 trillion on

[118] *See* http://www.nsx.com/content/etf-assets-list. These asset figures are as of May 2010 and May 2011.

behalf of over 91 million fund shareholders, funds have a strong interest in market regulation—and particularly in ensuring that the financial markets are highly competitive, transparent and efficient, and that regulations encourage, rather than impede, liquidity, transparency, and price discovery. Consistent with these goals, we have strongly supported efforts to address issues that may impact the fair and orderly operation of the financial markets and investor confidence in those markets, and we have long advocated for regulatory changes that would result in more efficient markets for investors.[119]

1. Derivatives and Title VII of the Dodd-Frank Act

The implementation of the Dodd-Frank Act will dramatically change the derivatives markets, establishing a new regulatory framework for the swaps markets and their participants.[120] Funds are participants in these markets, and they use swaps and other derivatives in a variety of ways to manage their portfolios.[121] Accordingly, ICI and its members have encouraged reform efforts in these markets.[122] During the hearings that led to the Dodd-Frank Act, for example, ICI specifically supported measures that would

[119] *See, e.g.*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 21, 2010 (Concept Release on Equity Market Structure), available at http://www.ici.org/pdf/24266.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 22, 2010 (Non-Public Trading Interest), available at http://www.ici.org/pdf/24142.pdf; Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2004 (Regulation NMS), available at http://www.ici.org/vgn-ext-templating/v/index.jsp?vgnextoid=efeb68d4041de110VgnVCM1000005b0210acRCRD ; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 12, 2000 (Market Fragmentation Concept Release), available at http://www.ici.org/pdf/11894.pdf; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 28, 1998 (Regulation of Exchanges and Alternative Trading Systems), available at http://www.ici.org/pdf/comment98_reg_exch_ats.pdf; and Letter from Craig S. Tyle, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 16, 1996 (Order Execution Obligations), available at http://www.ici.org/pdf/7561.pdf.

[120] Throughout this section of the testimony, we will use the term "swaps" to refer to both swaps and security-based swaps. Likewise, we will use the term "major swap participant" or "MSP" to refer to both major swap participants and major security-based swap participants.

[121] For example, funds use derivatives to hedge positions; equitize cash that a fund cannot immediately invest in direct equity holdings; manage the fund's cash positions more generally; adjust the duration of the fund's portfolio, managing bond positions in general; or manage the fund's portfolio in accordance with the investment objectives stated in its prospectus.

[122] Testimony of Karrie McMillan, General Counsel, Investment Company Institute, before the Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, United States House of Representatives, on "Implementing Dodd-Frank: A Review of the CFTC's Rulemaking Process" (April 13, 2011).

increase transparency and reduce counterparty risk of certain over-the-counter derivatives.[123] We, therefore, have urged the CFTC and the SEC to promulgate regulations in a manner that provides the protections sought by the Dodd-Frank Act while minimizing disruptions to the markets, market participants, and customers. [124] Among others, three issues rise to the forefront: the implementation process for the final rules; the definition of "major swap participant" ("MSP"); and the reporting of swap transaction data and the determination of block trades.

a. Implementation of Title VII

The process of finalizing and implementing the rulemakings proposed under Title VII of the Dodd-Frank Act must ensure that the new rules are tailored appropriately, work in tandem with one another, and strike the right balance between costs and benefits. ICI commends the SEC and CFTC (together, the "Commissions") for their extraordinary efforts in the very difficult task of developing rules to address the complexities of the swaps markets while avoiding unintended consequences. To ensure that the final regulatory framework "gets it right," however, it is critical that the CFTC and SEC sustain a transparent and open rulemaking process that: (1) solicits public comment in a manner that provides affected parties a meaningful opportunity to comment; (2) harmonizes and coordinates with domestic and international regulators, as appropriate; and (3) phases in the effective and compliance dates of the final rules.

ICI believes that the following steps are necessary for the Commissions to achieve these goals.[125] First, the Commissions should repropose for a brief period the swaps rules in the order in which they will be implemented. This will allow the public the opportunity to assess the implications of any changes from the rules as proposed, particularly in light of concerns regarding regulatory certainty and unintended consequences.[126] In this regard, we have no intention of protracting or impeding the adoption and implementation of the final swaps rules. In light of the complex and highly interdependent nature of these rules, however, we strongly believe that any changes

[123] Stevens July 2009 Testimony, *supra* note 50.

[124] The Dodd-Frank Act was enacted to reduce risk, increase transparency, and promote market integrity within the financial system.

[125] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated June 10, 2011 (commenting on phase-in schedule for requirements for Title VII of the Dodd-Frank Act) ("ICI Phase In Letter"), available at http://www.ici.org/pdf/25276.pdf.

[126] We suggest that the Commissions provide a minimum 30-day comment period for each of the reproposed rules.

made in response to comments may raise new considerations for the Commissions to address in the amended rule or other interrelated proposals.[127]

Second, implementation of the new regulatory framework must follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies.[128] Specifically, the implementation periods should afford adequate time for the Commissions to gather additional market data to inform rulemaking; allow market participants to build market infrastructures, modify business operations, complete testing, and perform outreach and education of customers; and phase in rule requirements by type of market participants and asset class. Market participants are struggling with the implications of the proposed rules on their activities in these markets, and are hampered in developing compliance strategies by the need to wait for action from other market participants. Phasing in the rules will provide market participants with essential time to identify the cumulative impact of the rule changes, build upon the actions of other market participants, and manage the cumulative costs of the rule changes.

Ultimately, the Commissions should not celebrate speed over precision in finalizing the rules and establishing the compliance deadlines. By seeking public input on the revised rules in the way we recommend and by carefully phasing in the effective dates of the rules to allow the markets and market participants to come into compliance, the Commissions will have far greater assurance of the quality and efficacy of the final regulatory framework.

b. Definition of Major Swap Participant

ICI continues to be greatly concerned about the potential regulation of funds as "major swap participants." Regulating funds as MSPs would not further the important goals of the Dodd-Frank Act, such as minimizing systemic risk. Instead of providing important protections for the markets, regulation of funds as MSPs would impose costs

[127] We note and appreciate the CFTC's recent extension of the comment periods on the proposed swap rules by 30 days. The extension was provided, however, at a time when market participants also were first presented with a set of newly proposed rules, including proposed margin rules, capital rules, swap definition rules, and customer collateral rules - all of which are extremely complex and have significant import to market participants. Thus, the opportunity to review and comment on the entire framework of published rules has been limited. Further, the extension did not afford commenters the opportunity to assess the final rules—the rules as may be amended in response to comments.

[128] *See* Letter from American Bankers Ass'n, ABA Securities Ass'n, The Clearing House Ass'n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass'n, Investment Company Institute, Managed Funds Ass'n and Securities Industry and Financial Markets Ass'n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated December 6, 2010, available at http://www.ici.org/pdf/24761.pdf.

well in excess of the benefits sought to be achieved and would disregard guidance from members of Congress to consider the existing regulatory regime of swap market participants.[129] To avoid unnecessary and burdensome regulatory overlap, we have recommended that the SEC and CFTC exclude funds from the definition of MSP on the grounds that funds do not present the risks that underpin the proposed definition.

As discussed, funds are subject to a comprehensive regulatory framework under the federal securities laws that sets them apart from other types of financial entities and ensures that their swap activities do not threaten the U.S. financial system.[130] Current regulation of funds addresses their margin, capital, leverage, risk disclosure, recordkeeping, registration, and business conduct. The risk associated with funds' swap activity is mitigated by their use of collateral and asset segregation, and regulatory limits on their ability to use leverage.[131] The provisions of the Dodd-Frank Act establish regulatory oversight for leverage, volatility, and collateral related to swap trading . Applying these provisions to funds would unnecessarily subject them to duplicative or potentially inconsistent regulatory requirements, with significant additional costs for fund investors and no corresponding benefits.

c. Reporting of Swap Transaction Data and the Determination of Block Trades

Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals that would require, upon execution, reporting of swap transaction data to a registered swap data repository ("SDR"). The SDR would make certain of the swap data publicly available in real time. Market transparency is a key element to ensuring the integrity and quality of these markets,[132] but ICI is deeply concerned that neither the SEC's nor the

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[129] In formulating regulation and further defining the term MSP, among others, the SEC and CFTC were advised to focus on those risk factors that contributed to the recent financial crisis such as excessive leverage and under-collateralization of swap positions and to consider the nature and current regulation of swap market participants. *See* Congressional Record, S5907, July 15, 2010 (remarks by Senator Lincoln, Chair of the Senate Agriculture, Nutrition, & Forestry Committee, in a colloquy related to the passage of the Dodd-Frank Act).

[130] For a detailed discussion of the federal securities laws applicable to funds in this regard, *see* Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010 and February 22, 2011 ("ICI MSP Letters"), available at http://www.ici.org/pdf/24551.pdf and http://www.ici.org/pdf/24987.pdf.

[131] *See, e.g.,* Section 18 (asset coverage requirements and restrictions on leverage and senior securities) and Section 17 (custody requirements for collateral) of the Investment Company Act and the rules promulgated thereunder.

[132] As part of its recommendations to the SEC and CFTC regarding the sequence for implementation of the new swaps regulatory framework, ICI has recommended that the Commissions begin by finalizing and implementing rules requiring reporting of swap transaction data to the regulators. Initially, reporting should be limited to non-public, regulatory reporting to gather data to inform, for example, block trading rules without significantly disrupting the swaps market and market participants' trading strategies by

CFTC's proposal adequately protects information regarding a fund's block trades. Failure to do so would compromise funds' sensitive trading data, enabling market participants to identify funds and their trading strategy to the detriment of funds, their shareholders and the liquidity of the market in which those trades occur. To prevent this outcome, we have recommend that in each of their proposals the SEC and CFTC should (1) define a block trade by evaluating the market for a particular swap category to determine what might be an illiquid size and (2) change the reporting timeframe to the later of 24 hours after trade execution or the opening of trading the following day. We also recommend that the Commissions harmonize and coordinate their proposals to the extent possible.

1) Block Trades

Block trades enable funds, on behalf of their shareholders, to transact in large amounts off an exchange with minimal disruption to the swaps market. After a block trade has been executed, one or more of the counterparties will seek to reduce risk by hedging its exposure, usually by transacting on an exchange. Knowledge of a block trade therefore signals to other market participants that there is the potential for subsequent trading activity.[133] This signaling can negatively affect the market and fund shareholders by significantly skewing pricing if the market does not have sufficient time to digest the block order. In addition, opportunistic market participants may piece together information about a fund's holdings or trading strategy, leading to front running of a fund's trades, which also adversely impacts the price of the swap and the underlying security to the detriment of fund shareholders.

Flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity. First, swaps are not as liquid or traded as frequently as futures. Without block trading in the swaps market, market participants will not execute larger size transactions, further impeding the development of more liquidity in these markets. Second, the signaling problem discussed above is more severe for swaps than futures or other securities because the highly distinctive terms of even "standardized" swaps reveal larger amounts of information about the positions and trading strategies of the counterparties to a trade, and can often be used to infer the identity of at least one of the counterparties to the trade.[134] Third, swaps are commonly

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impacting liquidity. ICI believes that the information gathered through this process will assist the Commissions in better understanding the structure and operations of the swaps markets and adopting appropriately tailored and effective rules. Further, only after such analysis can the Commissions accurately determine the effect of public dissemination of certain of the swap transaction data. *See* ICI Phase In Letter, *supra* note 125.

[133] In post-transaction analysis of block trades, our members report being able to see that the market tracked their movements.

[134] Identification would be particularly easy in swaps markets in which there are a limited number of market participants actively trading and such participants were required to disclose a large amount of transaction data.

used by market participants to hedge their exposures in the futures market because of the extremely limited block trading in that market.

2) Thresholds for Qualifying as a Block Trade

The best way to identify the appropriate thresholds for block trades in the swaps market is to account for the liquidity in each unique category of swaps.[135] The risks, trading and liquidity associated with a particular swap differ for each individual swap category within an asset class based on type, term and underlying security.[136] The SEC and CFTC should reflect these granular but significant differences by creating narrow buckets to which the threshold formulas would apply. These thresholds should be calculated regularly (*e.g.*, quarterly) to ensure that they are appropriately tracking liquidity in the swap categories.

In addition, the thresholds must be low enough to encourage the use of block trades. Setting the thresholds too high could cause significant market disruption and harm to fund shareholders by eliminating the use of block trades in these markets and the associated benefits provided by such trades. Further, the Commissions should err on the side of caution by setting the thresholds low initially to collect data to enable them to evaluate the thresholds and the appropriate delays for data dissemination.

3) Delayed Reporting

The SEC and CFTC proposals take different approaches to the proposed reporting period for block trade information. The CFTC proposal would provide that the reporting party for a block trade would report the transaction data in real time but data would not be publicly disseminated before the expiration of 15 minutes. The SEC proposal would delay public dissemination of the notional size of block trades for a minimum of 8 hours or, in certain cases, until re-opening of an SDR.[137] These timeframes are inadequate to allow the market to absorb the impact of a block trade and could result in higher costs for block trades which, ultimately, would be felt by fund shareholders. We recommend instead that reporting for block trades be delayed until the later of 24 hours following execution of the trade and the opening of the next following trading day.

[135] Under the proposed CFTC thresholds, many transactions that should be treated as block trades would not qualify as such. The SEC proposal does not include thresholds. Instead, the SEC seeks comment on the general criteria that should be used by SDRs to determine whether a transaction is a block trade.

[136] The SEC proposal states that it would be inappropriate to establish different thresholds for similar instruments with different maturities. We strongly disagree because of the unique characteristics associated with each swap.

[137] ICI recommends that all block trade information be delayed, not just the notional amount. The absence of the notional amount in the reported transaction data will be an indicator to other market participants that there is the potential for subsequent trading activity.

Swaps are not as liquid or traded as frequently as futures or equities so time frames for dissemination of block transaction data in other markets is of limited value. In some cases, it may take a day or more for large or illiquid transactions to be off-set in the swaps market. Moreover, whether a swap is illiquid may depend on the time of day and the term. Longer delays are unquestionably needed for swaps to avoid front running by opportunistic market participants looking to trade ahead of the hedging (or risk-offsetting) transaction.

In fact, we believe that the appropriate time for dissemination of block trade data is best determined by evaluating the type of swap and the factors considered in establishing a "block trade." The SEC and the CFTC do not yet have the information to make these determinations. A 24-hour reporting time frame generally should be adequate to account for off-setting a trade regardless of the type of swap. Once the Commissions gain a better understanding of the appropriate thresholds for a "block trade" and the time it takes the market to absorb a block trade in the various categories of swaps, our 24-hour recommendation could be revisited.

4) Consistency between CFTC and SEC Reporting Requirements

As identified above, the SEC and CFTC proposals differ, sometimes substantially. The principles guiding the regulatory approaches and the underlying rules should be the same with respect to real-time reporting. The approach to reporting should be uniform and consistent, reflecting the unique characteristics of the swaps market even though application of the final rules to the individual swaps within the Commissions' jurisdictions should differ in recognition of the liquidity for those products. Duplicative requirements are burdensome and inconsistent requirements pose operational problems.

At a minimum, we recommend that the agencies coordinate their proposals with respect to reporting parties, reporting time frames, data to be reported, the approach to establishing block trade thresholds, and the time frames and data requirements for reporting block trades. Such coordination would be in keeping with the Dodd-Frank Act mandates and would help to minimize excessive and unnecessary regulatory burdens caused by the different regulatory requirements.

2. Trading and Market Structure Issues

Efficient financial markets are critical for investors given the dramatic changes to market structure that have occurred in just the last few years alone. The structure of the markets in the United States today is an aggregation of exchanges, broker-sponsored execution venues and alternative trading systems. Particularly in the equity markets, trading is fragmented with no single destination executing a significant percentage of the total U.S. equity market. Some of the biggest and most active traders are so-called high frequency traders, who by most accounts trade more than half of the daily volume of the equity markets. Tremendous competition exists among exchanges and other execution venues, primarily driven by differences in the fees they charge and the speed by which they execute trades, with floor-based exchanges quickly becoming irrelevant.

With all that said, the Institute believes that the U.S. equity markets generally are functioning well. Investors, both retail and institutional, are better off than they were just a few years ago. Trading costs have been reduced, more tools are available to investors for executing trades, and technology has increased the overall efficiency of trading. A primary driver and enabler of the market changes has been the continual evolution of technologies for generating, routing and executing orders, and related improvements to the speed, capacity and sophistication of the trading functions available to investors. Nevertheless, long-time challenges for funds remain and the changes we have experienced in the structure of our markets have not addressed all of the components we believe necessary for a fully efficient market structure. Posted liquidity and average execution size is lower, while trading large blocks of stock has become more difficult. In addition, new challenges have been created due to some of the recent market structure developments discussed below.

Investor confidence in the financial markets also has been shaken of late, notably by the May 6, 2010 "flash crash." As SEC Chairman Schapiro stated in a speech at ICI's recent General Membership Meeting:

> [The] significance of May 6 is greater than the investor harm caused by [the] wild swings in prices – it lies in the significant blow to investor confidence this volatility delivered, as well. Because, while every investor accepts financial risk as a fact of life, they operate under the assumption that America's markets are structurally sound – that the funds you represent and the investors you advise could confidently entrust their capital to the world's most sophisticated financial markets. When that confidence declines, the ramifications – in lost wealth and increased cost of capital – can be great.[138]

Regulators have made great strides in addressing needed market structure reforms. We were particularly pleased when the SEC determined to take a broad look at the current U.S. equity market structure and its impact on long-term investors, such as mutual funds, through its concept release on the structure of the equity markets.[139] The SEC's concept release raised a number of significant market structure issues, including the need for improved transparency of information about the markets, high frequency trading and liquidity that is not displayed in the public markets.

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[138] *See* Speech by SEC Chairman Mary L. Schapiro, *Remarks Before the Investment Company Institute's General Membership Meeting*, May 6, 2011, available at http://www.sec.gov/news/speech/2011/spch050611mls.htm.

[139] SEC Release No. 34-61358 (January 14, 2010).

