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A legal update from Dechert's Financial Services Group

IOSCO and FSB Recommend Additional Money Market Fund Reform, Putting International Pressure on the SEC to Take Action

Introduction

The International Organization of Securities Commissions (IOSCO), an international organization of securities regulators, recently published its "Policy Recommendations for Money Market Funds" (Final Report).[1] In the Final Report, IOSCO outlined 15 recommendations (the Recommendations) that seek to provide common standards for the regulation of money market funds (money funds) across jurisdictions and to augment existing regulatory frameworks. Most notably, IOSCO recommended that, in jurisdictions where money funds are offered at a stable net asset value (NAV) per share, such as in the United States, regulators either: (i) require that, where workable, money funds issue and redeem their shares at a floating NAV per share; or (ii) impose additional safeguards to reinforce stable NAV money funds' resilience and ability to withstand significant redemptions (Recommendation 10).

Although a member of IOSCO, the U.S. Securities and Exchange Commission (SEC) did not support the Final Report. However, since the issuance of the Final Report, the SEC has faced growing international pressure to consider reforms similar to those recommended in the Final Report.[2] IOSCO discussed the Final Report with the G20 Finance Ministers at a meeting held on November 5, 2012. On November 19, 2012, the Financial Stability Board (FSB), an international organization of regulators established after the G20 Leaders Summit of April 2009, endorsed IOSCO's recommendations, including Recommendation 10, in its final report "Strengthening Oversight and Regulation of Shadow Banking" (FSB Report).[3]

This *DechertOnPoint* provides background on the Final Report and compares the IOSCO Recommendations, including Recommendation 10, to the requirements of Rule 2a-7 under the Investment Company Act of 1940 (1940 Act), the primary rule regulating U.S. money funds, and other rules governing U.S. money funds.

1 International Organization of Securities Commissions, Policy Recommendations for Money Market Funds (Oct. 2012), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf.

2 In addition to international pressure, the U.S. Financial Stability Oversight Council (FSOC), a council of U.S. banking and securities regulators, placed domestic pressure on the SEC when the FSOC issued proposed recommendations for money fund reform. For additional information on the FSOC's proposed recommendations, see our *DechertOnPoint* "U.S. Financial Stability Oversight Council Proposes Recommendations for Money Market Fund Reform."

3 Financial Stability Board, Strengthening Oversight and Regulation of Shadow Banking (Nov. 18, 2012), available at http://www.financialstabilityboard.org/publications/r_121118a.pdf. The FSB is accepting comments on the FSB Report until January 14, 2013.

Background

In October of 2011, the FSB published its consultation report "Shadow Banking: Strengthening Oversight and Regulation" (Shadow Banking Report), in which the FSB identified money funds as "shadow banks."[4] The Shadow Banking Report defined shadow banking as "credit intermediation involving entities and activities outside the regular banking system."[5] In the Shadow Banking Report, the FSB requested that IOSCO review potential regulatory reforms for money funds as part of the FSB's overall goal of addressing the risks inherent in the "shadow banking system."

Following the FSB's request, IOSCO initially published a consultation report titled "Money Market Fund Systemic Risk Analysis and Reform Options" (Consultation Report) on April 27, 2012.[6] IOSCO released the Consultation Report without the support of a majority of the SEC Commissioners. Shortly after the Consultation Report was issued, the three Commissioners of the SEC who did not support the Consultation Report issued a joint statement noting that the Consultation Report had been published without the concurrence of the SEC and stating that the Consultation Report did not reflect the views and input of a majority of the SEC.[7] The Consultation Report provided IOSCO's preliminary analysis of the possible risks to financial stability presented by money funds and discussed possible reform options. During the consultation period, which ended on June 24, 2012, IOSCO received 41 comments, a majority of which came from the asset management industry.

The IOSCO board approved the release of the Final Report at its meeting in Madrid on October 3 and 4, 2012. Similar to the Consultation Report, IOSCO released the Final Report without the concurrence of the SEC.

