November 21, 2012

Money Market Mutual Funds

Financial Stability Oversight Council Proposes Recommendations for Money Market Mutual Fund Regulation

SUMMARY

On November 19, 2012, the Financial Stability Oversight Council (the "FSOC") published for public comment proposed recommendations regarding the regulation of money market mutual funds ("MMFs"). The FSOC also proposed to determine, pursuant to its authority under Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), that MMFs could create or increase the risk of significant liquidity and credit problems spreading among financial companies and markets. If the FSOC were to make such a determination, it could then recommend reforms to the SEC. In the proposal, the FSOC presents three potential structural reform alternatives, which would not necessarily be mutually exclusive:

- ***Alternative One**: Floating Net Asset Value ("NAV"):* This proposal would eliminate the amortized cost valuation methodology currently used by most MMFs to maintain a stable $1.00 NAV, as well as the penny rounding pricing methodology available to MMFs, and require MMFs to have a floating NAV, starting at $100.00, that reflects the market value of the underlying portfolio holdings.
- ***Alternative Two**: Stable NAV Combined with an NAV Buffer and Minimum Balance at Risk:* MMFs would be required to have an NAV buffer of up to 1% in excess of the assets necessary to maintain the $1.00 share price, the size of which would be determined by the riskiness of a fund's assets. Additionally, MMFs would be required to delay for 30 days any portion of a redemption that would leave a remaining account balance of less than 3% of a shareholder's highest account value in excess of $100,000 during the previous 30 days, subject to certain exceptions. The FSOC refers to the portion of an account subject to delayed redemption as the "Minimum Balance at Risk." If an MMF's losses exceeded the buffer, the losses would be borne first by the Minimum Balances at Risk of shareholders who had recently redeemed in excess of $100,000.
- ***Alternative Three**: Stable NAV Combined with an NAV Buffer and Other Measures:* MMFs would be required to have an NAV buffer similar to the one required under Alternative Two, except that the buffer could be as high as 3%. The buffer would be enhanced by other measures, possibly including more stringent investment diversification requirements, increased minimum liquidity levels, and heightened disclosure requirements.

The FSOC is soliciting comments by January 18, 2013 from interested parties on all aspects of the proposed recommendations. It is also seeking comment on other measures that may mitigate MMFs' perceived vulnerabilities, and it requests any quantitative analyses or data from commenters relating to each proposal.[1]

Following the 60-day public comment period, the FSOC may issue a final recommendation to the SEC which, pursuant to Dodd-Frank, would be required either to implement the recommended standards, likely following its own notice-and-comment rulemaking process, or explain to the FSOC in writing within 90 days why the SEC has determined not to implement them. The FSOC would also be required to report to Congress on its recommendation and the SEC's implementation of, or failure to implement, the recommendation.

THE PROPOSAL

BACKGROUND

MMFs are required to register under the Investment Company Act of 1940 ("ICA") and are, therefore, subject to the regulatory requirements generally applicable to all mutual funds. Subject to the conditions of rule 2a-7 under the ICA ("Rule 2a-7"),[2] initially adopted after extensive public hearings in 1981, an MMF may maintain a stable NAV, typically $1.00 per share, by valuing the portfolio securities underlying the fund at acquisition cost with adjustments for amortization of premium or accretion of discount, instead of fair market value, or rounding the MMF's share price to the nearest penny. Among other conditions, Rule 2a-7 requires an MMF to periodically calculate its market-based, or "shadow," NAV and compare this value to the MMF's stable $1.00 share price. If there is a difference of more than 0.5%, the MMF's board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of these methods and re-price the securities of the fund at a value other than $1.00 per share, an event commonly referred to as "breaking the buck."

In response to the financial crisis in 2008, the SEC adopted numerous changes to MMF regulation in 2010, including the imposition of (i) risk-limiting conditions relating to portfolio maturity, credit quality, liquidity and diversification; (ii) stress-test requirements; (iii) enhanced reporting and disclosure obligations on portfolio holdings; and (iv) redemption and liquidation procedures designed to minimize contagion issues stemming from an MMF breaking the buck.[3]

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1 The proposal is available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-19/pdf/2012-28041.pdf.

2 17 C.F.R. § 270.2a-7.

3 For additional information regarding the 2010 MMF reforms, Sullivan & Cromwell's previous publications can be found at http://www.sullcrom.com/publications/detail.aspx?pub=643 and http://sullcrom.com/publications/detail.aspx?pub=776. The proposal notes that, at the time the SEC adopted the 2010 reforms, it noted that they were the "first step" in addressing MMF reform.

