DechertOnPoint

August 2012 / Issue 17

A legal update from Dechert's Financial Services Group

U.S. SEC Chairman Schapiro Announces SEC Will Not Vote on Money Market Fund Reform, But Other Regulators May Take Action

Chairman Mary L. Schapiro of the Securities and Exchange Commission (SEC) issued a press release on August 22, 2012, announcing that the SEC would not call a meeting to vote on a proposal to introduce additional reforms for money market funds (money funds).[1] There have been several years of controversy regarding whether additional regulatory reform of money funds is warranted, and there had been reports that the SEC would vote on a draft proposal in late August. However, the press release states that three of the four other SEC Commissioners had informed Chairman Schapiro that they would not support the draft proposal prepared by SEC staff. While Chairman Schapiro's announcement has decreased the potential for structural changes to money funds in the near term, the possibility remains for further action by the Financial Stability Oversight Council (FSOC) or the Board of Governors of the Federal Reserve System (Federal Reserve) to change the regulatory structure or treatment of money funds.

This *DechertOnPoint* discusses the events that led to the SEC's impasse on proposing additional reforms, provides an overview of Chairman Schapiro's statements in the press release and outlines possible actions that the FSOC or Federal Reserve might take in order to address perceived weaknesses in the structure of the money fund industry.

Background

During the 2008 financial crisis, the Reserve Primary Fund became the second money fund in history to break the buck when its shares dropped from $1.00 to $0.97 in the wake of the Lehman Brothers' bankruptcy. This led to a "flight to quality" as money funds' 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. The redemptions from prime money funds aggravated a lack of liquidity in the commercial paper market, which some have argued led to further distress in the financial system.

In 2010, the SEC adopted amendments to Rule 2a-7 under the Investment Company Act of 1940, the rule that primarily governs money funds, to address many of the concerns raised during the financial crisis (2010 Amendments). These reforms included enhanced liquidity requirements and tighter maturity, diversity and credit quality standards for money funds' investments. When the 2010 Amendments were adopted, Chairman Schapiro described them as "an important first step in our efforts to strengthen the money market regime."[2]

Since the adoption of the 2010 Amendments, Chairman Schapiro and other regulators have

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[1] Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012).

[2] Statement of SEC Mary L. Schapiro on Money Market Funds at the Open Commission Meeting (Jan 27, 2010).

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stated the belief that further reforms of money funds are necessary to reduce the potential for harm to the U.S. financial system. These statements included the report of the President's Working Group on Money Market Fund Reform, an SEC Roundtable, the 2011 and 2012 Annual Reports of the FSOC, a report in 2012 by a working group of the International Organization of Securities Commissions, and public statements by Chairman Ben Bernanke and others at the Federal Reserve. During this time, the industry held its own roundtable, submitted numerous comment letters to the SEC and met with members of Congress and the SEC Commissioners to express opposition to further money fund reforms. In addition, many municipal and corporate issuers and representatives of investors expressed their opposition to further reform.

In testimony before the Senate Committee on Banking, Housing, and Urban Affairs on June 21, 2012, Chairman Schapiro acknowledged that the 2010 Amendments had been successful, but reiterated her belief that further regulation of money funds was necessary. Chairman Schapiro outlined a proposal prepared by the SEC staff that would require money funds to either (i) convert to a floating net asset value (in contrast to their current stable $1.00 net asset value per share) or (ii) maintain a stable net asset value while maintaining a capital buffer and imposing certain restrictions on redemptions (the Staff Proposal).

According to press reports and her press release, Chairman Schapiro sought to bring the Staff Proposal to a vote before the SEC Commissioners in late August. If approved by a majority of the Commissioners, the Staff Proposal would have been released for public comment and could have served as the basis for a final rule on money funds by the SEC.

Overview of Chairman Schapiro's Statements in the Press Release

In the press release, Chairman Schapiro stated that three Commissioners informed her they would not support the Staff Proposal. Although the press release did not mention which Commissioners opposed the Staff Proposal, Democratic Commissioner Luis Aguilar and Republican Commissioners Troy Paredes and Daniel Gallagher, who had long questioned the need for further reform, have subsequently issued press releases stating their reasons for opposing the Staff Proposal.

