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A legal update from Dechert's Financial Services Group

U.S. Financial Stability Oversight Council Proposes Recommendations for Money Market Fund Reform

Introduction

On November 13, 2012, the U.S. Financial Stability Oversight Council (FSOC) voted to issue proposed recommendations (Proposed Recommendations) to the U.S. Securities and Exchange Commission (SEC) regarding additional reforms to Rule 2a-7 and other rules under the Investment Company Act of 1940 (Act) that govern money market funds (money funds).[1] The vote to issue the Proposed Recommendations is the next step in a long and, at times, contentious debate regarding whether and to what extent money funds exacerbated the 2008 financial crisis. Proponents of the Proposed Recommendations (or other similar recommendations) contend that, in addition to the reforms adopted by the SEC in 2010, money funds should be subject to reforms that address a money fund's perceived susceptibility to "runs" or the "first-mover advantage." Although SEC Chairman Mary Schapiro was not able to reach a consensus with other SEC Commissioners as to a package of proposed reforms put together by the SEC Staff, the Proposed Recommendations will no doubt stimulate additional debate and could lead, ultimately, to a compromise.

This update provides a brief background on the events leading up to the Proposed Recommendations. It also describes the Proposed Recommendations and provides commentary on the substance of these recommendations.

Comments on the Proposed Recommendations are due by January 18, 2013.

Background

SEC Fails to Vote on Money Fund Reform

In 2010, the SEC adopted amendments to Rule 2a-7 (2010 Amendments) to address many of the concerns raised during the 2008 financial crisis, during which the Reserve Primary Fund became only the second money fund in history to break the buck.[2] These reforms included enhanced liquidity, maturity, diversification and credit quality standards for money fund investments. At the time, the 2010 Amendments were described by Chairman Schapiro as "an important first step."

In 2012, Chairman Schapiro outlined a proposal prepared by the SEC Staff that would

1 *See* Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) (FSOC Release).

2 This led to a "flight to quality" as many money fund shareholders moved their investments out of prime money funds that invested in short-term corporate debt and into money funds that invested in government securities, thereby further aggravating illiquidity in the commercial paper market. *See* Letter from Investment Company Institute (ICI) to the SEC (Aug. 20, 2012) (estimating that, "[f]or every dollar that left prime funds, 61 cents went into Treasury and government and agency funds").

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have required money funds to either: (i) convert to a floating net asset value (NAV);[3] or (ii) maintain a stable NAV while maintaining a capital buffer and imposing certain restrictions on redemptions (Staff Proposals). However, Chairman Schapiro was not able to reach a consensus with other SEC Commissioners on the Staff Proposals and announced in late August that the SEC would not be moving forward with the proposals. Democratic Commissioner Luis Aguilar and Republican Commissioners Daniel Gallagher and Troy Paredes subsequently issued statements giving their reasons for not supporting the Staff Proposals.[4]

FSOC and Money Fund Reform

On September 27, 2012, Timothy Geithner, Treasury Secretary and Chairman of the FSOC, issued a letter in which he "urged" other members of the FSOC to use the FSOC's authority under Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to recommend to the SEC that it adopt further regulations governing money funds.[5] Secretary Geithner's letter described reforms that were similar to those contained in the Staff Proposals and included: (i) a floating NAV; and (ii) a capital buffer coupled with a "minimum balance at risk" requirement. The letter also described enhanced capital and liquidity requirements, as well as the possibility of liquidity fees or temporary "gates" on redemptions.

Section 120 of Dodd-Frank gives the FSOC the authority to recommend that a primary financial regulator, such as the SEC, apply new or heightened standards and safeguards to financial activities or practices conducted by bank holding companies (BHCs) or "nonbank financial companies" under the primary regulator's jurisdiction. If the FSOC recommends that the SEC impose enhanced requirements on money funds, the SEC would be required to either: (i) impose the recommended standards or similar standards that the FSOC deemed acceptable; or (ii) explain in writing within 90 days to the FSOC why the SEC determined not to follow the FSOC recommendations. The FSOC is required to report to Congress on any recommendations the FSOC issues and the implementation thereof, or the failure of the appropriate agency to implement such recommendations.