These issues have taken on increased importance since the "flash crash." It is clear that the large and sudden price dislocations experienced on May 6, 2010 were, at least in part, the result of inefficiencies in the current market structure. Most significantly, while the financial markets have become highly automated and increasingly complex and fragmented, the rules governing the markets have not kept pace with the level of complexity and growth of the wide variety of trading venues and market participants.

As Congress and regulators continue to examine the reform of the rules overseeing the financial markets, it is important not to view any specific market structure issue in a vacuum. The congeries of complex issues posed by the current market structure are closely linked – decisions made about one will impact, in one way or another, many others.

In addition, it is important that Congress and regulators take a measured approach to market structure reform. Otherwise, by restricting new practices or technology, policymakers may impede funds' use of new and innovative trading venues and of tools designed to assist in executing large orders. Automated trading systems, for example, have become an important tool for funds in the normal course of the routing and execution of orders. Regulatory initiatives should not impede funds' use of legitimate trading practices. Similarly, as discussed further below, while we strongly support the need for more transparency of information about the financial markets, Congress and regulators must be careful to not create a regulatory environment that allows for the premature disclosure of critical information about fund orders to the detriment of fund shareholders.

Finally, should regulations become too onerous or costly for certain market participants, they may decline to offer certain products or services to investors. Similarly, trading costs may increase as market participants shift the burden of compliance to investors. We therefore urge policymakers to carefully balance these and other potential costs with the benefits any new regulations would provide to investors.

a. Need for Increased Transparency of Information Regarding the Financial Markets

Given the complexities of the current market structure, there is a clear need for improved market information to investors and regulators. As the events of May 6, 2010 illustrated, information about a growing portion of trading in the financial markets is insufficient. Improved information would allow investors to make better informed investment decisions, and help regulators and market participants better assess current market performance.

We have urged the SEC to examine the sufficiency of the information about trade execution provided to investors by brokers and other trading venues, including whether brokers are providing adequate and accurate information directly to investors about how orders are handled and routed; the need for more public disclosure about how orders provided to brokers are handled; and better trade reporting by all types of execution venues regarding order execution.

We also have urged the SEC to continue to examine ways to improve transparency about current trading practices and market participants. The SEC has taken a number of steps in this area. For example, the SEC has proposed to develop, implement, and maintain a consolidated audit trail and a central repository for the consolidated audit trail data for the trading of listed equities and options. The SEC also has proposed the creation of a large trader reporting system that would enhance the SEC's ability to identify the effects of certain large trader activity on the markets, reconstruct trading activity following periods of unusual market activity, and analyze market events and trading activity for regulatory purposes. While concerns remain over several aspects of the implementation of these systems, together these systems could enhance the SEC's ability to identify large market participants, collect information on their trades, and analyze their trading activity.[140]

b. Role of Liquidity Providers and High Frequency Trading

The role of liquidity providers under the current market structure has garnered significant attention from Congress, regulators, and market participants in general. Much of this focus has been on the increased presence of high frequency traders in the markets. The role of high frequency traders, as well as traditional liquidity providers such as market makers, has taken on more significance since the events of May 6, 2010, as the sudden absence of liquidity in the markets played a critical role in the severe decline in stock prices.

High frequency trading represents, by most estimates, a majority of the activity in the U.S. equity markets today. The rapid increase in high frequency trading has, at the very least, raised questions about the lack of transparency into this practice and about the costs and/or benefits that high frequency traders bring to the markets.

To be clear, funds do not object to high frequency trading per se. High frequency trading arguably brings several benefits to the markets. There is no doubt that a group of market participants that represents such a significant portion of the daily trading volume does provide liquidity to the markets and, in turn, facilitates the tightening of spreads.

At the same time, however, there are potential concerns associated with high frequency trading. These include, among other things, the potential for "gaming" through the use of high-speed computer programs for generating, routing, and executing orders. In addition, the submission of numerous orders that are cancelled shortly after

[140] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated August 9, 2010, available at http://www.ici.org/pdf/24477.pdf.

submission can create unnecessary market traffic and misleading market "noise." Of particular concern, Institute members report that strategies employed by high frequency traders (as well as by other market participants) can be designed to detect the trading of large blocks of securities by funds and to trade with or ahead of those blocks.

We believe the issues surrounding this trading practice are ripe for further examination by regulators given the significant amount of the daily trading volume that high frequency trading now constitutes. First and foremost, there is an immediate need for more information about high frequency traders and the practices of high frequency trading firms. We believe it would be extremely helpful for regulators to have access to increased information to better understand the impact of high frequency trading on the markets, and for investors likewise to make more efficient trading decisions.

Second, high frequency traders, to some extent, may have replaced more familiar liquidity providers in the equity markets such as market makers, but they are not subject to many of the obligations that in the past attached to market makers. We therefore recommend that the SEC examine the trading activity of high frequency trading firms versus the liquidity they provide and consider whether they should be subjected to further obligations.[141]

Third, the SEC should examine the strategies employed by high frequency trading firms to determine whether certain strategies should be considered as improper or manipulative activity. While many high frequency trading strategies may not be in violation of any specific regulation, this does not mean that they are beneficial to the markets or to investors, nor that they promote with efficient price discovery.[142]

Fourth, the SEC should act to address the increasing number of order cancellations in the securities markets, particularly when numerous orders are cancelled shortly after submission. Institute members report that certain of the practices and strategies surrounding cancellations can be designed to detect the trading of large blocks of securities by funds and to trade with or ahead of those blocks. At the very least, this is an area worthy of further examination.

[141] We also believe that the SEC should examine whether more stringent obligations are necessary for traditional market makers in times of market stress.

[142] ICI supports, in general, action by regulators to clearly define practices involving trading strategies that may constitute market abuse, in order to ensure adequate regulatory consequences for these practices. The varied and complex trading practices used by market participants today often makes it difficult to distinguish between legitimate and disruptive trading practices in a number of situations. Lack of clarity also may have a chilling effect on legitimate practices or make enforcement of illegal activities more difficult.

Finally, regulators need to examine the incentives that currently exist for market participants to route orders to particular venues and any related conflicts of interest that may arise due to these incentives.

Investors deserve careful examination of the issues surrounding high frequency trading. To the extent that the additional restrictions on high frequency trading can increase investor confidence in the markets, such restrictions should be carefully considered.

c. Undisplayed Liquidity and the Need for Increased Public Display of Orders

Much of the current debate over the structure of the U.S. securities markets has centered on the proliferation of undisplayed, or "dark," liquidity and the venues that provide such liquidity, particularly so-called "dark pools." Funds have long been significant users of undisplayed liquidity and the trading venues that provide such liquidity. These venues provide a mechanism for transactions to interact without displaying the full scale of a fund's trading interest, thereby lessening the cost of implementing trading ideas and mitigating the risk of information leakage. These venues also allow funds to avoid transacting with market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders. The confidentiality of information regarding fund trades is of significant importance to ICI's members. Any premature or improper disclosure of this information can lead to frontrunning of a fund's trades, adversely impacting the price of the stock that the fund is buying or selling.[143]

At the same time, we recognize that while venues providing undisplayed liquidity bring certain benefits to funds, not displaying orders detracts to some extent from overall market transparency. We therefore understand regulators' desire to examine trading venues that do not display quotations to the public and its concerns about, for example, the creation of a two-tiered market.

Nevertheless, there is real value in enabling entities, such as funds, that frequently trade in large amounts to have access to venues that do not disclose their trading interest. We therefore believe it is imperative that policymakers take a measured approach to making trading through venues such as dark pools more transparent and we urge policymakers to ensure that there are no unintended consequences for funds from further regulations in this area.

[143] *See, e.g.*, Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, SEC, dated September 14, 2005, August 29, 2006, and September 19, 2008.

d. Other Market Structure Issues Arising from May 6, 2010 Events

The events of May 6, 2010 not only highlighted the need for improved transparency of information about the financial markets and for an examination of high frequency trading and undisplayed liquidity but also the need to examine several other related questions. These include: (1) market-wide and stock-by-stock circuit breakers; (2) better procedures for resolving clearly erroneous trades; (3) the use of market orders; (4) the inconsistent practices of exchanges regarding addressing major price movements in stocks; and (5) coordination across all types of markets.

Regulators have taken steps to address several of these issues, including implementing a stock-by-stock circuit breaker program, approving rules designed to bring clarity to the process of resolving "clearly erroneous" trades, enhance the quotation standards for market makers and eliminate "stub quotes," and require broker-dealers with market access to put in place pre-trade risk management controls and supervisory procedures. The Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues also recently issued its final report containing a number of recommendations related to the "flash crash."[144] The Institute strongly supports these initiatives and encourages regulators to continue to examine these issues.

e. Review of Fixed-Income Markets Needed

Compared to the attention given to the equity markets, there has been far less debate about the structure of the fixed-income markets. This clearly has not been the result of the lack of need for reform in this area. Many of the concerns relating to the structure of the equity markets—such as improving transparency by certain market participants, addressing conflicts of interest that may be present, and assuring regulation keeps pace with how securities actually are traded—all these are present in the fixed-income markets, perhaps to an even greater degree. ICI has long advocated for reform in this area, particularly relating to municipal securities, as discussed below.

We strongly believe that more needs to be done to enhance the structure of the fixed-income markets. To start, the SEC should issue a comprehensive concept release examining the fixed-income markets to gather comments from a wide variety of market participants to assist in determining what regulatory changes are needed to best serve investors. Such an examination is long overdue. Investors would be well served by such an initiative.

[144] *See "Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010,"* available at http://www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf.

3. Municipal Securities Markets Reform

The tax-exempt municipal securities market provides an important mechanism for the almost 90,000 units of state and local government to access capital primarily for infrastructure needs including schools, streets and highways, bridges, hospitals, public housing, sewer and water systems, power utilities, and various public projects.[145] The tax treatment of municipal securities in Section 103 of the Internal Revenue Code, which states that the interest on municipal bonds is exempt from federal income tax, serves to bolster demand for municipal securities. For many of these small government units, the municipal securities markets are the only way in which they can truly raise needed funding for their operations. Funds are a critical part of this market. At the end of 2010, individual investors held 33 percent of the $2.9 trillion municipal securities market through funds and another 37 percent directly.[146]

Funds provide an efficient and cost-effective means for individual investors to obtain municipal securities. With approximately 1.2 million active municipal bonds,[147] however, the municipal securities markets are complex. Investors will naturally gravitate toward issues for which they have ready access to the detailed, consistent, and timely disclosure necessary to informed investment decisions. Unfortunately, under the current municipal securities regulatory regime, disclosure too often is limited, non-standardized, and often stale.[148]

For these reasons, we repeatedly have called for reform of the municipal securities disclosure regime.[149] ICI consistently has supported SEC efforts to enhance the disclosure of information regarding municipal securities by amending Rule 15c2-12 under the Securities Exchange Act of 1934,[150] which establishes requirements on the initial

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[145] In addition to the 50 State governments, there were about 87,500 local governments in 2007, according to the U.S. Census Bureau. These included about 3,000 county governments; 19,500 municipal governments; 16,500 townships; 13,500 school districts; and 35,100 special districts.

[146] ICI Fact Book, *supra* note 3.

[147] According to Interactive Data, there are approximately 1.2 million active municipal bonds, with a continuous flow of new securities.

[148] *See, e.g.,* Recent Trends in Municipal Continuing Disclosure Activities, DPC Data, Peter J. Schmitt (February 3, 2011) (finding that failure to file annual financial disclosure documents appears to be rising among issues and obligors or municipal bonds and that annual financial statements are filed too late to be of practical use in credit risk analysis).

[149] *See e.g.,* Stevens July 2009 Testimony, *supra* note 50, Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009, available at http://www.ici.org/policy/markets/domestic/09_oversight_stevens_stmt; and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, SEC, dated September 22, 2008.

[150] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, SEC, dated September 8, 2009 ("ICI Municipal Securities Letter").

disclosure, periodic disclosure, and secondary market reporting of municipal securities.[151] The Rule requires dealers and underwriters, through contract, to obtain issuer representations that certain disclosures may be made. Since adoption, time has shown that the attenuated nature of this disclosure system is extremely difficult to enforce.[152]

A better disclosure regime should be devised for this important market. Municipal securities now trade on a nationwide scale; their trading volume has increased substantially; and the market is composed of many complex instruments. Individual investors increasingly must evaluate not only default risk, but also market price and the corresponding value of a bond. The credit environment for municipal securities has become, and likely will continue to be, more challenging in the coming years, primarily in small or unrated issues.

Until 2008, the need for better disclosure was tempered by the fact that most municipal securities were insured. It was presumed that in the absence of publicly available information, a bond insurer had ready access to the municipal issuer's most recent financial statements and had performed necessary due diligence. Now, however, a smaller segment of the municipal securities market has bond insurance because of the skepticism of investors about the ability of the insurance industry to conduct quality risk assessments following the 2008 financial crisis. Disclosure gaps have been compounded by the adoption of a single global rating scale, which rates corporate and municipal securities on the same scale, and reduces the granularity of available information on municipal securities. Headline risk and the cyclical nature of retail trading further exacerbate the problem. Industry initiatives have made some headway for disclosure improvements in certain categories of municipal securities but these too are limited and voluntary.[153]

Improvements should begin with all investors in municipal securities receiving all material information related to an issue. Disclosure improvements should, at a minimum, include enhancements to timeliness *and* the number and type of individual data points.[154] It also could involve providing investors with information that is produced

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[151] *See* SEC Release No. 26985 (June 28, 1989) and SEC Release No. 34961 (November 10, 1994).

[152] Section 15B(d) of the Exchange Act, known as the Tower Amendment, prohibits the SEC or Municipal Securities Rulemaking Board ("MSRB") from directly or indirectly requiring issuers of municipal securities to file documents with them before securities are sold. As a result, the SEC has had to resort to indirect regulation of disclosure by placing certain obligations on those that distribute municipal securities.

[153] We commend, for example, the National Association of Bond Lawyers for its recent efforts in the area of pension disclosure and we are working with the Association to address investor concerns. We also commend the Government Finance Officers Association for its many "Best Practices" for issuers, including those related to disclosure.

[154] The Governmental Accounting Standards Board ("GASB") recently reported that the usefulness of financial report information to investors diminishes quickly over time. The study stated that, "89 percent of respondents to a survey rated information received within 45 days as 'very useful,' but that proportion

for other purposes, issuing interim disclosures of unaudited information, or establishing incentives for meeting (or consequences for failing to meet) disclosure obligations. Any of these steps would aid investors in navigating the municipal securities markets and making informed investment decisions.[155]

We recognize that the benefits of increased disclosure will entail added costs to municipal issuers. Many issuers have claimed that such costs could be significant and therefore have been opposed to increasing disclosure. We believe, however, that these costs would be minimal for many issuers as they currently provide the major rating agencies with financial information such as annual reports and budgets on a regular basis. In addition, some issuer information is available at public meetings, on the Internet and through a government's annual financial report. This information could be extremely useful to investors in a form that provided for consistency, standardization or comparability.

New disclosure obligations also may raise concerns because of the wide disparity in the size of municipal issuers and differences in primary and secondary market disclosure. These concerns may be misplaced, however, because the quality of disclosure seems to be issuer specific and independent of these factors.[156] In addition, technological advances should help to minimize costs of increased disclosure. Specifically, relatively minor costs would be incurred to provide investors, via the Internet or the MSRB's EMMA system,[157] with material information that is currently produced and provided for underwriters, rating agencies, or internal use.

Ultimately, better communications with investors, especially during times of stress, increase the likelihood of investors sticking with a particular issuer. Municipal securities issuers should recognize that complete, accurate and timely disclosure improves the investors' ability to accurately price their bonds. This, in turn, has the potential to enhance the marketability of municipal securities, which over time could

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dropped to 44 percent for information received within 3 months and fewer than 9 percent for information received within 6 months." *See* Research Brief: The Timelines of Financial Reporting by State and Local Governments Compared with the Needs of Users, GASB, March 2011.

[155] We believe investors in the municipal securities markets should have access to full, accurate, and timely information comparable to that provided to investors in many other U.S. capital markets. We are not, however, seeking a disclosure regime exactly the same as that imposed, for example, on corporate issuers. The disclosure regime should be tailored to the needs of the municipal securities market. *See* ICI Municipal Securities Letter, *supra* note 150

[156] *Id.*

[157] We commend the MSRB for its creation and expansion of the EMMA system. EMMA has improved municipal market disclosure by bringing certain disclosure information together in a central, easily navigated depository at no cost to the user.

increase the liquidity of the entire market.[158] Consequently, ICI believes that the benefits of improving disclosure likely would outweigh the associated costs.

ICI commends Congress for including the municipal securities markets within its review of the financial system under the Dodd-Frank Act, including directing the U.S. Government Accountability Office ("GAO") to study the municipal securities markets. ICI has provided and will continue to provide the GAO with comments regarding the operation of these markets and the absence of appropriate disclosure within these markets. ICI also commends the SEC on its efforts to study the municipal securities markets through field hearings and public outreach, and to identify creative ways to improve disclosure in these markets within the limitations of its authority. We note, however, that the SEC has stated on numerous occasions that it has generally reached the limits of its authority to increase disclosure in the municipal securities markets.[159] Instead of forcing the SEC to develop attenuated and piecemeal rules designed to target disclosure deficiencies, we urge Congress to go beyond its Dodd-Frank Act mandate by providing the SEC with the additional authority it needs to improve disclosure in the municipal securities markets.

4. Housing Finance Reform

As of year-end 2010, funds held about thirteen percent of the outstanding agency and agency-backed mortgage pool securities ("MBS") outstanding in the market, much of which are MBS guaranteed by, and debt securities issued by, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"; together with Fannie Mae, the "GSEs").[160] Currently, Congress is

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[158] For example, if increased availability of financial information reduces overall search and transaction costs, this has a positive effect on liquidity in the market. *See* "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board," Brian Bushee and Christian Leuz, Journal of Accounting and Economics, 2005, vol. 39 (finding that firms that were newly compliant with the SEC disclosure regulation experienced significant increases in liquidity consistent with a reduction of information asymmetry from improved disclosure; the authors also found that firms that were already in compliance prior to the disclosure regulation taking effect experienced positive stock returns and permanent increases in liquidity after the rule took effect, indicating positive externalities from the mandatory regulation disclosure).

