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FSOC Publishes Money Market Mutual Fund Reform Recommendations

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On November 13, 2012, the Financial Stability Oversight Council (the “FSOC”) unanimously approved the publication of several proposed recommendations for money market mutual fund (“MMMF”) reform (the “Proposed Recommendations”). While these reform options are not proposed rules, their publication represents an important step in structural MMMF reform. It also represents one of the first major tests of the FSOC’s growing jurisdictional authority over the regulatory prerogatives of financial regulators, especially the Securities and Exchange Commission (the “SEC”).

Authority for Proposed Recommendations

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the FSOC’s chief mandates are to identify risks to the financial stability of the United States, promote the expectation that the federal government will not guarantee losses in the event of a market failure, and respond to emerging threats to the financial stability of the United States. Thus, the Proposed Recommendations can be understood as the FSOC’s response to a perceived threat to the financial stability of the United States.

Section 120 of Dodd-Frank permits the FSOC to propose recommendations for more stringent regulation of a financial activity if “the conduct, scope, nature, size, scale, concentration, or interconnectedness of a financial activity or practice...could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, the financial markets of the United States, or low-income, minority, or under-served communities.” The Proposed Recommendations determine that the MMMF industry poses significant liquidity and credit risk for the following reasons:

- amortized cost accounting;
- on-demand redemptions from shareholders with limited same-day liquidity;
- a lack of explicit loss-absorption capacity;
- discretionary sponsor support in the case of a run;
- a base of highly risk-averse investors that are prone to increase the risk of a potential run in the case of an MMMF’s failure; and
- the overall size, scale, and interconnectedness of the MMMF industry.

A determination that the MMMF industry poses significant liquidity or credit risk is a prerequisite to proposing final recommendations to the SEC. While recognizing that the 2010 amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended, directly addressed liquidity risks associated with maturity transformation and MMMF portfolio exposures to credit and interest-rate

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risk, the FSOC takes the position that the central credit and liquidity issues that caused the Reserve Primary Fund to “break the buck” in 2008 persist today.

Upon issuance of the final recommendations, the SEC must: (1) implement the Proposed Recommendations; (2) implement similar standards acceptable to the FSOC; or (3) explain why it declines to follow the Proposed Recommendations within ninety days of their issuance. After agreeing to move forward with one or more of the FSOC’s recommendations, the SEC is required to issue proposed rules for public comment and issue final rules thereafter. Dodd-Frank does not provide a mandatory timeline by which the SEC must implement any of the FSOC’s recommendations.

The Proposed Recommendations

The FSOC provides three main paths for MMMF reform, which are designed to represent trade-offs among stability, yield, and liquidity:

1. requiring the use of a floating net asset value (“NAV”);
2. requiring MMMFs to maintain an NAV buffer with a tailored amount of assets of up to 1% of a fund’s value coupled with delayed redemptions for funds in a “first loss” position; and
3. requiring MMMFs to maintain an NAV buffer with a tailored amount of assets of up to 3% of a fund’s value combined with other measures, such as investment diversification requirements, minimum liquidity levels, and/or more robust diversification requirements.

It is important to note that the three recommendations are not necessarily alternatives and could be combined in a variety of fashions. For example, the FSOC states in the Proposed Recommendations that it may be preferable to allow investors to choose between floating NAV funds and stable NAV funds with enhanced protections and allow investors to determine which they prefer. Each proposal, however, is meant to address the lack of explicit sponsor support in the case of a run on an MMMF and the “first mover” advantage for investors that redeem their shares at the first indication of a threat to an MMMF’s value or liquidity.

A. Floating Net Asset Value

This recommendation would require replacing the current stable NAV of MMMFs with a floating NAV that would fluctuate with the value of the underlying portfolio, aligning the valuation methodology of MMMFs with that of other mutual funds. An MMMF also would be required to re-price its shares from \$1.00 to \$100 to more acutely reflect fluctuations in the value of a fund’s portfolio securities. Existing MMMFs would be “grandfathered” into the new valuation regime and could maintain a stable NAV for a phase-out period potentially as long as five years, but no new share purchases would be allowed in grandfathered stable-NAV MMMFs after a predetermined date.

