CMFI
Coalition of Mutual Fund Investors

September 10, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

VIA ELECTRONIC MAIL

Subject: Money Market Fund Reform, File Number S7-11-09

Dear Ms. Murphy:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to submit comments on the proposal by the Securities and Exchange Commission ("SEC") to amend the regulatory rules that govern money market funds under the Investment Company Act.

The Successful History of Money Market Funds

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. Over the course of this 25-year period, money market funds have been unable to redeem fund shares at full par on only two occasions: once in 1994 and, of course, during the financial crisis in 2008.[2]

As noted by the Investment Company Institute ("ICI"), the 1994 occurrence involved a small institutional money market fund that "broke the buck" because it had invested in adjustable-rate securities that did not return to par at the time of an interest rate adjustment.[3] This money market fund only lost four percent (4%) of its principal,

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual investors on mutual fund policy issues. CMFI's website can be accessed at www.investorscoalition.com.
[2] See Leslie Eaton, New Caution About Money Market Funds, The New York Times, Sept. 29, 1994; and Christopher Condon, Reserve Primary Money Fund Falls Below $1 a Share, Bloomberg, Sept. 16, 2008.
[3] Paul Schott Stevens, President and CEO, Investment Company Institute, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 10, 2009), at 13 (hereinafter, "ICI Testimony"), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9b2abf52-a7ab-4d89-a1ad-d91d0340cfb4.

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and returned $0.96 a share in the liquidation of the fund.[4] The second occurrence involved the Reserve Primary Fund, a money market fund holding a large position of commercial paper issued by Lehman Brothers before its bankruptcy on September 15, 2008.[5]

The ICI has correctly observed that this impressive safety and soundness record can be contrasted with the failure of 2,400 commercial banks and savings institutions in the United States over a similar 25-year period.[6]

The Liquidity Risks of Money Market Funds

The credit crisis in the fall of 2008, including the liquidation of the Reserve Primary Fund, has caused the SEC to re-evaluate its regulatory framework for money market funds.[7] To respond to the events surrounding this crisis, the SEC seeks to accomplish the following in its Proposed Rule:

- to increase the resilience of money market funds to market disruptions, such as those that occurred in the fall of 2008;
- to reduce the vulnerability of money market funds to liquidation events (i.e., "breaking the buck"), by improving their ability to satisfy significant demands for redemptions; and
- to facilitate the orderly liquidation of a fund that does "break the buck," in order to protect the interests of all fund shareholders.[8]

CMFI strongly supports these objectives and offers the following comments on the regulatory provisions advanced by the SEC in its Proposed Rule.

The SEC Proposal to Distinguish Between Retail and Institutional Money Market Funds

To address the liquidity issues facing money market funds, the SEC proposes to amend its Rule 2a-7, to "add new risk-limiting conditions designed to improve money market funds' ability to meet significant redemption demands."[9]

In its Proposing Release, the SEC describes the problem as follows:

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[4] Id.
[5] See Complaint, Securities and Exchange Commission v. Reserve Management Company, Inc., No. 09-4346 (S.D. N.Y. May 5, 2009), available at http://www.sec.gov/litigation/complaints/2009/comp21025.pdf
[6] ICI Testimony at 13.
[7] Money Market Fund Reform, SEC Release No. IC-28807, 74 Fed. Reg. 32, 688 (July 8, 2009) (hereinafter "Money Market Fund Reform"), available at http://sec.gov/rules/proposed/2009/ic-28807fr.pdf
[8] Id. at 32,694.
[9] Id. at 32,703.

> As discussed above, liquidity of a money market fund portfolio is critical to the fund's ability to maintain a stable net asset value. Our traditional notions of liquidity incorporated into our guidelines (discussed above) appear to be inadequate to meet the needs of a money market fund because the guidelines assume that a fund has time (up to seven days) to sell securities and that there will be a market for the securities. As noted above, money market funds typically undertake to pay their investors more quickly (frequently the same or following day). As the events of last fall demonstrated, money market funds may be unable to rely on a secondary or dealer market ready to provide immediate liquidity at amortized cost under all market conditions. Therefore we are proposing new liquidity tests that would be based on the fund's legal right to receive cash rather than its ability to find a buyer of the security.[10]

The SEC goes on to say in its Proposing Release that the amount of liquidity required by a particular fund will depend on the type of shareholders a fund has, along with knowledge of what the liquidity needs of its shareholders are:

> The amount of liquidity a fund will need will vary from fund to fund and will turn on cash flows resulting from purchases and redemptions of shares. As a general matter, a fund that has some large shareholders, any one of which could redeem its entire position in a single day, will have greater liquidity needs than a retail fund that has thousands of relatively small shareholders. A fund that competes for yield-sensitive shareholders (*e.g.*, 'hot money') through electronic 'portals' will have substantially greater liquidity needs than a fund holding the cash of commercial enterprises that have predictable needs (such as payrolls).[11]