IOSCO Report

Initial Findings

IOSCO made several claims in the Final Report, the most significant of which was that IOSCO believes that, while money funds did not cause the 2008 financial crisis, their performance during the financial crisis demonstrates their ability to spread or even amplify a crisis. The Final Report asserted that this is due in large part to the size of the money fund industry, which IOSCO estimated at $4.7 trillion in global assets under management at the end of the first quarter of 2012. Additionally, IOSCO claimed that money funds are part of the "shadow banking system," because they perform maturity and liquidity transformation and do not have access to official support and backstop facilities. Overall, IOSCO concluded that money funds pose a systemic risk to the financial system and that additional reforms are needed.

IOSCO recognized that the SEC had adopted reforms since the 2008 financial crisis, acknowledging that the SEC had approved significant amendments to Rule 2a-7 and other rules regulating money funds in order to strengthen the existing risk-limiting provisions applicable to U.S. money funds (the 2010 Amendments).[8] The 2010 Amendments tightened maturity, diversity and credit quality standards and imposed new liquidity requirements on U.S. money funds. However, IOSCO argued that these reforms did not address the systemic features of money funds, including the incentive for investors "to redeem quickly when they fear that the fund will record a loss, which can lead the fund to burn the rest of its liquidity through fire sales and can lead to contagion effects to other funds."[9] IOSCO asserted that the 2010 Amendments were only a first step and did not address

4 Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation (Oct. 27, 2011), available at http://www.financialstabilityboard.org/publications/r_111027a.pdf.

5 *See Id.*

6 International Organization of Securities Commissions, Money Market Fund Systemic Risk Analysis and Reform Options (April 2012), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf.

7 *See* Statement Concerning Publication by IOSCO on April 27, 2012 of the "Consultation Report of the IOSCO Standing Committee 5 on Money Market Funds: Money Market Fund Systemic Risk Analysis and Reform Options," U.S. Securities and Exchange Commission (May 11, 2012), available at http://www.sec.gov/news/speech/2012/spch051112laatapdmg.pdf.

8 Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010). For further information regarding the 2010 Amendments, please refer to our *DechertOnPoint* "Amendments to the Regulatory Structure Governing Money Market Funds."

9 *See* Final Report at 7.

other vulnerabilities, which IOSCO claimed include: (i) the stable NAV; (ii) the first mover advantage; (iii) the discrepancy between the NAV published and the value of the assets; (iv) the implicit support; and (v) the importance of ratings.

The Recommendations

The Final Report listed 15 Recommendations, many of which have already been adopted by the SEC as part of Rule 2a-7 and other rules governing U.S. money funds. Below is a list of the Recommendations and a comparison of each Recommendation against existing U.S. regulations:

1. **Money funds should be explicitly defined in Collective Investment Scheme regulation.**

IOSCO stated in the Final Report that regulators should define money funds as funds that seek to preserve capital and provide daily liquidity, while offering returns consistent with money market rates or a similar definition. IOSCO noted that the definition should ensure that all "Collective Investment Schemes" (*i.e.*, investment funds or investment pools) that present the characteristics of a money fund are properly regulated as money funds.

In the United States, the SEC has already addressed this recommendation with respect to those investment funds that are subject to its oversight and regulation. In particular, Rule 2a-7 explicitly provides that a registered investment company holding itself out and using a name or title that suggests that the fund is a money fund or is the equivalent of a money fund, such as "cash," "liquid," "money," "ready assets" or similar terms, is subject to the substantive requirements of Rule 2a-7.[10] These requirements apply whether or not a fund maintains a stable price per share.

2. **Specific limitations should apply to the types of assets in which money funds may invest and the risks they may take.**

IOSCO next recommended that regulators restrict the type of assets that a money fund may hold. IOSCO stated that money funds should hold high quality money market instruments and other low-duration fixed income instruments. The Final Report listed several proposed restrictions, including limitations on currency exposure, portfolio holdings, diversification, concentration, weighted average term to maturity (WAM) and weighted average life (WAL) of the portfolio. With respect to WAM and WAL of a money fund's portfolio, IOSCO recommended that the fund should not exceed 60 days and 120 days, respectively.