In his press release issued on August 23, 2012, Commissioner Aguilar explained that, before he would be able to support a proposal, he sought further analysis of (i) the cash management industry as a whole, (ii) the 2010 Amendments and their impact and (iii) the potential impact of the reforms outlined in the Staff Proposal.[3] Commissioner Aguilar also noted that he believed that the Staff Proposal would be a catalyst for investors to move investments out of money funds and into unregulated investment vehicles.

Commissioners Gallagher and Paredes released a joint press release on August 28, 2012 in which they stated the "necessary analysis has not been conducted to demonstrate" the efficacy of the reforms outlined in the Staff Proposal.[4] Commissioners Gallagher and Paredes recommended an approach that "(i) would empower money market fund boards to impose 'gates' on redemptions; (ii) mandate enhanced disclosure about the risks of investing in money market funds; and (iii) conduct a searching inquiry into, and a critical analysis of" the 2010 Amendments and the impact that additional reforms would have on money funds, investors, financial institutions, systemic risk and the overall economy.[5] Finally, in response to Chairman Schapiro's suggestion that other regulators consider further money fund reform, the Commissioners expressed the belief that "money market funds are squarely within the expertise and regulatory jurisdiction of the SEC."[6]

Notwithstanding the lack of support from her fellow Commissioners, Chairman Schapiro stated her view that "the issue [of money fund reform] is too important to investors, to our economy and to taxpayers to put our head in the sand and wish it away. Money market funds' susceptibility to runs needs to be addressed."[7] Chairman Schapiro also raised the possibility that other financial regulators may pursue money fund regulation, noting that "other policy makers now have the clarity that the SEC will not act to issue a money market fund reform proposal and can take this into account in deciding what steps should be taken to address this issue."[8] Following the issuance of the press release, a Treasury Department spokeswoman stated that the

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3 Statement of SEC Commissioner Aguilar Regarding Money Market Funds (Aug. 23, 2012).

4 Statement of SEC Commissioners Gallagher and Paredes on the Regulation of Money Market Funds (Aug. 28, 2012).

5 *Id.*

6 *Id.*

7 *See supra* note 1.

8 *Id*.

Treasury Department is consulting with other regulators "to consider the appropriate next steps to reduce risks to financial stability from money-market funds."[9]

Potential Action by the FSOC or Federal Reserve

Although further rulemaking by the SEC appears unlikely at this point, it is possible that the FSOC or the Federal Reserve could take actions to address the perceived issues with money funds. In particular, the FSOC could consider recommending that the SEC impose enhanced standards on money fund operations or consider placing one or more money funds, and potentially their sponsors, under the Federal Reserve's supervision, by determining that such money funds and their sponsors are "systemically important financial institutions" (SIFIs).[10] It is also possible that the Federal Reserve could exercise its supervisory authority over bank holding companies (BHCs) in a manner that takes account of the potential financial support that a BHC or one of its subsidiaries might provide to a sponsored fund or by setting new limits on BHCs' reliance on funding provided by money funds.

Possible Intervention by the FSOC

Recommend Additional Reforms to the SEC

Section 120 of the Dodd-Frank Act 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 BHCs or nonbank financial companies under the primary regulator's jurisdiction. In order to exercise this authority with regard to money funds, the FSOC would have to determine that the conduct, scope, nature, size, scale, concentration or interconnectedness of money fund activities could create or increase the risk of significant liquidity, credit or other problems spreading among BHCs and nonbank financial companies or in U.S. financial markets. In this regard, the Federal Reserve has issued a proposed rule that would provide guidance as to whether a company is predominantly engaged in financial activities and, thus, is subject to being treated as a nonbank financial company. However, commenters on the proposed rule have asserted positions that, if accepted by the Federal Reserve, could result in money funds not qualifying as nonbank financial companies. Depending on the final form of the Federal Reserve's rule and the impact of any potential judicial challenges to it, the FSOC might decide to issue Section 120 recommendations to the SEC as to enhanced standards for money funds. Indeed, the FSOC in its 2012 Annual Report specifically supported the issuance by the SEC of a proposal based on the staff recommendations that were supported by Chairman Schapiro.