To address this problem, the SEC proposes to require that the board of a money market fund determine whether a fund is an "institutional" fund or a "retail" fund, for the purpose of meeting certain minimum daily and weekly liquidity requirements.[12] This determination will be made "no less frequently than once each calendar year."[13] The process would work as follows:

> In particular, the fund's board of directors would determine whether the money market fund is intended to be offered to institutional investors or

[10] Id.
[11] Id.
[12] Id. at 32,705. The SEC proposes that retail funds have a minimum daily liquidity requirement of 5% of its assets invested in cash (or in securities that can be reasonably expected to be converted to cash within a day). The SEC proposes that institutional funds have a minimum daily liquidity requirement of 10% of its assets in daily liquid assets. Funds also would have to comply with minimum weekly liquidity requirements for funds designated as retail funds (15% invested in weekly liquid assets) and institutional funds (30% invested in weekly liquid assets), under the SEC's proposal.
[13] Id.

> has the characteristics of a fund that is intended to be offered to institutional investors, based on the: (i) Nature of the record owners of fund shares; (ii) minimum amount required to be invested to establish an account; and (iii) historical cash flows, resulting or expected cash flows that would result, from purchases and redemptions. The provision is designed to permit fund directors to evaluate the overall characteristics of the fund based on relevant factors. Under the provision, a fund offered through two classes, a majority of whose shares are held by retail investors, should nonetheless be deemed to be an institutional fund by the fund board if the cash flows from purchases and redemptions and the portfolio management required to meet liquidity needs based on those cash flows are more characteristic of an institutional money market fund.[14]

In CMFI's view, it will be very difficult to accurately classify funds into retail or institutional categories. The SEC's approach to this issue is overly formulaic, may cause unintended consequences, and will be subject to potential manipulation by both funds and investors.

The liquidity needs of each type of investor cannot be neatly organized into a "one-size fits all" framework. Some institutional investors have shorter time horizons and frequent liquidity needs, such as the use of a money market fund for the payroll needs of a small business. Other institutional investors have a longer time horizon for their assets and more random liquidity demands, such as the use of a money market fund for the cash allocation of a university endowment or employer pension plan. Likewise, differences in time horizons and uses of proceeds can vary widely among retail investors. Some retail investors may use a money market fund for frequent expenditures, while others may use a money market fund as a longer-term savings vehicle.

The classification of retail vs. institutional may cause unintended consequences in managing fund liquidity risks. A fund will have a strong disincentive to characterize a fund as institutional, as it would then subject the fund to higher minimum thresholds for cash and cash-equivalent investments. Similarly, institutional investors will have a strong incentive to be in funds that are classified as retail funds, as the lower liquidity requirements will permit the managers of those funds to offer higher yields by investing in longer term securities.[15]

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[14] Id. at 32,705. Under the street name/omnibus accounting system the "record owner" referred to in the Proposing Release is a financial intermediary who generally holds shares on behalf of underlying beneficial owners.

[15] See Stan Wilson, SEC Proposal Puts Fund Boards on Spot, Fund Action, July 6, 2009 ("The proposal would require institutional funds to have twice as much liquidity as retail funds. The new split level liquidity requirement would mean retail funds would have a greater percentage of assets free to be placed in longer term securities, likely resulting in a better return for them .... This would give institutional investors a strong incentive to find loopholes to switch their dollars into retail.").

In CMFI's view, it is impractical to restructure the money market regulatory framework in this manner. It will be excessively complicated to construct procedures to accurately classify investors into retail or institutional categories. And it is not clear that the end result will be helpful in managing liquidity risks, especially when retail and institutional investor types have as many similarities as differences.

Industry Comments About Hidden Money Market Accounts

Several prominent fund industry leaders have expressed concern with how to implement the SEC's proposal to classify funds into retail or institutional categories, with so many fund shares held in hidden intermediary accounts.[16]

On June 25, 2009, a Wall Street Journal article described the problem with this proposal through an interview with ICI President Paul Schott Stevens:

> One item causing the industry concern is the requirement that funds selling to institutional investors have more cash on hand than those sold to individual investors. Institutional investors tend to move large amounts of money around quickly. The industry says it isn't easy to distinguish between the two. 'In many instances, funds simply don't know the nature of their investors,' such as when a brokerage firm holds a position in a fund on behalf of many different shareholders, says Paul Schott Stevens, president and chief executive of fund-industry trade group Investment Company Institute. Since the institutional funds will be required to have more liquid holdings, they also will likely have lower yields. An industry concern is that 'this would create an incentive for people to try to game the system by masquerading as retail investors' when in fact they are institutions, Mr. Stevens says.[17]