Rule 2a-7 currently includes these risk limiting provisions. First, Rule 2a-7 requires that a U.S. money fund limit its portfolio investments to U.S. dollar-denominated securities that present minimal credit risk.[11] A U.S. money fund also must limit portfolio investments to securities that qualify as "eligible securities," which are defined as short-term securities that are rated in one of the top two short-term debt ratings by nationally recognized statistical rating organizations (NRSROs) or, if unrated, are of comparable quality.[12] Furthermore, a U.S. money fund must limit its investments in second tier securities to no more than 3% of the fund's total assets, with no more than 0.5% in any one issuer.[13] Rule 2a-7 also establishes stringent quality, diversification and concentration limits. Finally, under Rule 2a-7, a U.S. money fund's portfolio must have a WAM of 60 calendar days or less and a WAL of 120 days or less.[14]

3. **Regulators should closely monitor the development and use of other vehicles similar to money funds.**

In the Final Report, IOSCO stressed the importance of regulators monitoring other vehicles that are similar to money funds. IOSCO noted that, in the case of private funds or unregulated cash pools, regulators should assess the need to extend the perimeter of regulation to such products.

In the United States, short-term investment funds (STIFs) — a type of collective investment fund that pools together investments for investors and uses the amortized cost method — are similar to money funds. On October 9, 2012, the U.S. Office of the Comptroller of the Currency (OCC) revised rules governing STIFs in order to strengthen existing regulations and more closely align those regulations with Rule 2a-7 under the

10 *See* 17 CFR 270.2a-7(b).

11 *See* 17 CFR 270.2a-7(c)(3)(i).

12 *See* 17 CFR 270.2a-7(a)(10). As discussed below, the SEC has proposed to remove all references to NRSROs from its regulations.

13 *See* 17 CFR 270.2a-7(c)(4)(i)(C).

14 *See* 17 CFR 270.2a-7(c)(2)(ii)-(iii).

1940 Act.[15] With respect to monitoring private funds and unregulated cash pools that are comparable to money funds, in August 2012, three of the SEC Commissioners requested that the staff of the Division of Risk, Strategy, and Financial Innovation consider, among other things, how future reforms to Rule 2a-7 could affect the demand for investments in money fund substitutes. On December 5, 2012, the SEC published for public comment a report prepared by the staff of that Division addressing those Commissioners' requests. (SEC Staff Report).[16] The SEC Staff Report will likely assist the SEC and other regulators in determining whether regulation is needed to enhance the oversight of money fund substitutes.

4. Money funds should comply with the general principle of fair value when valuing the securities held in their portfolios. Amortized cost method should only be used in limited circumstances.

IOSCO stated in the Final Report that it "acknowledges that amortized cost accounting may provide an accurate estimate of market price for certain short-term instruments," but that there are certain situations where there may be a major divergence between mark-to-market pricing and the amortized cost method.[17] IOSCO recommended that the amortized cost method generally should not be used when a security has a maturity of longer than 90 days.

The SEC currently permits a U.S. money fund to use the amortized cost method only if the board of the fund determines, in good faith, that it is in the best interest of the fund and shareholders.[18] The SEC also only allows a fund to continue to use the amortized cost method if the board believes that it fairly reflects the market-based NAV per share.[19] Under Rule 2a-7, a board of a U.S. money fund that uses the amortized cost method must adopt written procedures that, among other things, require that the board promptly consider action when (i) the deviation of the fund's NAV per share calculated using available market quotations and the fund's amortized cost per share exceeds ½ of 1 percent, or (ii) the board believes the extent of any such deviation may result in material dilution or other unfair results to investors or existing shareholders.[20] Finally, U.S. money funds are permitted to invest only in eligible securities (*i.e.*, securities with maturities of 397 days or less). Although U.S. money funds are permitted to use the amortized cost method to value securities with maturities of greater than 90 days, the WAM and WAL limitations under Rule 2a-7 effectively limit the number of securities with maturities of 90 days or longer in which a fund may invest.[21]

5. Money fund valuation practices should be reviewed by a third party as part of their periodic review of the fund's accounts.

