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FSOC and Money Market Fund Reform: A Path to Nowhere

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In a letter (the "Geithner Letter"), to the members of the Financial Stability Oversight Counsel ("FSOC"), Treasury Secretary Geithner started the next round of debate over subjecting money market funds to further regulatory reforms. In the aftermath of SEC Chairman Schapiro's announcement that "a majority of the Commission … will not support a staff proposal to reform the structure of money market funds", Secretary Geithner asked FSOC "to consider taking a series of additional steps to address this challenge." He characterized these steps as a "path forward to protect investors and the economy." This client alert discusses each of the steps the Geithner Letter urged FSOC to take, and why these steps will probably not lead to the structural reform of money market funds.

What Is FSOC?

FSOC was created by the Financial Stability Act of 2010, which is Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Action (the "DFA"). The voting members of FSOC are the Treasury Secretary (who serves as Chairman of the Council), the Chairmen of the Federal Reserve, the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission ("CFTC"), the Federal Deposit Insurance Corporation and the National Credit Union Administration Board, the directors of the Bureau of Consumer Financial Protection and the Federal Housing Finance Agency, the Comptroller of the Currency and an independent insurance expert appointed by the president. FSOC also has five nonvoting members.

The purposes of FSOC are:

> (A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
>
> (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
>
> (C) to respond to emerging threats to the stability of the United States financial system.

(DFA § 112(a)(1))

Although the Dodd-Frank Act only requires FSOC to meet quarterly, it has averaged a meeting every one or two months since its initial meeting October 1, 2010. The Geithner Letter proposes that FSOC take action on money market fund reforms at its next meeting in November.

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Secretary Geithner's Path Forward

Secretary Geithner seeks to have FSOC exercise, for the first time, its authority under section 120 of the DFA to:

> provide for more stringent regulation of a financial activity by issuing *recommendations* to the primary financial regulatory agencies to apply new or heightened standards and safeguards, …, for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions, if [FSOC] determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such 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, financial markets of the United States, or low-income, minority, or underserved communities. [Added emphasis]

Nonbank financial companies include any company predominantly engaged in financial activities. (DFA § 102(a)(4)) The DFA incorporates by reference the "financial activities" specified in section 4(k) of the Bank Holding Company Act, which expressly includes selling interests in pools of assets (§ 4(k)(4)(D)) and advising an investment company (§ 4(k)(4)(C)). Thus, money market funds and their managers are arguably "nonbank financial companies" for purposes of the DFA.

Before making a recommendation, FSOC must consult with the primary financial regulatory agency (the SEC in the case of money market funds and their managers), and must solicit public comment on the proposed recommendation. When making a recommendation, FSOC must "take costs to long-term economic growth into account." (DFA § 120(b)) Once this process is completed, the primary agency is not required to adopt FSOC's recommendation. The agency may "explain in writing to [FSOC], not later than 90 days after the date on which [FSOC] issues the recommendation, why the agency has determined not to follow the recommendation …." (DFA § 120(c)(2)) FSOC must report to Congress on any recommendations and the implementation or failure to implement the recommendation. (DFA § 120(d))

Where Does Section 120 Lead?

Secretary Geithner has "asked staff to begin drafting a formal recommendation immediately" that "include[s] the two reform alternatives put forward by Chairman Schapiro [and] request comment on a third option …." (Geithner Letter at 2) Chairman Schapiro's reform alternatives (which were rejected by a majority of the SEC Commissioners) are to either (1) force money market funds to price their shares using a floating net asset value ("NAV") or else (2) require money market funds to maintain a capital buffer (probably less than 1 percent) coupled with a "minimum balance at risk" for each shareholder of at least 3 percent of the highest account balance during the preceding 30 days. The new third alternative "would entail imposing capital and enhanced liquidity requirements, potentially coupled with liquidity fees or temporary 'gates' on redemptions" as an alternative to the minimum balance at risk. The third alternative reflects a proposal that two of the SEC Commissioners have expressed interest in studying, apparently without any cooperation from Chairman Schapiro.