Secretary Geithner's letter also stated that the FSOC should take "active steps in the event the SEC is unwilling to act in a timely and effective manner" and evaluate the money fund industry to identify firms that could pose a threat to U.S. financial stability.[6]

FSOC's Proposed Recommendations

In order to make the Proposed Recommendations under Section 120, the FSOC is required to make a determination that "the conduct, scope, nature, size, scale, concentration, or interconnectedness" of a financial activity or practice as conducted by BHCs or nonbank financial companies "could create or increase the risk of significant liquidity, credit or other problems spreading among" BHCs and nonbank financial companies, U.S. financial markets or low-income, minority or under-served communities.

Money Fund Practices Identified by the FSOC

In the FSOC Release, the FSOC identified five activities or practices of money funds (or money fund investors) that, it argues, are mutually reinforcing, create a "first-mover advantage" and make money funds vulnerable to runs. These activities or practices are:

3 Rule 2a-7 facilitates a money fund's ability to maintain a stable $1.00 price per share by permitting the fund to use the amortized cost method of valuation and the penny-rounding method of pricing.

4 The joint statement from Commissioners Gallagher and Paredes stated that the "necessary analysis has not been conducted to demonstrate" the efficacy of the reforms outlined in the Staff Proposals. The Commissioners also recommended other approaches, including empowering money fund boards to impose "gates" on redemptions. *See* Statement of SEC Commissioners Gallagher and Paredes on the Regulation of Money Market Funds (Aug. 28, 2012).

5 *See* Letter from Secretary Geithner to the Financial Stability Oversight Council (Sept. 27, 2012).

6 Section 113 of Dodd-Frank grants the FSOC the authority to designate individual nonbank financial companies, potentially including money funds, as systemically important financial institutions (SIFIs). A money fund designated as a SIFI would be subject to enhanced prudential standards. Uncertainties regarding the application of prudential standards to non-banking entities raise significant issues for such entities, including money funds, which do not operate in a manner comparable to banking entities.

- The use of amortized cost accounting to support a stable NAV;
- The redeemability of money fund shares on demand, while some money fund assets have longer maturities and limited same-day liquidity;
- The exposure of money fund assets to interest rate risk and credit risk without any explicit capacity to absorb losses that may arise from those risks;
- The use of *ad hoc* support from money fund sponsors to address such risks and avoid "breaking the buck," which obscures such risks; and
- The highly risk-averse nature of many money fund investors, particularly institutional investors.

The FSOC Release focused on the high profile of money funds during the 2008 financial crisis and also noted an increase in redemptions of money fund shares during the summer of 2011 during heightened concern over European financial stability. However, the FSOC Release did not extensively address whether and to what extent the 2010 Amendments, as some commenters have argued, reduced money funds' vulnerability to runs and disrupted the strong causal relationship to identified risks that is required to support a Section 120 recommendation.

In the FSOC Release, the FSOC noted that the 2010 Amendments increased portfolio quality, reduced portfolio maturity, increased portfolio diversification, increased portfolio liquidity, mandated periodic stress testing, enhanced disclosures and reporting and improved procedures for orderly fund liquidation. However, the FSOC dismissed the impact of these reforms, stating that they do not address money funds' "structural vulnerabilities."

Certain industry participants, as well as Commissioners Gallagher and Paredes, have questioned the narrative of money fund vulnerability to runs, on the basis of the record of government money funds receiving fund inflows after Lehman Brothers failed in September 2008. The FSOC noted this contention in the FSOC Release, but stated that the fact that runs were limited to prime money funds does not mean that government money funds could not also be vulnerable to similar runs.

