THE TRUTH ABOUT MONEY FUNDS

BY

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FEBRUARY 2009

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INTRODUCTION

As Congress prepares to consider proposals to reform the financial regulatory structure, the regulation of money market mutual funds will be a likely topic of discussion. Although money funds play a vital role in the financial markets, their activities and operations are not well understood and questions may arise as to how they should be regulated.

This paper provides information for lawmakers and others on money market funds, their role in the financial markets, and the regulatory regime that governs them. As described more fully herein, money funds are short-term investment vehicles that contribute efficiency, liquidity, and safety to the financial markets. They are highly regulated under existing law and have a proven track record as safe investments.

Some commentators have mistakenly suggested that money market funds function like banks and should be regulated as such. This paper shows that such a view fundamentally misconceives the nature of money market funds and would result in inappropriate regulation of money funds to the detriment of U.S. financial markets.

[Note: Since this paper was written, the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] has been enacted. Congress did not significantly alter the regulation of money market funds in that Act but certain of the Act's provisions provide authority that could be used by the Financial Stability Oversight Council and the Federal Reserve Board to fundamentally alter the regulation of money market funds.]

[Note: Some of the regulatory provisions described in this paper have been amended by the Securities and Exchange Commission to further strengthen the regulation of money market funds under the Investment Company Act of 1940 and Rule 2a-7 thereunder.[2]]

[1] Pub. L. No. 111-203, 111th Cong. 2d Sess. (July 21, 2010).
[2] *See* 17 C.F.R. § 270.2a-7, as amended, 75 Fed. Reg. 10060 (March 4, 2010).

MONEY FUNDS ARE HIGH QUALITY, LIQUID INVESTMENT VEHICLES

Money market funds (also called "money funds") are a specialty form of investment company that have as their objective the generation of income and preservation of capital and liquidity through investment in short-term, high quality securities.[3] These funds have relatively low risks compared to other mutual funds and pay dividends that generally reflect short-term money market interest rates.

A money fund's portfolio investments are subject to regulatory restrictions on quality, maturity and diversity. A money fund generally may purchase only the highest quality debt securities maturing in 13 months or less and must maintain a weighted average portfolio maturity of 90 days or less. At least 95 percent of a money fund's assets must be held in U.S. Treasury obligations and privately issued securities carrying the highest credit rating by at least two major rating agencies.

Eligible investments for a money fund include obligations of the U.S. government and its agencies, repurchase agreements on such securities, highly rated commercial paper and other short-term debt instruments, municipal securities, certificates of deposit, and other money market instruments. A money fund may not invest more than five percent of its assets in any one issuer (except for government securities and repurchase agreements on such securities).

Money funds are managed with the goal of maintaining a stable net asset value of $1.00 per share, which makes them highly functional in the marketplace as cash equivalents.[4] Because of the quality of their investment portfolios, they are permitted to use amortized cost valuation in order to facilitate a stable net asset value but, as described below, they also shadow price their assets based on market values and correct any material deviations from market value.[5]

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[3] Money market funds are investment companies registered with the SEC under the Investment Company Act of 1940 that hold themselves out as money market funds and comply with SEC Rule 2a-7 under the Act.

[4] The SEC has observed that "investors generally treat money market funds as cash investments." 61 Fed. Reg. 13955, 13957 (Mar. 28, 1996).

[5] Money funds are required to monitor the market value of their assets in a process called "shadow pricing". If a fund board of directors believes that the extent of any market value deviation from a fund's amortized cost price per share may result in material dilution or other unfair results to investors, the board must cause the fund to eliminate the dilution or reduce unfair results to the extent to the extent reasonably practicable. The SEC recently has allowed money funds to use amortized cost values in shadow pricing certain fund assets with a maturity of 60 days or less.

An investor may buy and sell money fund shares on any business day. A money fund may not suspend the right of redemption and is required to pay redemption proceeds within seven days.[6] Some funds offer investors the ability to access their fund shares by writing checks on a linked bank account.

