Client Alert.

October 16, 2012

IOSCO Calls for More Regulation of Money Market Funds; Majority of SEC Commissioners Object

By Jay G. Baris

On October 9, 2012, the International Organization of Securities Commissions ("IOSCO") released a final report calling for additional regulation of money market funds ("MMFs"), including options for a floating NAVs, NAV buffers and liquidity fees.

The Financial Stability Board (FSB), established by the heads of state of the "Group of 20," considers MMFs to be part of a "shadow banking system" because they are important sources of short-term funding, particularly for banks. For this and other reasons, the FSB urged IOSCO to review potential regulatory reforms of MMFs that would mitigate their susceptibility to runs and other systemic risks and to develop policy recommendations. FSB indicated that a key issue for consideration was the stable net asset value feature of MMFs.

IOSCO reported that although MMFs did not cause the crisis, their performance during the financial turmoil highlighted their potential to spread or even amplify a crisis. It said that while the regulatory reforms established in the U.S. and in Europe after the events of 2007-2008 went a long way to promote financial stability of money market funds, the report says, these changes did not go far enough, especially since the Dodd-Frank Act limited the ability of the U.S. government to act as a backstop if money market funds "break the buck." U.S. and European MMFs account for 90 percent of the $4.7 trillion global money market industry.

The report noted that "investors still have the incentive 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." The 2010 reforms did not address either "credit event" risk, the report said.

On April 27, 2012, IOSCO published a Consultation Report, Money Market Fund Systemic Risk Analysis and Reform Options, which provided a preliminary analysis of the possible risks that money market funds could pose to financial stability and proposed a broad range of possible policy options to address those risks as well as to address other potential issues identified with regard to money market funds. Following a consultation period that ended on June 24, 2012, IOSCO published its final report on October 9, 2012.

The IOSCO final report recommended various potential regulatory reforms designed to mitigate this perceived vulnerability. The report makes 15 distinct recommendations, which can be broadly summarized as follows:

- General recommendations
    - MMFs should be explicitly defined in Collective Investment Scheme regulation.
    - Specific limitations should apply to the types of assets in which MMFs may invest and the risks they may take.
    - Regulators should closely monitor the development and use of other vehicles similar to money market funds (e.g., collective investment schemes or other types of securities).

- Recommendations regarding valuation
    - MMFs 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.
    - MMF valuation practices should be reviewed by a third party as part of their periodic reviews of the funds accounts.
- Recommendations regarding liquidity management
    - MMFs should establish sound policies and procedures to know their investors.
    - MMFs should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.
    - MMFs should periodically conduct appropriate stress testing.
    - MMFs should have tools in place to deal with exceptional market conditions and substantial redemptions pressures.
- Recommendation regarding MMFs that offer a stable Net Asset Value ("NAV")
    - MMFs 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, when workable, a conversion to floating/variable NAV. Alternatively, regulators should introduce safeguards to reinforce stable NAV MMFs' resilience and ability to face significant redemptions.
- Recommendations regarding the use of ratings
    - MMF regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoid any mechanistic reliance on external ratings.
    - CRA supervisors should seek to ensure that credit rating agencies make more explicit their current rating methodologies for MMFs.
- Recommendations regarding disclosure to investors
    - MMF documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal loss.
    - MMFs' disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress.
- Recommendations regarding MMFs' practices in relation to repos
    - When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repos by money market funds, taking into account the outcome of current work on repo markets.

During the consultation period, IOSCO received 39 comment letters, many of which strongly disagreed with the approach suggested by IOSCO. Moreover, the IOSCO report acknowledged that its report does not reflect the views and input of the Securities and Exchange Commission. Rather, following publication of the initial consultation report, a majority of the SEC's Commissioners released a statement on May 11, 2012, expressing their unequivocal view that SEC representatives should oppose publication of the Consultation Report. IOSCO acknowledged as much in a statement accompanying the release of the final report, noting that "a majority of the Commissioners of the US Securities and Exchange Commission did not support its publication [of the final report]."

While the IOSCO report is not binding on the SEC, it may be another weapon in the arsenal of other U.S. financial regulators to pressure the SEC to tighten regulation of money market funds by requiring either a floating NAV or requiring a financial buffer to stem the effect of significant rapid shareholder redemptions.

Contact:

Jay G. Baris
(212) 468-8053
jbaris@mofo.com

Thomas M. Devaney
(212) 336-4232
tdevaney@mofo.com

Kelley A. Howes
(303) 592-2237
khowes@mofo.com

Robert E. Putney, III
(212) 336-4451
rputney@mofo.com

Isabelle Sajous
(212) 336-4478
isajous@mofo.com

Luke T. Bagley
(212) 336-4379
lbagley@mofo.com

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