[159] *See Opening Statement Before the Commission Open Meeting,* Mary L. Schapiro, Chairman, Securities and Exchange Commission, July 15, 2009 ("These proposals represent an important Commission effort to do what we can, within our statutory authority, to address the disclosure disparity that exits for municipal securities."). *See also, Keynote Address at the National Federal of Municipal Analysts 28th Annual Conference,* Elisse B. Walter, Commissioner, Securities and Exchange Commission, May 4, 2011 ("And, speaking of there always being room for improvement... as you well know, the SEC's authority with respect to the municipal securities market is quite limited. We do not have the ability to set even general disclosure requirements or require that reports be issued on a periodic basis in the municipal securities arena.").

[160] Data are unpublished information drawn from a quarterly survey of the Investment Company Institute as of December 2010.

considering a variety of options to shrink, and ultimately eliminate, the role of the GSEs in the mortgage market, and increase the role of private mortgage financing. In winding down the GSEs, we believe it is essential to the stability of the markets that Congress ensure that the GSEs have sufficient capital to perform under their existing or future MBS guarantees and the ability to meet their debt obligations. The Department of the Treasury and the U.S. Department of Housing and Urban Development, in their report to Congress earlier this year, stated in strong terms their agreement with this principle.[161] If Congress does not ensure that the GSEs can satisfy their commitments on legacy securities, prices on these securities will fall, and prices on Treasury securities will likely rise sharply as investors move out of GSE securities into Treasury securities. Thus, regardless of the housing finance reform option Congress ultimately may decide upon, it is clear that ensuring the GSEs are able to satisfy their current, and any future, obligations is critically important.

5. Proxy Voting Disclosure

Section 951 of the Dodd-Frank Act added Section 14A(d) to the Securities Exchange Act of 1934 (the "Exchange Act"), which imposes a new requirement on certain institutional investment managers to report annually how they voted on three new types of shareholder advisory votes: say on pay; say on frequency; and golden parachute (collectively, the "Section 14A Votes").[162] Although we strongly support the purpose and intent of this requirement, it is only a step in the right direction. Congress or the SEC should require all institutional investors to disclose every proxy vote they cast, as funds currently do.[163]

Since 2004, registered investment companies—alone among all institutional

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[161] The Department of the Treasury and the U.S. Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress* (Feb. 2011) at 12, *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf ("Our commitment to ensuring Fannie Mae and Freddie Mac have sufficient capital to honor any guarantees issued now or in the future and meet any of their debt obligations remains unchanged. Ensuring these institutions have the financial capacity to meet their obligations is essential to continued stability, and the Administration will not waver from its commitment.").

[162] "Say on pay" votes are shareholder advisory votes to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K. "Say on frequency" votes are shareholder advisory votes to determine how often an issuer will conduct a say on pay vote. "Golden parachute" votes are shareholder advisory votes on certain compensation arrangements in connection with a merger or similar transaction.

[163] We have consistently and strongly supported requiring institutional investors to disclose every proxy vote they cast. *See* Statement of the Investment Company Institute on "Corporate Governance and Shareholder Empowerment" before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (April 21, 2010), available at http://www.ici.org/policy/ici_testimony/10_house_corp_gov_tmny. *See also* letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated Oct. 20, 2010 ("ICI Proxy Concept Release Letter"), available at http://www.ici.org/pdf/24636.pdf.

investors—have been required to publicly disclose each and every proxy vote they cast.[164] As a result of this unique disclosure requirement, ICI has been able to conduct the broadest study of funds' proxy votes ever undertaken, covering more than 10 million proxy votes cast by over 200 of the largest fund families from 2007 to 2009.[165] That research indicates, among other things, that: (1) funds devote substantial resources to proxy voting; (2) funds vote proxies in accordance with their board-approved guidelines; (3) funds do not reflexively vote "with management," as some critics claim, but rather make nuanced judgments in determining how to vote on both management and shareholder proposals in order to promote the best interests of funds and their shareholders; and (4) fund voting patterns are often broadly consistent with vote recommendations of proxy advisory firms, although funds do not reflexively adopt the recommendations of proxy advisors.

Unless current law changes, however, one aspect of fund proxy voting that will remain undocumented is how most fund votes compare with those of other institutional investors. At present, such a comparison is not possible because other institutional investors are not required to disclose their proxy votes, except for Section 14A votes.

We have long advocated for a provision that would require institutional investors to disclose each and every proxy vote they cast.[166] In the aggregate, institutional investors other than funds hold approximately thirty-five percent of outstanding U.S. equity securities. Requiring these investors to disclose proxy votes would significantly enhance the quality of the debate concerning how the corporate franchise is used. Section 951 of Dodd-Frank was certainly a step in the right direction by requiring certain of these other institutional investors to disclose their advisory votes on "say on pay" and "golden parachute" proposals. But more can be done. The universe of institutional investors subject to the disclosure requirements should be broadened, and the requirement should extend to all types of votes, not just Section 14A votes.

We are not alone in calling for increased transparency about the proxy votes of other institutional investors. As early as 2003, House Financial Services Committee Chairman Barney Frank questioned the appropriateness of a proxy voting disclosure

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[164] *See* Rule 30b1-4 under the Investment Company Act. As a result, Section 951 has little practical import for funds, because they would have had to disclose Section 14A Votes regardless of whether Section 14A(d) was added to the Exchange Act. The purpose of Section 14A(d) is to extend proxy vote disclosure to other institutional investors.

[165] *See* Investment Company Institute, *Trends in Proxy Voting by Registered Investment Companies, 2007-2009*, November 2010, Vol. 16, No. 1, available at http://www.ici.org/pdf/per16-01.pdf.

[166] *See, e.g.*, 2007 ICI Testimony, *supra* n.9; Investment Company Institute, Submission to U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century, January 26, 2007, available at http://www.ici.org/policy/comments/07_reg_cap_mark_stmt; Letter from Paul Schott Stevens, Investment Company Institute, to Professor Hal S. Scott, Director, Committee on Capital Markets Regulation, Nov. 20, 2006, available at http://www.ici.org/pdf/20606.pdf.

requirement unique to funds.[167] The late Senator Edward M. Kennedy commissioned a 2004 GAO study that concluded, among other things, that workers and retirees would benefit from increased transparency in proxy voting by pension plans.[168] More recently, a number of notable commentators have supported the notion, including the Investors' Working Group, an independent task force sponsored by the CFA Institute and Council of Institutional Investors and chaired by former SEC Chairmen Arthur Levitt and William Donaldson.[169] The AFL-CIO has also strongly supported increased transparency in proxy voting by all capital market participants,[170] and voluntarily discloses its proxy votes and proxy voting policies even though it is not legally required to do so.

The rationale for requiring funds to disclose their proxy votes is that such disclosure helps achieve important public policy aims by enhancing the quality of the debate concerning how the corporate franchise is used. That rationale is not specific to mutual funds, but extends equally to all types of institutional investors. The disclosure rules should do so as well.

Section 4: Oversight by the Securities and Exchange Commission

A. Funds Have an Interest in a Strong, Effective SEC

As major participants in the securities markets and as issuers of securities (fund shares) that are held by almost half of all U.S. households, funds have a vested interest in a strong and effective SEC. Funds and their shareholders stand to benefit if the SEC has the tools needed to fulfill important policy objectives, such as: preserving the integrity of the capital markets; ensuring the adequacy and accuracy of periodic disclosures by public issuers; and promoting fund regulation that protects investors, encourages innovation, and does not hinder market competition.

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[167] *See* H.R. 2420, Mutual Fund Integrity and Fee Transparency Act of 2003, Committee on Financial Services markup (July 23, 2003). *See also* Siobhan Hughes, Rep. Frank Plans Hearing on Disclosure of Proxy Votes, Dow Jones News Service, March 22, 2007.

[168] *See* GAO-04-749, *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting* (August 2004), available at www.gao.gov/new.items/d04749.pdf.

[169] *See A Report by the Investors' Working Group, An Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors*, July 2009, at p.6 ("Institutional investors—including pension funds, hedge funds and private equity firms—should make timely public disclosures about their proxy voting guidelines, proxy votes cast, [and] investment guidelines."), available at http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf.

[170] *See* "Facts about the AFL-CIO's Proxy Votes," available at http://www.aflcio.org/corporatewatch/capital/upload/facts_aflcio_proxy_votes.pdf.

For this reason, ICI consistently has supported adequate funding for the SEC to carry out its critical regulatory functions.[171] To pursue its regulatory mission successfully, the SEC needs to attract and retain experienced, high-caliber professional staff with specialized expertise in a variety of areas. In addition to this "human capital," the SEC needs sophisticated technology—for example, to facilitate analysis and protect the security of data it collects.

These longstanding needs have only increased in the wake of the most recent financial crisis. The Dodd-Frank Act gave the SEC significant new responsibilities. Among other things, it both formalized and expanded the SEC's role as a federal financial regulator with front-line responsibility for monitoring for potential systemic risks, including in areas where regulatory gaps previously existed such as over-the-counter derivatives and the oversight of hedge fund advisers. Other recent rulemakings, such as the SEC's 2010 money market fund reform measures, also have increased the amount of data the SEC collects and must analyze.

B. The SEC Must Utilize Its Resources to Their Maximum Effect

While we there support providing the SEC with the resources it needs to do its job, we also believe it is vitally important for the SEC to utilize its resources to the best effect. Intensive, high-level, and sustained attention to improving the agency's internal operations and management will be necessary to achieve this goal. While the SEC has taken some steps to improve its management and operational efficiency, it is clear that much work remains to be done.[172] Chairman Mary Schapiro has acknowledged this and has indicated plans to devote substantial additional attention to improving the agency's management infrastructure and correcting problems that have surfaced.[173] We strongly support these efforts.

C. Robust Cost-Benefit Analysis Is Critically Important

One area that cries out for further improvement concerns building strong capabilities to conduct economic research and analysis, and using this analysis to inform SEC rulemaking and oversight activities. Economic analysis must play an integral role in

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[171] *See, e.g.*, Statement of the Investment Company Institute on the U.S. Securities and Exchange Commission's Appropriations for Fiscal Year 2012 Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations (May 27, 2011), available at http://www.ici.org/pdf/11_senate_sec_approp.pdf.

[172] *See, e.g.*, Boston Consulting Group, U.S. Securities and Exchange Commission Organizational Study and Reform (March 10, 2011), available at http://www.sec.gov/news/studies/2011/967study.pdf.

[173] *See, e.g.*, Testimony on the President's 2012 Budget Request for the SEC by Chairman Mary Schapiro, U.S. Securities and Exchange Commission, Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations (May 4, 2011), available at http://www.sec.gov/news/testimony/2011/ts050411mls.htm.

the rulemaking process, because many regulatory costs ultimately are borne by investors. When new regulations are required, or existing regulations are amended, the SEC should thoroughly examine all possible options and choose the alternative that reflects the best trade-off between costs to, and benefits for, investors.

Effective cost-benefit analysis is not just a good idea—it is a statutory mandate. Generally speaking, when the SEC engages in rulemaking it is obligated to consider—in addition to the protection of investors—whether a proposed rule will promote efficiency, competition, and capital formation.[174] The United States Court of Appeals for the District of Columbia Circuit has emphasized repeatedly how important it is for the SEC to consider the costs regulated entities would incur in order to comply with a rule.[175] And yet, SEC rulemaking efforts continue to be seriously deficient when it comes to carefully analyzing costs and benefits, as the following examples illustrate.[176]

1. Regulation of Mutual Fund Distribution Fees

As discussed above, the SEC proposed rule changes that would replace Rule 12b-1 with a new regulatory framework to govern fund distribution costs.[177] Given the important role 12b-1 fees have played in the growth of the industry for forty years, it would appear incumbent upon the SEC—when proposing far-reaching changes to the current economics of the industry—to conduct a careful, comprehensive economic analysis. Unfortunately, our review of the SEC's economic analysis and the results of our own independent analysis revealed serious flaws in the SEC's consideration of the rule's costs and benefits.[178] In light of the uncertain and, quite possibly, illusory benefits of the proposal, and the significant operational and transitional costs on funds, intermediaries,

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[174] *See* Section 3(f) of the Securities Exchange Act of 1934 and Section 2(c) of the Investment Company Act.

[175] *See, e.g., Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133, 144 (June 21, 2005) ("Uncertainty...does not excuse the Commission from its statutory obligation to do what it can to apprise itself - and hence the public and the Congress - of the economic consequences of a proposed regulation before it decides whether to adopt the measure."); *American Equity Investment Life Insurance Company v. Securities and Exchange Commission*, Case No. 09-1021 (July 21, 2009) (finding that the SEC's analysis of effects on efficiency, competition, and capital formation in adoption of rules related to indexed annuities was arbitrary and capricious, and remanding the matter to the SEC for reconsideration).

[176] This concern about cost-benefit analysis is not unique to the SEC. As discussed above, the CFTC's cost-benefit analysis of a proposal of critical concern to ICI's members - amendments to CFTC Rule 4.5 - is seriously lacking.

[177] *See* Section 3.A.1, *supra*.

[178] Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, U.S. SEC, dated November 5, 2010, at 7-9, available at http://www.ici.org/pdf/24689.pdf. *See also* Letter from Karrie McMillan, General Counsel, Investment Company Institute and Brian Reid, Chief Economist, Investment Company Institute, to Elizabeth Murphy, Secretary, SEC (December 1, 2010), available at http://www.ici.org/pdf/24752.pdf.

and investors, we have urged the SEC to conduct a more careful economic analysis before proceeding with this rulemaking.

2. Proxy Access Rules

Another disappointing example is the SEC's adoption in August 2010 of new rules and rule amendments ("proxy access rules") to facilitate shareholders' ability to nominate directors of companies, including funds.[179] In particular, new Rule 14a-11 under the Securities Exchange Act requires companies, in certain circumstances, to include shareholder nominees for director in their proxy materials.

Unfortunately, in adopting the proxy access rules, the SEC failed to address the distinct burdens that Rule 14a-11 would impose on funds. In addition, the SEC failed adequately to consider Rule 14a-11's effect on efficiency, competition, and capital formation.

The Business Roundtable and U.S. Chamber of Commerce filed a petition in the U.S. Court of Appeals for the District of Columbia Circuit challenging the validity of the proxy access rules and urging the court to vacate the rules with respect to both operating companies and funds.[180] ICI and the Independent Directors Council, as amici curiae ("friends of the court"), filed a joint brief[181] in support of the Business Roundtable's and U.S. Chamber of Commerce's petition. The Brief urges the court to vacate the proxy access rules solely as applied to investment companies.

3. Legislation Mandating Robust Cost-Benefit Analyses

The preceding examples make abundantly clear that there is room for improvement in the SEC's process for evaluating the relative costs and benefits of rulemaking actions. Concerns about inadequate cost-benefit analysis, particularly by the CFTC, also are part of the impetus behind proposed legislation co-sponsored by Capital Markets Subcommittee Chairman Garrett. H.R. 1573 would require the SEC and CFTC ("Commissions"), in connection with regulation of the over-the-counter swaps markets, to conduct public hearings and roundtables and take testimony and comment on proposed rules before they are made final, and factor those comments into cost-benefit analysis. Specifically, the Commissions would be required to evaluate the time and

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[179] *See* SEC Release No. 33-9136 (August 25, 2010), available at http://www.sec.gov/rules/final/2010/33-9136.pdf.

[180] *See* Business Roundtable, et al. v. SEC, No. 10-1305 (D.C. Cir. Filed Sept. 29, 2010). The SEC subsequently stayed the effectiveness of the rules pending resolution of the case. *See also* Opening Brief of Petitioners Business Roundtable and Chamber of Commerce of the United States of America (D.C. Cir. Filed Nov. 30, 2010).

[181] See Brief of Amici Curiae Investment Company Institute and Independent Directors Council In Support of Petitioners and Vacatur as Applied to Registered Investment Companies (December 9, 2010) ("Brief").

resources that would be required of affected parties to develop systems, infrastructures, and policies and procedures to comply with any new rules as well as any alternative approaches capable of accomplishing the rulemaking objectives.

As we indicated in a letter to the leadership of the House Agriculture Committee and the House Financial Services Committee, ICI strongly concurs with the policy goals that are reflected in H.R. 1573–rulemaking that is informed by robust public input; meaningful cost-benefit analysis that reflects those public comments; and careful consideration by regulators of alternative approaches to achieve their objectives.[182] We appreciate Congress' attention to cost-benefit analysis in the implementation of Title VII of the Dodd Frank Act,[183] and urge its continued oversight of the Commissions' analyses in other rulemakings.

D. The Future of Adviser Oversight

While recognizing the many challenges facing the agency, we believe that, on balance, the SEC should retain its responsibility to oversee the largest US investment advisers, including mutual fund advisers. Entrusting this function to a self-regulatory organization would raise a host of complex issues, and would not necessarily improve the regulatory oversight of investment advisers or substantially reduce the overall costs of adviser regulation. To assure that the SEC has the resources necessary to conduct effective oversight of all advisers under its jurisdiction, we would support the imposition of user fees to fund the SEC's examination program.

Conclusion

We appreciate the opportunity to share our views with the Subcommittee, and we look forward to working with Congress and regulators as they seek to address these many important issues in the best possible way for the millions of American investors who rely on funds to achieve their investing goals.

[182] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Hon. Frank D. Lucas, Chairman, Committee on Agriculture, Hon. Collin Peterson, Ranking Member, Committee on Agriculture, Hon. Spencer Bachus, Chairman, Committee on Financial Services, Hon. Barney Frank, Ranking Member, Committee on Financial Services, U.S. House of Representatives, dated May 3, 2011.

[183] *See* Section 3.B.1, *infra*.