As this will be FSOC's first attempt to exercise its section 120 authority, it raises several novel questions:

- Section 120 requires consultation with the agency—not just its chairman. Does this mean that FSOC must consult with the SEC as a whole (e.g., all five commissioners) before making a recommendation?

- How detailed must FSOC's recommendation be, both to provide a meaningful basis for public comments and to be useful to the primary agency? A recommendation to have money market funds maintain capital, without addressing the structural, operational and economic difficulties entailed in the recommendation, may not be sufficient.

- How must FSOC weigh the certain harm to the credit markets that would result from the recommended reforms (due to, if nothing else, the uniform view that the reforms will reduce investments in money market funds) against the speculative benefits of the reforms (curtailing runs that might occur under rare circumstances) when assessing the "costs to long-term economic growth" of the recommendations?

But the larger question is: what would be the point of a section 120 recommendation? The SEC will not adopt the first two proposals unless one of the current SEC Commissioners changes his mind,1 and the third proposal is a variation of an alternative already proposed by two of the commissioners. The SEC Commissioners have already explained their reasons for rejecting the Chairman's proposals and have detailed the additional information they would require before supporting structural reforms. There is no need to resort to section 120 to address their concerns and answer their questions.

Returning to the path metaphor, section 120 leads to the same three SEC Commissioners who rejected the Chairman's reform proposals. Unless new information is presented or the reform proposals are modified so as to be acceptable to at least one of these commissioners, we should expect these Commissioners to reject any section 120 recommendations from FSOC. Secretary Geithner and Chairman Schapiro could be developing and presenting new information or modified proposals to these SEC Commissioners today. Section 120 adds nothing to this process and, thus, represents a detour from the true path to structural reform of money market funds.

Secretary Geithner's Alternative Paths

The Geithner Letter also urges FSOC to pursue two alternatives "in parallel" to a section 120 recommendation, "in the event the SEC is unwilling to act in a timely and effective manner." (Geithner Letter at 3) The first alternative would be to designate money market funds or their managers as systemically important financial institutions ("SIFIs") under Title I of the DFA. The second alternative would be to designate money market funds as systemically important financial market utilities ("SIFMUs") under Title VIII of the DFA. The Title I approach would produce, at best, piecemeal reform of money market funds, while the Title VIII approach should run into a dead end.

Designation as a Systemically Important Financial Institution

Section 113 of the DFA provides that FSOC:

> by a vote of not fewer than 2/3 of the voting members then serving, including an affirmative vote by the Chairperson, may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, …, if [FSOC] determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.

As noted above, both money market funds and investment advisers arguably fall within the definition of nonbank financial companies. Thus, in theory, the FSOC could designate money market funds or their managers as subject to Federal Reserve supervision under section 113.

Although neither the DFA nor FSOC's regulations use the term, it has become common to use the acronym "SIFI" to refer to a financial company that becomes subject to Federal Reserve supervision and enhanced prudential standards. The process of designating a SIFI is time consuming.2 It begins with a three-stage process within FSOC, which culminates with a written notice that FSOC is considering designating a company as a SIFI. The notified company then has at least 30 days to submit written materials to contest the designation. (12 CFR § 1310.21(a)) After reviewing the materials, if FSOC decides to proceed with the designation, it must give another written notice to the company of the proposed designation. The notice must include an explanation of the basis for designation. (12 CFR § 1310.21(b))

The company then has 30 days to request a nonpublic evidentiary hearing before FSOC. FSOC must set a hearing date within 30 days of the request, and determine whether to permit oral testimony and argument in addition to the company's written submissions. (12 CFR § 1310.21(c)) FSOC must make a final determination within 60 days of the hearing date. (12 CFR § 1310.21(d)) If FSOC ultimately designates the company as a SIFI, the company has a right to have the designation reviewed by a U.S. district court. (DFA § 113(h)) Although the court may overturn the designation only if it finds the designation arbitrary and capricious, litigants have succeeded in meeting this standard in cases challenging the SEC's cost/benefit analysis of certain new regulations. FSOC must review each designation annually (DFA § 113(d)), which is also subject to court review.