IOSCO recommended that a third party should review the valuation practices of a money fund, especially the sourcing of prices for valuing its assets. If a money fund uses the amortized cost method, IOSCO suggested that a third party should review the conditions for using that method and the processes for calculating the fund's shadow NAV (*i.e.*, the NAV of the shares of the fund calculated using values for portfolio instruments based upon current market factors).

Although Rule 2a-7 does not require that valuation practices be reviewed by a third party as part of the periodic review of a U.S. money fund's accounts, the SEC does require that an independent public accountant certify certain reports to fund shareholders. In particular, Section 30(g) of the 1940 Act requires that financial statements contained in annual shareholder reports be accompanied by a certificate

15 *See* Short-Term Investment Funds, 77 FR 61229 (Oct. 9, 2012). For a discussion regarding the similarities between STIFs and money funds, see our *DechertOnPoint* "OCC Tightens Regulatory Requirements for STIFs."

16 Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission (Nov. 30, 2012), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

17 *See* Final Report at 12.

18 *See* 17 CFR 270.2a-7(c)(1).

19 *Id.*

20 *See* 17 CFR 270.2a-7(c)(8).

21 The SEC has also taken the position that a fund that does not maintain a stable NAV per share may nonetheless use amortized cost to value securities that mature in 60 days or less as long as the fund's board determines in good faith that amortized cost is an appropriate measurement of the fair value of the securities. *See* Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Accounting Series Release No. 219, Investment Company Act Release No. 9786 (May 31, 1977).

of an independent public accountant. Pursuant to Rule 2-01 and Rule 2-02(c) of Regulation S-X, the accountant certifying an annual report must be independent and the accountant must state its opinion (i) with respect to the financial statements covered by the report and (ii) as to the consistency of the application of the accounting principles. Together, these regulations require that the value of a U.S. money fund's assets be reviewed by an independent accountant as part of the annual audit.

6. Money funds should establish sound policies and procedures to know their investors.

IOSCO next recommended that money funds establish a system to identify their larger investors' cash needs and their risk aversions. Additionally, IOSCO recommended that money funds understand the effects of one or concurrent redemption requests by the larger investors. IOSCO suggested that a money fund put in limits on how much of the fund a single investor may hold, where practicable. If not practicable, IOSCO stated that money funds should at least try to gather as much information about the larger investors as possible.

As part of the 2010 Amendments, the SEC adopted new liquidity requirements that require U.S. money funds to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions. [22] In the release adopting this liquidity requirement, the SEC stated that, in order to fulfill the requirements of Rule 2a-7, a U.S. money fund, under Rule 38a-1, would have to implement policies and procedures designed to know the customers of the fund (KYC Procedures). [23] Accordingly, U.S. money funds have established KYC Procedures to identify the risk characteristics of certain customers that are likely to make large redemption requests.

7. Money funds should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.

IOSCO next suggested that regulators should define a minimum level of liquid securities that each money fund may hold depending on the characteristics of each market. The Final Report also noted that money funds should adjust their holdings of liquid assets depending on market conditions and the fund's profile and investor base.