FSOC Position Regarding How Money Fund Activities or Practices Contribute to Risk

The FSOC must determine whether "the conduct, scope, nature, size, scale, concentration, or interconnectedness" of money funds' financial activities or practices could create or increase the risk of significant liquidity, credit or other problems. The FSOC attempted to address this requirement by identifying several characteristics that allegedly increase money funds' vulnerability to runs or the damage that such runs may cause:

- <u>Size</u>. Money funds held $2.9 trillion in assets and had $2.6 trillion of shares registered for sale to the public as of September 30, 2012.
- <u>Scale</u>. Money funds owned 44% of all U.S. dollar-denominated financial commercial paper outstanding, and about 30% of all uninsured dollar-denominated time deposits, as of September 30, 2012.
- <u>Concentration</u>. The top five money fund sponsors managed 46% of all money fund assets, and the top 20 sponsors managed 90% of such assets, as of September 30, 2012.
- <u>Interconnectedness</u>. Money funds sponsored by BHC affiliates accounted for 41% of all money fund assets, and affiliates of savings and loan holding companies accounted for an additional 11% of industry assets. Eighty-six percent of the funding provided by money funds to private entities was extended to the financial sector of the economy, and 46 of the 50 private sector firms receiving the largest funding from money funds were financial firms. In addition, 13 of the top 15 financial firms were domiciled outside the United States, creating international channels for the transmission of financial stress.
- <u>Conduct</u>. The cash management features of many money funds, in combination with the size of money funds as a percentage of the U.S. money supply, pose a potential liquidity problem for millions of money fund investors in the event of widespread runs.

FSOC's Proposed Recommendations

The Proposed Recommendations are intended to address certain attributes of money funds that, according to the FSOC, make money funds "more vulnerable to destabilizing runs." The FSOC Release describes these attributes as (i) "the lack of explicit loss-absorption capacity in the event of a drop in the value" of money fund portfolio holdings; and (ii) "the first-mover advantage that provides an incentive for investors to redeem their shares at the first indication of any perceived threat to [a money fund's] value or liquidity." According to the FSOC, the three alternatives set forth in the Proposed Recommendations are not mutually exclusive and a money fund sponsor could potentially use any alternatives in combination.

FSOC Alternative One

Alternative One proposes that the SEC require money funds to implement a floating NAV per share, by removing the exemption under Rule 2a-7 that permits money funds to use the amortized cost method of valuation and the penny-rounding method of pricing.[7] Consistent with other mutual funds, money funds would be required to value portfolio holdings for which market quotations are readily available at their market value, and other securities and assets at their "fair value," as determined in good faith by or under the supervision of the fund's board of directors or trustees.[8] Accordingly, a money fund's price per share would fluctuate daily based on changes in the money fund's portfolio holdings.

Under the approach described in Alternative One, each floating-NAV money fund would be required to re-price its shares to $100.00 per share to increase the sensitivity of each share to fluctuations in the value of the fund's portfolio holdings.[9] For example, a 5 basis point loss would not decrease the share price of a floating-NAV money fund with a share price of $1.00. That is, a share price of $0.9995 — which reflects a 5 basis point loss on a share price of $1.00 — would be rounded to $1.00 even without penny rounding. However, a 5 basis point loss on a share price of $100.00 would result in a new share price of $99.95.

According to the FSOC, a floating NAV, together with the share re-pricing described above, would: (i) limit the incentive to redeem money fund shares under real or perceived deteriorating market conditions because shareholders would no longer be entitled to redeem shares at $1.00 when the market-based share value is less than $1.00; and (ii) modify expectations that shareholders do not bear any risk of loss because a floating NAV would make gains and losses a regular occurrence. The FSOC also proposed a transition period — potentially lasting five years — to "reduce potential disruptions and facilitate the transition to a floating NAV for investors and issuers."