Several days later, in a subsequent Wall Street Journal article, the Chief Executive Officer of Federated Investors, J. Christopher Donahue, raised concerns about the difficulty of distinguishing between retail and institutional shareholders within hidden or omnibus accounts:

[16] Fund shares are hidden from mutual funds as a result of omnibus accounting and third-party recordkeeping by intermediaries. At the end of each trading day, financial intermediaries aggregate all purchase and redemption requests from their customers into one consolidated order for each mutual fund. A fund handles this "omnibus" order as a single transaction, treating the financial intermediary, instead of the underlying beneficial owners, as the shareholder of record. Each consolidated account may represent the transactions of thousands of customers of a particular financial intermediary. However, no information is generally disclosed to the compliance personnel at a mutual fund about the specific trading activities of these underlying investors. Likewise, the identities of these investors are normally not disclosed to the fund for compliance purposes.

[17] Kara Scannell and Eleanor Laise, SEC Commissioners Talk Money Funds, The Wall Street Journal, June 25, 2009.

> In some of Federated's funds, one class attracts institutional investors while another class attracts retail investors, Mr. Donahue said. 'But it's all part of the same investment portfolio or fund,' he said. In the case where Federated has one omnibus customer with a million retail clients behind it, Federated doesn't see the million customers behind the account, Mr. Donahue said. 'So what do you say that is? We really need some definition here.'[18]

This point was also made in a comment letter to the SEC regarding this Proposing Release by The Vanguard Group, filed on August 19, 2009:

> Our experience tells us that differentiating funds as retail or institutional based on the nature of the 'record owners' of fund shares, as the Proposal requires, is overly simplistic. The nature of the record owner does not always correspond to the nature, and likely behavior, of the ultimate investor. A large 'institutional' omnibus account held in the name of a financial intermediary could actually be a conduit account for thousands of individual retail investor accounts. Although technically 'institutional' under the Proposal, such intermediaries lack decision-making authority for their constituent accounts and would not pose the mass redemption risk and liquidity issues of a real institutional holder, such as a hedge fund. On the other hand, a 'retail' investor could have a large balance that could pose a liquidity challenge for a fund.[19]

The SEC Proposal to Establish a General Liquidity Requirement

The SEC has concluded that its proposed minimum daily and weekly requirements may not be enough protection for funds, as the liquidity needs of individual funds may be greater than the SEC's proposed daily and weekly minimum requirements. To address this issue, the SEC proposes a General Liquidity Requirement, mandating a fund at all times to hold highly liquid securities "sufficient to meet reasonably foreseeable shareholder redemptions," in light of its regulatory obligations and any specific commitments to shareholders.[20]

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[18] Daisy Maxey, Mutual-Fund Giants Give Mixed Reviews to SEC Proposals, The Wall Street Journal, June 29, 2009.
[19] Letter from F. William McNabb III, President and Chief Executive Officer, The Vanguard Group, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission at 8, SEC File No. S7-11-09 (Aug. 19, 2009), available at http://www.sec.gov/comments/s7-11-09/s71109-35.pdf. This letter also notes that the SEC's proposed rule does not address liquidity risks that arise from factors other than the size of accounts, such as the geographical concentration of shareholders investing in state tax-exempt funds. Despite these concerns, the Vanguard letter does not recommend full transparency at the investor level within hidden or omnibus accounts. Compare infra note 36.
[20] Money Market Fund Reform at 32,736 and proposed Rule 2a-7(c)(5)(ii).

According to the Proposing Release, a money market fund can comply with this General Liquidity Requirement in the following manner:

> To comply with this condition, we would expect money market funds to consider a number of factors that could affect the fund's liquidity needs. For example, a money market fund would have to understand the characteristics of its investors and their likely liquidity needs. A volatile investor base, *e.g.*, one consisting of a few relatively larger investors that are likely to make significant redemptions, would require a fund to maintain greater liquidity than a stable investor base, which is generally associated with a retail fund with many hundreds or thousands of smaller investors. With this information, a fund manager could take different steps to protect the fund from greater liquidity risk. For example, the fund manager could increase the amount of daily or weekly assets above those required by the daily and weekly requirements, or could decline to accept new investments from investors whose liquidity needs are inconsistent with the objectives of the management of the fund.[21]

The SEC's proposed General Liquidity Requirement will be an ongoing obligation for money market funds, with an expectation that individual funds will adopt policies and procedures regarding the risk characteristics of shareholders trading through third-party intermediaries:

> Because the obligation would be ongoing, we believe a fund should adopt policies and procedures to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders, particularly those that hold their securities through omnibus accounts, or access the fund through 'portals' or through other arrangements that provide the fund with little or no transparency with respect to the beneficial shareholder.[22]

In its Proposing Release, the SEC also recommends that fund boards consider adopting guidelines to address the potential conflict between a fund manager's interest in increasing the amount of assets under management and the need to ensure that new shareholders to the fund do not present excessive risks to the fund:

> In their consideration of these procedures and in their oversight of their implementation, fund directors should understand that fund managers' interest in increasing fund assets, and thus their advisory fees, may lead them to accept investors who present greater risks to the fund than they

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[21] Money Market Fund Reform at 32,706.