The SEC has historically limited the amount of illiquid securities in which a U.S. money fund may invest. Prior to the 2010 Amendments, the SEC prohibited U.S. money funds from holding more than 10% of their assets in illiquid securities and, after the 2010 Amendments, the SEC reduced the percentage of assets that U.S. money funds may invest in illiquid securities to 5% of their assets. [24] As part of the 2010 Amendments, the SEC also required U.S. money funds to maintain certain levels of liquid assets. In particular, under Rule 2a-7, a taxable money fund is subject to requirements that 10% of its assets be invested in "Daily Liquid Assets" (that is, cash, U.S. Treasury securities and securities convertible into cash in one business day) and 30% of its assets be invested in "Weekly Liquid Assets" (that is, cash, U.S. Treasury securities, agency notes with remaining maturities of 60 days or less and securities convertible into cash, whether by maturity or through exercise of a demand feature, within five business days). Tax-exempt money funds must comply with the Weekly Liquid Assets requirement. [25] Finally, as noted above, Rule 2a-7 establishes a general liquidity requirement that obligates U.S. money funds to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions. [26]

8. Money funds should periodically conduct appropriate stress testing.

IOSCO recommended that money funds periodically test their portfolios against hypothetical and/or historical events. The Final Report stated that, if a stress test reveals certain vulnerabilities, the money fund should adjust its portfolio holdings accordingly.

Since the 2010 Amendments, the SEC has required U.S money funds to conduct stress testing of hypothetical situations and to report the results of these stress tests to the funds' boards. [27]

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22 *See* 17 CFR 270.2a-7(c)(5).

23 *See supra* note 8 at n. 98.

24 *See* 17 CFR 270.2a-7(c)(5)(i).

25 *See* 17 CFR 270.2a-7(c)(5)(ii)-(iii).

26 *See* 17 CFR 270.2a-7(c)(5).

27 *See* 17 CFR 270.2a-7(c)(10)(v).

9. Money funds should have tools in place to deal with exceptional market conditions and substantial redemption pressures.

IOSCO explained that the main purpose of this Recommendation is to help prevent contagion effects stemming from a "run" on a money fund. In order to accomplish the prevention of contagion effects, IOSCO proposed that regulators put in place tools for money funds to cease redemptions in times of significant redemption requests. IOSCO suggested temporary suspensions, gates and/or redemptions-in-kind, in order to manage runs on money funds.

The SEC has already provided U.S. money funds and their boards and advisers with important tools to prevent contagion effects and to assist a fund during exceptional market conditions. First, Rule 22e-3 permits a U.S. money fund to suspend redemptions if: (i) the fund's board (including a majority of independent board members) determines that the deviation between the fund's amortized cost price per share and the market-based NAV per share may result in material dilution or other unfair results; and (ii) the board irrevocably approves the liquidation of the fund. If the board votes to suspend redemptions, it must first notify the SEC by email of that decision. Additionally, the 2010 Amendments broadened the ability of U.S. money fund affiliates (such as a fund's investment adviser) to buy securities from funds under Rule 17a-9. Under 17a-9, a U.S. money fund's investment adviser can purchase problematic securities from the fund, subject to certain conditions, including SEC notice and the ability of the fund to claw-back any profits on a subsequent sale of the securities by the affiliate.

10. Money funds that offer a stable NAV should be subject to measures designed to reduce the specific risks associated with their stable NAV feature and to internalize the costs arising from these risks. Regulators should require, where workable, a conversion to floating/ variable NAV. Alternatively, safeguards should be introduced to reinforce stable NAV money funds' resilience and ability to face significant redemptions.

As mentioned above, IOSCO suggested that, in jurisdictions that allow the use of a stable NAV, regulators either: (i) require that, where workable, money funds issue and redeem their shares at a floating NAV per share; or (ii) impose additional safeguards to reinforce stable NAV money funds' resilience and ability to face significant redemptions. With respect to requiring money funds to adopt a floating NAV, IOSCO stated its belief that a floating NAV per share will improve investors' understanding of the risks inherent in money funds and the difference between money funds and bank deposits. IOSCO also argued that a floating NAV would reduce the need for sponsor support during periods of market stress. IOSCO noted, however, that moving to a floating NAV could be challenging and could cause disruptive effects for the financial system and the economy at large. As an alternative to a floating NAV, IOSCO stated that regulators should impose additional safeguards to reinforce stable NAV money funds' resilience and ability to face significant redemptions. In this regard, IOSCO suggested NAV buffers, liquidity fees or hold back of redemption proceeds as appropriate safeguards.