As of December 2008, almost 2,000 money funds were in operation with total assets of nearly $3.8 trillion. Of this amount, approximately $1.3 trillion was in retail money funds and $2.5 trillion was in institutional money funds.[7] [Note: The total volume of assets invested in money funds increased to $3.9 trillion during the financial crisis as investors viewed these funds as a safe haven for cash.]

Money Funds Serve a Variety of Investment Needs

Money funds serve a variety of useful purposes for large and small investors. They serve the short-term cash management needs of corporate treasurers, municipal governments, and other institutional investors and assist broker-dealers, trustees, pension funds, and charitable foundations in managing customer assets. Because they maintain a constant net asset value of $1.00 per share, money funds often are treated as a form of cash.

Money funds also provide a safe means by which retirees and other individual investors can earn a return on short-term cash awaiting investment and provide a low-risk, low-volatility asset class as part of an overall investment strategy.

Money funds come in different varieties, depending on the composition of their portfolios. Some money funds invest exclusively in U.S. government and/or government agency securities while others also invest in commercial paper, asset-backed securities, certificates of deposit, or other qualifying securities. Tax-free money funds invest in tax-exempt securities issued by municipalities and may be specific to one or more particular states.

Money funds are a highly efficient means by which investors may hold high quality, short-term securities. Many investors would be unable invest in such securities to the same extent otherwise. The transaction fees and administrative costs of assembling and managing a portfolio of individual

[6] The SEC may allow a fund to suspend redemptions in certain emergencies or for such other periods as the SEC may permit for the protection of shareholders of the fund.

[7] Retail money funds are offered primarily to individuals with moderate-sized accounts at securities brokerage firms. Institutional money funds are available to corporations, governments, and fiduciaries. They have low expense ratios because of high minimum investment requirements and often are used as overnight investments for funds swept from a company's main operating account at a bank.

money market investments would be prohibitive for most retail investors and many institutional ones. In addition, money funds offer the benefits of diversification to a degree that most investors cannot achieve otherwise.

Money Funds Contribute Efficiency, Liquidity and Safety to the Financial Markets

Money funds contribute to the fluid operation of the financial markets. They are highly efficient intermediaries between issuers of high-quality short-term securities and investors. Because of their large size, money funds offer economies of scale to both issuers and investors.

They enable the federal government, corporations, municipalities, and other issuers to readily sell their securities into the marketplace with reduced transaction costs. Instead of dealing with a multitude of individual investors in a large of number of individual transactions, issuers can sell their securities in bulk transactions to money funds, which then hold the securities in their portfolios for the benefit of their shareholders.

Likewise, money funds provide investors with easy access to high quality investments and eliminate transaction costs that otherwise would be incurred in purchasing a diverse basket of individual money market securities.

Money funds also afford investors greater liquidity than direct investments in securities, which typically have varying maturities and must be managed to meet an investor's cash needs. While direct investments in government and other securities may be disposed of prior to maturity, early sale typically results in a discount from amortized cost. Similarly, early withdrawals of bank certificates of deposit result in penalties. In contrast, investors in money funds may redeem their shares at $1.00 per share on any business day and may have same day access to their fund shares through transaction accounts linked to their money fund accounts.

The liquid nature of money fund portfolio investments enables them to meet normal shareholder withdrawals without resorting to central bank liquidity facilities, unlike banks which invest their deposits in loans and other assets that cannot be readily liquidated and need access to the Federal Reserve's discount window.

Money funds have a proven track record of safety. Until the events of last September, only one money fund ever failed to maintain a $l.00 net asset value. That fund was a relatively small fund that paid investors 96 cents on the dollar. Even during the extraordinary events of September 2008, only a single money fund failed to maintain a $1.00 net asset value, while another money fund closed rather than "break a dollar." Swift government action helped to maintain confidence in money funds, reversing an unusual volume of redemption requests.[8]

Money funds have provided a crucial haven for investors during the current financial crisis. Money fund assets have increased by nearly 20 percent since last September as investors have rushed to money funds as a source of safety and liquidity for financial assets.[9]

Money Funds Assist the Government Securities Market

Money funds are the single largest investors in U.S. government securities directly and through repurchase agreements. Without money funds, the government securities market would not function as efficiently as it normally does. As a result, the U.S. government—and taxpayers—would face higher funding costs.