Significant tax, accounting, and operational issues would need to be addressed if the SEC required MMMFs to adopt a floating NAV. First, the basis reporting tax rules applicable to funds with floating NAVs would now apply to MMMFs, which would require investors to report any gain or loss and impose substantial operational and recordkeeping challenges for MMMFs and their shareholders. The FSOC indicates that the Internal Revenue Service may be willing to modify the basis reporting rules in the context of MMMFs and provide administrative relief for certain *de minimis* gains or losses. Second, under the relevant accounting rules, MMMFs no longer would be treated as cash equivalents, and the FSOC recognizes that this treatment would need to be addressed. Third, MMMFs would need to overhaul their internal systems to switch to a floating NAV model, but the FSOC claims that the costs associated with such an overhaul would be mitigated by current shadow pricing requirements

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under Rule 2a-7 that require MMMFs to have systems in place to determine the current market price of portfolio securities. Finally, the FSOC concedes that, while there may be a “flight” of MMMF investors if the industry is required to adopt a floating NAV, the long-term reaction would be “difficult to predict with any precision.” Instead, the FSOC argues that a long transition period and grandfathering of existing fund shareholdings would lessen this risk. Interestingly, the FSOC does not address the legal inability of many municipalities and other investors to invest in products other than stable NAV products.

B. 1% Capital Buffer with a Minimum Balance at Risk

This recommendation requires: (1) maintaining an NAV buffer of a tailored amount of assets of up to 1% of a fund’s value; and (2) requiring that 3% of a shareholder’s highest account value in excess of \$100,000 during the previous 30 days (the minimum balance at risk, or “MBR”) be available for redemption after a 30-day period of being in a “first loss” position. The \$100,000 MBR threshold is meant to exempt most retail investors from the delayed redemption requirement and its accompanying first-risk loss position.

The size of the NAV buffer would vary depending on the riskiness of the MMMF’s assets according to the following formula:

- No buffer amount would be required for holdings of cash, Treasury securities, and Treasury repos (repos collateralized solely by cash and Treasury securities);
- A 0.75% buffer requirement would be required for other daily liquid assets (or for weekly liquid assets, in the case of tax-exempt funds); and
- A 1% buffer would be required for all other assets.

The FSOC also indicated that the NAV buffer could be funded in a number of different ways, including via an escrow account, through the issuance of subordinated “buffer shares” that would assume a first loss position, or through retained earnings. MMMFs would be required to implement one-half of the required buffer within one year of the effective date of any rule, with the remaining half to be in place within two years.

An investor’s MBR would be equal to 3% of the investor’s “High Water Mark,” which is the amount, if any, by which the highest balance in the investor’s account over the previous 30 days exceeds \$100,000. For example, an investor with a \$200,000 MMMF account and a \$100,000 High Water Mark would have an MBR of 3% of \$100,000, or \$3,000. At the same time, the size of an account balance available for immediate redemption would be equal to the account balance minus the MBR. Thus, an investor redeeming a \$200,000 MMMF account would be able to redeem \$197,000 immediately, with \$3,000 as the MBR subject to a 30-day delayed redemption and a first loss position.

While the FSOC praised this recommendation’s attempt to address a lack of explicit sponsor support and the “first mover” problem, it recognizes that the proposal would result in reduced investor yields and make MMMFs less attractive as investment options because of new restrictions on liquidity. The FSOC also noted that the operational and technological difficulties of tracking an investor’s High Water Mark, MBR shares subject to redemption delays, and subordinated MBR shares would be substantial and costly to both fund sponsors and shareholders.

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C. 3% Capital Buffer Combined with “Other Measures”

This recommendation requires maintaining an NAV buffer of a tailored amount of assets of up to 3% of a fund’s value and combined with one or perhaps several other measures to enhance the effectiveness of the buffer and increase the resiliency of MMMFs. The NAV buffer in this recommendation would function in the same manner as the one outlined in the FSOC’s second recommendation, except that the size of the NAV buffer would be tailored based on the riskiness of a fund’s assets under the following formula:

- No buffer amount would be required for holdings of cash, Treasury securities, and Treasury repos (repos collateralized solely by cash and Treasury securities);
- A 2.25% buffer requirement would be required for other daily liquid assets (or for weekly liquid assets, in the case of tax-exempt funds); and
- A 3% buffer would be required for all other assets.