The FSOC Release acknowledged that Alternative One would be a "significant change" to the multi-trillion dollar money fund industry, which may cause the money fund industry's assets under management to contract because, among other things, individuals, institutions and state and local governments may be unable or unwilling to use, or statutorily prohibited from using, floating-NAV money funds for cash management or other purposes.[10] The FSOC noted that this contraction would likely impact the borrowing costs of certain financial institutions, businesses and state and local governments that rely on money funds for short-term funding.

The FSOC Release also acknowledged certain concerns raised by industry participants relating to federal income tax reporting and operational considerations.

7 Floating-NAV money funds would remain subject to the credit quality, maturity, liquidity and diversification requirements under Rule 2a-7. However, because money funds would no longer seek to maintain a stable NAV, the FSOC is proposing that the SEC rescind two rules under the Act – Rule 17a-9 (affiliated purchases) and Rule 22e-3 (orderly liquidation). These rules provide exemptions to money funds to prevent a fund from breaking the buck, and limit the disruption caused by a fund that has broken or is close to breaking the buck.

8 Similarly, consistent with other mutual funds, securities with remaining maturities of 60 days or less could generally be valued at amortized cost. *See* Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Accounting Series Release No. 219, Investment Company Act Rel. No. 9786 (May 31, 1977).

9 To the extent consistent with a money fund's governing documents, shareholders could continue to purchase and redeem fractional shares. It should be noted that the proposed $100 share price would require a change to a fund's share price every time the net asset value of the fund changes by one basis point. This level of sensitivity is ten times that of the one-tenth of one percent standard established by the SEC in Accounting Series Release 219. *See Id.*

10 Industry participants have raised similar concerns. *See, e.g.,* Letter from Fidelity Investments to the SEC (Feb. 3, 2012); Letter from American Public Power Association to the SEC (Mar. 8, 2012) (joint letter with 13 other state and local government organizations).

Currently, purchases and sales of shares of stable-NAV money funds generate no taxable gains or losses because shares are generally purchased and sold at $1.00. However, purchases and sales of shares of floating-NAV money funds could generate gains and losses and, therefore, it would be necessary to determine: (i) which shares were redeemed; (ii) the tax basis of the redeemed shares; and (iii) whether the holding period of the redeemed shares was long-term or short-term. However, the FSOC states that the Treasury Department and Internal Revenue Service will consider relief for money fund shareholders and sponsors (*e.g.,* wash sale rules for *de minimis* losses on floating-NAV money fund shares).

Industry participants also contend that a mandated floating NAV could lead to adverse economic consequences. For example, industry participants argue that a mandated floating NAV would make money funds a less desirable choice for investors, which could increase the concentration of short-term assets in the banking system and, ultimately, systemic risk. Additionally, industry participants have suggested that a move by investors away from money funds would increase the cost of short-term funding for corporations, financial institutions and governments by decreasing the ability of money funds to provide such funding. [11]

FSOC Alternative Two

Alternative Two would require money funds (except Treasury money funds) to maintain an NAV "buffer," which would be a tailored amount of assets of up to 1% in excess of those needed for a money fund to maintain a $1.00 price per share. This NAV buffer would be intended to absorb day-to-day fluctuations in the value of a money fund's portfolio holdings. In addition, Alternative Two would mandate that money funds (except Treasury money funds) require that 3% of a money fund investor's highest account balance in excess of $100,000 during the prior 30-day period only be available for redemption with a 30-day delay (the "minimum balance at risk" or MBR). To the extent a money fund suffers losses that exceed its NAV buffer, such losses would first be borne by the MBRs of investors that redeemed during the prior 30-day period.

NAV Buffer. The NAV buffer would require money funds to maintain additional assets that could absorb daily fluctuations in the value of a fund's portfolio holdings, and would replace the exemption under Rule 2a-7 that permits money funds to use the amortized cost method of valuation and the penny-rounding method of pricing. The size of the NAV buffer would be based on the level of risk of the fund's portfolio holdings, determined as follows:

- no buffer requirement for cash, Treasury securities and Treasury repurchase agreements (repurchase agreements collateralized solely by cash and Treasury securities (repos));
- a 0.75% buffer requirement for other "daily liquid assets" (other "weekly liquid assets" in the case of tax-exempt funds); [12] and
- a 1% buffer requirement for all other assets.