Investors in government securities would face inefficiencies in purchasing individual securities and incur increased transaction costs due to the greater number of transactions required to assemble a portfolio with different maturities to meet cash needs.

Because of the inefficiencies inherent in managing a portfolio of individual government securities, many investors might elect instead to place their uninvested cash in uninsured bank deposits, foregoing any interest and incurring the risk of bank failure for amounts in excess of deposit insurance limits.[10]

Without money funds to process large scale investments in government securities, the government securities market would be more cumbersome and costly to market participants as well as the government.

Money Funds Enhance the Overall Competitiveness of U.S. Financial Markets

Money funds contribute to the overall competitiveness of U.S. financial markets by enhancing overall market efficiency and liquidity. Money funds do not exist in foreign financial markets to the extent they do in the United States, but money fund equivalents are now appearing in foreign markets.

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[8] The Treasury Department announced a program to insure money fund assets invested as of September 19, 2008, and the Federal Reserve Board established central bank liquidity facilities for money funds.

[9] Source: Investment Company Institute data.

[10] Although the FDIC has implemented a program to increase the deposit insurance limit to $250,000 and to provide unlimited insurance for non-interest-bearing checking accounts, these program are temporary.

If U.S. money funds were to become less efficient due to changes in the regulatory regime governing them, sophisticated investors likely would find ways of utilizing foreign money fund equivalents. The competitiveness of U.S. capital markets thereby could be diminished.

A loss of investors in U.S. money funds particularly could affect the ability of U.S. companies to finance their short-term operations in the commercial paper market. U.S. companies that rely on money funds to purchase their commercial paper would find that source of funding diminished and incur increased financing costs as a result.

MONEY FUNDS ARE NOT BANKS OR "BANK-LIKE"

Some policymakers have suggested that money funds are banks or bank-like. This view reflects a fundamental misconception of money funds and their role in the financial markets.

A bank generally is an entity that takes deposits and makes loans.[11] Money funds do neither. Nor do they securitize or otherwise leverage their assets like banks or engage in any of the other activities in which banks engage.

The key differences between money funds and banks are described below.

Money Funds Are Not Operating Companies

Money funds are investment conduits, not operating companies. They consist of pools of securities. A money fund does not exist independently of or have activities apart from its pool of securities. Securities in the pool are bought and sold as investors buy and sell shares of the pool.

Unlike banks, which are corporations, money funds typically are organized as trusts. They are governed by a board of trustees which acts on behalf of the fund's shareholders subject to fiduciary duties.

Unlike banks, which have offices open to the public, money funds generally have no public offices. Investors in a money fund generally purchase their shares through an intermediary, such as a broker-dealer or bank. Unlike banks, money funds have no employees.

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[11] *See, e.g.*, the definition of "bank" in the Bank Holding Company Act: "An FDIC insured bank, or an institution organized under domestic law that both accepts demand deposits or checking accounts (transaction accounts) and is engaged in the business of making commercial loans." 12 U.S.C. § 1841(c).

A money fund is managed by an investment adviser, typically assisted by other service providers. A custodian provides safekeeping for fund assets. A transfer agent records purchases and sales of fund shares. A distributor, assisted by intermediaries, assists shareholders in buying and selling fund shares and provides related administrative services.

Money Funds Do Not Take Deposits

Money funds do not take deposits. They sell interests in pools of securities to investors. These interests are registered as securities under the Securities Act of 1933. Investors who own these securities are the fund's shareholders—not depositors.[12]

Whereas banks rely on the proceeds of loans and other illiquid assets to repay their depositors, money funds liquidate securities in their portfolio to repay their shareholders on a dollar for dollar basis.

Money funds serve a purpose similar to that of bank deposits to the extent that they afford ready access to liquid assets. Retail funds frequently offer investors a checking account option, subject to a minimum amount on each check. The checking account is an instrument of a bank separate and apart from the money fund.