Testimony of

René M. Stulz

Reese Chair of Banking and Monetary Economics and Director of the Dice

Center for Research in Financial Economics, Ohio State University

Before the

Subcommittee on Capital Markets and Government Sponsored

Enterprises

United States House of Representatives

June 24, 2011

Written Testimony of René M. Stulz

Reese Chair of Banking and Monetary Economics and Director of the Dice Center

for Research in Financial Economics, Ohio State University[1]

Before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

United States House of Representatives

June 24, 2011

Chairman Garrett, Ranking Member Waters, and members of the committee, I want to thank you for giving me the opportunity to testify in front of you. The testimony is my own. However, I am a member of the Squam Lake Group, a group of economists who authored the Squam Lake Report: Fixing the Financial System. The Squam Lake Group has put forth proposals for reforming money market funds in a memorandum titled "Reforming money market funds" which is included as an appendix to my testimony and my testimony will present these proposals.[2]

Systemic risk is used everywhere all the time within the regulatory community. At the same time, it is rarely defined and almost never quantified, which makes possible a lot of mischief. My definition of systemic risk is that it is the risk that the financial system becomes incapable of performing one or more of its key functions in a way that prevents normal economic activity. To

[1] My resume and biography available at http://www.cob.ohio-state.edu/fin/faculty/stulz/index.htm provide disclosures on my compensated activities. I am currently retained as a consultant and as an expert witness by firms in the financial services industry. In addition, I hold shares of mutual funds, which in the context of this hearing could be viewed as a potential conflict of interest.

[2] See "Reforming money market funds," by Martin N. Baily et al., available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1740663 .

justify regulation in the name of preventing systemic risk, it is important to assess both the costs and the benefits of that regulation. One should be leery of designating financial firms as systemically important without having proper tools to quantify the systemic impact of such firms. Any systemic designation should be based on objective and quantifiable criteria. I would urge restraint in designating a financial firm as systematically important as long as its systemic importance is not quantified and as long as it is not shown that the benefit in terms of systemic risk of designating this firm as systemically important offsets the additional regulatory burden that such a designation would impose on the firm.

On economic grounds, there is no reason to believe that either specific mutual funds or mutual fund complexes should be designated as systemically important. The asset management industry plays a critical role in our economy by managing the funds of investors. The failure of a player in that industry in performing its role does not create a systemic risk. If one player runs in trouble, another player can take its place. In general, difficulties with one player would not mean that the investors in the funds managed by that player would be at risk for regulated funds because the monies of the investors are segregated. Should a firm that manages mutual funds fail, the funds have boards that can replace the manager. There is no reason for that transition to be problematic.

There is no evidence that the asset management industry created systemic risk during the recent crisis except in one segment, the money market funds segment. However, rather than designating money market funds as systemically important, it would make more sense to eliminate the features of money market funds that create systemic risk. Similarly, should one conclude that some aspects of the mutual fund industry create systemic risk in the future, the best approach to addressing that issue would be to attack the source of risk at its source and eliminate it, rather than increase regulations on fund management companies.

It is important to focus on the exact channel through which money market funds created systemic risk during the crisis. The cost of the systemic risk of money market funds is not the potential losses of investors in these funds, or losses not covered by the fund management company. By their very nature, money market funds are prone to runs. When investors run from funds, this forces funds to sell their assets and disrupts the provision of short-term funding in the financial system. In 2008, the run was started by losses on Lehman investments at one fund, the Reserve Primary Fund, which was forced to redeem shares at less than $1 – in other words, it broke the buck. In the past, when funds had made losses that could have forced them to break the buck, the management companies made up these losses even though they were not contractually required to do so. In the case of the Reserve Fund, the management company did not have the resources to do so. In the two weeks following the bankruptcy of Lehman, more than $400 billion left prime money market funds. Further, money market funds changed their investment policies to make themselves better able to cope with further redemptions. Runs and anticipated redemptions led to chaos in the commercial paper market as well as in the repo market. Companies and financial institutions could not get the funding that they anticipated. Intervention by the Treasury and by the Fed was necessary to stop the acceleration of redemptions and inject some stability in the commercial paper market. The fundamental issue is that we cannot have a financial system that is at the mercy of runs in money market funds. The point of reform of money market funds is not, therefore, to make investors in these funds safer. It has to be to make the financial system safer.

Some might argue that reforms that have already taken place have eliminated the problem. This is not correct. Money market funds are still vulnerable to runs. Further, they are particularly vulnerable to developments in Europe. A recent study finds that the top 15 largest prime AAA funds have more than 50% of their assets invested in foreign banks, the lion's share of these investments in European banks.[3]

The key reason why money market funds are prone to runs is that they allow investors to redeem at $1 when the market value of the fund's assets is worth less than $1 a share. If the market value of a fund's assets is worth less than $1 a share by a sufficient amount, it becomes rational for investors to run since they receive $1 by redeeming immediately instead of possibly receiving less if they do not. A run decreases the value of the assets once the most highly liquid assets are depleted because it forces money market funds to sell assets at a discount to raise cash quickly. This discounting can give additional momentum to the run since investors receive more before the fund has to discount its assets to meet redemptions and lose because of the fire sales even if they stay in the fund.

To make runs much less likely, the Squam Lake Group has proposed that money market funds either should have a floating NAV or should have a buffer that could be used to prevent the NAV from falling below $1 a share. By buffer, we mean resources committed by the management company or by third parties that absorb losses so that the fund can keep redeeming shares at $1 even if it has made losses. The use of a buffer makes it possible to keep the fixed NAV mechanism but largely eliminates the incentives for investors to run since the buffer insures that the mark-to-market value of the shares does not fall below $1 as long as the buffer is

[3] "Dissecting prime money fund holdings," by Lance Pan, Capital Advisors Group, February 1, 2011. See also Fitch Ratings, "U.S. Money Fund Exposure to European Banks Remains Significant," June 21, 2011.

large enough to cover losses. A floating NAV eliminates the free option that investors have to receive $1 when the true value of a share is less than $1. At the same time, we understand that a floating NAV does create operational difficulties for institutional investors.[4] It is not at all clear, however, that these difficulties are insurmountable.

We propose several mechanisms to create a buffer. However, irrespective of how the buffer is implemented, we recommend that any buffer mechanism should have three important characteristics. First, the mechanism should be such that in the presence of losses the buffer could be replenished quickly. Second, a fixed-NAV fund should immediately convert to a floating-NAV fund if the buffer is depleted so that its value is below some minimum threshold. Third, once losses have been made, the buffer should be replenished within a short period of time and if it is not the fund should convert to a floating-NAV fund.

We propose four possible mechanisms for the buffer:

1) Federal Reserve deposits contractually committed to buffering the fund.
2) Highly liquid government securities held in a segregated custody account that is contractually committed to buffering the fund.
3) Insurance by a party that meets the fund regulator's standard for creditworthiness and liquidity.
4) "Equity tranche" claims on a pool of "2a-7 compliant assets" whose senior claimant is the money market fund. The assets would be used to pay redemptions at $1 NAV for the investors in the money market fund as long as this is feasible.

[4] These difficulties are well described in the "Report of the Money Market Working Group" of the Investment Company Institute.

Let me now discuss two additional issues related to the buffer. First, I want to elaborate on the concept of "equity tranche" and, second, I want to comment on the size of the buffer.

It may not be a popular analogy at this time, but it is useful to think of a securitization of the assets of the fund. With a securitization, investors in the most senior tranche have priority and the lower tranches serve as a buffer that absorbs losses. When we think of an "equity tranche", we think of it in the same way as junior tranches in a securitization. However, because of inflows and outflows in money market funds, the size of the equity tranche would have to increase as inflows occur. Alternatively, one could think of the buffer as capital that supports the risk of the money market fund, so that if the fund makes losses, they can be absorbed by that capital.

There are a number of different ways to implement the equity tranche concept, but I will give just one example. The fund could issue notes at regular intervals in the amount necessary to create the required buffer. For example, let's say that the notes have a six-month maturity. The notes could promise a fixed interest payment or could receive the income in the fund in excess of some amount. With a fixed interest payment, the principal would be reduced if losses have to be paid. Alternatively, with a floating payment, the payment would be negative in the case of losses and come as a reduction of principal. The notes could be issued through a bidding process or could be privately placed. If the assets are invested more safely, the note-holders would require lower compensation for bearing the risk of losses. The compensation required by the note holders would provide information about the risk of the assets. It would be in the interest of money market funds to offer more transparency to the investors in the notes. The money market fund investors would receive the return on the assets minus the payments made to the note-holders, the costs of issuing the notes, and the fees paid to the fund manager.

To have a sense of the numbers involved, suppose that a fund has currently a total net asset value of $1 billion and that the buffer is required to be 3%. In this case, the principal amount of the notes issue would have to be at least $30 million so that the note holders could lose an amount equal to the buffer. Say that the probability of a loss equal to the buffer over six months is 0.05%. In this case, the note holders would be compensated for the actuarial value of the expected loss by an additional return of 5 basis points if the face amount of the notes is $30 million. The impact of 5 basis points paid to the note holders on the return to the money market fund investors would be minuscule since it would be a reduction of $15,000 of the return of the fund. One would expect the note-holders to require a risk premium. However, even if the risk premium is a multiple of the actuarial cost, it would still have only a very small impact on the return of the money market fund investors.

Let me now briefly comment on the size of the buffer. In the two-day period following Lehman's bankruptcy, the Reserve Primary Fund reported a minimum share price of 97 cents. A buffer of at least $0.03 would have been necessary to prevent the fund from breaking the buck. From August 2007 to December 2010, using data from Moody's, 21 firms provided support to funds. The average support was 1.62% of net assets. Finally, as of June 2010, using again data from Moody's, the top five exposures of U.S. prime money market funds were all to European banks and the lowest exposure was 2.5%. The numbers suggest that a buffer in the range of 1.5% to 3% is not unreasonable.

Some market participants have argued that money market funds do not pose a systemic risk since other funds that do not have a fixed NAV also experienced large redemptions during the crisis. Investors will often leave poorly performing funds. However, the problem with the fixed

NAV concept is that investors are paid to leave by the investors who do not leave. This is because investors in fixed NAV money market funds have a free put option.

My last point is that it is important when considering changes in the regulations that affect money market funds to take into account the impact of reform on the financial system as whole and to be wary of unintended consequences of regulation. After all, money market funds largely came into existence because of regulations that limited the interest payments banks could make on deposit accounts. Further, the risk of runs on money market funds exists because regulation allows them to not use fair market value for redemptions.

In summary, the main concern about systemic risk with mutual funds has to do with the potential for runs at money market funds. I have proposed several mechanisms that could dramatically reduce this potential for runs. Implementing a mechanism that diminishes the probability of runs at money market funds would help in making the financial system safer.

Appendix

Reforming Money Market Funds

A Proposal by the Squam Lake Group*

January 14, 2011

Abstract

The current stable-NAV model for prime money market funds exposes fund investors and systemically important borrowers to runs like those that occurred after the failure of Lehman in September 2008. This working paper, by the Squam Lake Group, argues that, to reduce this risk, funds should have either floating NAVs or buffers provided by their sponsors that can absorb losses up to a level to be set by regulators. We suggest alternative designs for such a buffer, as well as considerations that should be taken into account when determining its required size.

* The members of the Squam Lake Group are Martin N. Baily (Brookings Institution), John Y. Campbell (Harvard University), John H. Cochrane (University of Chicago), Douglas W. Diamond (University of Chicago), Darrell Duffie (Stanford University), Kenneth R. French (Dartmouth College), Anil K Kashyap (University of Chicago), Frederic S. Mishkin (Columbia University), David S. Scharfstein (Harvard University), Robert J. Shiller (Yale University), Matthew J. Slaughter (Dartmouth College), Hyun Song Shin (Princeton University), Jeremy C. Stein (Harvard University), and René M. Stulz (Ohio State University). Individual members of the group have potential conflicts of interest, including affiliations with rating agencies, which rate money market funds, with investment management firms that manage or invest in money market funds, with other forms of mutual funds, or with banks. Specific affiliations are disclosed on the web sites of individual members. Because he is involved with a firm that sponsors a money market fund, Ken French did not participate in deliberations concerning this proposal. We are grateful for assistance from Joseph Abate, Marnoch Aston, Barry Barbash, Richard Cantor, Jason Granet, Catherine Newell, Barbara Novick, Alex Roever, Henry Shilling, Peter Tufano, and Alex Yavorsky.

In 2010, the U.S. Securities and Exchange Commission tightened the risk requirements for assets held by money market funds in response to the run on the Reserve Primary Fund, and severe redemptions from other money market funds, that followed the collapse of Lehman in September 2008. Despite the improvements represented by the resulting new version of Rule 2a-7, we believe that money market funds continue to pose significant systemic risk. In our view, funds based on a so-called "stable" net asset value, described below, should meet a regulatory buffer requirement that we outline in this note. The proposed buffer would lower the risk of destructive runs by significantly lowering the risk that a money market fund could ``break the buck,'' and would better align the incentives of fund managers with the interests of the public in reducing systemic risk.

Our principal concern is the industry norm of a "stable" net asset value (NAV), by which purchases and redemptions of money market funds occur at a price equal to the per-share amortized cost of the fund's assets, rounded to the nearest penny. Under normal conditions, this rounding implies a purchase or redemption price of one dollar per share. If, however, investors in a money market fund fear that the actual market value of fund assets may be less than one dollar per share, or that this could easily happen in the near future, then they have an incentive to redeem their shares, and to do so before the rounded NAV per share drops below one dollar, an event known as ``breaking the buck.'' This incentive to run is exacerbated by the knowledge that the first investors to run have less risk than those that follow because redemptions at one dollar per share dilute the claims of unredeemed shares whenever the actual NAV is less than one dollar. A run can be further accelerated by a lack of transparency of the actual NAV and by fears that large sudden redemptions from a fund can only be met through a fire sale of its assets. The problem is worsened because the asset holdings of money market funds with similar objectives are likely to be similar, so that fire sales from one fund are likely to be accompanied by fire sales of other funds. For example, in the two-week period following the failure of Lehman, net outflows from a subset of prime money market funds tracked by Moody's exceeded $400 billion, almost entirely through redemptions by institutional investors, who are prone to run for cover much more quickly than are retail investors.[5] During the same period, money market funds dedicated to holding only government securities experienced net *inflows* of over $225 billion, again largely because of the quick decisions of institutional investors, who account for over 65% of investments in money market funds.

The potential for a run on money market funds is a systemic risk. A large fire sale of assets held by money market funds could destabilize the markets for these assets. Investments in U.S. prime stable-NAV money market funds and similar European "CNAV" money market funds now total over $2 trillion. Industry concentration has increased significantly, to the point that the top 5 U.S. fund managers now account for about 50% of the U.S. total. In the event of a run on money market funds, systemically important borrowers such as large securities dealers could suddenly lose access to a significant source of

[5] From Moody's data, over the period from September 9, 2008 to September 23, 2008, holdings by institutional investors in prime money market funds dropped from $1,330 billion to $948 billion, while holdings by retail investors declined from $755 billion to $727 billion. As a matter of disclosure, one of the members of the Squam Lake Group is a member of the board of directors of Moody's Corporation.

financing, as happened following the fall of Lehman in 2008. The commercial paper market essentially stopped functioning and Lehman experienced a run by money market funds, who typically buy the commercial paper of large banks and lend overnight to dealers through tri-party repurchase agreements.[6] A run on money market funds could therefore set off fire sales of securities by dealers and, potentially, the failures of systemically important financial institutions. The withdrawal of funding could also lead large financial firms to reduce their lending.

Part of the government's response to the massive redemptions from money market funds that occurred in the wake of Lehman's failure was to guarantee that money market fund investors could redeem at one dollar per share.[7] If money market fund managers believe that such guarantees will be forthcoming in response to any systemic event, they will have incentives to take greater risks than is prudent from a systemic perspective. Moreover, if investors also believe that their money market fund investments are protected in a systemic event, they will overinvest in money market funds, thereby increasing the magnitude of the systemic risk. And while money market fund managers and investors may believe that they will be protected, it is always possible that they will not be and that a run on money market funds succeeds in destabilizing the financial system, while the government stands by either because it cannot or will not intervene. Indeed, Treasury's program to protect money market funds was outlawed by the Emergency Economic Stabilization Act of 2008, the legislation that created the Troubled Asset Relief Program. Whether there are other programs that could be used to stabilize money market funds is an open question.

In the past, without the prospect of government guarantees, whenever money market funds threatened to break the buck, it had been common for their managers to bail them out in order to preserve the franchise values of their fund management businesses. Between August 2007 and December 31, 2009, at least 36 U.S. and 26 European money market funds received support from their sponsor or parent[8] because of losses incurred on their holdings of distressed or defaulted assets, as well as the costs of meeting the redemption demands of investors through sales of assets. Going forward, if sponsors believe that their funds will receive government support, their incentive to bail out their own funds may be substantially reduced, particularly given the squeeze on profitability associated with exceptionally low money-market interest rates.

We can envision two broad ways of addressing the systemic risks created by stable-NAV funds. First, and most directly, regulation could simply require that all money market funds have a variable NAV. In effect, this would force any fund that holds risky assets to be fully transparent about the evolution of

[6] See the "The Trustee's Preliminary Investigation Report and Recommendations," United States Bankruptcy Court, Southern District of New York, in Lehman Brothers Inc., Debtor, and "Report of Anton R. Valukas, Examiner," in Lehman Brothers Holdings Inc., et al., Debtors, United States Bankruptcy Court, Southern District of New York.

[7] Details on the Treasury Money Market Guarantee program, announced on September 19, 2008, are available at https://ustreas.gov/press/releases/hp1147.htm. The program expired on September 18, 2009.