Money funds that invest at least 80% of fund assets in cash, Treasury securities and Treasury repos would not be required to have any NAV buffer. [13] Any other money fund whose NAV buffer falls below the required amount would have to limit new investments to cash, Treasury securities and Treasury repos. A money fund that exhausted its NAV buffer would be required to suspend redemptions and liquidate or convert to a floating-NAV

11 *See, e.g.,* Letter from Fidelity Investments to the International Organization of Securities Commissions (IOSCO) (filed with SEC) (May 30, 2012).

12 Under current Rule 2a-7, a taxable money fund is subject to requirements that: (i) at least 10% of its assets be invested in "daily liquid assets" (*i.e.,* cash, direct obligations of the U.S. government, such as Treasury securities, and securities convertible into cash, whether by maturity or through exercise of a demand feature, in one business day) and (ii) at least 30% of its assets be invested in "weekly liquid assets" (*i.e.,* cash, direct obligations of the U.S. government, such as Treasury securities, certain U.S. government agency securities 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 only with the weekly liquid asset requirement. *See* Rule 2a-7(c)(5)(ii)-(iii).

13 The FSOC Release stated that Treasury money funds would be permitted to continue to use the penny-rounding pricing method and, accordingly, generally would be able to maintain a stable NAV.

money fund, either indefinitely or until it has restored its NAV buffer.

To fund its NAV buffer, a money fund would be permitted to use any funding method or combination of methods it found to be optimal. Examples of possible funding methods included in the FSOC Release are:

- Escrow Account – an escrow account established by the fund's sponsor and pledged to support the fund's NAV (limited to weekly liquid assets);

- Subordinated Buffer Shares – subordinated, non-redeemable equity securities that: (i) would absorb first losses in the fund's portfolio; (ii) could be sold to third parties or purchased by the fund's sponsor or affiliates; and (iii) could pay higher dividends than those paid on redeemable shares; [14] and

- Retained Earnings – retained earnings (*i.e.,* a holdback of earnings that would otherwise be distributed to investors). [15]

The SEC would have to amend Rule 2a-7 and provide other relief to permit money funds to engage in these funding methods. The FSOC Release also noted that, if adopted, money funds would have a one-year transition period to establish half of the buffer and a two-year transition period to establish the full NAV buffer.

MBR Requirement. In addition to the NAV buffer, Alternative Two would feature an MBR requirement for accounts in excess of $100,000. The MBR requirement, which would not apply to Treasury money funds, is designed to ensure that certain investors who redeem from a money fund are partially invested in the fund for 30 days and would be the first to participate in any losses incurred by the fund during that 30-day period (once the NAV buffer is exhausted).

The size of an investor's MBR would be 3% of the investor's account balance in excess of $100,000 (calculated at the highest balance in the account over the prior 30-day period). [16] For example, if an account's highest balance was $150,000 during the prior 30-day period, the MBR would be $1,500 (*i.e.*, 3% of $50,000). The investor's account balance available for immediate redemption would be the account balance minus the MBR (in the case of the above example, $148,500). If an investor attempted to redeem more than the available balance, the money fund would be required to delay payment of the investor's MBR for 30 days. In the case of the above example, if the investor attempted to redeem the entire account balance, the investor would receive $148,500 immediately and would receive the remaining redemption proceeds after the 30-day delay period, unless, as discussed below, the money fund suffered losses in excess of its NAV buffer during that 30-day period.