Money Funds are Not FDIC Insured

Unlike banks, money funds are not FDIC-insured, although they have a long record of safety.[13]

Money Funds Pay Market Rates of Return

Because of their limited activities and purpose, money funds do not incur the same operating costs as full service banks and thus can pay rates of return based on the underling value of their assets, which normally are higher than the interest banks pay on deposits. Unlike banks, money funds are not subject to artificial regulatory limits on the amount of interest they can pay.

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[12] Shares of a money market mutual fund are not considered to be deposits for purposes of the Glass-Steagall Act because fund shares are deemed to constitute an equity interest rather than giving rise to a debtor-creditor relationship as in a deposit. *See* Letter dated Dec. 18, 1979, from the Assistant Attorney General, Criminal Division, U.S. Department of Justice, to M. Lybecker, Associate Director, Division of Marketing Management, SEC, concluding that the Merrill Lynch cash management account was not a deposit.

[13] Due to emergency conditions in the financial markets, the Treasury Department in September of last year announced a temporary program to insure amounts invested in money funds as of September 19, 2008.

Bank deposits are not a substitute for the role of money funds in the financial markets. Banks generally cannot pay money market rates of return on their deposits due to the substantially greater internal operating costs a bank incurs from its lending operations and other activities requiring a large number of employees, infrastructure, and overhead. Federal law historically has prohibited banks from paying interest on checking accounts of business customers. Banks normally are able to pay interest rates that are competitive with money funds only on certificates of deposit with maturities of one year or longer.

Money Funds Do Not Make Loans

Money funds do not make loans. They are not permitted to offer mortgages or make commercial or consumer loans.

Money funds may invest in highly rated asset-backed securities where the underlying collateral consists of a pool of loans. But they do not originate or hold the loans directly. They do not perform the same credit underwriting function of banks or assume the same credit risks. Money funds may invest in commercial paper, which has some characteristics of a short-term loan but nonetheless is a security.[14]

Because they do not make loans, money funds do not carry loans (or other illiquid assets) on their balance sheets.

Money Funds Do Not Leverage Like Banks

Unlike banks, money funds do not leverage their assets. Banks are permitted to leverage their assets 10 to 1 or greater. For every dollar of shareholder equity or other capital, a bank generally may acquire $10 of assets. In contrast, for every dollar of investment by its shareholders, a money fund generally may invest that amount and no more.

Money Funds Do Not Create Off-Balance Sheet Liabilities

Unlike banks, money funds do not have the ability to create off-balance sheet liabilities by transferring their assets to securitization trusts or other special purpose vehicles. All of their assets are carried on-balance sheet.

[14] *See* Securities Industry Association v. Board of Governors, 468 U.S. 137 (1984) (rejecting argument by Federal Reserve Board that commercial paper is a loan rather than a security for purposes of the Glass-Steagall Act). Approximately one-third of the total assets in money funds is invested in commercial paper.

The securitization of bank assets, more than any other factor, was instrumental in causing the current financial crisis by spreading the risk of toxic mortgages throughout the global financial system. Money funds do not have this ability.

Money Fund Assets Are Carried at Near-Market Value

Banks are subject to accounting standards that enable them to carry a substantial portion of their assets at book value rather than market value. Money funds, in contrast, carry their assets at near market value.

While money funds value their assets on an amortized cost basis, the amortization occurs over short periods of time. Moreover, as described below,, money funds are subject to shadow pricing requirements under which they are monitor the market value of their assets and make adjustments if the market value deviates significantly from the amortized cost value.

Money Funds Do Not Create Moral Hazard

Unlike banks, money funds normally are not federally insured and do not have daily access to central bank liquidity facilities. Accordingly, they are not affected by the moral hazard that allows banks to take risks they otherwise would avoid in the absence of federal backing.

Unlike banks, money funds are not designed as risk-taking entities. The limitations on their portfolio investments are designed to avoid loss. Although they evaluate the credit of issuers whose securities they purchase, they do not anticipate losses on those investments, unlike banks. They typically have no need to maintain loan loss reserves. Banks have no comparable limits on the risk content or maturity of their loan and investment portfolios and routinely take risks that would be impermissible for a money fund. Consequently, they need to maintain loan loss reserves.

