Financial Stability Oversight Council Issues Proposed Recommendations Regarding Money Market Reform

On November 13, 2012, the members of the Financial Stability Oversight Council ("FSOC")[1] voted unanimously to advance for public comment Proposed Recommendations Regarding Money Market Reform ("Proposed Recommendations"). The Proposed Recommendations generally incorporate the major components of the reforms that were anticipated to be proposed by the SEC in a hearing that was scheduled to occur in August. The FSOC's action was prompted by the announcement by SEC Chairman Mary Shapiro that the SEC would not proceed with a vote to publish a notice of proposed rulemaking on such a proposal due to a lack of sufficient support among SEC Commissioners. The Proposed Recommendations put forward the following three potential areas for reform:

- ***Floating Net Asset Value*** - The price of money market fund ("MMF") shares would no longer be fixed at $1.00. As part of this proposal, MMFs would not be allowed to utilize amortized cost accounting and/or penny rounding to maintain a stable NAV.

- ***NAV Buffer and "Minimum Balance at Risk" Limitations on Redemptions*** - MMFs would be allowed to maintain a stable share price but would be required to have a risk-based NAV buffer of up to 1 percent of the fund's assets. In addition to the NAV buffer, MMFs would be a required to delay redemptions of a shareholder's minimum balance at risk ("MBR"), defined as 3 percent of a shareholder's highest account value in excess of $100,000 during the previous 30 days. Under this proposal, if an MMF suffers losses that exceed its NAV buffer, the losses would be borne first by the MBRs of shareholders who have recently redeemed. These requirements would not apply to Treasury MMFs, and the MBR requirement would not apply to investors with account balances below $100,000.

- ***Stable NAV with NAV Buffer and Other Measures.*** - MMFs would be required to have a risk-based NAV buffer of up to 3 percent of the fund's assets and satisfy other regulatory requirements that are more stringent than those imposed under current regulations including higher investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements.

The FSOC notes that the Proposed Recommendations are not necessarily mutually exclusive and could be implemented in combination to allow funds sponsors to offer different types of MMFs.

As the authority for advancing the Proposed Recommendations, the FSOC is exercising, for the first time, the powers granted to it by Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Section 120 allows the FSOC to provide for more stringent regulation of financial activities by issuing formal recommendations to the primary financial regulatory agency. In order for this authority to be exercised, the FSOC must determine that the specific activities "could create or increase the risk of significant liquidity, credit or other problems" that would spread through the financial system. As part of the Proposed Recommendations, the FSOC proposes to make a determination that MMFs create or increase such risks. Section 120 also requires the FSOC to take into account the costs of its actions.

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[1] The members of the FSOC include Tim Geithner, Treasury Secretary (Chairperson of the Council); Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System; Richard Cordray, Director of the Consumer Financial Protection Bureau; Edward DeMarco, Acting Director of the Federal Housing Finance Agency; Gary Gensler, Chairman of the Commodity Futures Trading Commission; Martin Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation; Debbie Matz, Chairman of the National Credit Union Administration; Mary Schapiro, Chairman of the U.S. Securities and Exchange Commission; Thomas Curry, Comptroller of the Currency.

By advancing the Proposed Recommendations, the FSOC is starting a process which may result in a recommendation that the SEC engage in rulemaking to adopt what the FSOC describes as "much needed structural reforms of MMFs." A sixty-day public comment period began on November 19, the date the Proposed Recommendations were published in the Federal Register. Under Dodd Frank, if the FSOC issues a final recommendation, the SEC would be required to impose the recommended standards, or similar standards that the FSOC deems acceptable, or else to explain in writing, not later than 90 days after the date on which the FSOC issues the final recommendation, why the SEC has decided not to follow the FSOC's recommendation. If the SEC accepts the FSOC's recommendation, the SEC would then implement the recommendation through its own rulemaking process, which would include consideration of the economic consequences of implementing the rule, as informed by the SEC staff's own economic study and analysis.

Notwithstanding the FSOC's recent action, the future course of money market reform remains uncertain and the regulatory process could travel down a number of different tracks. In the Proposed Recommendations, the FSOC explicitly recognized that the SEC is the agency best positioned to implement MMF reform. If the SEC moves forward with reforms before the FSOC completes its Section 120 process, the FSOC expects that it would not issue a final Section 120 recommendation to the SEC. The Proposed Recommendations also note that the FSOC has other options in addition to the Section 120 recommendation process, and is "actively evaluating alternative authorities in the event the SEC determines not to impose the standards recommended by the Council in any final recommendation." As an example, the FSOC points out that under Title I of Dodd-Frank, it has the authority and the duty to designate any nonbank financial company, which in its view may include the sponsors of MMFs, that could pose a threat to U.S. financial stability.[2] If the FSOC so designated MMF sponsors, such companies would then be subject to supervision by the Federal Reserve and such enhanced prudential standards as the Federal Reserve may deem appropriate. Alternatively, the FSOC mentions that its authority to designate systemically important payment, clearing, or settlement activities under Title VIII of the Dodd-Frank Act could enable the application of heightened risk-management standards on an industry-wide basis. As the FSOC is still a new regulatory body and this is the first time the Section 120 recommendation authority has been invoked, there are significant administrative law and procedural questions that may give rise to judicial challenges to the validity of actions proposed to be taken by the FSOC.

The action by the FSOC is the latest step in a lengthy regulatory process that has been marked by strong disagreements among the leadership of the most significant financial regulators in the United States, the SEC Commissioners and representatives of the MMF industry. The FSOC's discussion accompanying the Proposed Recommendations reflects a firm conviction on the part of its members that MMFs currently have inherent structural vulnerabilities that leave them susceptible to destabilizing runs. The FSOC attributes these structural problems to MMFs' maintenance of a stable value per share and the lack of any explicit capacity to absorb losses in their portfolio holdings without depressing the market-based value of their shares. As a result, these structural vulnerabilities create what the FSOC describes as a "first-mover advantage" that promotes runs on MMFs by giving the first investors to redeem "a free option to put their investment back to the fund by redeeming shares at the customary stable share price of $1.00, rather than at a price that reflects the reduced market value of the securities held by the MMF." Representatives of the MMF industry have vociferously disagreed with this line of argument and have asserted that the types of reforms in the Proposed Recommendations will eliminate MMFs as a viable product, to the detriment of investors. These fundamentally differing perspectives have the potential to protract further efforts to reform MMFs.

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[2] The FSOC has separately engaged in rulemaking under this authority. For a further discussion of this topic please see our IM Update for May-June 2012 entitled "FSOC Establishes Process for Designating Nonbank Financial Companies for Oversight by the Board of Governors of the Federal Reserve System" which can be found here.

If you would like to learn more about the developments discussed in this Alert, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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