If an investor subject to the MBR requirement were to make net redemptions in excess of $100,000 during the prior 30-day period, any losses the fund experiences in excess of its NAV buffer would first be absorbed by such investor's MBR (with the extent of subordination approximately proportionate to the investor's cumulative net redemptions during the prior 30-day period). The FSOC Release provided the following illustrations:

- Example One – An investor has a $200,000 money fund account. The highest balance in the account over the prior 30-day period *in excess of $100,000* was $100,000 ("high water mark"). The investor redeems $120,000, which is unaffected by the MBR requirement because the remaining balance of $80,000 exceeds the MBR *of* $3,000 (*i.e.,* 3% of $100,000 – the high water mark). *However*, the transaction causes *a portion* of the investor's MBR to be placed in a subordinated position. The portion of the investor's MBR that would be subordinated is $619. [17] The number of subordinated shares would be zero for an investor whose account value *exceeds* the high water mark.

14 To prevent overreaching, a money fund would not be permitted to pay dividends on buffer shares held by a sponsor or its affiliates at a higher rate than paid on redeemable shares, unless at least 75% of the fund's buffer shares are owned by unaffiliated persons.

15 The FSOC Release noted that, as a practical matter, this method would be limited due to tax considerations. Unlike Alternative One, the FSOC Release did not suggest that tax relief to address this point might be forthcoming.

16 The MBR requirement would apply to recordholders of money fund shares, including recordholders that are financial intermediaries, unless the intermediaries provide the money fund with sufficient information to apply the MBR requirement to the individual customers of the intermediaries.

17 The subordinated portion of an investor's MBR is equal to: MBR x ((high water mark – current balance) ÷ (high water mark – MBR)).

- Example Two – Same facts as Example One, except that, on the following day, the investor closes her account. The investor receives $77,000 (*i.e.,* the remaining account balance minus the $3,000 MBR). The MBR shares will be redeemed after a 30-day delay. The investor, by closing her account, subjects her entire MBR to subordination during that 30-day period. The investor will receive the remaining $3,000 after the 30-day delay, unless the money fund suffers losses in excess of its NAV buffer.

According to the FSOC Release, the NAV buffer and MBR requirement are intended to reduce the incentive for investors, particularly institutional investors, to quickly withdraw large amounts of assets from money funds under real or perceived deteriorating market conditions because investors would no longer be entitled to redeem shares at $1.00 when the market-based share value is less than $1.00. Instead, the NAV buffer, which would absorb daily fluctuations in the value of a fund's portfolio holdings, would prevent redeeming investors from receiving more than their *pro rata* share of fund assets.

The FSOC Release acknowledged that Alternative Two would likely lead to reduced money fund yields because funding the NAV buffer through the issuance of buffer shares and/or retained earnings would reduce net yields paid to investors. The FSOC Release also noted that reduced yields as well as constraints on liquidity would likely lessen the demand for money funds, particularly prime money funds. [18] Alternative Two could also impose substantial operational and technology costs because, among other things, sponsors would have to track an investor's high water mark, MBR shares that are subject to redemption delays and subordinated MBR shares. [19] This would reduce the financial incentives for fund sponsors to offer and manage money funds, and possibly lead to further consolidation in the money fund industry.

FSOC Alternative Three

Alternative Three would require money funds (except Treasury money funds) to have a risk-based NAV buffer of 3%, which could be reduced if the money fund implements a combination of other possible measures outlined by the FSOC, namely more stringent investment diversification requirements, increased minimum liquidity levels and more robust portfolio holdings disclosure requirements.

NAV Buffer. The buffer that would be required in Alternative Three would be in the same form and function in the same manner as the buffer proposed in Alternative Two. However, the maximum required buffer amount would be increased from 1% to 3%, determined as follows:

- no buffer requirement for cash, Treasury securities and Treasury repos;
- a 2.25% buffer requirement for other "daily liquid assets" ("weekly liquid assets" in the case of tax-exempt funds); [20] and
- a 3% buffer requirement for all other assets.