Unlike banks, money funds have existed for decades without the need for deposit insurance or access to Federal Reserve liquidity facilities. The liquid nature of their portfolios enables money funds to meet normal shareholder withdrawal requests without resort to central bank liquidity facilities. Banks require routine access to the Federal Reserve’s discount window because their deposits are invested in loans and other assets that cannot be readily liquidated.

Bank Regulation Is Inappropriate for Money Funds

Because of their limited activities, money funds do not require on-site supervision of the type applicable to banks. They are subject to extensive regulation under the Investment Company Act of 1940 by the Securities and

Exchange Commission, as described below, but their operations do not warrant the expenditure of examination and supervisory resources that banking operations do.

Bank supervisory requirements are not well-suited for money funds. Bank capital requirements in particular are inappropriate. The purpose of bank capital is to absorb losses on a bank's assets and to minimize losses to the federal deposit insurance fund in the event of a bank's failure. In recent years, regulators also have used the capital standards as a yardstick for assessing the condition of banking organizations, determining when to intervene with supervisory discipline, and when to allow greater leeway for expanded activities. Only well-capitalized banking organizations, for example, are permitted to engage in securities underwriting and dealing.

These uses of bank capital do not correspond to the activities of money funds. Unlike banks, money funds do not engage in underwriting and dealing in securities or other activities that would place fund assets at risk. Their only activity is investing in high quality, liquid securities. Due to the nature of their investments, money funds generally do not experience portfolio losses such that capital is necessary.

Unlike banks, which own substantial assets in the form of loans, money funds do not own any assets against which bank capital requirements could be assessed. Their only assets are their investments, which are owned by their shareholders on a pass-through basis. Money funds have no means of meeting capital requirements other than by assessing their shareholders additional fees. The imposition of capital requirements on money funds would constitute a tax on money fund shareholders, who already earn small yields on money fund investments.[15]

The imposition of capital requirements on money fund advisers also would be inappropriate. Investment advisers generally have insubstantial assets (relative to the assets in the funds they advise) against which capital could be assessed or paid. The assets in a money fund belong to the fund's shareholders, not the fund's adviser.

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[15] In any event, it is difficult to conceive how money fund shareholders would be assessed a capital charge. Would an investor be entitled to a return of the capital charge upon redemption of his or her shares? That would defeat the purpose of capital since a run on a money fund, however unlikely, would take with it the fund's capital. Would an investor be charged a capital fee every time he or she buys and sells shares? In that case, the fund's capital would be a function of the velocity of purchases and redemptions. Money fund shares have a high velocity because they are designed for liquidity. They frequently are bought and sold on a daily basis, as in sweep arrangements, for example.

The imposition of reserve requirements on money funds also would be inappropriate. Reserve requirements do not serve the same function as bank capital but rather historically were imposed on banks by the Federal Reserve as a tool of monetary policy. The Federal Reserve no longer uses reserve requirements as its main monetary policy tool.[16] In any case, the Federal Reserve has not complained that the absence of reserve requirements on money funds has impaired its ability to conduct monetary policy.

Money funds and their shareholders already bear significant costs of federal regulation under the Investment Company Act. Those costs are proportionate to the regulatory benefits and do not impose an undue burden on fund shareholders. The costs of banking regulation are substantial and are imposed on banks in the form of examination and supervisory fees.[17] It is doubtful that money fund shareholders could bear such costs.

MONEY FUNDS ARE HIGHLY REGULATED

Money funds and their managers are highly regulated under the Investment Company Act of 1940.[18] The Act imposes extensive reporting requirements on money funds and strict limitations on their operations, investments, and relationships with investors, advisers and other interested parties.

It is difficult to imagine how federal banking regulation would be an improvement over regulation under the Investment Company Act or how the federal banking regulators, who lack the experience and expertise in money fund regulation, would be better suited to regulate money funds than the Securities and Exchange Commission, which currently regulates them.

