Client Alert.

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Money Market Funds: FSOC Proposes Reforms

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This afternoon, November 13, 2012, the Financial Stability Oversight Council (FSOC), faced with a Securities and Exchange Commission (SEC) that has been deadlocked over whether or how to address concerns about money market funds (MMFs), voted unanimously to propose three MMF reforms. The vote was the FSOC's first exercise of its power under section 120 of the Dodd-Frank Act to recommend heightened regulatory standards to financial regulatory agencies. If finalized, today's proposal will result in a recommendation that the SEC act on at least one of the reforms.[1]

Last August, SEC Chairman Mary Schapiro, in a controversial decision, tabled proposed rulemaking on MMFs because of the lack of support from three Commissioners of the SEC. In a letter sent in late September, Treasury Secretary Timothy Geithner urged the FSOC members at their November meeting to take up MMF reform through their section 120 powers. According to Secretary Geithner at today's meeting, the FSOC's decision was taken on the recommendation of Chairman Schapiro.

Today's proposal from the FSOC presents three options for MMF reform, two of which were before the SEC in August, and requests public comment during the 60 days following publication of the proposal in the Federal Register. The FSOC does not regard the three options as mutually exclusive and thus could recommend more than one to the SEC. The three options are as follows:

- *Option One: Floating Net Asset Value.* Under the first option, MMFs would be required to float the net asset value (NAV) and use mark-to-market valuation, like other mutual funds.
  - This option would underscore for investors that MMFs are not guaranteed and that they could lose money. The daily price of MMFs would reflect gains and losses.
  - In theory, by eliminating the potential of a fund to "break the buck," the likelihood of a run on an MMF would be reduced.
- *Option Two: Stable NAV with NAV Buffer and "Minimum Balance at Risk."* Under the second option, MMFs would keep the constant dollar NAV per share feature, but would tailor a capital buffer of up to one percent of fund assets, adjusted to reflect the fund's risk characteristics. The capital buffer would absorb day-to-day variations in the fund's NAV.
  - The buffer would be paired with a requirement for a minimum balance at risk ("MBR"). The MBR would be three percent of an investor's highest account value in excess of $100,000 during the previous 30 days. This amount would be held back for 30 days. Investors subject to the MBR requirement would be able to redeem up to 97 percent of their assets in the normal course of business.

[1] The press release is available at http://www.treasury.gov/press-center/press-releases/Pages/tg1764.aspx, and the full proposed recommendation is available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Pages/open-notices.aspx.

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- The holdback amount would take a so-called “first-loss” position and could be used to provide extra capital to an MMF that suffered losses greater than its capital buffer during that 30-day period.
- The capital buffer and its companion loss-absorption feature are designed to counteract the "first-mover advantage” that the regulators believe exacerbate an MMF’s vulnerability to runs.
- The MBR requirement would not apply to Treasury MMFs, nor would it apply to investors with account balances below $100,000.

- *Option Three: Stable NAV with NAV Buffer and Other Measures.* The third option would impose a risk-based NAV capital requirement of three percent, as well as other standards. Such standards would include more stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements. The FSOC said that it would be open to a lower capital standard if it can be "adequately demonstrated" that diversification requirements (and possibly other standards) would reduce the vulnerabilities of MMFs.

In presenting the options today, Chairman Schapiro characterized the first option as the one most consistent with SEC regulatory policy. However, if MMFs are to retain a stable NAV, then the second and third options would come into play. The FSOC has invited comment on other possible reforms as well.

The FSOC’s vote today begins a lengthy process that could entail two separate, full-blown notice-and-comment proceedings. Section 120 of the Dodd-Frank Act authorizes the FSOC to “recommend” to the SEC (or any other primary financial regulatory agency) enhanced regulation of a business, in this case the MMF business. Before issuing a recommendation, the FSOC must propose the recommendation and seek public comment—a process similar to the traditional rulemaking of federal agencies.

Section 120 also imposes two substantive requirements on the FSOC. First, in order to make a recommendation to the SEC, the FSOC must determine that the MMF business (by virtue of its conduct, scope, nature, size, scale, concentration, or interconnectedness) could create or increase “the risk of significant liquidity, credit, or other problems” spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities. Second, before finalizing a recommendation, the FSOC must “take costs to long-term economic growth into account.” Today's proposal describes the FSOC's determination on the first point and explains how the FSOC has taken costs to economic growth into account. These decisions are open to public comment.

An FSOC recommendation is not binding or legally enforceable. Once the FSOC has approved a recommendation, the SEC must decide whether to initiate its own rulemaking. Such a process may seem duplicative, but the SEC can adopt a final regulation only on the basis of its own rulemaking. The SEC may choose not to proceed, but if so it must inform the FSOC in writing within 90 days of the FSOC’s recommendation. The FSOC must report to Congress on the SEC’s response to the recommendation.

How a final recommendation from the FSOC will in fact induce the SEC to implement further MMF reforms is far from certain. The FSOC cannot compel the SEC to take action, and an FSOC recommendation is not legally enforceable. The recommendation process, however, will certainly encourage agency action. Indeed, Secretary Geithner emphasized at today’s meeting that the FSOC would suspend its recommendation process should the SEC begin its own rulemaking on the proposed reforms.

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What recommendation will finally emerge and how the SEC will respond to it present a complex set of substantive and administrative issues. Funds will naturally weigh in and are expected to oppose the proposed options. MMFs serve as important investment vehicles not only for their investors but also for the financial markets where they provide a key source of liquidity. A significant shift of funds from MMFs to bank deposits could have consequences for the financial markets and banking policy, including "too big to fail," that are difficult to predict.

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