According to the FSOC, although the 2010 reforms increased the resiliency of MMFs and limited their exposure to certain risks, they did not rectify certain structural vulnerabilities, primarily the MMFs' lack of explicit loss-absorption capacity and susceptibility to runs, which the proposed recommendations seek to address. Unless a fund's sponsor intervenes, the FSOC believes that even small portfolio losses may depress the shadow value of the fund's shares. Shareholders who redeem their shares before the fund breaks the buck will receive the full $1.00 share price despite the fact that the market-based value of each share is less than $1.00. Such redemptions may further depress the market-based NAV, which may force the fund to break the buck, resulting in a share price less than $1.00 for shareholders who redeem at a later point. In the FSOC's view, this creates an incentive (in other words, a first-mover advantage) for shareholders to redeem upon the first indication of a threat to the fund's stable NAV.

Section 120 of Dodd-Frank authorizes the FSOC to issue recommendations to a financial regulatory agency to adopt new or heightened standards for a financial activity or practice conducted by bank holding companies or nonbank financial companies under the regulatory agency's jurisdiction that address risks to financial stability. Before issuing a recommendation in respect of MMF regulation, the FSOC must first determine that the conduct, scope, nature, size, scale, concentration or interconnectedness of MMFs' activities or practices could create or increase the risk of significant liquidity, credit or other problems spreading among bank holding companies and nonbank financial companies or U.S. financial markets.

PROPOSED DETERMINATION

After assessing the requisite statutory criteria in Section 120, the FSOC has proposed a determination that the conduct, nature, size, scale, concentration, and interconnectedness of MMFs' activities and practices could create or increase the risk of significant liquidity and credit problems spreading among bank holding companies, nonbank financial companies, and the financial markets of the United States. In this connection and as discussed in the proposal, the FSOC asserts that because of the size, scale, concentration, and interconnectedness of MMFs' activities, liquidity pressures on the MMF industry resulting from a run could cause any stress to propagate rapidly throughout the financial system and to the broader economy.

In proposing this determination, the FSOC characterizes MMFs or their shareholders as having the following attributes:

- ***Conduct and Nature of Activities and Practices:*** Combined with the aforementioned first-mover advantage, the FSOC believes that several activities and practices of MMFs may combine to make MMFs susceptible to runs.
    - The stable, rounded NAV per share does not reflect the changing market values of the securities in the fund's portfolio, which the FSOC views as fostering an expectation that share prices will not fluctuate. The FSOC argues that, when an MMF risks breaking the buck, investors have an incentive to redeem shares before the share value declines below $1.00.

   - MMF investors may redeem shares on demand despite the fact that MMFs invest in securities that have terms longer than one day, resulting in a liquidity mismatch. According to the FSOC, redemptions in excess of the fund's available liquidity may require an MMF to sell less-liquid assets to pay shareholders, potentially resulting in losses. Since such losses would be borne by the remaining investors, the FSOC believes a "first-mover advantage" is created, which incents investors to redeem shares at the first sign of losses to the fund's value and before any additional losses are created by other shareholders' redemptions.
   - MMFs invest in securities with interest-rate and credit risk in order to increase their yields, but they have no formal capacity to absorb losses. The FSOC suggests that, as a result, even small losses may create an incentive for investors to redeem shares.
   - Rather than utilizing capital, insurance or any other formal mechanism to absorb losses, MMFs historically have relied on discretionary support from their sponsors to avoid breaking the buck. In the FSOC's view, the uncertainty regarding whether a sponsor will be willing and able to provide support may make MMFs more vulnerable to runs during times of financial distress.
   - The FSOC also believes that MMF investors tend to be risk-averse and are, therefore, more likely to redeem shares when fund losses appear possible.

- ***Size, Scale, and Concentrations:*** The MMF industry (i) is large, with $2.9 trillion in assets under management, (ii) plays a key role in the short-term funding markets, and (iii) is concentrated, with MMFs sponsored by a small number of firms accounting for most MMF assets.
- ***Interconnectedness:*** The FSOC views MMFs as highly interconnected with the rest of the financial system and able to propagate stress throughout it because of their role as financial intermediaries, as important investors in the short-term funding markets, as potential beneficiaries of monetary support from financial institutions that sponsor them, and as providers of cash-management services.

For these reasons, the FSOC has proposed to make the determination set forth above. Dodd-Frank mandates that a final determination be made before the FSOC may issue any recommendations to the SEC. Although the FSOC may make a recommendation to the SEC, the SEC has the ultimate authority to determine whether to adopt it.