The salient features of money fund regulation are described below. It should be noted that money fund regulation is extremely comprehensive and complex and the description that follows is in general terms only.

Money Funds Must Register With the SEC

The Act requires each money fund to register with the SEC and to provide required information concerning its organization, management, and

[16] As its main monetary policy mechanism, the Federal Reserve engages in the purchase and sale of government securities in the open market through the Federal Reserve Bank of New York's open market desk.

[17] The supervisory activities of the Office of the Comptroller of the Currency, which charters and regulates national banks, are funded entirely by bank supervisory fees.

[18] 15 U.S.C. § 80a-1 *et seq*.

operations.[19] Among other things, the Act prohibits convicted felons and other wrongdoers from employment with a money market fund.[20]

Money funds are required to register with the SEC not only when they are created but when they cease operations. The SEC may issue an order prescribing the terms and conditions under which a fund may cease operations if necessary for the protection of investors.[21]

Money Funds Must Have Independent Boards of Directors

Money funds are governed by boards of directors or trustees. The Investment Company Act prohibits any money fund from having a board of directors (or trustees) more than 60 percent of whose members are "interested persons" of the fund.[22] As a practical matter, most large money fund complexes have boards that are 75 percent independent.

In addition, a money fund generally may not employ as a broker or underwriter any company affiliated with a board member (unless a majority of the money fund's board consists of persons who are so unaffiliated).[23]

Money Fund Shareholders Must Approve Key Operations

Money funds must obtain the approval of their shareholders for certain of their key operations. For example, fund shareholders must approve the fund's contract with its investment adviser.[24] Fund shareholders also must approve any changes in a money fund's investment policy.[25]

Money Funds Are Subject to Strict Portfolio Limitations

SEC Rule 2a-7 imposes strict limitations on money fund portfolio investments.[26] A money fund must maintain a dollar-weighted average portfolio maturity of 90 days or less and may not acquire any instrument having a remaining maturity of greater than 397 calendar days.

[19] 15 U.S.C. § 80a-8. Certain money funds are exempt if they have fewer than 100 investors or are not offered to the public.
[20] 15 U.S.C. § 80a-9.
[21] 15 U.S.C. § 80a-8(f).
[22] In practice, most money funds follow the Investment Company Institute's best practice recommendation of a 75 percent disinterested board.
[23] 15 U.S.C. § 80a-10.
[24] 15 U.S.C. § 80a-14.
[25] 15 U.S.C. § 80a-13.
[26] 17 C.F.R. § 270.2a-7.

Money funds generally may purchase only securities that are denominated in United States dollars, pose minimal risk to the fund, and qualify as "eligible securities" under SEC Rule 2a-7. An "eligible security" is (1) a security that is rated in one of the highest two short-term rating categories by a nationally recognized statistical rating organization (NRSRO), or (2) a comparable unrated security.[27] Such securities must be determined by the fund's board of directors to present minimal credit risks.

Rule 2a-7 also imposes diversification requirements designed to limit a fund's exposure to the credit risk of any single issuer, as well as stringent portfolio liquidity standards. A money fund may hold no more than 10 percent of its assets in illiquid securities. A security is considered to be illiquid if it cannot be disposed of within 7 days in the ordinary course of business at approximately the price at which the fund has valued it.

The basic objective of Rule 2a-7 is to limit a money fund's exposure to credit risks (i.e., risks associated with the creditworthiness of the issuer) and market risk (i.e., risk associated with significant changes in prevailing interest rates). Because of the conditions imposed by Rule 2a-7, an investment in a money fund generally does not present any risks greater than a direct investment in the securities the fund holds.

Money funds are prohibited from purchasing any security on margin, except short-term credits as necessary for clearing transactions.[28]

Money Funds Are Subject to Extensive Disclosure Requirements

Money funds are required to make periodic disclosures to the SEC and their shareholders regarding their costs, portfolio investments, performance, and other matters.