[22] Id. at 32,707. The SEC also notes in this section of the Proposing Release that it does not believe that it needs to amend Rule 2a-7 to expressly require that funds adopt specific procedures to implement this new requirement. Once this requirement is adopted by the SEC, Rule 38a-1(a)(1) requires funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund.

> might otherwise have accepted. We urge directors to consider the need for establishing guidelines for advisers to money market funds that address this potential conflict. We are aware of more than one occasion in which a fund adviser (or its affiliate that served as the principal underwriter to the fund) has marketed the fund to 'hot money' in order to increase fund assets, which has exposed the fund to substantially higher risks.[23]

The Investment Company Institute "Know Your Customer" Proposal

A similar proposal to identify and evaluate the risk characteristics of money market fund shareholders was advanced by the Investment Company Institute ("ICI") in its Money Market Working Group Report, released in March 2009.[24] In this Working Group Report, the ICI noted that the liquidity needs of a money market fund are closely correlated with the composition and diversification of its shareholder base.[25] For this reason, the Working Group Report recommended the development of a "robust shareholder due diligence/know your client process."[26] This process was intended to continue after a shareholder is first admitted, with a regular review of trading patterns and an ongoing effort to monitor client activity.[27]

Like the SEC explanation above, the Working Group Report acknowledged the challenges of obtaining investor-level information in non-transparent street name and omnibus accounts:

> In particular, funds should consider the various risk levels of shareholders that are omnibus accounts, external direct clients, or internal accounts or cash sweeps from other lines of business of the fund sponsor. Funds also should look closely at the shareholders' use of portals (especially those portals that do not provide funds with the identities of the underlying users) or other third-party distribution methods, because the intentions of the shareholders using the portals may be unclear. ... Our recommendation is designed to encourage money market fund advisers to take a more active role in their assessment of clients as a means of identifying (or excluding) those shareholders that could be detrimental to their funds, and adjusting their liquidity needs accordingly.[28]

To alert investors and third-party commentators to the potential risks that particular types of investors may pose to a fund, the Working Group Report

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[23] Id.
[24] Investment Company Institute, Report of the Money Market Working Group, Mar. 17, 2009, at 82, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf (hereinafter cited as "ICI Working Group Report").
[25] Id. at 82 ("A money market fund's ability to maintain sufficient liquidity is closely related to the composition and diversification of its shareholder base.").
[26] Id. at 83.
[27] Id.
[28] Id. at 84.

recommended that funds provide monthly website disclosure of client concentration, by categories of investor type.[29] Regarding third-party accounts, the Report noted:

> Some types of investors, such as street name accounts, omnibus accounts, and non-transparent portals, do not provide a fund manager with much (or any) transparency about the intentions of the various participants in that account. In those instances, we anticipate that the fund would disclose the percentage of its portfolio held by street name accounts, omnibus accounts, non-transparent portals or similar investors.[30]

The most significant problem with implementing any type of "know your customer" process is the fact that the ***substantial majority*** of mutual fund shares are held in these non-transparent, third-party accounts. In a Report issued on December 18, 2006,[31] the ICI estimated that a median of 80% of mutual fund shares sold by sales forces and a significant number of fund shares sold directly are held in street name:

> Mutual funds ... have a significant portion of their shares held in street name. For mutual funds sold via sales forces (either proprietary or non-proprietary), shares held in street name ranged from 78 percent to 100 percent of total fund shares, with a median of 80 percent—similar to that of closed-end funds. Even mutual funds that are marketed directly to investors had a considerable amount of their shares held in street name. ... half of mutual funds sold directly had at least 57 percent of total shares outstanding held in street name. Direct-sold mutual funds are offered on platforms or supermarkets, and these shareholder accounts generally are held in street name.[32]

As described in more detail below, the better regulatory approach is to help funds evaluate the liquidity needs of all their shareholders by requiring full transparency of shareholders investing through intermediaries. This will provide funds with ongoing investor identification information and transaction data, permitting funds to evaluate liquidity needs in an accurate and real-time basis.