PROPOSED ALTERNATIVES

The FSOC seeks comment on proposed recommendations to the SEC to address the structural vulnerabilities of MMFs discussed above. The proposal indicates that the alternatives may not be mutually exclusive and that a flexible approach that would permit investors to choose between different fund structures may be preferable. Each of the three alternatives is described in more detail below.

Floating Net Asset Value. The exemption in Rule 2a-7 that currently allows MMFs to utilize amortized cost accounting or penny rounding to maintain a stable NAV would be removed, requiring MMFs to have an NAV reflecting the market value of the underlying portfolio holdings. This alternative would also require funds to re-price their shares from $1.00 to $100 (or initially sell shares at that price) to provide more price sensitivity to NAV fluctuations. Other provisions of Rule 2a-7 would continue to apply to any fund that uses a name similar to "money market fund," but, the FSOC states, the SEC's orderly liquidation provisions in ICA Rule 22e-3[4] and sponsor support provisions in ICA Rule 17a-9[5] would serve no function

[4] 17 C.F.R. § 270.22e-3.

for MMFs with floating NAVs and likely would be rescinded or, if applicable, have their application limited to any remaining stable value MMFs.

The FSOC suggests that regular fluctuations in NAVs likely would acclimatize investors to NAV fluctuations, and that a floating NAV would (i) reduce the first-mover advantage because investors would no longer be able to redeem shares for $1.00 when the shares' shadow value was lower and (ii) provide the same price transparency available in other mutual funds. In contrast, certain disadvantages to the proposal were also noted. According to the FSOC, the first-mover advantage would not be entirely eliminated because the liquidity mismatch described above would continue to threaten the value of shares that are redeemed after a large number of redemptions forces a fund to sell less liquid assets, potentially at a loss. Also, shareholders would need to consider whether a floating-NAV MMF may be properly characterized as a cash equivalent for accounting purposes, and they may face a more complex federal income tax analysis upon redemption, although the proposal asserts that the Treasury Department and Internal Revenue Service would consider certain types of administrative relief. Finally, operational changes necessary to enable MMFs to price shares at market value on a daily basis may increase operational costs and be less efficient. These issues, as well as the changed characteristics of MMFs resulting from a switch to a floating NAV, may reduce the number of investors willing or able to include MMFs in their cash-management systems.

The proposal would permit a transition period, which would grandfather existing MMFs, allowing them to maintain stable NAVs for a set time while prohibiting any new share purchases in current stable-NAV funds after a certain date, and require that any new investments be made in floating-NAV MMFs.

Stable Net Asset Value with Maximum 1% Buffer and Minimum Balance at Risk. Alternative Two would require that MMFs (i) maintain an NAV buffer and (ii) delay for 30 days any portion of a redemption that would leave a remaining account balance of less than 3% of a shareholder's highest account value in excess of $100,000 during the previous 30 days (the "Minimum Balance at Risk" or "MBR"). The FSOC states that the NAV buffer and the MBR would function to reduce MMFs' susceptibility to runs by allowing a fund to better absorb day-to-day fluctuations in the value of its portfolio securities, providing a disincentive for investors to redeem their fund shares in stressful times, and allocating more fairly the costs to the fund that can result when shareholders do redeem.

An MMF would be required to maintain assets of a specified percentage, not to exceed 1%, in excess of the assets needed for it to maintain its $1.00 share price and absorb day-to-day fluctuations in the value of the securities in the fund's portfolio. The buffer would replace the provisions of Rule 2a-7 that allow MMFs to use the penny rounding method of pricing and the amortized cost method of valuation, and its minimum size would be determined according to the riskiness of the fund's assets, as follows:

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[5] 17 C.F.R. § 270.17a-9.

- No buffer would be required for cash, Treasury securities, and Treasury repos (those repos collateralized solely by cash and Treasury securities).
- A 0.75% buffer requirement for other daily liquid assets (or, in the case of tax-exempt funds, weekly liquid assets).[6]
- A 1.00% buffer requirement for all other assets.

MMFs that invest at least 80 percent of their assets in cash, Treasury securities, and Treasury repos ("Treasury MMFs") would not be required to maintain an NAV buffer in order to maintain a stable $1.00 share price.[7] A fund whose NAV buffer dipped below the required minimum amount would have to limit its new investments to cash, Treasury securities, and Treasury repos until the appropriate buffer level was restored, while a fund that exhausted its NAV buffer would either have to suspend redemptions and liquidate under ICA rule 22e-3, which the SEC would have to amend for this purpose, or it could continue to operate as a floating-NAV MMF indefinitely or until it restored its NAV buffer.