For example, SEC rules require money funds to disclose fund expenses that are borne by shareholders, including (i) the cost in dollars associated with an investment of $1,000 based on the fund's actual expenses for the period, and (ii) the cost in dollars associated with an investment of $1,000 based on the fund's actual expense ratio for the period and an assumed return of 5 percent per year.[29]

[27] The SEC has proposed to eliminate the reference to NRSRO's and require fund board's of directors to determine that the security presents minimal credit risks based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.

[28] 15 U.S.C. § 80a-12(a).

[29] 17 C.F.R. § 270.30b1-5.

A money fund also must file a schedule of its complete portfolio holdings with the SEC on a quarterly basis. These filings are publicly available through the SEC's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR).

A money fund's board of directors also must disclose to shareholders the material factors (and conclusions with respect to those factors) that form the basis for the board's approval of contracts with the fund's investment advisers.[30]

Money Funds Use Amortized Cost Valuation

Mutual funds generally are required to calculate their current net asset value by valuing their portfolio securities for which market quotations are readily available at market value and valuing other securities and assets at fair value as determined in good faith by the board of directors.[31] Rule 2a-7 exempts money funds from these provisions but contains maturity, quality, and diversification conditions designed to minimize the deviation between a money market fund's stabilized share price and the market value of its portfolio.

Rule 2a-7 permits money market funds to use the amortized cost method of valuing their securities for securities with remaining maturities of thirteen months or less, thus facilitating a money fund's ability to maintain a stable net asset value of $1.00 per share.[32]

Nevertheless, money funds are required to "shadow price" their assets based on market values. In this regard, money funds must adopt written procedures requiring the periodic calculation of "the extent of deviation, if any, of the current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund's amortized cost price per share."[33] If any deviation from the fund's amortized cost price per share may result in material dilution or other unfair results to investors, the fund must take such action as is reasonably practicable to eliminate or reduce the dilution or unfair results.[34]

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[30] 17 C.F.R. § 240.14a-101.

[31] 15 U.S.C. § 80a-2(a)(41); 17 C.F.R. § 270.2a-4 and 22c-1.

[32] The amortized cost method of valuation means "the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors." Rule 2a-7(a).

[33] Investment Company Act Rule 2a-7(c)(7)(ii)(A)(1).

[34] Investment Company Act Rule 2a-7(c)(7)(ii)(C). When shadow pricing a money market fund portfolio, a fund's board must value all portfolio instruments, regardless of the time to maturity, based on market factors and not their amortized cost value. Investment Company Act Release No. 13380 (July 11, 1983) at text accompanying n.44. The SEC staff

Money Funds Are Subject to Strict Prohibitions on Affiliate Transactions and Conflicts of Interest

The Investment Company Act and SEC rules set forth restrictions on prohibited transactions between a money fund and its investment adviser, principal underwriters, and other service providers ("affiliated persons").[35]

For example, an affiliated person of a money fund generally is prohibited from buying or selling securities to or from the fund and generally may not borrow from or lend to a fund. Money funds and their affiliated persons also are prohibited from engaging together in joint enterprises.[36]

Money Funds are Subject to Restrictions on Fairness to Shareholders

Money funds are required to treat all shareholders of the same class of fund shares equally. They are prohibited from issuing senior securities or otherwise treating shareholders of the same class disparately.[37] Each share of a money fund must have equal voting rights with all other shares in the fund.[38]

Money Fund Advisers Are Regulated

Money funds are organized and operated by investment advisers who are required to register with the SEC. No person may serve as an investment adviser to a money fund except pursuant to a written agreement approved by a majority of the fund's shareholders.[39] The investment advisory agreement must be approved annually by the fund's independent board of directors or by a majority vote of the fund's shareholders. The advisory agreement must include terms providing that it may be terminated at any time, without penalty, by the board of directors or a majority vote of the fund's shareholders on not more than 60 days' written notice, and may be terminated automatically if the agreement is assigned to another person.[40]

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has allowed shadow pricing based on amortized cost valuation of certain assets with a remaining maturity of more than 60 days. See SEC No-Action Letter dated Oct. 10, 2008. The assets must be "first tier" securities and the fund reasonably must expect to hold them to maturity.

[35] 15 U.S.C. § 80a-17(a).