MMMFs would be required to implement one-sixth of the required buffer within one year of the effective date of any rule, one-third of the buffer within two years, and the remainder in a multi-year transition. New restrictions could include:

- *Investment diversification requirements*, including a reduction in the Rule 2a-7 limitation of investing no more than 5% of total assets in securities issued by a single issuer and expanding the definition of “issuer” to include affiliates of a consolidated group.
- *Revised minimum liquidity levels*, such as increasing minimum daily liquidity from 10% to 20% and increasing minimum weekly liquidity from 30% to 40%.
- *Enhanced disclosure requirements*, including increasing the frequency of required disclosures and reducing or eliminating the delay in public disclosure by the SEC.

The FSOC acknowledges that each of these proposals has potential negative consequences, including reduced investor yield, fund investment in less creditworthy firms, and decreased ability to invest in longer-dated or higher-risk instruments. The Proposed Recommendations indicate, however, that the size of the capital buffer could be reduced if it could be “adequately demonstrated” that enhanced diversification requirements, alone or potentially with other reforms, complement the capital buffer and reduce the vulnerabilities of MMMFs.

Next Steps

The 60-day comment period for the Proposed Recommendations will close on January 18, 2013. Given this timing, it is possible that the FSOC could issue a set of final recommendations to the SEC by mid-2013. If the SEC accepted the final recommendations, it would then move to issue proposed rules for public comment.

There is no guarantee, however, that the SEC will accept the Proposed Recommendations. In August 2012, an SEC staff proposal to impose floating NAVs on MMMFs was tabled after three SEC Commissioners, Daniel M. Gallagher, Troy A. Paredes, and Luis A. Aguilar, informed SEC Chair Mary Schapiro that they would not support that proposal. These Commissioners have nevertheless

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expressed support for additional MMMF reform, but believe that it would be inappropriate to introduce further reforms to the MMMF industry without studying the effects of regulatory changes adopted in 2010 that imposed more stringent liquidity, credit quality, and disclosure requirements on MMMFs. Commissioner Aguilar also argues that the SEC should study the risks posed by the cash management industry as a whole before proposing rules on MMMF reform. In the Proposed Recommendations, the FSOC also acknowledges that there is the potential for investors to shift their assets to less-regulated investment products in response to further MMMF reform. Additionally, Treasury Secretary and FSOC Chair Tim Geithner indicated that the FSOC would drop its plans for recommending further MMMF reform if the SEC put forward its own proposed rules on MMMF reform.

Recent industry reaction to the Proposed Recommendations has ranged from hostility to a willingness to consider additional MMMF reform. Chairman Schapiro's recently announced departure from the SEC also calls into question how the SEC will respond to receiving the Proposed Recommendations from the FSOC or whether it will broker a compromise with the MMMF industry.

Under Dodd-Frank, the FSOC could take several other actions to address MMMF reform if the SEC does not accept the Proposed Recommendations. One option is to designate certain MMMFs (and presumably their investment advisers) as systemically important financial institutions that would be subject to macroprudential regulation and oversight by the Federal Reserve Board. The FSOC also could designate the entire MMMF industry as a systemically important payment, clearing, or settlement activity, subjecting the industry to certain risk management standards as determined by the Federal Reserve Board. Finally, the FSOC could ask the Federal Reserve Board to impose safety and soundness restrictions on bank investment in MMMFs.

Given the dramatic impact of any of these reforms, there is a substantial possibility that the FSOC's or the SEC's actions will be challenged in court, most likely on the basis of inadequate cost-benefit analysis. While the Proposed Recommendations are not subject to the Administrative Procedure Act, the FSOC must show that it has taken "costs to long-term economic growth into account" when issuing final recommendations to the SEC. The Proposed Recommendations argue that additional MMMF reform will significantly reduce the risk of runs on MMMFs, thereby lowering the risk of significant long-term cost to economic growth, and that these benefits outweigh the marginally increased cost of credit for U.S. businesses, households, and state and local governments. If the SEC accepts the Proposed Recommendations, it will also need to conduct a cost-benefit analysis of the final recommendations on MMMF reform.

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