The proposal does not restrict the methods by which an MMF may raise the buffer but suggests the following methods as possibilities:

- ***Escrow Account.*** An escrow account holding weekly liquid assets could be established by an MMF's sponsor, which would be similar to the segregated accounts established by certain sponsors during the financial crisis to support the MMFs' stable NAVs.
- ***Issuance of Subordinated Buffer Shares.*** A class of subordinated, non-redeemable equity securities could be issued, which would absorb first losses in the MMF's underlying securities until such losses affected the redeemable shareholder's $1.00 per share value. The buffer shares would be permitted to pay higher dividends than those paid on redeemable shares, provided that no more than 25% of the buffer shares are held by the sponsor and its affiliates.
- ***Retained Earnings.*** An MMF could retain earnings; however, such amounts would be subject to fund-level taxes.

The transition provision would require that one-half of the applicable buffer be in place one year following the effective date of any rule and that the full buffer be in place two years after such effective date.

To permit buffers to be built through the issuance of buffer shares or the retention of earnings, the SEC would need to amend Rule 2a-7 to allow an MMF to redeem and sell its redeemable shares for $1.00 per share, even when the value of the MMF's assets, including the NAV buffer, is above $1.00.

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6 "Daily liquid assets" and "weekly liquid assets" are defined in Rule 2a-7. Daily liquid assets generally include cash, U.S. Treasury obligations, and securities that convert into cash (by maturing or through a put) within one business day. Weekly liquid assets generally include daily liquid assets, securities of an instrumentality of the U.S. government that have a remaining maturity of 60 days or less, and securities that convert into cash within five business days.

7 The proposal notes that Treasury MMFs "would be permitted to continue to use penny rounding," generally enabling them to maintain a stable value without a buffer.

Additionally, shareholders would not be able to redeem on demand a certain portion of their account. The MBR rule would not restrict any of an investor's redemptions in the MMF as long as the account balance remained above the MBR. Once the account balance equals the MBR, proceeds from any additional redemptions would be received after the 30-day period, as long as the MMF did not suffer losses in excess of its NAV buffer during that time. In the event an MMF suffered losses in excess of its NAV buffer, a portion of each investor's MBR could be subject to first loss if the investor had made net redemptions in excess of $100,000 during the prior 30 days, with the extent of such loss borne by the investor approximately proportionate to the investor's cumulative net redemptions during the prior 30 days. The proposal provides examples of the amount of an investor's account that would be subject to first loss. According to the proposal, the MBR requirement would not apply to Treasury MMFs, or to any investor in an MMF with an account balance of less than $100,000.[8]

The FSOC believes that this alternative would reduce the first-mover advantage and potentially make MMFs less susceptible to runs by limiting the share of the fund's assets that may be redeemed by any investor at one time and forcing investors that make large redemptions to first share in fund losses. Additionally, it posits that the combination of a buffer to absorb losses and the disincentive for investors to make large redemptions when a fund may experience losses would make MMFs more resilient and provide some protection for shareholders who do not redeem when an MMF's value declines.

The FSOC notes, however, that the buffer would likely reduce the yield offered to investors and increase operating costs for MMFs. Sponsors would have to determine whether, for accounting purposes, MMFs would need to be consolidated on their balance sheets. If a sponsor that is a bank or bank holding company is required to consolidate, or if the sponsor provided explicit guarantees or liquidity to MMFs, bank regulatory capital concerns may be implicated. The MBR requirement also could pose an issue under the Commodity Futures Trading Commission's requirements for the investment of customer funds supporting futures and swaps positions.[9]

Stable Net Asset Value with Maximum 3% Buffer and Other Measures. This proposal would function much like Alternative Two and require MMFs to maintain a buffer as described in Alternative Two, but would involve higher buffer requirements and additional measures, other than an MBR, to mitigate MMFs' perceived vulnerabilities. The FSOC states that this proposal is meant to accomplish the same goals, but the NAV buffer is larger in order to provide more capacity for loss absorption than Alternative Two because it does not believe that the complementary measures employed in this option would provide the

8 An example in the proposal suggests that the exemption from the MBR requirement would be available only to those investors in MMFs whose current account balance is less than $100,000 *and* whose highest account balance in the previous 30 days was not more than $100,000.

9 Additionally, funds with omnibus account arrangements would need to rely on brokers to make the calculations required to comply with the MBR requirements, which would impose a burden on brokers as well.

same structural protections as an MBR. The higher buffer requirements would again be determined according to the riskiness of the fund's assets:

- No buffer would be required for cash, Treasury securities, and Treasury repos.
- A 2.25% buffer requirement for other daily liquid assets (or, in the case of tax-exempt funds, weekly liquid assets).
- A 3.00% buffer requirement for all other assets.