The FSOC Release stated that the buffer in Alternative Three differs from that in Alternative Two in that the 3% buffer in Alternative Three would be the primary tool to increase the resiliency of money funds and reduce their perceived vulnerability to runs. In contrast, the buffer in Alternative Two is primarily designed only to absorb day-to-day variations in the value of portfolio holdings and would be secondary to the MBR requirements.

In addition to the alleged benefits previously discussed for Alternative Two, the FSOC Release noted that a larger NAV buffer would provide money funds with additional loss-absorption capacity, which could provide stability if a money fund's largest single-name exposure defaulted, causing losses potentially exceeding a 1% NAV buffer. The FSOC Release also stated that a larger NAV buffer would further reduce the incentive for excessive risk-taking because raising

18 Industry participants have raised similar concerns. *See, e.g.,* Letter from ICI to the SEC (Apr. 19, 2012); Letter from BlackRock to the SEC (Mar. 2, 2012). With regard to the proposal to use subordinated equity to fund the NAV buffer, commenters have expressed concerns regarding the practicality of such a proposal, as it is unlikely investors would invest in such subordinated interests. *See, e.g.,* Letter from Charles Schwab to IOSCO (filed with the SEC) (May 30, 2012).

19 Commenters also expressed concerns that such a proposal would have substantial operational and accounting costs, particularly for omnibus accounts. *See, e.g.,* Letter from ICI to the SEC (June 20, 2012); Letter from Federated Investors to the SEC (Mar. 16, 2012).

20 *See* footnote 12, above, for a discussion of daily and weekly liquid assets.

funds through subordinated buffer shares may involve having to pay higher dividends to buffer share investors based on perceptions of the money fund's risk. A larger NAV buffer funded by a money fund sponsor or retained earnings may also force the sponsor to internalize the cost of risk-taking because of the threat of losing the contributed capital. The FSOC Release acknowledged that Alternative Three, similar to Alternative Two, would result in additional costs, which could potentially alter financial returns for sponsors "such that they contemplate exiting or reducing their [money fund] businesses."

The transition period for the Alternative Three NAV buffer would involve the following "phase-in" schedule: (i) an NAV buffer of one-sixth of the total amount would be required after one year; (ii) an NAV buffer of one-third the total amount would be required after two years; and (iii) a multi-year transition period would follow to allow the full implementation.

Other Measures. Alternative Three contemplates additional measures that could complement the NAV buffer or potentially reduce the size of the buffer requirement. The first of such measures would impose more stringent investment diversification requirements, namely (i) reducing the 5% single-issuer exposure limitation currently found in Rule 2a-7 and (ii) revising the definition of "issuer" in this context to include all affiliates of a consolidated group. The FSOC observed that more stringent diversification requirements would lower the maximum loss from default of a single issuer, but acknowledged that such requirements could cause money funds to invest in less creditworthy issuers if they are required to reduce their largest exposures.

An additional measure contemplated by Alternative Three would increase the current daily and weekly liquidity requirements from 10% to 20% and from 30% to 40%, respectively. The FSOC Release suggested that this could be combined with additional "know-your-investor" requirements to improve the ability of money funds to predict investors' redemption activities. The FSOC Release acknowledged that increasing liquidity requirements could decrease money fund yields and restrict the ability of money funds to invest in longer-term or higher-risk instruments and therefore impact the ability of money funds, in particular prime money funds, to "serve their traditional role as a financial intermediary and potentially change the nature of the product."

Finally, the FSOC Release stated that the NAV buffer could be accompanied by enhanced portfolio holdings disclosure requirements that would increase a money fund investor's ability to monitor investment risk. The FSOC Release suggested that these disclosure requirements could include more frequent public reporting of portfolio holdings information (*e.g.,* daily or weekly). The FSOC believes that this would improve the ability of investors to monitor risk and allow investors to differentiate between money funds, thus preventing runs on all money funds. The FSOC Release acknowledged, however, that increased portfolio holdings information disclosure may make investors more inclined to redeem when there are signs of deterioration and could increase the volatility of money fund flows if investors are highly sensitive to changes in the portfolio information.