In making any recommendations to the SEC, the FSOC would be required to consult with the SEC and to provide notice to the public and the opportunity for comment on its recommendations. Section 120 also requires the FSOC to take into account the costs of a proposed recommendation upon long-term economic growth. If the FSOC recommends that the SEC impose enhanced requirements on money funds, the SEC would be required either (i) to impose the recommended standards or similar standards that the FSOC deemed acceptable or (ii) to explain in writing within 90 days to the FSOC why the SEC has 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.

Designate Money Funds as SIFIs

Regulators have stressed that they are concerned about the possibility of an industry-wide run on money funds, and that even a run on a small money fund could have a spillover effect. Thus, it seems likely that the FSOC would first seek to address any of its concerns through the vehicle of industry-wide Section 120 recommendations. However, the FSOC, apart from or in conjunction with such recommendations, might seek to impose added regulatory requirements on a particular money fund by designating it as a SIFI.

Section 113 of the Dodd-Frank Act grants the FSOC the authority to designate individual nonbank financial companies, potentially including money funds, as SIFIs. Such a designation would subject a SIFI to supervision and regulation by the Federal Reserve. Although the FSOC issued interpretive guidance in April of this year as to how it would generally evaluate whether to designate a nonbank financial company as a SIFI, it has not yet

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[9] Christopher Condon, Money Funds Test Geithner, Bernanke as Schapiro Defeated, Bloomberg, August 23, 2012.

[10] *See* Sections 120 and 113, respectively, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

designated any institution as a SIFI.[11] Depending on the terms of the Federal Reserve's final rule on the term "predominantly engaged in financial activities," discussed above, if money funds qualify as nonbank financial companies, they may be eligible for designation as SIFIs.

Assuming that money funds do qualify as nonbank financial companies, based on the interpretive guidance adopted by the FSOC, the FSOC would generally follow a three-stage process for the preliminary review of a money fund for potential designation. Stage 1 includes the application by the FSOC of a set of six quantitative factors, or screens, to identify companies that may merit further in-depth review. The primary screen is the requirement that a company must have $50 billion or more of global total consolidated assets. A company also must meet one or more of the other five screens, which measure credit default swaps outstanding for which a company is the reference entity, derivatives contracts into which a company has entered, total debt outstanding, leverage and short-term debt.[12]

Following Stage 1, a company that was preliminarily identified based on the six quantitative factors would be subjected in Stage 2 to a more comprehensive and company-specific analysis, addressing both qualitative and quantitative factors. If, after the Stage 2 analysis is completed, the FSOC believes that further review is necessary, in Stage 3 it could request more detailed information directly from a company and would provide the company an opportunity to submit its own views regarding its possible designation as a SIFI.

At this point, the FSOC would decide whether to make a preliminary determination that a company should be designated as a SIFI and would inform the company of the basis for that determination. A designated company then would have the opportunity to request a hearing before the FSOC. If a hearing was held, the FSOC would be required to make a final determination within 60 days thereafter. A company that receives a SIFI designation would have the right to seek judicial review of that designation.

A money fund designated as a SIFI would be subject to enhanced prudential standards regarding its capital, liquidity and single counterparty credit exposure limitations and would be subject to stress testing, resolution planning and early remediation requirements. The Federal Reserve published a proposed rule regarding enhanced prudential standards in January 2012. The Federal Reserve acknowledged that its proposal was focused on large BHCs and did not address the variety of circumstances that might be presented by nonbank financial companies that are designated as SIFIs, but suggested that it would tailor in some manner the enhanced standards that it would apply to each particular SIFI.[13] The uncertainties in the proposal present significant issues for entities, such as money funds, which do not operate in a manner comparable to large BHCs.