[8] See "Sponsor Report to Key Money Market Funds," by Henry Shilling, Moody's Investor Service, August 9, 2010. The forms of support included capital contributions, purchases of distressed securities at par, letters of credit, capital support agreements, and letters of indemnity or performance guarantees.

these risks—it would no longer be possible to present the performance of risky investments as though they are riskless. While we believe that this "floating NAV" alternative has substantial advantages, the fund management industry has spoken out strongly against it. The industry argues that investors derive significant operating, accounting, and tax management benefits from the ability to transact at a fixed price.[9] In our view, the magnitude of these benefits—particularly from a social perspective—remains an important open question. We have not seen any analysis of the value of these benefits to money market fund investors relative to the cost to the public of the associated systemic risk. Another source of uncertainty comes from the potential impacts on other types of financial institutions. If investors strongly prefer stable-NAV type products, then requiring that all funds have a floating NAV might induce investors to shift their investments into bank deposits as a substitute for stable-NAV money market funds. Because the bank deposits of large institutional investors are uninsured, this could simply move the threat of runs from money market funds to the banking sector. Given that banks are less transparent than money market funds, the likelihood of a damaging run could theoretically increase as a result of this shift. Again, this possibility is difficult to assess empirically.

Thus, as an alternative to floating NAV, a second broad approach, which we focus on below, preserves the stable NAV structure but enhances its safety by requiring sponsors to establish contractually secure buffers that could absorb at least moderate investment losses to their money market fund investors. This is akin to a capital requirement for stable-NAV funds. The President's Working Group Report (2010) describes various alternatives, including some forms of liquidity facility or insurance that are consistent in spirit with this approach, but it does not make a specific recommendation.[10]

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[9] See "Report of the Money Market Working Group," Investment Company Institute, March 17, 2009. With respect to tax issues, the Money Market Working Group writes: "With a floating NAV, investors could be required to track the amount and timing of all money market fund purchases and sales, capital gains and losses, and share cost basis. To be sure, investors already face these burdens in connection with investments in long-term mutual funds. But most investors do not trade in and out of long-term mutual funds on a frequent basis, as many do with money market funds. Thus, if money market funds had a floating NAV, all share sales become tax-reportable events, potentially greatly magnifying investors' tax and recordkeeping burdens." As for financial accounting costs, "companies would face the additional burden of having to mark to market the value of their money market fund shares. Corporate treasurers would also have to track the costs of their shares and determine how to match purchases and redemptions for purposes of calculating gains and losses for accounting and tax purposes. Moreover, under the new treatment, companies could not enter and reconcile cash transactions nor calculate the precise amount of operating cash on hand until the money market fund's NAV became known at the end of the day, creating additional disincentives for corporations to use money market funds for cash management purposes." The Money Market Working Group also details some operational and legal difficulties that would confront certain investors in stable-NAV funds if these funds did not exist. The Money Market Working Group (2009) also points out that floating-NAV instruments, such as "ultra-short" bond funds and certain French floating-NAV money market funds were not immune from substantial sudden redemptions during the financial crisis.

[10] See "Report of the President's Working Group on Financial Markets: Money Market Fund Reform Options," October 2010, which suggests that money market funds continue to pose systemic risk. Among the alternative policies described in the President's Working Group Report are: conversion of all funds to floating NAV; a private or public insurance scheme for stable-NAV funds; a rule by which large redemptions would be paid in kind (that is, with a portfolio of assets held by the fund); a two-tier system of both floating-NAV and stable-NAV funds under which stable-NAV funds would be required to have some support mechanism; a two-tier system under which stable-NAV funds are only available to retail investors; a rule forcing stable-NAV funds to convert to special purpose banks, holding capital and having access to lender of last resort facilities, and for which depositors would have some insurance coverage.

Buffering Stable-NAV Money Market Funds

The following suggested buffer requirement for stable-NAV funds could be met via a number of alternative contractual approaches. The premise behind these suggestions is that Rule 2a-7 sufficiently restricts the investments of money market funds that the full set of restrictions imposed on banks need not be imposed on money market funds.

Proposed buffer requirement for stable-NAV funds:

The manager of a stable-NAV money market fund must provide dedicated liquid financial resources that, in combination with those represented by the assets of the fund class investors, are sufficient to achieve a net buffer of "X" per dollar of net asset value. These additional resources are to be drawn upon as needed to support fund redemptions at one dollar per share until the fund converts to a floating-NAV or until the buffer resources are exhausted. That is, at the end of each business day, the combined resources available to fund investors represented by the sum of dedicated additional sources and the previous day's marked-to-market per-share value of the fund's assets must exceed 1+X per share held as of the end of the current day. The fund must convert to a floating-NAV fund within a regulatory transition period, such as 60 days, in the event that the fund manager falls out of compliance with this buffer requirement.

Some potential alternative forms of buffers include:

1. Federal Reserve deposits, contractually committed to buffering the fund to the point of liquidation or conversion to a floating-NAV fund, at which point any residual deposits can be reclaimed by the original depositor, which could be the fund management firm or investors in a separate investment vehicle.[11]
2. Liquid assets such as Treasury bills held in a segregated custody account that is contractually committed to buffering the fund, as in the previous example.
3. Insurance by a party that meets the fund regulator's standard for creditworthiness and liquidity.
4. "Equity tranche" claims on a pool of "2a-7 compliant" assets whose senior claimant is the money market fund. That is, equity-tranche investors may receive distributions only to the extent that the total market value of the pool assets at the end of each business day meets the buffer requirement. Money market fund investors, however, can redeem at one dollar per share

[11] In March 1980, the Board of Governors of the Federal Reserve announced a requirement for money-market funds to maintain additional deposits at the Federal Reserve, according to a specified formula, pursuant to the Credit Control Act of 1969. The SEC issued an associated series of rulings on March 14, 1980 (19 SEC Docket 908) implementing the rule, on April 22, 1980 (19 SEC Docket 1275) providing exemptive relief, and (after the Federal Reserve eliminated the requirement on July 3, 1980), on July 21, 1980 (20 SEC Docket 746) providing for rescission of its rule. That is, this "reserve" requirement was introduced and almost immediately dropped. Our proposal would not require a money market to make such deposits, but rather for its fund manager to arrange for such deposits, or for some other form of buffer, dedicated to covering risks to fund investors.

until the fund is forced for lack of resources to convert to a floating NAV fund. At the end of the transition period, equity tranche investors may claim any available residual.

We illustrate the buffer requirement with a simple example, taking, for sake of illustration, a buffer size X of \$0.03 per share, in the form of Federal Reserve deposits.

Monday: The marked-to-market end of day value of fund assets is \$1.004 per share. The dedicated Federal Reserve deposits at the end of that day are \$0.02 per share. Thus, with the combined resources of \$1.024 per share, the 1+X requirement is not satisfied, triggering a minimum additional deposit on Tuesday of \$0.006 for each share held at the end of Tuesday in order for the fund to maintain its stable-NAV status.

Tuesday: At the end of the day, the fund has 1 billion shares. A minimum deposit of \$6 million is therefore to be added to the Federal Reserve buffer account by the end of the day. (A deposit of only the minimum of \$6 million would rule out acceptance of any fund investments that would bring the total number of fund shares above 1 billion.) At the end of the day, the market value of the fund assets is \$1.002 per share and, based on the actual buffer deposits, the buffer deposit is \$0.032 per share. The 1+X requirement is thus exceeded by \$0.004 per share. No action is required on the next day. A withdrawal from the Federal Reserve buffer account of up to \$0.004 per share held at the Wednesday close will be permitted on Wednesday.

Wednesday: At the end of the day, the market value of the fund assets is \$0.996 per share and the buffer is \$0.0280 per share. In order to meet the 1+X requirement, the buffer must be "topped up" on Thursday.

Thursday: The buffer provider fails to make additional Federal Reserve deposits. The buffer requirement is therefore not met. As a result, the 60-day transition period to floating-NAV begins. No buffer withdrawals by the fund sponsor are permitted during this period, even if, through the effects over time of fund redemptions and investments and the revaluation of fund assets, the buffer per share exceeds X. Meanwhile, fund redemptions and investments may continue to be made at 1 dollar per share, drawing as needed on the buffer deposits until they are exhausted (which occurs when the sum of the buffer deposits and the mark-to-market NAV is equal to \$1). If there is an insufficient buffer to allow redemptions, the fund immediately floats its NAV. At the end of the transition period, the fund emerges as a floating-NAV fund if it has not already been liquidated or floated. Any residual buffer deposits at that time may be retrieved by the buffer provider.

The cost to the sponsor of the buffer requirement, beyond administrative expenses, is primarily of two forms:

1. The value of an effective put option, struck at \$1 per share, on the fund's assets.
2. The potential loss of "convenience yield" associated with tying up buffer assets for a dedicated purpose.

The value of the put option depends of course on the volatility and illiquidity of the fund assets. The cost of providing a buffer thus aligns the asset investment incentives of the fund manager with the public's interest in lowering systemic risk. The loss of financial flexibility associated with segregating liquid assets has some value. If one assumes for this cost a convenience yield of, say, 1%, then for each increase in the buffer size by 1% of NAV, there is an additional cost of roughly 1 basis point of NAV per year.[12] It therefore seems safe to guess that the bulk of the cost of meeting the proposed buffer requirement is represented by the risk of loss borne by the buffer provider, and perhaps by administrative costs.

Because fund sponsors have frequently provided voluntary support to their funds as needed to avoid breaking the buck, some of the cost of our proposal has already been effectively borne by fund sponsors and, indirectly through fees, by fund investors. How the additional costs of being required to buffer a stable-NAV fund are shared between a fund's manager and its investors would depend on financial industry competition, among other factors.

In the United States, some if not all of the alternative buffer approaches that we have discussed would require exemptive relief or significant rule changes from the SEC. We presume that rule changes would also be needed in Europe. It is possible that changes in accounting standards for money market funds may also be required. Because of significant variation in the types of fund managers and investors, we are not proposing a specific contractual approach. Regulators may choose to design a rule that mandates the required effect of the buffer without tightly restricting the specific mechanism by which the required effect is to be achieved. If the value of stable-NAV funds is low relative to the costs of our proposed method of avoiding systemic risk, then funds will presumably choose to adopt a floating NAV structure.

When setting the size "X" of a required buffer, regulators may wish to consider the amounts by which money market funds have broken the buck in the past, or the amounts per share that fund sponsors have contributed in order to prevent them from breaking the buck. In the two-day period following Lehman's bankruptcy, the Reserve Primary Fund reported a minimum share price of 97 cents.[13] Had redemptions not been halted by the Reserve Fund's sponsors, a fire sale of additional assets could have caused significant additional losses. A buffer of at least $0.03 per share would therefore have been necessary to prevent the Reserve Fund from breaking the buck.

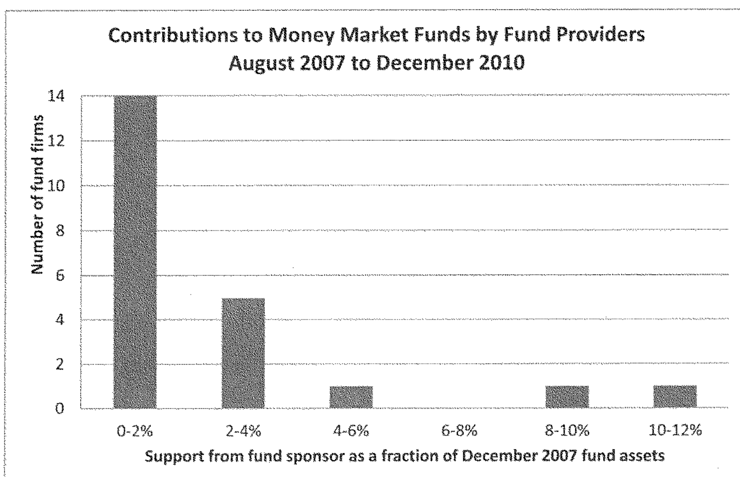
Another consideration in determining the size of a buffer requirement is the concentration of fund assets among the debt instruments of a small number of borrowers. As of June 2010, for example, the

[12] Evidence that such an estimate is reasonable can be found in "The aggregate demand for Treasury debt," by Arvind Krishnamurthy and Annette Vissing-Jorgensen, working paper, Northwestern University.

[13] In the two days following Lehman's failure, and before the Reserve Fund halted redemptions, the Reserve Fund suffered a net loss of assets of $27.3 billion, taking total assets from $62.6 billion to $35.3 billion. The Reserve Fund had held approximately $785 million of Lehman debt instruments, or about 1.3%. See Sam Mamudi and Jonathan Burton, MarketWatch, "Money market breaks the buck, freezes redemptions", September 17, 2008. The only other instance of a breaking of the buck was that of Community Bankers U.S. Government Money Market, which when it broke the buck in 1994, was valued at 96 cents per share.

top 5 exposures of U.S. prime money market fund assets, were all to European banks, with each of the 5 banks representing an exposure of at least 2.5% of aggregate fund assets.[14]

A third consideration in choosing an appropriately sized buffer is the level of support from fund sponsors that has been necessary in the past to prevent money market funds from breaking the buck. The bar chart below shows the levels of support provided to prime money market funds by their sponsors or parents from August 2007 to December 2010, from data provided to us by Moody's Investors Service, and obtained from public disclosures. The support was provided by 21 firms with asset management units, some of which are foreign. The levels of support are shown in the figure as a fraction of the net assets of the relevant funds as of December 31, 2007. The total amount of support provided in these 21 cases was $12.1 billion, for an average of 1.62% of net assets under management by the money market funds. Had these firms not made these contributions to the money market funds that they managed, then, absent other effects, these funds would have required buffers of the illustrated sizes in order to avoid breaking the buck. This is not to suggest that an appropriate buffer should necessarily have been large enough to prevent losses to fund investors in all cases. A buffer that suffices to cover losses with a high probability could significantly reduce the likelihood of a run by investors, and increase the incentive of the fund sponsor to cover additional losses from its own resources in order to protect its franchise value.



Data source: Moody's

[14] See "Money Market Funds: 2010 Outlook," by Henry Shilling, Moody's Investors Service, April 2010, revised, June 18, 2010. These top-five exposures, as a fraction of total Prime MMF Assets, were to BNP Paribas (3.5%), Société Générale (3.0%), Crédit Agricole (2.7%), Lloyds (2.7%), and Banco Bilbao Vizcaya Argentaria (2.5%). Because these are industry-average exposures, any variation across funds would have caused exposures of some individual funds to these borrowers to exceed these averages.

In general, the regulatory buffer should be sufficient in size to cover both (a) default losses on fund assets, and (b) potential additional losses that could arise from a need to sell or restructure fund assets quickly because of a moderately large surge of redemption demands. This second category of losses is relevant if the assets are illiquid or if their market values are affected by changes in market interest rates or credit spreads. The Investment Company Institute has recently proposed[15] an industry-wide "emergency liquidity facility," a bank with access to liquidity from the Federal Reserve, that could purchase assets from money market funds at a price equal to amortized cost. While an emergency liquidity facility would mitigate the liquidity risk of money market funds, it would leave them, and itself, exposed to default risk. Fund investors would have a lower incentive to run if they were confident of at least a moderate level of coverage of losses due to both illiquidity and default.

[15] See the letter of January 10, 2011, of Paul Schott Stevens, President and CEO of the Investment Company Institute, to the Securities and Exchange Commission, commenting on the report of the President's Working Group Report on Money Market Reform Options.

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June 22, 2011

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on
Capital Markets and Government-Sponsored
Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Subcommittee on
Capital Markets and Government-Sponsored
Enterprises
U.S. House of Representatives
Washington, DC 20515

Statement of the Association of Commerce & Industry on
The Subcommittee on Capital Markets and Government Sponsored Enterprises Oversight
Hearing on Issues in the Mutual Fund Industry

Dear Chairman Garrett and Ranking Member Waters:

The Association of Commerce and Industry serves as the statewide chamber of commerce. In this capacity, the Association represents employers in the state at the state and federal level. The Association's mission is to enrich the lives and prosperity of New Mexicans through a vibrant business climate built by effective advocacy and education.

We are pleased that the Subcommittee is holding this hearing to explore the issues facing mutual funds and their investors. We wish to register our concerns regarding proposed changes to the structure of money market funds, particularly our strong opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

Our members rely upon money market funds as powerful tools for managing cash. Since the financial crisis of 2007–2009, policymakers have made great progress in making money market funds even stronger. A few regulators and commentators, however, continue to advocate changes that would undermine the economic and investor benefits of money market funds by eliminating the stable $1.00 per-share price.

In our view, forcing money market funds to float their NAVs would harm investors, our members, and the broader U.S. economy. We thus strongly support maintaining the ability of money market funds to offer a stable $1.00 per-share value.

For investors, the stable NAV provides vital benefits. Investors purchase and redeem millions of dollars in money market fund shares every day. With a stable NAV, typically set at $1.00 per share, those investors are relieved of the burden of tracking gains or losses for tax or financial accounting purposes.

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To force floating NAVs would take away these benefits while risking the following negative effects:

- **Hobbling cash management**. Like many others, our members operate under investment constraints that require them to keep cash balances in accounts or products with stable principal value. If money market funds were required to float their NAVs, business would simply no longer be allowed use these funds to manage cash. Alternative funds are less regulated, less secure, and less liquid.

- **Driving up the cost of doing business**. Businesses and other institutions use money market funds to hold excess cash for short periods of time. Floating the NAV would undermine the convenience and simplicity using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. The consequences of such a move would increase costs and affect all sectors of the U.S. economy.

- **Increasing the cost of financing.** Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligation, such as funding payrolls, replenishing inventories, and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to businesses will be significantly disrupted.

- **Creating a financing gap**. Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure, and less liquid.

To avoid these negative consequences, we believe that any further reforms for money market funds must preserve their fundamental features. As Treasury Secretary Timothy Geithner recently noted, any further changes to money market funds must be made "without depriving the economy of the broader benefits that those funds provide."

Forcing the adoption of floating NAVs for money market funds would not add resilience, and it would destroy many economic benefits. We therefore oppose any proposals that would change the stable $1.00 value of money market funds.

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We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues.

Sincerely,

Beverlee J. McClure
President & CEO

CC: Chairman Spencer Bachus and Ranking Member Barney Frank

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Association for
Financial Professionals®

June 22, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett:

The Association for Financial Professionals (AFP) welcomes the opportunity to provide you and the Members of the Subcommittee with our thoughts on the various options currently being discussed relating to money market reforms, as you prepare for the hearing entitled Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence. AFP fully supports amending the current rules governing money market funds (MMFs) in a manner that encourages clear and concise transparency which not only protects investors, but provides them with the necessary information needed to make the most sound and practical investment decisions for their organizations. As such, AFP members have concerns regarding several options that have been presented throughout the course of the debate and we appreciate the opportunity to offer our thoughts to you.