Recommendation 10 is the most controversial Recommendation in the Final Report and is likely the main reason that the SEC did not endorse the Final Report. At the time IOSCO released the Final Report, the SEC Commissioners were divided regarding the need to propose similar reforms. In fact, Commissioners Luis Aguilar, Daniel Gallagher and Troy Paredes had previously issued public statements expressing their disagreement with then-Chairman Mary Schapiro over the need to pursue additional money fund reforms. [28]

Although the SEC has not yet acted to propose additional reforms, such as those suggested in Recommendation 10, on November 13, 2012, the FSOC issued proposed recommendations, which closely resemble Recommendation 10. [29] The FSOC is currently seeking comments on its proposed recommendations and, if after the comment period the FSOC issues formal recommendations, the SEC would be required to either adopt the recommended standards or similar standards, or to explain in writing

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28 *See* Statement on the Regulation of Money Market Funds by Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission (Aug. 23, 2012), available at http://www.sec.gov/news/speech/2012/spch082312laa.htm and Statement on the Regulation of Money Market Funds by Commissioner Daniel M. Gallagher; Commissioner Troy A. Parades, U.S. Securities and Exchange Commission (Aug. 28, 2012), available at https://www.sec.gov/news/speech/2012/spch082812dmgtap.htm.

29 *See supra* note 2.

within 90 days why it has determined not to follow the FSOC's recommendations.[30]

11. Money fund regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoid any mechanistic reliance on external ratings.

IOSCO stated that investment advisers to money funds should be responsible for assessing the credit worthiness of investments and that external ratings should only be one element to take into consideration when assessing a portfolio security. IOSCO claimed that when investment advisers avoid "mechanistic reliance on external ratings," then "herding and 'cliff effects' and the risks of fire sales" can be reduced.[31]

Rule 2a-7 has never permitted mechanistic reliance on external ratings, instead requiring U.S. money fund boards (or their designee) to assess the quality of a fund's portfolio securities and determine that those securities present "minimal credit risk." In making that determination, a board (or its designee) must use factors "pertaining to credit quality in addition to any rating assigned to such securities by [a Nationally Recognized Statistical Ratings Organizations]."[32]

Section 939A of the Dodd-Frank Act, however, directed the SEC to remove any references to Nationally Recognized Statistical Ratings Organizations (NRSROs) from its rules. On March 3, 2011, the SEC proposed a set of amendments to certain rules, including Rule 2a-7, that would remove references to credit ratings issued by NRSROs and replace them with new, more subjective, standards of creditworthiness.[33] Although the SEC has not yet adopted the changes, based on the proposed release and given Section 939A of the Dodd-Frank Act, the SEC may well move forward to limit a U.S. money fund's use of NRSROs and credit ratings when making portfolio investments.

12. Credit rating agency supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money funds.

IOSCO suggested that credit rating agencies should develop ways to educate investors about ratings methodologies and the meaning of credit ratings. IOSCO noted that credit rating agencies impose on rated money funds strict criteria on the types of securities such funds may hold and that a downgrade to a security can lead to a fire sale. IOSCO also stated that further study should be conducted on the advantages, drawbacks and potential risks of rating money funds.

Section 939(h)(1) of the Dodd-Frank Act required the SEC staff to undertake a study on the feasibility and desirability of: (i) standardizing credit rating terminology, so that all credit rating agencies issue credit ratings using identical terms; (ii) standardizing the market stress conditions under which ratings are evaluated; (iii) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and (iv) standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.[34] Consistent with the Dodd-Frank Act, the SEC submitted its report to Congress, in which the SEC staff recommended to the SEC that it not take any further action at this time with respect to any of those four topics. Instead, the SEC staff recommended that the SEC focus on the rulemaking initiatives mandated under the Dodd-Frank Act. In particular, Section 938(a) of the Dodd-Frank Act required the SEC to establish rules that require NRSROs to establish, maintain and enforce policies and procedures that clearly define and disclose the meaning of any symbol used by an NRSRO. The SEC has proposed rules to implement this requirement.[35]

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30 *See* Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010) (Dodd-Frank Act).