Possible Intervention by the Federal Reserve

The Federal Reserve has also indicated informally that it could exercise supervisory authority over BHCs in a manner that takes account of potential financial support that a BHC might provide to a sponsored fund or by setting new limits on the ability of BHCs to rely on funding provided by money funds.

In a recent speech, Eric S. Rosengren, President of the Federal Reserve Bank of Boston, suggested that, if the SEC does not move forward with money fund reform, BHCs that sponsor prime money funds could be made subject to stress tests that take account of their exposure to the risk of a sponsored money fund breaking the buck.[14] In particular, Mr. Rosengren stated that, if the SEC failed to enact additional reforms, "an alternative for funds with depository institution or depository institution-affiliated sponsors would be to include likely money market mutual fund

[11] Financial Stability Oversight Council, Final Rule Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (Apr. 11, 2012). See our *DechertOnPoint* "Final U.S. Rule on Designation of SIFIs Emphasizes the Importance of Full Engagement in the Designation Process."

[12] Although a money fund may not fit within the interpretive guidance established by the FSOC (*e.g.*, the fund may have less than $50 billion in assets), the FSOC has stated that it reserves the right to subject any nonbank financial company to further review if the FSOC believes that further analysis of the company is warranted to determine if it could pose a threat to U.S. financial stability, irrespective of whether the company meets the thresholds in Stage 1. In addition, the FSOC has indicated that it may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar. See our *DechertOnPoint* "Final U.S. Rule on Designation of SIFIs Emphasizes the Importance of Full Engagement in the Designation Process."

[13] See our *DechertOnPoint* "Potential SIFIs Take Note – Your Future Is Being Decided Now: FRB Prepares to Act on Enhanced Prudential Standards."

[14] Eric S. Rosengren, Remarks at the Amsterdam Conference on Post-Crisis Banking: "Our Financial Structures – Are They Prepared for Financial Instability?" (June 29, 2012).

support in the sponsor's stress tests." [15] He further explained that these sponsors could calculate the likely capital support needed in a stress scenario "[b]ased on the historical experience of their money market funds, the historical experience of similar funds, and their money market funds' exposures." [16] The outcome of these stress tests could have implications for the Federal Reserve's review of BHC capital plans and of the capital that BHCs will be expected to maintain.

In another speech given earlier this year, Federal Reserve Board Governor Daniel Tarullo suggested a different approach that would restrict money fund investments in banks. [17] Governor Tarullo indicated that, in the absence of SEC reforms, the Federal Reserve could set new limits on BHCs' reliance on funding provided by money funds. This could have the effect of limiting investments by prime money funds in BHCs, which could affect short-term funding overall for BHCs.

Furthermore, in the Federal Reserve's enhanced prudential standards proposal under Section 165 of the Dodd-Frank Act, the Federal Reserve proposed to exclude the credit exposure of a fund that was sponsored or advised by a BHC or SIFI from the calculation of the BHC's or SIFI's single counterparty credit exposure as long as certain conditions were satisfied. [18]

At the same time, the Federal Reserve suggested that this treatment might be at odds with the support that some companies provided during the financial crisis to funds that they advised or sponsored. The Federal Reserve asked for comment on whether advised or sponsored funds should be included as part of the BHC or SIFI for purposes of the single counterparty credit exposure limitations.

Conclusion

While the money fund industry has avoided further regulation from the SEC for the time being, the industry continues to face uncertainty due to the potential for action by the FSOC and the Federal Reserve. Given the fact that the SEC proved unable to propose additional reforms as a result of strong opposition by the money fund industry, corporate and government issuers and money fund investors, it is likely that the FSOC and the Federal Reserve will face similar opposition as they consider their next steps.

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[15] *Id.*

[16] *Id.*

[17] Governor Daniel K. Tarullo, Remarks at the Federal Reserve Bank of San Francisco Conference on Challenges in Global Finance: The Role of Asia, San Francisco, California (June 12, 2012).

[18] See our *DechertOnPoint* "Federal Reserve Board's Enhanced Supervision Standards Could Raise Significant Issues for Money Fund Sponsors."

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