<u>The SEC Should Require Investor-Level Transparency to Enable Funds to Accurately Evaluate the Liquidity Needs of Individual Shareholders</u>

Without full transparency at the investor level, funds and their boards are not going to be able to make appropriate and informed judgments about the liquidity needs of their shareholders. The only sensible way to evaluate the expected redemption demands

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[29] <u>Id.</u>
[30] <u>Id.</u> at 84-85.
[31] Investment Company Institute, Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors, Dec. 18, 2006, at 5, <u>available at</u> <u>http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692-100.pdf</u>.
[32] <u>Id.</u> This data was provided to the ICI from Automatic Data Processing, Inc.

of the entire shareholder base is to "look through" the intermediaries to the beneficial shareholder level.

As CMFI has noted in previous comment letters and correspondence with the SEC, the structure of the mutual fund distribution system is going to—once again—prevent funds from honoring their regulatory obligations because of a lack of transparency in circumstances where fund shares are purchased through third-party intermediaries.

The fund industry relies heavily on financial intermediaries—such as brokers, fund supermarkets, financial advisers, and retirement plan providers—to market its fund shares. While this type of distribution system has allowed mutual funds to become the primary investment vehicle for more than 90 million individuals, the use of omnibus accounting has created a number of regulatory problems that have yet to be resolved in a satisfactory manner.

The SEC has tried to improve transparency within these hidden, third-party accounts through the enactment of Rule 22c-2. This Rule requires all mutual funds to have written agreements with their financial intermediaries that provide for "upon request" information sharing at the individual investor level.[33] However, funds are not using this tool, either on a periodic or a daily basis.[34]

For unexplained reasons, the SEC believes that funds are regularly "looking through" their intermediaries to evaluate redemption behavior for underlying shareholders:

> Our proposed requirement that fund boards distinguish between retail and institutional money market funds would require boards to make a determination based on an understanding of the investors in the fund and their behavior. Our proposed liquidity requirements also would require money market funds to 'know their customers,' including their expected redemption behavior. We expect that most money market funds already have methods to understand their customers and their redemption needs

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[33] Mutual Fund Redemption Fees, SEC Release No. IC-26782, 70 Fed. Reg. 13,328 (Mar. 18, 2005); Mutual Fund Redemption Fees, SEC Release No. IC-27255, 71 Fed. Reg. 11, 351 (Mar. 7, 2006); and Mutual Fund Redemption Fees, SEC Release No. IC-27504, 71 Fed. Reg. 58,257 (Oct. 3, 2006) (codified at 17 C.F.R. § 270.22c-2).

[34] See Coalition of Mutual Fund Investors, Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts (Mar. 27, 2009), available at http://www.investorscoalition.com/AnalysisofOmnibusSurveillanceProceduresMarch2009.pdf; See also Coalition of Mutual Fund Investors, An Evaluation of Mutual Fund Redemption Fees and Other Market Timing Policies (June 20, 2007); Coalition of Mutual Fund Investors, An Evaluation of the Redemption Fee and Market Timing Policies of the Largest Mutual Fund Groups (May 5, 2005); and Coalition of Mutual Fund Investors, Analysis of Redemption Fee Policies by the Fifty Largest Mutual Fund Groups (Aug. 3, 2004), available at http://www.investorscoalition.com/fundstudy.html.

> because 'knowing your customer' is already a best practice. As a result, we do not expect that these requirements would impose any material costs on funds.[35]

The fund industry's "know your customer" programs only consist of evaluating aggregated trade data that does not include shareholder identification or transaction data at the beneficial owner level. Without this information, a fund can only speculate about potential redemption demands, instead of conducting a much more precise evaluation of expected liquidity demands through a review of the actual identity and redemption history of all fund investors. A review of consolidated trading data from a fund's financial intermediaries will not be adequate to help the fund prepare for the liquidity needs of all its shareholders.

Aside from the issue of whether or not the SEC requires a classification of money market funds into "retail" vs. "institutional" categories, the best regulatory approach for helping funds accurately evaluate and manage the liquidity needs of all their shareholders is to require full transparency of all shareholders trading through third-party intermediaries. This can be accomplished in one of two ways: (1) by requiring same-day disclosure of investor identity and transaction information through Rule 22c-2, or (2) through the direct registration of all shares purchased through third-party intermediaries.

The SEC Should Improve Rule 22c-2 or Require Direct Registration of All Fund Shares

The SEC's new Rule 22c-2 may be an effective tool in providing full transparency through intermediary accounts, especially if intermediaries are required to provide information on a same-day basis.[36] An even simpler method may be to require direct registration of fund shares purchased through intermediaries.