AFP's membership includes more than 16,000 financial professionals employed by over 5,000 corporations and other organizations. AFP members represent a broad spectrum of financial disciplines and their organizations are drawn generally from the Fortune 1,000 and middle-market companies in a wide variety of industries, including manufacturing, retail, energy, financial services, universities/colleges and technology. Many AFP members manage their organization's investment portfolios and have an active interest and a sizable stake in the manner under which MMFs operate. The options discussed in the President's Working Group (PWG) on Financial Markets' study of possible MMF reforms report, address areas that are of critical importance to financial professionals. These professionals are responsible for directing the investment of corporate cash and pension assets for their organizations and are charged with considering action on all available investment alternatives to protect principal, ensure liquidity and prudently maximize returns. Financial professionals are unique in that they are responsible for observing business conditions that affect their organizations and making assumptions on how those conditions will change in both the short and intermediate term. In addition, they must also make critical business decisions—including those concerning corporate borrowing and business investment—based on those observations and assumptions.

AFP recognizes that concerns about the liquidity of MMFs played a role in exacerbating the financial crisis that began in September 2008. As a result, we have been and remain largely supportive of rules already enacted by the Securities and Exchange Commission (SEC) to improve the liquidity and transparency of MMFs. The impact of many of these rules, including the monthly reporting of each fund's shadow NAV, has not yet been fully felt in the market. We believe that these new rules instituted significant changes that will, on their own, substantially reduce the liquidity concerns and systemic risks posed by MMFs. AFP is in favor of allowing these recently-adopted rules to serve their intended purpose **before** instituting any of the PWG's proposals, which are likely to eliminate MMFs as a viable investment alternative for many corporate investors.

AFP offers the following comments on the various options presented by the PWG:

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Floating Net Asset Value (NAV) and a Two-Tier System of MMFs with Enhanced Protection for Stable NAV Funds

AFP opposes the proposal to eliminate the stable NAV in favor of a floating NAV, as we believe it would greatly reduce investors' interest in utilizing MMFs as a cash management and investment tool, whether applied to all investors or just institutional investors. For purchasers of MMFs, the return *of* principal is a much greater driver of the investment decision than return *on* principal. For a large number of institutional investors, the potential of principal loss would preclude floating NAV MMFs from being an internally approved investment alternative.

American businesses make their investment decisions based on many factors unique to their organizations. In many instances, MMFs are the vehicle that most closely matches the risk/return profile sought for surplus operating cash, as specified by a written investment policy. Changing to a floating NAV would significantly change the risk/return profile of MMFs.

In December 2010, AFP conducted a survey of its members on expected business conditions for 2011. The *2011 AFP Business Outlook Survey* included a number of questions on the role public policy may have on the business decisions that financial professionals will make in 2011. It specifically discussed the implications that recent proposals to have MMFs report a floating NAV would have on investment strategies and general business choices going forward. Our research indicated that a majority of financial professionals—54 percent—would *not* support dropping the $1.00 fixed asset value for money market funds for the implementation of a floating NAV. Just 14 percent would support such a move.

Four out of five organizations that currently include MMFs in their short-term investment portfolios would likely move at least some of these funds out of MMFs as a result of a shift to a floating NAV. Fifty-four (54) percent of survey respondents indicate that their organizations would shift corporate cash into bank deposits and U.S. Treasury securities. Twenty-two (22) percent would move funds out of MMFs and into non-2a & fixed-value investment vehicles (e.g., offshore money market funds, enhanced cash funds and stable value vehicles). Four percent (4) of survey respondents anticipate their organization would move funds currently in MMFs into other short-term, variable share price investments (e.g., ultra-short bond funds).

Moving to a floating NAV would have implications on the balance sheets of organizations according to many financial professionals. MMFs are currently treated as cash equivalents for accounting purposes because they are readily convertible to a known amount of cash. If corporations report balances of MMFs that use a floating NAV, those corporations will no longer be permitted to treat their investments as cash equivalents.

Due to these changes to the risk/return profile of MMFs and the accounting treatment of these instruments, many corporate investors will either be precluded from investing in MMFs, or will be required to modify their investment policies to allow for the flexibility to invest in instruments that fluctuate in value. Expanding permissible investments to allow for principal fluctuation may result in increased risk in corporate investment portfolios, as financial professionals could potentially be authorized to pursue other highly liquid, but riskier short-term investments, such as enhanced cash funds and short-term bond funds. More likely, organizations will choose to abandon MMFs as viable investment options.

The move to a floating NAV would also create significant disruptions in the corporate funding market. Many organizations issue commercial paper to meet their short-term financing needs, such as funding payroll, replenishing inventories, and financing expansion. Since the mid-1980s, MMFs have been major, reliable buyers of those securities and today purchase more than one-third of the commercial paper issued by American businesses. Should regulators eliminate the stable NAV of MMFs, some corporate investors will be forced to walk away due to mandatory investment guidelines that require a stable per-share value. The resulting reduction in MMF balances would reduce the capital available to purchase commercial paper, making short-term financing for these businesses less efficient and more costly.

AFP is not opposed to multiple investment options being available for corporate investors. The likely success of any individual investment product will be a function of the characteristics of the investment, measured against the needs of the investor. For example, a stable NAV MMF with a redemption-in-kind mechanism would not be attractive to corporate investors, who may not be willing to accept anything but the original investment in repayment. Corporate investors currently have the opportunity to purchase variable NAV MMF-like products. These are cash enhanced and separate-account investments. These products have not enjoyed the same success as stable NAV MMF products, due to the fact that the characteristics of the investment have not matched the needs of corporate investors.

Private Emergency Liquidity Facilities for MMFs and Insurance for MMFs

AFP opposes the introduction of a private emergency liquidity facility or insurance for MMFs. Corporate financial professionals recognize that there is liquidity risk associated with MMFs. Instituting a private liquidity backstop or insurance for MMFs could help to mitigate some of the systemic risk that MMFs cause to the system. However, AFP believes that the creation of this type of guarantee only attempts to morph MMFs into a more secure vehicle than they were ever intended to be, and results in investment characteristics that look very similar to bank deposits.

If a private emergency liquidity facility or insurance were put in place, AFP suggests that participation should be mandatory for all MMFs. Funding should be assessed fairly to each MMF using a risk-based approach.

It needs to be stated that there will always be a trade-off between risk and return. To the extent we increase the safety of MMFs through a private liquidity facility or insurance, the cost of the liquidity facility or insurance will ultimately be borne by the investor, resulting in a lower yield. Investors will have to determine whether they are interested in purchasing a safer but lower yielding investment.

Mandatory Redemptions in Kind

AFP strongly advises against the introduction of a redemptions-in-kind payment mechanism for MMFs. We believe such a payment mechanism would effectively render MMFs as an ineligible investment option for most corporate investors.

The focus of corporate investors is the preservation of principal and to maximize liquidity. The possibility that an organization would not receive cash as a result of a MMF redemption request, but instead may receive securities that it must attempt to liquidate on its own, would not provide adequate assurances of liquidity for most corporate investors. Therefore, AFP believes that any change that could result in investors receiving securities rather than cash in response to a redemption request would render MMFs as unattractive to most financial professionals.

Regulating Stable NAV MMFs as Special Purpose Banks

We believe that regulating MMFs as Special Purpose Banks (SPBs) would have the net effect of turning the MMF product into nothing more than a bank deposit. There is nothing wrong with bank deposits as an investment option, and in fact, bank deposits already represent a very large portion of corporate investment portfolios. However, we believe this option would have the net effect of removing an attractive investment alternative from the corporate investors' list of investment choices.

We appreciate the opportunity to provide our thoughts and offer data to some of the possible alternatives offered to reform the money market fund industry. If you have any questions about our comments, please contact Jeff Glenzer, Managing Director, at 301.961.8872 or jglenzer@AFPonline.org.

Sincerely,

James Kaitz

James A. Kaitz
President and CEO
Association for Financial Professionals

American Public Power Association
Council of Development Finance Agencies
Council of Infrastructure Financing Authorities
Government Finance Officers Association
International City/County Management Association
International Municipal Lawyers Association
National Association of Counties
National Association of Local Housing Financing Agencies
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National League of Cities
U.S. Conference of Mayors

June 23, 2011

The Honorable Scott Garrett
Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2344 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

We are pleased that the Capital Markets and Government Sponsored Enterprises Subcommittee is holding this hearing to look at the mutual funds market. We are particularly interested in money market mutual funds (MMMFs), due to our role as investors in these products, as well as issuers of municipal securities which are purchased by these funds. The state and local government groups listed above support initiatives that both strengthen money market funds and that ensure investors are investing in high-quality securities. However, we would like to voice our concerns about suggested changes to the structure of these funds, especially any changes from a stable to a floating net asset value (NAV).

Changing MMMFs from a fixed NAV to a floating NAV would dampen investor demand for the securities we offer and deprive state and local governments of much-needed capital. The fixed NAV is the fundamental feature of money market funds. Consider that MMMFs are the largest investor in short-term municipal bonds, holding 56% of all outstanding short-term bonds equaling nearly \$352 billion.[1] Creating a marketplace where the NAV changes from fixed to floating would make MMMFs far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt issuance costs for many state and local governments across the country.

Additionally, as investors, many state and local governments look to MMMFs as part of their cash management practice. In the Government Finance Officer Association Best Practice, "Use of Various Types of Mutual Funds by Public Cash Managers," governments are encouraged to look to money market funds for short-term investments, with appropriate cautions. One of the critical reasons for this recommendation is the fixed NAV found in these products. In fact, many governments have specific policies that mandate stable values, and money market funds are to be used for their short-term investments due to the fixed NAV. Furthermore, MMMFs are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked.

If the Securities and Exchange Commission were to adopt a floating NAV, the organizations listed above expect that many, if not all, of their members would divest a significant percentage of their investments in MMMFs and would have to look at competing products that, in turn, could be more susceptible to market conditions, more difficult to account for and manage, more likely to pose greater market risks, and more expensive, increasing the costs and fees associated with investing.

To avoid these negative consequences, we believe that any money market fund reforms must refrain from eliminating this fundamental feature.

Thank you for considering our concerns and for holding this hearing on mutual funds.

Sincerely,

American Public Power Association, Amy Hille, 202-467-2929
Council of Development Finance Agencies, Toby Rittner, 614-224-1300
Council of Infrastructure Financing Authorities, Rick Farrell, 202-547-1866
Government Finance Officers Association, Susan Gaffney, 202-393-8468
International City/County Management Association, Beth Kellar, 202-289-4262
International Municipal Lawyers Association, Chuck Thompson, 202-466-5424 x7110
National Association of Counties, Mike Belarimo, 202-942-4254
National Association of Local Housing Financing Agencies, John Murphy, 202-367-1197
National Assn. of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou, 202-624-5451
National Association of State Treasurers, Kevin Johnson, 202-624-8592
National League of Cities, Lars Etzkorn, 202-626-3173
U.S. Conference of Mayors, Larry Jones, 202-861-6709

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[1] Investment Company Institute, letter to SEC, January 10, 2011, page 16.

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21 June 2011

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Dear Mr. Secretary:

On behalf of the clients and employees of Davenport & Company LLC, I am writing to ask your consideration regarding the proposal to eliminate the stable net asset value ("NAV") per share of money market funds.

We support measures to enhance the regulatory framework governing money market funds, where necessary; however, we oppose steps that would require money market funds to abandon their stable per-share value. Preserving the stable NAV of money funds is vitally important to protecting the central role that money funds play in our investors' investment strategy. We urge you and the members of the President's Working Group on Financial Markets not to create a hardship for our clients by forcing them to dramatically alter their investment strategies.

Our clients currently rely on their money market funds to provide a high degree of liquidity, diversification, and stability in principal value, along with a market-based yield. It is a feature on almost every account in our firm, and the loss of this key benefit would create tremendous disruption. If money market funds were required to float their net asset values, we would no longer be able to use them to manage our clients' cash allocations and alternative investment options are wholly unsuited to this purpose. Based on a stable NAV, investors purchase and redeem millions of dollars in money market fund shares daily, and are relieved of the burden of tracking the gains or losses for tax accounting purposes. Requiring funds to float their value would make every single money market fund sale a tax-reportable event, increasing our overly-complex tax and recordkeeping burdens.

We respectfully urge you not to disrupt a key feature that, when appropriately managed and used, provides liquidity and flexibility to millions of individual investors. We greatly appreciate the efforts of the President's Working Group and support the goal of making our financial system stronger, and thank you for your work on behalf of investors everywhere.

Very truly yours,

Coleman Wortham, III

Coleman Wortham III
President & CEO

DALLAS REGIONAL CHAMBER®

Statement of the Dallas Regional Chamber on
The Subcommittee on Capital Markets and Government Sponsored Enterprises Oversight Hearing on Issues in the Mutual Fund Industry

Since 1909, the Dallas Regional Chamber (DRC) is a 501(c)6 not-for-profit organization committed to the betterment of and providing a public service to our region. Its membership consists of approximately 2,500 businesses across twelve counties representing nearly 600,000 employees. The DRC manages a wide variety of member engaging programs and events, is actively involved in public policy issues on the local, state, and national levels, is driven by a 91 member Board of Directors, and supported by several committees made up of more than 500 volunteer leaders. The DRC promotes prosperity through public policy, economic development and member engagement.

We are pleased that the Subcommittee is holding this hearing to explore the issues facing mutual funds and their investors. We wish to register our concerns regarding proposed changes to the structure of money market funds, particularly our strong opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

For investors, the stable NAV provides vital benefits. Investors purchase and redeem millions of dollars in money market fund shares every day. With a stable NAV, typically set at $1.00 per share, those investors are relieved of the burden of tracking gains or losses for tax or financial accounting purposes.

To force floating NAVs would take away these benefits while risking the following negative effects:

- **Hobbling cash management**. Many institutions operate under investment constraints that require us to keep our cash balances in accounts or products with stable principal value. If money market funds were required to float their NAVs, business like ours would simply no longer be allowed use these funds to manage cash. Alternative funds are less regulated, less secure, and less liquid.

- **Driving up the cost of doing business**. Businesses and other institutions use money market funds to hold excess cash for short periods of time. Floating the NAV would undermine the convenience and simplicity using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. The consequences of such a move would increase costs and affect all sectors of the U.S. economy.

- **Increasing the cost of financing.** Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligation, such as funding payrolls, replenishing inventories, and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to businesses will be significantly disrupted.

- **Creating a financing gap**. Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure, and less liquid.

We thus support maintaining the ability of money market funds to offer a stable $1.00 per-share value.

We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues.

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fei
financial executives international
www.financialexecutives.org

COMMITTEE ON CORPORATE TREASURY

June 24, 2011

The Honorable Scott Garrett
Chairman
House Financial Services
Subcommittee on Capital Markets
2129 Rayburn HOB
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services
Subcommittee on Capital Markets
B301 C Rayburn HOB
Washington, DC 20515

Re: Money Market Funds and the Need to Preserve Stable Net Asset Value (NAV)

Dear Chairman Garrett and Ranking Member Waters:

Given the hearing scheduled in the House Financial Services Subcommittee on Capital Markets to explore the issues facing mutual funds and their investors, I am writing on behalf of Financial Executives International (FEI)'s Committee on Corporate Treasury (CCT) to express our views on the need to preserve money market funds' stable net asset value (NAV) structure during continued discussions to reform these funds, and also express concerns with policy proposals requiring funds to float their value.

FEI is a professional association representing the interests of more than 15,000 chief financial officers, treasurers, controllers, tax directors, and other senior financial executives from over 8,000 major companies throughout the United States and Canada. FEI's CCT formulates policy positions regarding treasury matters for FEI in line with the views of the membership and when appropriate, works to educate relevant policymakers and regulators on issues impacting corporate treasurers.

Many corporate treasurers rely on money market funds for cash management purposes and investment. Businesses issue commercial paper to meet short-term financing needs such as funding payroll, replenishing inventories, and financing expansion, and money market funds have been major, reliable buyers of those securities. In fact, today money market funds purchase more than one-third of the commercial paper issued by American businesses.

While policymakers have made progress since the financial crisis in making money market funds a stronger tool for investment, we are concerned with recent comments by some regulators and policymakers who would seek to eliminate these funds' stable NAV, or $1.00 per-share price, and move to a floating NAV.

As one corporate treasurer stated during the recent U.S. Securities and Exchange Commission Money Market Funds and Systemic Risk Roundtable on May 10, corporate treasurers use money market funds as a diversification tool and are not financial institutions running investment houses. Therefore, company systems are not geared to mark-to-market on a daily basis and will have to pull out of money market funds if a floating NAV is adopted.

Floating the NAV may drive up the cost of doing business for many companies. This change could undermine the convenience and simplicity of using money market funds for cash management and instead confront businesses with new tax, accounting, and legal hurdles. To add concern to these proposals is that there are few immediate substitutes to fill the financing role money markets play.

Mandating a floating NAV would make short-term financing for American business less efficient and far more costly, ensuring a severe setback for a soft economy still rebuilding from the recent recession. We support maintaining the ability of money market funds to offer a stable $1.00 per-share value. We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues.

Sincerely,

S. M. Stalnecker

Susan Stalnecker
Chair
FEI's Committee on Corporate Treasury

Eckel, Scott

From: Lauren Hexton [lhexton@fortworthchamber.com]
Sent: Thursday, June 23, 2011 4:13 PM
To: Eckel, Scott
Subject: House of Representatives Subcommittee on Capital Markets and Government-Sponsored Enterprises - June 24th Oversight Hearing on issues in the Mutual Fund Industry

Mr. Eckel,

We are pleased that the Subcommittee is holding a hearing to explore the issues facing mutual funds and their investors. We wish to register our concerns regarding proposed changes to the structure of money market funds, particularly our opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

We thus support maintaining the ability of money market funds to offer a stable $1.00 per-share value.