The consequence of a successful SIFI designation is that the money market fund or its manager will become subject to supervision by the Federal Reserve and enhanced prudential standards established by the Federal Reserve. Thus, SIFI designation cannot, by itself, result in any structural reforms to money market funds. It would only shift the onus for reforms from the SEC to the Federal Reserve.

Designation as a Systemically Important Financial Market Utility

The Payment, Clearing, and Settlement Supervision Act of 2010, Title VIII of the DFA, gives FSOC the power to:

> designate those financial market utilities or payment, clearing, or settlement activities that the Council determines are, or are likely to become, systemically important.

(DFA § 804(a)(1)) The Federal Reserve must develop risk management standards for these designated SIFMUs and designated activities, although responsibility for implementing the standards may remain with other member agencies (particularly the CFTC and SEC). (DFA § 805(a))

Money market funds do not resemble any of the SIFMUs that FSOC has designated to date.3 All of the designated SIFMUs clear, settle and make payments on millions of transactions on behalf of thousands of participants. SIFMUs have, at most, a nominal interest in these transactions; their businesses are limited to clearing and settling transactions in financial assets that they hold for their members. In contrast, a money market fund only clears and settles transactions involving shares issued by the fund or portfolio securities owned by the fund. A shareholder who redeems shares deals exclusively with the fund; the fund does not act as an intermediary between the shareholder and whomever the shareholder is paying with the redemption proceeds.

The DFA's definition of a "financial market utility" is much narrower than the definition of a nonbank financial company. It excludes, in particular, investment companies engaged in investment company activities. (DFA § 803(6)(B)(ii)) Because money market funds are registered investment companies, they cannot be designated as SIFMUs.

Some have suggested that the participation of money market funds in the payment system might constitute a "payment, clearing or settlement activity" that could be designated as systemically important. This suggestion overlooks the fact that money market funds do not directly participate in the payment system. Every check, debit card transaction or wire transfer drawn on a money market fund account is cleared, settled and paid by a bank, which then reimburses itself from the money market fund account. The only clearance, settlement and payment activities by a money market fund involve the sale and redemption of its shares.

This type of activity is expressly excluded from the DFA's definition of "payment, clearing, or settlement activity," which does "not include any offer or sale of a security under the Securities Act of 1933 [citation omitted], or any quotation, order entry, negotiation, or other pre-trade activity or execution activity." (DFA § 803(7)(A)) Every money market fund transaction involves a sale (either to the shareholder or to the fund) of a security under a registration statement filed under the Securities Act of 1933, and the $1 price is a quotation of the share price. Thus, the activities of money market funds, as well as the funds themselves, appear to be excluded from Title VIII of the DFA.

Where Do the Alternative Paths Lead?

In the case of designation under Title VIII, the answer to this question should be "'nowhere." Money market funds are expressly excluded from the definition of a SIMFU, and the only clearance, settlement and payment activities in which they engage are excluded from Title VIII. Any attempt by FSOC to exercise this designation authority will lead directly to a court battle with the industry.

With respect to designation under Title I, the only certainties are that this cannot be done on an industry-wide basis and will not result in immediate structural reform. The most it can accomplish is to pass responsibility for structural reform to the Federal Reserve, and then only with respect to the designated funds or managers. Whether FSOC can successfully designate any money market fund or managers as a SIFI is highly uncertain, particularly in light of the right of a fund or manager to challenge the designation in court.

FSOC does not need to resort to the designation process to achieve this limited end, however. Section 165(a) of the DFA gives the Federal Reserve power to impose prudential standards on "bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that … are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States." We estimate4 that, as of August 31, 2012, subsidiaries of these bank holding companies managed $1.157 trillion of U.S. money market fund assets, representing 48 percent of the industry's total assets. If the Federal Reserve could find a means of translating structural reforms of money market funds into more stringent "prudential standards," they probably could already impose these standards on nearly half of the existing money fund assets without attempting to designate any funds or other managers as SIFIs.