Treasury MMFs would not be subject to this NAV buffer requirement.

One-sixth of the buffer would need to be in place one year following the effective date of a rule implementing this alternative, an additional one-third of the buffer would need to be in place two years after the effective date, and a "multi-year" transition period would follow with regards to the remaining portion of the buffer.

In addition to the expanded buffer, Alternative Three contemplates the following other measures:

- ***More Stringent Investment Diversification Requirements.*** The proposed measure would reduce the percentage of total assets that a fund may invest in securities of an issuer, which is currently set at 5%. Additionally, "issuer" would be defined to include all affiliates of a consolidated group.
- ***Increased Minimum Liquidity Levels.*** An MMF is currently required to invest at least 10% of its total assets in daily liquid assets and 30% of its total assets in weekly liquid assets.[10] The proposal would increase the daily and weekly liquidity requirements to 20% and 40%, respectively.
- ***Expanded "Know-Your-Investor" Requirements.*** Additional rules[11] could be implemented to require MMFs to obtain more information about their beneficial owners, particularly in situations where MMF shares are held by financial intermediaries on behalf of their customers, so that MMFs may better anticipate redemption activity.
- ***More Robust Disclosure Requirements.*** MMFs are currently required to disclose information about their portfolio holdings on their websites each month and in monthly reports filed with the SEC.[12] Reporting obligations could be required on a more frequent basis or a more detailed level, including disclosure of valuation methodologies, factors taken into account by the board of directors to assess the credit risk of a security and instances of sponsor support.

The FSOC states that Alternative Three would result in similar benefits and burdens as discussed above with respect to Alternative Two; however, it suggests that the larger buffer requirement would further increase MMFs' loss-absorption capacity and further reduce the first-mover advantage, but also increase the costs to MMFs and sponsors relating to raising capital.

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[10] *See* 17 C.F.R. § 270.2a-7(c)(5)(ii) and (iii).

[11] The SEC's 2010 reforms stated that "money market funds should adopt policies and procedures designed to assure that appropriate efforts are undertaken to identify risk characteristics of shareholders." *See* Money Market Fund Reform, Rel. No. IC-29132 (Feb. 23, 2010), available at: http://www.sec.gov/rules/final/2010/ic-29132.pdf.

[12] *See* Rule 2a-7 and Form N-MFP.

REQUEST FOR COMMENT

The FSOC requests public comment on each of the alternatives and on any other reforms, including complements to the NAV buffer in Alternative Three, that meet the objectives of addressing the structural vulnerabilities inherent in MMFs and mitigating the risk of runs. Additionally, the FSOC requests any quantitative analyses or data from commenters relating to each alternative.

The other reforms on which the FSOC solicits public comment include liquidity fees and/or gates that would be implemented during times of market stress to reduce MMFs' vulnerability to runs. The proposal notes that some market participants and other stakeholders have suggested this approach as an alternative to the three alternatives discussed in the proposal. The FSOC requests comments as to whether and how alternative features only implemented during times of market stress, including standby liquidity fees charged to redeeming shareholders or temporary restrictions on redemptions, could reduce MMFs' vulnerabilities. The proposal describes standby fees or gates that would be triggered by certain measures indicating stress on an MMF's condition or by a board determination that would last until the MMF's NAV or liquidity was restored to levels required under Rule 2a-7 or until a predetermined number of days.

The comment period expires on January 18, 2013. The FSOC will then consider any comments and may issue a final recommendation to the SEC, which, pursuant to Dodd-Frank, would be required to either impose the recommended standards or explain in writing within 90 days why it has declined to do so. However, the FSOC has noted that it and some of its members are actively evaluating alternative authorities in the event the SEC determines not to impose the standards recommended by the FSOC in any final recommendation.[13] Alternatively, if the SEC moves ahead with substantive structural reforms of MMFs before the FSOC completes its process pursuant to Section 120 of Dodd-Frank, the FSOC expects that it would not issue a final recommendation to the SEC.

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[13] Specifically, the proposal identifies the FSOC's authority under Title 1 of Dodd-Frank to designate any nonbank financial company that could threaten financial stability, which, among other things, would subject such company to Federal Reserve supervision. The FSOC also noted that it has the authority to designate systemically important payment, clearing or settlement activities under Title VIII of Dodd-Frank, which could result in the imposition of heightened risk-management standards. Additionally, other FSOC member agencies have the authority to take action to address certain of the risks posed by MMFs identified in the proposal.

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