For investors, the stable NAV provides vital benefits. Investors purchase and redeem millions of dollars in money market fund shares every day. With a stable NAV, typically set at $1.00 per share, those investors are relieved of the burden of tracking gains or losses for tax or financial accounting purposes.

To force floating NAVs would take away these benefits while risking the following negative effects:

- **Hobbling cash management**. Many institutions operate under investment constraints that require us to keep our cash balances in accounts or products with stable principal value. If money market funds were required to float their NAVs, business like ours would simply no longer be allowed use these funds to manage cash. Alternative funds are less regulated, less secure, and less liquid.

- **Driving up the cost of doing business**. Businesses and other institutions use money market funds to hold excess cash for short periods of time. Floating the NAV would undermine the convenience and simplicity using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. The consequences of such a move would increase costs and affect all sectors of the U.S. economy.

- **Increasing the cost of financing.** Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligation, such as funding payrolls, replenishing inventories, and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to businesses will be significantly disrupted.

- **Creating a financing gap**. Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure, and less liquid.

We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues.

Sincerely,

Bill Thornton

Bill Thornton
President and CEO
Fort Worth Chamber of Commerce

Greater Boston Chamber The Hub of Business

June 16, 2011

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

The Greater Boston Chamber of Commerce wishes to register its opposition to some of the proposed money market fund reforms that are currently before this subcommittee. Specifically, the Chamber is concerned about the impact of proposals that would require money market funds to maintain a floating Net Asset Value (NAV), and would require the funds to be subject to bank-like regulation and capital reserves. Implementation of these reforms could drastically change the nature of money market funds, and could threaten the continued existence of these important and already highly-regulated investment products.

As a broad-based business organization, the Chamber represents a diverse range of industries that rely on money market funds to support their capital raising and investment needs. Forcing money market funds to abandon their traditional, stable per-share value, whether directly or indirectly, or subjecting the funds to onerous new regulatory and capital reserve requirements could impact the viability of these funds – as both an investment option and source of short-term financing for businesses.

Mandating a floating NAV could force some investors to walk away due to mandatory investment guidelines requiring a stable per share value, and lead others to take their money elsewhere after the simplicity and convenience of a stable NAV disappears. The imposition of additional regulatory requirements could further diminish the attractiveness of money market funds to the investor community. This investor migration could make short-term business financing less efficient and far more costly.

Money market funds remain substantial buyers of short-term debt securities and are estimated to purchase more than one-third of the commercial paper issued by U.S. businesses today. A reduction in money market fund assets, due to well-intentioned but overreaching new regulations and requirements, could in turn reduce the demand for commercial paper and increase interest costs to issuers.

Companies relying on money market funds to purchase their commercial paper could find it harder to fund payroll, replenish inventories, and finance expansion. Impairing the ability of companies to raise capital in the U.S. at this time could impact the nation's ability to achieve the levels of investment, expansion, and hiring needed to sustain an economic recovery.

The Chamber supports appropriate steps taken by the Securities and Exchange Commission, the Federal Reserve Board, the Department of the Treasury, and the Congress to preserve and strengthen this vital source of business financing. We respectfully ask you to oppose requirements which would alter the long-standing tradition of a stable NAV for money market funds or impose onerous new regulatory and bank-like capital reserve requirements on these funds.

We thank you in advance for your time and consideration of the Chamber's comments on this important matter.

Sincerely,

Paul Guzzi

Paul Guzzi
President & CEO

CC: Chairman Spencer Bachus and Ranking Member Barney Frank

National Association of Corporate Treasurers

Treasurers Talking to Treasurers

Statement of the National Association of Corporate Treasurers on
The Subcommittee on Capital Markets and Government Sponsored Enterprises
Oversight Hearing on Issues in the Mutual Fund Industry

The National Association of Corporate Treasurers has approximately 230 members who manage the treasury function at some of America's leading corporations. Our members represent companies comprising different industries such as manufacturing, transportation, finance and service, with many included in the Fortune 500 index of largest corporations. Corporate cash management, both the investment of surplus cash and the borrowing of short term cash for funding needs, is an important daily activity for our corporate treasurers. Many of them rely on money market funds to meet these daily cash management requirements.

NACT is pleased that the Subcommittee is holding this hearing to explore the issues facing mutual funds and their investors. We wish to register the concerns of our membership regarding proposed changes to the structure of money market funds, particularly our strong opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

Our members rely upon money market funds as powerful tools for managing cash. Since the financial crisis of 2007–2009, policymakers have made great progress in making money market funds even stronger. A few regulators and commentators, however, continue to advocate changes that would undermine the economic and investor benefits of money market funds by eliminating the stable $1.00 per-share price.

In our view, forcing money market funds to float their NAVs would harm investors, companies our members serve, and the broader U.S. economy. We thus strongly support maintaining the ability of money market funds to offer a stable $1.00 per-share value.

For investors, the stable NAV provides vital benefits. As managers of corporate cash, NACT members purchase and redeem millions of dollars in money market fund shares every day. With a stable NAV, typically set at $1.00 per share, corporations are relieved of the burden of tracking gains or losses for tax or financial accounting purposes.

12100 Sunset Hills Road | Suite 130 | Reston, Virginia 20190
703-437-4377 | FAX: 703-435-4390 | E-MAIL nact@nact.org | www.nact.org

To force floating NAVs would take away these benefits while risking the following negative effects:

- **Driving up the cost of doing business.** Businesses and other institutions use money market funds to hold excess cash for short periods of time. Floating the NAV would undermine the convenience and simplicity of using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. The consequences of such a move would increase costs to companies in our NACT membership.

- **Increasing the cost of financing.** Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligations, such as funding payrolls, replenishing inventories, and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to investment grade companies will be significantly disrupted. The spillover from that disruption could affect other companies that rely upon bank and other sources of financing.

- **Creating a financing gap.** Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure, and less liquid.

To avoid these negative consequences, we believe that any further reforms for money market funds must preserve their fundamental features. As Treasury Secretary Timothy Geithner recently noted, any further changes to money market funds must be made "without depriving the economy of the broader benefits that those funds provide."

Forcing the adoption of floating NAVs for money market funds would destroy many economic benefits. We therefore oppose any proposals that would change the stable $1.00 value of money market funds.

If you would like further information on NACT's views, please contact current Board member and former NACT Chairman, Brad Fox at brad.fox@safeway.com or 925-467-3352. Additional information about NACT is available at www.nact.org.

NACT thanks the Subcommittee for holding this hearing and for the work it is doing to address these issues.

New Jersey Business & Industry Association

Celebrating a Century of Service to NJ Business

GOVERNMENT AFFAIRS TEAM

Melanie Willoughby
Senior Vice President

Frank Robinson
First Vice President
Grassroots & Government Affairs

David Brogan
First Vice President
Taxation & Economic Development

Christine Stearns
Vice President
Health & Legal Affairs

Sara Bluhm
Vice President
Environment, Energy & Federal Affairs

Stefanie Riehl
Assistant Vice President
Employment and Labor

Jaime Reichardt, Esq.
Director
Taxation & Workforce Development

June 20, 2011

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

The New Jersey Business & Industry Association is an employer association providing information, services and advocacy for its member companies in order to build a more prosperous New Jersey. Today, our 22,000 members represent every industry in the State, including manufacturers, service providers, retailers, wholesalers, builders, engineers, you name it. As a group, our members employ more than one million people. That's one-third of the State's private-sector workforce. Three-quarters of our members are small companies with fewer than 25 employees.

NJBIA is pleased that the Subcommittee is holding this hearing to explore the issues facing mutual funds and their investors. Our Association appreciates the opportunity to register our concerns regarding proposed changes to the structure of money market funds, particularly our strong opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

Businesses within New Jersey rely upon money market funds as powerful tools for managing cash. Since the financial crisis of 2007–2009, policymakers have made great progress in making money market funds even stronger. A few regulators and commentators, however, continue to advocate changes that would undermine the economic and investor benefits of money market funds by eliminating the stable $1.00 per-share price.

For investors, the stable NAV provides vital benefits. Investors purchase and redeem millions of dollars in money market fund shares every day. With a stable

NAV, typically set at $1.00 per share, those investors are relieved of the burden of tracking gains or losses for tax or financial accounting purposes. To force floating NAVs would take away these benefits while risking the following negative effects:

- **Hobbling cash management.** Like many others, businesses in New Jersey operate under investment constraints that require them to keep cash balances in accounts or products with stable principal value. If money market funds were required to float their NAVs, business would simply no longer be allowed use these funds to manage cash. Alternative funds are less regulated, less secure, and less liquid.

- **Driving up the cost of doing business.** Businesses and other institutions use money market funds to hold excess cash for short periods of time. Floating the NAV would undermine the convenience and simplicity using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. The consequences of such a move would increase costs and affect all sectors of the U.S. economy.

- **Increasing the cost of financing.** Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligation, such as funding payrolls, replenishing inventories, and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to businesses will be significantly disrupted.

- **Creating a financing gap.** Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure, and less liquid.

To avoid these negative consequences, NJBIA believes that any further reforms for money market funds must preserve their fundamental features. As Treasury Secretary Timothy Geithner recently noted, any further changes to money market funds must be made "without depriving the economy of the broader benefits that those funds provide."

Forcing the adoption of floating NAVs for money market funds would not add resilience, and it would destroy many economic benefits. We therefore oppose any proposals that would change the stable $1.00 value of money market funds.

We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues.

THE STATE CHAMBER

June 21, 2011

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

Re: The Subcommittee on Capital Markets and Government Sponsored Enterprises Oversight Hearing on Issues in the Mutual Fund Industry

The New Jersey Chamber of Commerce is a business advocacy organization that represents its members on a wide range of business issues at the state and federal level. We represent 1,500 member companies of all sizes and industries.

We are pleased that the Subcommittee is holding this hearing to explore the issues facing mutual funds and their investors. We wish to register our concerns regarding proposed changes to the structure of money market funds, particularly our strong opposition to proposals that would force these funds to abandon their stable $1.00 per-share price and instead "float" their net asset values (NAVs).

The employer community relies upon money market funds as powerful tools for managing cash. Since the financial crisis of 2007–2009, policymakers have made great progress in making money market funds even stronger. A few regulators and commentators, however, continue to advocate changes that would undermine the economic and investor benefits of money market funds by eliminating the stable $1.00 per-share price.

In our view, forcing money market funds to float their NAVs would harm investors, New Jersey businesses, and the broader U.S. economy. We thus strongly support maintaining the ability of money market funds to offer a stable $1.00 per-share value.

For investors, the stable NAV provides vital benefits. Investors purchase and redeem millions of dollars in money market fund shares every day. With a stable NAV, typically set at $1.00 per share, those investors are relieved of the burden of tracking gains or losses for tax or financial accounting purposes.

To force floating NAVs would take away these benefits while risking the following negative effects:

- Hobbling cash management. Many businesses operate under investment constraints that require them to keep cash balances in accounts or products with stable principal value. If money market funds were required to float their NAVs, these businesses would no longer be allowed to use these funds to manage cash. Alternative funds are less regulated, less secure, and less liquid.

- Driving up the cost of doing business. Businesses and other institutions use money market funds to hold excess cash for short periods of time. Floating the NAV would undermine the convenience and simplicity of using money market funds for cash management by confronting businesses with new tax, accounting, and legal hurdles. The consequences of such a move would increase costs and affect all sectors of the U.S. economy.

- Increasing the cost of financing. Money market funds hold more than one-third of the commercial paper that businesses use to meet short-term obligations, such as funding payrolls, replenishing inventories, and financing expansion. If proposed reforms drive investors out of money market funds, the flow of short-term capital to businesses will be significantly disrupted.

- Creating a financing gap. Few immediate substitutes are available to fill the financing gap that would be created by a rapid shrinkage of money market funds. Even if banks could raise the new capital needed to meet corporate and municipal demand, the lending market would be less efficient and costs would rise. Alternative funds are less regulated, less secure, and less liquid.

To avoid these negative consequences, we believe that any further reforms for money market funds must preserve their fundamental features. As Treasury Secretary Timothy Geithner recently noted, any further changes to money market funds must be made "without depriving the economy of the broader benefits that those funds provide."

Forcing the adoption of floating NAVs for money market funds would not add resilience, and it would destroy many economic benefits. We therefore oppose any proposals that would change the stable $1.00 value of money market funds.

We thank the Subcommittee for holding this hearing and for the work it is doing to address these issues.

CC: Chairman Spencer Bachus and Ranking Member Barney Frank

New Jersey Chamber of Commerce, 216 West State Street, Trenton, NJ 08608

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LEGISLATIVE VIEWPOINT

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June 22, 2011

Hon. E. Scott Garrett
Congressman, District Four
137 Cannon House Office Building
Washington, D.C. 20515

RE: Request for Consideration SEC Proposal Could Damage Local Finance

Dear Congressman Garrett:

On Friday, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises is holding a general oversight hearing on mutual funds. While the hearing is not on any particular issue, the National league of Cities (NLC) – along with a broad coalition of financial services and public sector groups – is using the opportunity to express concern about an idea suggested by the Securities and Exchange Commission (SEC) to fundamentally alter money markets so they would have a floating NAV (net asset value), instead of the constant value they do today.

Money market mutual funds play a vital role in the economy, providing local governments, among others, short-term funding and convenient cash-management.

Currently, SEC Rule 2a-7 includes many protections for money market mutual fund customers. A distinctive feature of money market mutual funds is the stable $1.00 NAV, meaning investors can expect to get back at least one dollar for every dollar they invest in the fund, with moderate risk and return. This provides stability and liquidity for investors, including local governments.

NLC opposes moving to a floating NAV, because it would have significant negative effects for municipalities. Some key points to consider:

- A floating NAV will limit the number of investment product options available to government investors, potentially resulting in higher costs and lower returns for hometowns.
- A floating NAV will likely lead to an increase in accounting and record keeping requirements for government investors, which will make it very difficult for hometowns to use money market mutual funds for their daily cash management needs.

- A floating NAV will likely result in a decrease in demand for money market mutual funds. The decrease in demand will likely lead to a severe contraction in the availability of funding for many enterprises, including municipalities.

In summary, moving to a floating NAV would radically change the value money market mutual funds provide to local governments.

Again, while there is no specific proposal before the House Subcommittee on Capital Markets, NLC is using the oversight hearing to re-state our opposition to a floating NAV to help ensure the idea does not gain traction.

The New Jersey State League of Municipalities supports the position taken by the National League of Cities. We, respectfully, request your consideration of our concerns.

If you or your staff have any questions, please contact Senior Legislative Analyst Jon Moran at 609-695-3481, ext. 121 or jmoran@njslom.com.

Very truly yours,

William G. Dressel, Jr.
Executive Director

WGD:jm/sc

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D.C. 20062-2000
202/463-5310

June 23, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

The U.S. Chamber of Commerce, the world's largest business federation, representing the interests of over three million businesses and organizations of every size, sector, and region, believes that a coherent, stream-lined regulatory structure and effective commonsense regulations will ensure the safety and soundness of the financial markets while promoting economic growth and job creation.

As the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises holds a hearing entitled "Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence," it is important to highlight that money market fund reform would have far ranging implications for the mutual fund industry, their investors and the American economy.

In October 2010, the President's Working Group on Financial Markets proposed several reform options that would make structural changes to money market funds. Among these options is a requirement that money market funds float the net asset value, whereas the current practice for funds is to maintain a stable $1.00 price per share value. The Chamber strongly opposes the proposal to abandon the stable per share value. Shifting to a floating net asset value would leave a noticeable void as there are no ready, affordable alternatives to money market funds. Moreover, it would not accomplish the fundamental reform goal of preventing another run on the money, but rather add risk to the financial system.

Money market funds allow businesses and institutional investors to efficiently and affordably manage liquidity as funds can be invested and withdrawn on a daily basis. The stable net asset value makes money market funds an attractive investment product for excess cash because of its convenience and simplicity. The cost and complexity of accounting for money market fund investments with a floating net asset value will lead corporate treasurers and institutional investors to find other investment vehicles to place excess cash. Additionally, many businesses have investment policies that preclude corporate treasurers from investing cash in anything other than stable value accounts. Institutional investors, too, may be restricted by law or investment policy from investing in a product with a floating value.

Flight from money market funds will have significant consequences, shrink the capital pool and make financing less available and less affordable for commercial paper issuers. Businesses issue commercial paper to meet short-term financing needs such as payroll and inventory. For decades, money market funds have been major, reliable purchasers of commercial paper issued by businesses. With a shrinking money market capital pool, businesses will be forced to find alternative financing sources that are more costly and less flexible. Bank lending does not have the capacity to replace the void that would be left by a defunct $1.1 trillion commercial paper market. While larger businesses will almost always secure bank financing because of their sheer size and creditworthiness, smaller businesses in need of growth capital will struggle to compete for bank financing. Inevitably, there will be a ripple effect to the American economy, endangering the already fragile economic recovery.

If significant fundamental changes are made to money market funds making them less attractive investments, investors may seek investments in other, less regulated products. Encouraging investors to migrate to less regulated investment vehicles is not consistent with efforts to reduce risk, increase market transparency, and ensure greater market stability. Concentrating investments choices in a more narrow band of financial products and institutions increases systemic risk and weakens the stability of the financial markets.

The Chamber supports appropriate steps to preserve and strengthen money market funds as a vital source of business financing and investment. Last year, the Securities and Exchange Commission adopted new safeguards through changes to Rule 2a-7 of the Investment Company Act of 1940, including enhanced liquidity requirements and tightening existing investment and disclosure rules. Corporate treasurers are already experiencing the impact of these changes in their commercial paper programs. As the Committee conducts oversight of the mutual fund industry, the Chamber recommends that regulators fully consider and anticipate the potential unintended consequences of any reforms to the money market industry and that implemented reforms do not make the money market industry less useful as a source of investing and financing for main street businesses.

The Chamber looks forward to working with the Subcommittee on this issue and others to ensure the vibrancy of the American capital markets.