[36] The SEC may grant exceptions from these prohibitions consistent with the protection of investors.

[37] 15 U.S.C. § 80a-18(f).

[38] 15 U.S.C. § 80a-18(i).

[39] 15 U.S.C. § 80a-15.

[40] *Id.*

Money Fund Custodians Are Regulated

The custody of money fund assets is regulated under SEC rules.[41] Money funds generally must place all of their assets in a segregated safekeeping account in the custody of a bank supervised by federal or state regulatory authorities.

MONEY FUNDS DO NOT CREATE SYSTEMIC RISK BUT RATHER ENHANCE SYSTEM LIQUIDITY

It has been suggested by some that money funds pose systemic liquidity risk that has contributed to the current financial crisis.[42] In fact, money funds have provided liquidity to the financial system and contributed significantly to the government's efforts to relieve tight credit conditions and stabilize the economy.

Money funds did not cause the current financial crisis. Nor did any shortcomings in the regulation of money funds cause the financial crisis. Unlike banks, money funds did not make bad loans, distribute toxic assets throughout the financial system through securitization vehicles, or otherwise create systemic risk.

Rather than create liquidity risk, money funds have provided liquidity during the current financial crisis and helped to ease the liquidity risk created by other market participants. Money funds have continued their role as high-quality, liquid investments for investors seeking a safe haven for cash during the recent stock market instability.

Money fund assets have increased by approximately 20 percent during the past year, enabling them to continue to provide funding for the short-term debt and commercial paper markets and the market for municipal securities. Working with liquidity facilities provided by the Federal Reserve, money funds have served as a transmission belt for injecting liquidity into the economy.

The government has supported money funds in this role during the current financial crisis. The Treasury in September of 2008 established a program to insure assets in money funds as of September 19, 2008, and the Federal Reserve established facilities for the purchase of assets acquired by money funds from issuers of short-term debt. These actions helped to assure

[41] *See* Investment Company Act Rule 17f-2.

[42] *See, e.g.*, Group of Thirty, Financial Reform: A Framework for Final Stability (Jan. 2009).

investor confidence in money funds and allowed them to continue their important liquidity function in the financial markets.

Money funds and their shareholders have paid substantial fees to the government in connection with the Treasury's insurance program and the Federal Reserve's liquidity facilities. No money fund failure has occurred that has required the government to make any insurance payout.[43]

It may be appropriate in the future for money funds to have access to central bank liquidity facilities on an emergency basis in the future. Such access would assure that money funds can continue to serve as a source of liquidity in the financial markets during times of stress and would not create moral hazard of the type that affects the banking industry. Money funds do not otherwise need federal liquidity facilities, unlike banks.

CONCLUSION

Money market mutual funds are highly liquid, short-term investment vehicles that perform vital functions in the nation's financial markets and serve a variety of uses for investors. They afford investors access to high quality money market securities that otherwise would be unavailable to many investors. They are highly efficient and enhance the liquidity of the markets for U.S. government and agency securities, municipal bonds, commercial paper, and other money market instruments.

Money funds are comprehensively regulated under the Investment Company Act of 1940. The Act restricts the composition of money fund portfolios, imposes disclosure and reporting requirements, and otherwise limits money fund operations and relationships with their investment advisers and other service providers. [Changes to Rule 2a-7 adopted by the SEC in 2010 further strengthen the regulation of money market funds.]

Money funds have none of the defining characteristics of banks, including the moral hazard and systemic risks posed by large banks. Money funds do not take deposits or make commercial loans. Nor do they leverage their assets in the way banks do or create off-balance sheet liabilities by securitizing their assets. They have operated successfully for decades without federal insurance or the need for central bank liquidity facilities.

Money funds have provided critical liquidity to the financial system during the current crisis and thereby helped to stabilize the financial markets

[43] The Reserve Fund that broke a dollar was not bailed out and its shareholders were not covered by the money fund insurance program.

and provide essential funding for economic activity. Any changes in the regulation of money funds to subject them to capital requirements or other inappropriate bank-like regulation would be detrimental to the role of money funds in the U.S. financial system.