Other Potential Options

The FSOC also solicited comments on other possible reforms — namely, liquidity fees and/or temporary restrictions or "gates" on redemptions. The FSOC requested that comments on these other options specifically discuss how the reforms would address the perceived structural vulnerabilities of money funds and mitigate the perceived risks they pose to financial stability, as well as the potential impact to the money fund industry, shareholders and long-term economic growth.

Liquidity fees would be directly charged to redeeming investors to compensate the remaining investors and the money fund. Redemption gates, an alternative noted by Commissioners Gallagher and Paredes, would involve temporarily prohibiting redemptions to allow a fund to restore its health. The FSOC briefly discussed several design considerations, including:

- Trigger – Standby liquidity fees and gates could be imposed at predetermined thresholds indicating portfolio stress, such as when a money fund's NAV or the level of daily or weekly liquid assets fall below a certain level, or at the discretion of the money fund's board of directors/trustees.

- Duration – Standby liquidity fees and gates could continue until a money fund's NAV or the level of daily or weekly liquid assets increase to a certain level, or could be limited to a prescribed period, such as 30 days.

- Fee level – The level of liquidity fee could be a fixed fee (calculated as a percentage of the amount redeemed) or depend on the level of portfolio stress (*e.g.*, size of the decline in the money fund's NAV or its daily or weekly liquid assets).

- Gate Operation – Although Rule 22e-3 under the Act permits a money fund to suspend redemptions if the fund irrevocably approves liquidation and notifies the SEC, gates would be temporary and would permit the fund to remain in operation after the gates are removed.

The FSOC Release also discussed the sequencing of standby liquidity fees and gates if paired together, as well as the need to disclose additional information regarding a money fund's financial condition so that investors could monitor whether the fund was approaching its trigger points.

The FSOC Release suggested that these reforms may provide fairer treatment of redeeming and non-redeeming investors and impose additional discipline on fund managers, who would be motivated to manage funds in a way that avoids triggering a fee or gate. The FSOC expressed concern, however, that these reforms could increase the risk of preemptive runs by investors and also could potentially cause contagion runs where the triggering of fees or gates in one money fund could cause shareholders of other money funds to redeem.

Cost Benefit Analysis

Section 120 also requires the FSOC to consider the impact of its recommendations on long-term economic growth. In response to this requirement, the FSOC Release provided an abbreviated analysis of the costs of the Proposed Recommendations. In conducting this analysis, the FSOC focused primarily on "the potential effects of the [P]roposed [R]ecommendations on the rates at which [money funds] would lend to borrowers and the consequent effects of such higher borrowing costs on investment and other spending by U.S. businesses, households, and governments." However, the FSOC Release acknowledged that "[t]here may be economic impacts associated with lower profits for [money fund] sponsors if they are unable to pass through initial transition costs or higher operating costs...." Nonetheless, according to the FSOC Release, "the impact of such costs on long-term economic growth [is] likely to be less direct and smaller than the costs that affect borrowing rates." The FSOC Release also requested comment on the possible impact of reduced profitability of money fund sponsors on long-term economic growth, as well as the impact of the Proposed Recommendations on investor demand for money fund shares.

Conclusion

The money fund industry continues to face regulatory uncertainty due to the Proposed Recommendations and other potential actions that the FSOC or the Federal Reserve may take, if the SEC does not take action. Whether undertaken at the SEC's own initiative or on the formal recommendation of the FSOC, money fund reform will continue to be highly controversial. Undertaking reforms without adequate consideration and analysis of the economic impact on the industry, investors, corporate issuers and state and local governments, however, raises the danger that the cure might be worse than the disease, with reforms having a greater detrimental impact on the U.S. economy than the perceived risk exposures that the regulators are seeking to address.

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