Even before the implementation of the Direct Registration System ("DRS"), the use of electronic book-entry accounting within the mutual fund industry has been widespread, making it very easy to exchange shareholder account information and process purchase, redemption, and exchange orders between intermediaries and funds.[37] In particular, the Fund/SERV and Networking systems of the National Securities Clearing Corporation ("NSCC") have been able to facilitate mutual fund order processing

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[35] Money Market Fund Reform at 32,724.

[36] CMFI has advocated for a same-day disclosure requirement in the implementation of Rule 22c-2 because it would provide complete transparency of shareholder identities and transaction information at the individual investor level. A daily or per-order disclosure regiment can occur in a very cost-effective manner through the NSCC Networking system used to share account information between the substantial majority of intermediaries and funds. You can review CMFI's comment letters on how to improve Rule 22c-2 on the Regulatory Action page of the CMFI website: http://www.investorscoalition.com/regulatory.htm.

[37] See The Depository Trust & Clearing Corporation, An Overview of the Direct Registration System, Corporation, available at http://www.dtc.org/dtcpublic/html/lob2/prod6/drsdetail.htm (last visited Sept. 1, 2009).

and account management functions between participating third-party intermediaries and funds for more than a decade, in a cost-effective manner.[38]

Direct registration allows the shareholder to be recorded on the books of the fund and/or its transfer agent. Account information between a fund and its intermediaries can be transferred back and forth electronically in book-entry form and through the use of the NSCC Networking services referred to above.

Full transparency within intermediary accounts will permit funds to be able to monitor all investor account activity on a real-time basis, instead of evaluating consolidated data streams—data streams with substantial information gaps caused by the use of street name and omnibus accounting. Full transparency also provides a solution to at least two other compliance issues that remain as problem areas after the 2003-2004 mutual fund scandals: (1) the inability of funds to deter frequent trading of fund shares within intermediary accounts; and (2) the inability of funds and intermediaries to calculate breakpoint discounts on sales loads within brokerage and other third-party accounts.

The SEC Proposal Regarding Fund Liquidations

In its Proposing Release, the SEC recommends a new Rule 22e-3, to exempt money market funds that "break the buck" from section 22(e) of the Investment Company Act. This rule change would permit funds to suspend redemptions, in order to facilitate an orderly liquidation of a fund.[39]

This proposed Rule will replace Rule 22e-3T, a temporary rule that provides a similar exemption for money market funds participating in the temporary guarantee program established by the Treasury Department ("Treasury"). The SEC promulgated this temporary rule on November 26, 2008.[40] A primary purpose of this temporary rule is to prevent the sale of fund assets at "fire sale" prices if a fund breaks the buck.[41]

Rule 22e-3T expires with the termination of the Treasury guarantee program this fall. If the SEC decides to make this Rule a permanent one, then it needs to provide additional protections for individual investors transacting through financial intermediaries.

As CMFI argued in a comment letter submitted on December 14, 2008, the current rules of the Treasury guarantee program do not address the issues of third-party

[38] See The Depository Trust & Clearing Corporation, Mutual Fund Services, available at http://www.dtcc.com/products/wealthmgmt/funds/ps_index.php (last visited Sept. 1, 2009).
[39] Money Market Fund Reform at 32,714.
[40] Temporary Exemption for Liquidation of Certain Money Market Funds, SEC Release No. IC-28487, 73 Fed. Reg. 71,919 (Nov. 26, 2008). Rule 22e-3T provides exemptive relief from SEC redemption rules to facilitate an orderly liquidation of any fund that "breaks the buck."
[41] See Id.

hidden accounts and the use of omnibus accounting.[42] Under the written agreements used by funds participating in the Treasury program, payments in a liquidation are only made to "shareholders of record," which means that investors transacting through an intermediary must rely on that intermediary to disburse their guaranteed payment. The investment adviser and the fund itself only have to use "best efforts" to ensure that beneficial owners within omnibus accounts receive their payments.

The problem with disbursing liquidation payments within hidden accounts was described in more detail in a BoardIQ article, published last fall.[43] The article quoted an official from the ICI, who noted that any fund that experiences a liquidation event under the Treasury money market guarantee program must have a plan in place to identify its individual shareholders:

> If a trigger event occurs, firms must have a plan to identify individual shareholders who would need to be reimbursed. This means working with intermediaries, says Don Boteler, the ICI's vice president of operations, in an e-mail. 'That will likely require some research, given that many account balances will have changed since 9/19, some investors will have transferred their accounts to other brokers/advisors/recordkeepers, and/or re-registered their accounts after gifting, marrying, divorcing [or] dying,' he writes.[44]

In the same article, a partner at PricewaterhouseCoopers also notes that liquidating funds with omnibus account shareholders will need to obtain shareholder information at the beneficial owner level:

> What's more, funds that have omnibus accounts—large accounts that group individual shareholders—will have to be able to drill down to obtain individual shareholder information. From a testing perspective, [Tony Evangelista of PricewaterhouseCoopers] recommends that funds figure out how to deal with these accounts ahead of time to get individual details so that if the time comes, they'll be ready.[45]

None of the provisions in the Treasury guarantee program, temporary Rule 22e-3T, or the proposals advanced by the SEC in this rulemaking take advantage of Rule 22c-2, i.e., to "look through" these third-party accounts and provide full transparency at the beneficial owner level, once a liquidation event occurs. As CMFI argued in its December comment letter, the use of Rule 22c-2 in this circumstance will provide a liquidating fund

[42] Letter from Niels Holch, Executive Director, Coalition of Mutual Fund Investors, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission (Dec. 14, 2008), available at http://www.investorscoalition.com/CMFICommentLetterMoneyMktFundsDec2008.pdf.
[43] Lisa Lacy, Boards Keep Steady Watch on Money Funds, BoardIQ, Oct. 21, 2008.
[44] Id.
[45] Id.

with the ability to ensure that beneficial owners receive their guaranteed payments in a manner that is more precise and timely than the current process.

An even simpler solution is to require direct registration of all shareholder accounts, as noted above. Direct registration improves the ability of a fund to know who its shareholders are on an ongoing basis for liquidity risk management purposes. And direct registration also provides full transparency at the beneficial owner level in the event of a liquidation event.

The standard for any liquidation distribution to shareholders of a money market fund under the Investment Company Act is the "fair and equitable" treatment of all fund shareholders.[46] This is certainly the position being taken by the SEC in litigation it has brought against the Reserve Fund for "breaking the buck" last fall.[47] Unfortunately, with the substantial majority of fund shares held in third-party hidden accounts, this standard will be difficult to implement in any fund liquidation, unless there is full transparency at the investor level.

If temporary Rule 22e-3T is replaced with a permanent Rule 22e-3, the SEC should adopt full transparency measures within third-party accounts to protect the interests of individual investors. The conditions that the SEC has proposed in new Rule 22e-3 to protect fund shareholders are not adequate, in CMFI's view.[48]

The SEC Should Require Enhanced Disclosures by Money Market Funds About the Risks of Hidden Accounts

The ICI Working Group Report recommends that "money market funds reassess and, if appropriate, revise the risk disclosures they provide to investors and the markets."[49] CMFI agrees with this recommendation and urges the SEC to require more specific disclosures about the redemption and liquidation risks that shareholders face if they purchase money market fund shares through a financial intermediary.

[46] 15 U.S.C. § 80a-25(c) ("Any district court of the United States ... is authorized to enjoin the consummation of any plan or reorganization ... if such court shall determine that any such plan is not fair and equitable to all security holders.").
[47] SEC Memorandum of Law at 1, SEC v. Reserve Management Company, Inc., No. 09-4346 (S.D. N.Y. May 26, 2009), available at http://www.sec.gov/spotlight/reserve_primary_fund_investors/memorandum_of_law.pdf
[48] For example, the SEC proposes to condition its exemptive relief on the fact that a fund board act in its capacity as a fiduciary in these circumstances. Additionally, the SEC would be permitted to rescind or modify the exemptive relief if a fund has not devised (or is not properly executing) a plan of liquidation that protects fund shareholders. See Money Market Fund Reform at 32, 715. While these are certainly sensible conditions to impose, they are not a substitute for full transparency of the entire shareholder base in the event a fund needs to liquidate its shares. As fiduciaries, fund boards should have access to this information to ensure an orderly and timely liquidation.
[49] ICI Working Group Report at 91.

In 2004, the SEC promulgated a new regulation requiring that all funds improve their prospectus disclosures regarding the policies and procedures being used to address frequent trading abuses.[50] These prospectus disclosures are remarkably consistent across funds and fund families, and provide confirming evidence that fund compliance personnel are not able to provide effective oversight—at the beneficial owner level—over the hundreds of intermediaries that are marketing their fund shares.[51] Excerpts of these disclosures from the prospectus filings of the fifty (50) largest fund complexes can be reviewed on the CMFI website.[52]

It is now apparent that individual investors purchasing through financial intermediaries face redemption and liquidation risks in money market funds. These risks should be described with more specificity in fund prospectuses, in a manner consistent with the disclosures concerning a fund's policies regarding frequent short-term trading of shares.