Sincerely,

R. Bruce Josten

R. Bruce Josten

cc: Members of the House Committee on Financial Services

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Don't hobble money market funds

Print

By Robert Pozen and Theresa Hamacher
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Money market funds are under regulatory attack Their critics are calling for radical change in how these funds operate, proposing that money market funds either be prohibited from maintaining a constant $1 share price or required to maintain a substantial cushion against potential losses

These proposals would threaten the viability of an investment vehicle that has been an attractive alternative to banks for individual savers, businesses, and local governments

The critics contend they are correcting weaknesses in money market funds that were unmasked by the credit crisis

In 2008, one US money market fund, the Reserve Primary Fund, "broke the buck", meaning that it could no longer maintain a $1 share price because of losses on securities held within the fund To ensure that the Reserve Fund's problems did not spark a rush of fund redemptions throughout the industry, the US Treasury stepped in with a guarantee programme, which temporarily protected fund shares against loss.

In their rush to "fix" money market funds, however, critics are undervaluing the significant benefits the funds provide to investors and issuers

For individual consumers, money market funds normally have higher yields than bank passbook savings accounts that provide the same ready access to funds. To obtain higher rates at the bank, investors must give up daily liquidity – by committing to a three-month investment in a certificate of deposit, for example – and maintain a larger minimum investment.

US money market funds also provide retail investors with an option that is not available at the bank: they can invest in a tax-exempt fund that buys
short-term instruments issued by state and local governments. These securities are exempt from federal income taxes, a tax benefit that is passed on to shareholders.

On the negative side, money market fund investments are not covered by federal deposit insurance, which covers US bank deposits against loss up to $250,000 per account

Businesses, however, often hold cash balances exceeding this insurance limit, so many invest part of their cash in money market funds to diversify their risk. In 2010, the average non-financial business in the US held 25 per cent of its cash in money market funds

Money market funds benefit businesses in another way they provide a significant source of funding Today, money market funds buy one-third of all the commercial paper issued by US companies They play a similar role for state and local governments, owning $330bn in municipal obligations.

For both businesses and governments, money market funds serve as an important alternative to banks. Competition between funds and banks drives down the interest rates they must pay on short-term borrowings. Their funding costs would surely rise if money market funds were no longer able to compete effectively

Yet the latest set of reform proposals, if implemented, could well hobble money market funds, to the point where they are no longer an attractive option for investors or borrowers.

The proposals for a floating share price, in place of a stable $1 per share, would make money market funds less attractive to consumers With a fluctuating share value, money market funds would be much less attractive to conservative investors who want to earn interest on short-term cash without incurring either capital gains or losses

At the same time, requiring funds to hold some sort of a cushion against losses, in the form of a liquidity facility, earnings reserve or capital position, will increase the cost of managing money market funds Higher costs ultimately translate into lower yields, making funds less appealing to all types of investors.

Money market fund yields are already under pressure, because of the tighter investment restrictions that the Securities and Exchange Commission imposed in 2010. The new rules lowered limits on average maturity, raised liquidity requirements and upped quality standards – thereby reducing portfolio risk. But these new rules will also lower the yields of money market funds, making them less competitive with banks

The new SEC rules will substantially reduce the chance of any money market fund "breaking the buck" To provide yet more protection, every fund should change the way it handles large redemptions by institutional investors – redemptions that played a major part in the only two instances when a fund broke the buck

Money market funds usually sell securities in order to pay cash to the redeeming investor We suggest funds make greater use of existing rules that allow them to meet redemptions "in kind" and give the investor a proportional share of all the securities held by the fund This approach would reduce systemic risk without reducing the yields of money market funds

Would the remaining risk to money market funds be worth the benefits to investors seeking the best yield for their cash and issuers looking for the lowest rate on their short-term borrowings? The answer seems clear

Robert Pozen is a senior lecturer at Harvard Business School and a senior fellow at the Brookings Institution This piece was co-authored
by Theresa Hamacher, president of Nicsa (National Investment Company Service Association) Both are co-authors of The Fund Industry How Your Money is Managed (Wiley, 2011)

STATEMENT OF FEDERATED INVESTORS, INC.

SUBMITTED TO THE

SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

ON
"OVERSIGHT OF THE MUTUAL FUND INDUSTRY: ENSURING MARKET STABILITY AND INVESTOR CONFIDENCE"

June 24, 2010

Introduction

We appreciate the opportunity to submit this statement for the Subcommittee's hearing to explore the issues facing mutual funds and their investors. Federated Investors, Inc. ("Federated") supports the remarks of Paul Stevens, Chief Executive Officer of the Investment Company Institute ("ICI"), and the ICI's Statement. We make this Statement to reiterate our opposition to proposals to eliminate money market funds by requiring them either to convert to a floating Net Asset Value ("NAV") or to otherwise make fundamental structural changes.

Federated has more than thirty-five years of experience in managing money market funds through many business cycles and ups and downs in the market. None of our money market funds has ever "broken the buck" (*i.e.*, failed to maintain a stable $1 value). With 134 funds and a variety of separately managed account options, Federated provides comprehensive investment management to a broad range of investors.

Federated is currently the third largest manager of money market funds in the United States. Federated pioneered the money market fund by obtaining the very first exemptive order from the Securities and Exchange Commission in 1979 enabling the valuation of portfolio securities at amortized cost. These amortized cost exemptive orders ultimately led to the SEC's promulgation of Rule 2a-7 under the Investment Company Act of 1940.

Most people would agree that "As a general matter, money market funds have been a safe and sound investment for institutional and individual investors for more than twenty-five (25) years" (Comments of the Coalition of Mutual Fund Investors (Sept. 10, 2009))[1] and "that MMFs historically have been a paragon of stability" (Comments of Fund Democracy and the Consumer Federation of America (Sept. 8, 2009)).[2] This is largely a result of prudent regulation: the successful product of decades of cautious oversight by SEC over the development of a safe and reliable means for investors to obtain market rates of return on their cash investments, through the application of very conservative rules for money market fund's structure, operations and assets. This stewardship produced the first major regulatory changes to emerge after the crisis in 2008, when the SEC (with the support of the industry) amended money market fund regulations at the beginning of 2010 to further enhance liquidity and credit quality of money market funds. As a result of these regulations, money market funds, which currently hold $2.75 trillion in assets, represent one of the largest sources of short-term funding for our financial markets and, in Federated's estimation, have provided at least $500 billion of additional income to investors during the past twenty-five years.

In responding to the President's Working Group on Financial Markets' study of possible changes to money market funds in response to the crisis (the "PWG

[1] Available at http://www.sec.gov/comments/s7-11-09/s71109-135.pdf.

[2] Available at http://www.sec.gov/comments/s7-11-09/s71109-79.pdf.

Report"),[3] which included proposals to eliminate money market funds by requiring them either to convert to a floating NAV or to convert into banks, Federated made detailed and fully substantiated arguments regarding the tremendous benefits that money market funds bring to the U.S. economy and the catastrophic consequences of their elimination. Federated has also submitted comments to the banking regulators in connection with rulemaking proposals to implement Titles I and II of the Dodd Frank Act. These comment letters are referenced for the record and are as follows:

- John W. McGonigle, Vice Chairman, Federated Investors, Inc., Jan. 7, 2011, available at http://www.sec.gov/comments/4-619/4619-15.pdf ("1/7/2011 Comment Letter");
- John D. Hawke, Jr., on behalf of Federated Investors, Feb. 24, 2011, available at http://www.sec.gov/comments/4-619/4619-82.pdf ("2/24/2011 Comment Letter");
- John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., Mar. 15, 2011, available at http://www.sec.gov/comments/4-619/4619-89.pdf ("3/15/2011 Comment Letter");
- John W. McGonigle, Vice Chairman, Federated Investors, Inc., Mar. 25, 2011, available at http://www.sec.gov/comments/4-619/4619-83.pdf ("3/25/2011 Comment Letter");
- John W. McGonigle, Vice Chairman, Federated Investors, Inc., May 19, 2011, available at http://www.sec.gov/comments/4-619/4619-101.pdf ("5/19/2011 Comment Letter"); and
- John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to Federal Reserve Board and FDIC, June 10, 2011, available at http://www.federalreserve.gov/SECRS/2011/June/20110621/R-1414/R-1414_061011_81322_587072501071_1.pdf ("6/10/2011 Comment Letter").

We believe requiring a floating NAV or capital requirements will either directly or effectively kill the money market fund as a cash management vehicle. The record is extensive and clear that many cash investors do not want and will not use a floating NAV fund for cash investments. At a time when money market funds are

[3] The PWG Report was published for comment in Release No. IC-29497, President's Working Group Report on Money Market Funds (Nov. 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf.

offering annual yields of two basis points, the ability to invest on a "dollar-in/dollar-out" basis is the only plausible explanation for why money market funds continue to attract nearly $2.75 trillion in assets. Much of this money would leave the funds if they were forced to convert to a floating NAV. (1/7/2011 Comment Letter at 6.) Capital requirements, on the other hand, would have the same effect by completely eliminating any yield advantage to investing in a prime fund, which would result in investors moving en masse to government money market funds.

The following will, first, summarize the core arguments in favor of the continuation of money market funds, and second, address proposals that would change the structure of a money market fund to add a capital requirement.

Arguments in Favor of the Continuation of Money Market Funds

Money Market Funds Are a Vital Source of Funding for Our Economy. Money market funds provide critical financing to every sector of the short-term credit market. Money market funds held an estimated 36% of the Treasury bills outstanding at the end of 2010,[4] and typically hold approximately 30% of repurchase agreements, 40% of commercial paper and 80% of short-term municipal securities. (1/7/2011 Comment Letter at 4.)

Money Market Funds Have Added $500 Billion to America's Checkbook. Money market funds provide an important alternative to bank accounts for cash investments, offering higher yields than deposit accounts under normal market conditions. Federated has estimated that these higher yields have added at least $500 billion to investor returns over the past twenty-five years. (1/7/2011 Comment Letter at 3-4.) This is a conservative estimate, as it is unlikely that yields

[4] Based on information contained in the 2011 Investment Company Act Fact Book and the Treasury Department's Monthly Statement of the Public Debt for December 31, 2010.

on bank deposits would have been as high without competitive pressure from money market funds.

Eliminating Money Market Funds Would Make Systemically Significant Banks Even More Significant and Increase the Size of the Federal Safety Net. Investors leaving money market funds would look primarily for other stable value investments. This means that a substantial portion of the cash currently held in money market funds would flood into banks as deposits. In fact, six of the largest U.S. bank holding companies currently control some $800 billion in money market funds assets. If money market funds are eliminated, these banks are unlikely to redirect this cash into financial products they do not control. Elimination of money market funds will therefore increase the size of banks already found to pose systemic risks to the financial system. (1/7/2011 Comment Letter at 7.) These additional deposits would significantly increase the size of the deposit base of banks subject to an explicit federal guarantee. This increase in the size of the federal safety net is exactly what Title I of the Dodd-Frank Act was intended to prevent.

Eliminating Money Market Funds Would Create a Credit Crunch in the Short-Term Funding Markets. A wholesale shift of cash from money market funds to banks would require banks to raise tremendous amounts of capital at a time when banks are already short of capital. To attract this capital, banks would have to make more profitable investments than the short-term obligations typically held by money market funds. This means that borrowers will find it harder to obtain short-term financing from banks and short-term interest rates will rise. (3/15/2011 Comment Letter at 5.) In other words, eliminating money market funds would create a "credit crunch" for high quality short-term borrowers while increasing the propensity of systemically significant banks to make riskier investments. This is hardly the formula for an economic recovery or for financial stability.

Eliminating Money Market Funds Will Increase the Level of Risk in the Financial System. Cash that was not shifted to bank deposits after the elimination of money market funds would probably flow into offshore funds or to unregulated alternative stable value products. Institutions would lose the benefit of professional management and diversification of their cash investments, and would probably become more reliant on rating agencies for credit analysis. This would necessarily increase the overall risks taken by cash investors. (1/7/2011 Comment Letter at 8.)

Money Market Funds Have Proven to Be More Resilient than Other Major Financial Institutions. Money market funds weathered the financial crisis far better than banks, brokers, insurance companies or government sponsored enterprises. Only one money market fund "broke a dollar"(it paid out over 99 cents per dollar to investors) during the crisis, the other 806 money market funds in operation in 2008 did not break a buck and more than 95% of those funds did not receive any support from their sponsors. In the forty years that money market funds have been in operation only one other fund has broken the buck, and it paid out ninety-six cents on the dollar to investors. The government did not bail out these investors.

In contrast, during the crisis, more than 350 FDIC-insured banks failed. Over the past 40 years more than 2800 insured banks have failed, at a cost to the government of more than $188 billion. These losses in the banking industry are all the more startling when one considers that the federal banking agencies have a staff of 26,000 personnel overseeing banks. Money market funds did not hold any "toxic" assets requiring a government bailout and large scale redemptions from the prime funds (the consequence of a general flight from credit risk during the crisis) were stopped by a limited and temporary guarantee program. (2/24/2011 Comment Letter at 3-5.) The government turned a profit on this program and was not required to make any payouts to investors. If banks and brokers were as resilient as money market funds, the financial crisis would have been resolved by the end of 2008 at no cost to taxpayers.

Money Market Funds Have No Interest in a "Taxpayer Bailout." Since the financial crisis, Federated and the industry have consistently sought market-based solutions to any residual concerns about money market funds, paid for by the funds' advisers and investors. There are currently no "moral hazards" involved in managing the funds and we have no desire to create any. Yet many regulators continue to refer to an "implicit government guarantee" for money market funds and propose to increase investors' expectations that someone else will bear any losses incurred by their fund. Such public statements are counterproductive to the reform efforts and run the risk of confusing investors. (5/19/2011 Comment Letter at 1-2.)

Simpler Is Better. In an era of constrained federal budgets and severe limits on the ability of the federal government to finance future bail-outs or pay for a massive federal regulatory oversight staff, the simple and very conservative model used by the SEC in regulating and supervising money market funds should serve as a model for the way to proceed. Money funds are able to maintain their stable net asset value of $1 per share not because of an accounting rule, but because they are allowed to invest only in very short term, very high quality debt securities. Money funds do not use leverage, and are instead financed 100% by shareholder equity. Fundamental changes to this program of regulation would increase risk, not reduce it. Applying the failed model of federal bank regulation to money market funds is simply the wrong way to go.

Response to Proposals to Create Capital Requirements for Money Market Funds

As detailed in the ICI Statement, the SEC has acted to improve the ability of money market funds to withstand systemic events or shocks by amending Rule 2a-7. These changes have imposed a tangible, measurable cost in terms of reduction in yield to investors. Money market funds and their investors bear this additional cost in order to achieve the benefit of reducing systemic risk.

Some proposals, such as those of the so-called Squam Lake Group (the "Squam Lake Proposal"), would require either the fund or its adviser to maintain capital to protect the shareholders from losses incurred on the portfolio. These proposals are likely to be so costly that they would have the effect of killing the funds. In other words, the cost of trying to eliminate the risk of a money market fund ever breaking a dollar would be the complete loss of the benefits of money market funds.

At bottom, the Squam Lake Proposal would change money market funds into banks, by creating a junior layer of capital (either the adviser's or a series of non-redeemable shares) to protect the shareholders from losses. Nothing in the history of financial regulation suggests that this structure will work in a major financial crisis. In fact, it is the same structure used by collateralized debt obligations and structured investment vehicles, both of which were among the first financial entities to collapse during the recent financial crisis. (2/24/2011 Comment Letter at 6-7.)

Another problem with the Squam Lake Proposal is that it would decrease the stability of the market by replacing default risk with funding risk. The proposal would require funds that cannot meet the capital requirements to liquidate or convert to a floating NAV. A fund whose growth outstripped its capital raising abilities would have to shut down and liquidate its assets, even if there was nothing wrong with its portfolio. This would create entirely arbitrary disruptions in the financial markets. (3/25/2011 Comment Letter at 8).

The ultimate problem with the Squam Lake Proposal and similar proposed capital requirements is that they would be too costly. Money market funds are highly efficient investments, with total operating expenses normally measured in tenths of a percent. Moreover, the difference between yields on prime and government money market funds are small, often no more than 10 basis points. This leaves little room for prime funds to increase their expenses in order to pay for capital to protect shareholders.

Advocates for using capital (whether held in the fund or provided by the adviser) to prevent money market funds from breaking a dollar have ignored these economic constraints. Even a 2% capital requirement would represent over a dozen years of advisory fees for managing a money market fund, and the cost of such capital could nearly double a fund's expense ratio. (3/25/2011 Comment Letter at 8-9). Prime funds cannot afford to attract enough capital to absorb losses on defaulted securities or to compensate their advisers for taking on this risk and still offer a significant yield advantage over government funds. The economic reality is that money market funds can only afford to build capital slowly up to a relatively small amount.

This is why Federated believes efforts to use capital to prevent money market funds from ever breaking a dollar cannot succeed, and why we advocate focusing on ways to limit the impact of such events on the rest of the industry and the general market. The liquidity requirements added to Rule 2a-7 have already done much to limit the potential impact of a fund breaking a dollar. All funds can now redeem up to 30% of their shares without selling a single security. Even in severely distressed markets, money market fund holdings are so short-term and high quality that they could sell a substantial portion of their other assets without adding significantly to the market disruption.

If more is needed to contain the impact of a fund breaking a dollar, Federated would recommend using the limited resources of prime funds to enhance their response to such an event. We note that the industry's proposed liquidity bank is consistent with this view, insofar as it would provide additional liquidity during a crisis that should calm fears investors may have about their fund's ability to meet redemptions. In other words, while opinions may differ on the best approach, we believe that the industry agrees that regulators would spend their time more profitably on reducing the potential impact of a fund breaking a dollar than on trying to make sure that it never happens.

Conclusion

In conclusion, there is no justification for gambling with such a critical element of the U.S. financial system. Proponents of eliminating money market funds essentially propose to remove the source of 30 to 40% of the short-term financing in this country and hope that the markets will somehow "sort it out." We would therefore appreciate the Subcommittee's support of money market funds by urging regulators to focus on more beneficial proposals for strengthening our credit markets than eliminating money market funds or changing them into banks.