31 *See* Final Report at 17.

32 *See supra* note 8 at n. 98.

33 *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29592 (March 3, 2011).

34 *See* Credit Rating Standardization Study, Report to Congress as Required by Section 939(b) of the Dodd-Frank Act (Sept. 2012), available at http://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.

35 *See* Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 64514 (May 18, 2011), available at http://www.sec.gov/rules/proposed/2011/34-64514.pdf.

13. Money fund documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal loss.

In the Final Report, IOSCO claimed that investors view money funds as an alternative to bank deposits and, therefore, believe that money funds do not lose value. Accordingly, IOSCO suggested that a money fund should make the risk of loss to principal explicit.

The SEC has long required U.S. money funds to state prominently in their prospectuses that a person's investment in a money fund is not guaranteed and that it is possible to lose money by investing in the fund. [36] Form N-1A, which sets forth the disclosure requirements for open-end investment company registration statements, requires U.S. money funds to state: "[a]n investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund." [37] In addition, if a U.S. money fund is sold through an insured depository institution, the fund's prospectus must combine the foregoing statement with the following statement: "[a]n investment in the Fund is not a deposit of the bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency." [38]

14. Money funds' disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress.

IOSCO argued that, because the valuation processes for money funds differ from ordinary collective investment schemes, a money fund should disclose to shareholders its valuation methodologies.

The SEC currently requires all U.S. money funds to disclose their valuation methodology in the prospectus and Statement of Additional Information. In particular, Form N-1A requires U.S. money funds to provide in the prospectus and Statement of Additional Information an explanation that the price of the shares is based on the fund's NAV and the method used to value the fund's shares. [39]

15. When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repurchase agreements by money funds, taking into account the outcome of current work on repurchase agreement markets.

IOSCO represented that money funds play an important role in the securities lending and the repurchase agreement (repo) markets. IOSCO argued that regulators should develop guidelines governing the use of repos by money funds that cover settlement, counterparty risks and collateral management.

The SEC generally limits a U.S. money fund's investments in repos through its limitations on investments in single issuers. Under the 1940 Act, a repo is deemed to be a security issued by the counterparty to the repo agreement, unless the repo is collateralized with cash or government securities and the fund's board (or its designee) has evaluated the creditworthiness of the counterparty. [40] Therefore, if a repo is not collateralized by cash or government securities or the fund's board (or its designee) has not evaluated the creditworthiness of the counterparty, the SEC restricts a U.S. money fund's exposure to the counterparty to five percent of the fund's assets, thereby reducing counterparty risk. Because most money funds seek to collateralize their repo agreements with cash or government securities, the risks associated with settlement and collateral management are also reduced. [41]

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36 *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991).

37 *See* Form N-1A, Item 4(b)(ii).

38 *See* Form N-1A, Item 4(b)(iii).

39 *See, e.g.,* Form N-1A, Items 11(a)(1) and 23(c).

40 *See* 17 CFR 270.2a-7(c)(4)(ii)(A).

41 The SEC has long required all registered investment companies engaging in repos to take possession of collateral securities through delivery to the fund's custodian bank. *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 13005 (Feb. 2, 1983).

Conclusion

As explained above, the SEC has addressed many of IOSCO's Recommendations in Rule 2a-7 under the 1940 Act and other rules. However, the Final Report highlights the continued international pressure on the SEC to adopt additional regulation, including the adoption of reforms suggested in Recommendation 10. Going forward, it is possible that the SEC will either consider on its own or through a formal recommendation from the FSOC reforms similar to those suggested in Recommendation 10.

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