An Unasked Question—Is SIFI Designation Constitutional?

Although we always approach constitutional issues with trepidation, we cannot overlook the unprecedented nature of the SIFI designation process. Section 113 gives a group of regulators the power to expand the authority of the Federal Reserve on an ad hoc basis. The standard for expansion is so vague (posing a threat to the financial stability of the United States) and the factors for the FSOC's consideration so general, as to raise a question of whether Congress has given the FSOC an intelligible principle to guide it in designating a SIFI. By the same token, there is a question about whether a court can engage in meaningful review of any SIFI determination that the FSOC makes under the "arbitrary and capricious" standard

Section 113 thus raises a question under what is known as the "nondelegation doctrine." We offer Justice Scalia's statement of the doctrine for its clarity:

> Legislative power is nondelegable. Congress can no more "delegate" some of its Article I power to the Executive than it could "delegate" some to one of its committees. What Congress does is to *assign responsibilities* to the Executive; and when the Executive undertakes those assigned responsibilities it acts, not as the "delegate" of Congress, but as the agent of the People. At some point the responsibilities assigned can become so extensive and so unconstrained that Congress has in effect delegated its legislative power; but until that point of excess is reached there exists, not a "lawful" delegation, but no delegation at all. [Original emphasis]

Loving v. U.S., 517 U.S. 748, 777 (1996) (concurring). In other words, it is one thing for Congress to give the SEC responsibility for regulating brokers and dealers, as broadly defined by Congress, but it would be quite another thing for Congress to have the SEC determine who in the securities markets might need regulating and to regulate them as the SEC sees fit.

The question is whether the powers granted to FSOC in section 113 are "so extensive and so unconstrained" as to amount to a power to amend the Federal Reserve and Bank Holding Company Acts without an act of Congress signed by the President. While findings of unlawful delegations by Congress are exceedingly rare, given the lack of precedent for anything like FSOC's designation power, this should not be regarded as a trivial question. We hope that any institution notified of potential SIFI designation would consider raising this question in court, perhaps at the very outset of the designation process. This would be in addition to the other serious constitutional challenges to Title I recently raised in *State National Bank of Big Springs v. Geithner*, No. 1:12CV1032 (D.D.C), such as granting FSOC unlimited discretion to designate SIFIs, including nonvoting members not appointed by the President with the advice and consent of the Senate, and the absence of meaningful judicial review, that a company threatened with SIFI designation might assert.

Conclusion—the Geithner Letter Is the Wrong Path to Reform

We have shown that FSOC cannot implement structural reforms to money market funds by itself. While FSOC can recommend structural reforms to the SEC under section 120, unless the composition of the SEC changes, this is apt to be a protracted path to the same end as Chairman Schapiro's failed attempt at reforms. The other viable alternative is to designate funds or their managers as SIFIs. This is a convoluted path, however, that would ultimately lead to a court battle that may include a serious constitutional challenge to FSOC's designation powers. Either path will probably take more than a year to traverse, with no certain end. This is why the Geithner Letter represents a continuation along paths that will probably not lead to successful money market fund reforms.

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1. Commissioner Gallagher has stated that he remains open to requiring money market funds to float their NAVs, http://www.bloomberglaw.com/document/MAZDWA6JTSF7, but his support would be conditional and Secretary Geithner has not indicated that he plans to address these conditions.
2. The DFA permits a quicker determination on an emergency basis, but this process does not appear to be applicable to designation of money market funds.
3. The designated SIFMUs are the Clearing House Interbank Payments Systems, CLS Bank International, Chicago Mercantile Exchange, Inc., Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation and Options Clearing Corporation. FINANCIAL STABILITY OVERSIGHT COUNCIL 2012 ANNUAL REPORT, Appendix A.

4. Based on information from the U.S. Federal Reserve System National Information Center and Cranedata.

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