The SEC also requests comments about whether client concentration information should be disclosed on a monthly basis to help investors evaluate the risk characteristics of a fund.[53] As noted above, monthly website disclosure of client concentration information—by categories of investor type—was recommended in the ICI Working Group Report.[54] However, this information will not convey any meaning to investors if funds merely disclose that a significant portion of its shareholders are hidden from its view in street name or omnibus accounts. This will have the effect of decreasing investor confidence in a fund because of its inability to identify and evaluate the characteristics of those investors within these third-party accounts, for the protection of all of its shareholders. On the other hand, the monthly disclosure of categories of investor type would be helpful to investors, once a fund can "look through" hidden accounts and receive accurate information from the investor level for its entire shareholder base.

<u>Money Market Funds Should Not Become Special-Purpose Banks</u>

The Group of Thirty and former Federal Reserve Board Chairman Paul Volcker have advocated that money market funds reorganize as special-purpose banks and become regulated in the same manner as these financial institutions are regulated. CMFI opposes this recommendation.

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[50] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, SEC Release Nos. 33-8408 and IC-26418, 69 Fed. Reg. 22,300 (Apr. 23, 2004).
[51] <u>See</u> Coalition of Mutual Fund Investors, CMFI White Paper: Who is Watching Out For Mutual Fund Shareholders? (Mar. 30, 2009), <u>available at</u> <u>http://www.investorscoalition.com/CMFIWhitePaper3-27-09.pdf.</u>
[52] <u>See</u> <u>supra</u> note 34.
[53] <u>Money Market Fund Reform</u> at 32,711.
[54] <u>ICI Working Group Report</u> at 84 ("In those instances [of third-party accounts], we anticipate that the fund would disclose the percentage of its portfolio held by street name accounts, omnibus accounts, non-transparent portals or similar investors.").

On January 15, 2009, the Group of Thirty released its recommendations for reforming the regulation of financial institutions.[55] Among its many recommendations, the Group of Thirty advocates that money market funds become special-purpose banks:

> Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.[56]

Paul Volcker also has raised this issue in his individual capacity. In an August 2009 interview with Bloomberg, he stated:

> Banks remain the functioning heart of the financial system, and they are protected and regulated ... To the extent they have competitors that have different ground rules, kind of free-riders in my view, weakens the financial system.[57]

As noted above, money market funds have been a safe investment for institutional and individual investors for more than twenty-five (25) years. More importantly, money market funds differ from deposit-taking banks in at least three respects. First, a money market fund is not engaged in the use of leverage to extend credit that is tied to its level of deposits or capital. Second, money market funds are not seeking government insurance after the expiration of the temporary Treasury guarantee program. And third, money market funds are not seeking access to Federal Reserve funding to meet their obligations.

Given the safety and soundness record of money market funds and the difference in structure of these funds compared to commercial banks, there is no compelling reason to require these funds to reorganize as special-purpose banks.

Conclusion

The SEC's proposed amendments to Rule 2a-7 should require full transparency of beneficial owner accounts. This can be accomplished either by: (1) a requirement that financial intermediaries provide same-day disclosure of third-party account information,

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[55] Group of Thirty, Financial Reform: A Framework for Financial Stability (Jan. 15, 2009), available at http://www.group30.org/pubs/reformreport.pdf. The Group of Thirty is a nonprofit, international body composed of senior representatives of the private and public sectors and academia (www.group30.org). The Group of Thirty is chaired by Paul Volcker.

[56] Id. at 29 (Recommendation #3: Money Market Mutual Funds and Supervision).

[57] Christopher Condon, Volcker Says Money-Market Funds Weaken U.S. Financial System, Bloomberg, Aug. 25, 2009.

through an amendment to Rule 22c-2; or (2) the direct registration of all shareholders investing through intermediaries.

Full transparency within third-party accounts will provide money market funds with accurate, real-time information about its entire shareholder base. This level of transparency will significantly improve the ability of funds to manage their liquidity risks and will provide a framework for a more precise and timely payment process to beneficial owners in the unlikely event that a fund has to liquidate.

The full transparency model also addresses other regulatory problems that remain unresolved after the 2003-2004 mutual fund scandals:

- Funds will be able to monitor short-term trading activities by all investors on a real-time basis;
- Funds will be able to enforce their prospectus policies and procedures in a uniform manner across all distribution channels;
- Investors will be able to receive properly calculated breakpoint discounts on sales load charges;
- Money market funds will be able to manage liquidity risks by reviewing and monitoring all investor activities on a daily basis; and
- Money market liquidation payments (and SEC Fair Fund distributions) can be made in a more precise and timely manner than under the current process that relies on "best efforts" within third-party accounts.

Thank you for your consideration of these comments.

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

cc: The Honorable Mary Schapiro
The Honorable Kathleen Casey
The Honorable Elisse Walter
The Honorable Luis Aguilar
The Honorable Troy Paredes
Andrew Donohue
Robert Plaze