

# FS Regulatory Brief

## FSOC moves swiftly on money market reform

November 2012

As expected, on November 13, 2012, the Financial Stability Oversight Council (FSOC) unanimously voted to issue proposed recommendations for structural reforms to money market funds (MMFs) intended to make them more resilient to runs. The public comment period will run for 60 days (through January 18, 2013).<sup>1</sup>

We recently described the state of the debate around MMFs more broadly in a *Closer Look: Money market reform in flux: Reading the tea leaves on money market fund regulation*.<sup>2</sup>

The FSOC concluded that “the conduct and nature of MMFs’ activities and practices make MMFs vulnerable to destabilizing runs, which may spread quickly among funds, impairing liquidity broadly and curtailing the availability of short-term credit.”

The FSOC concluded that the SEC’s 2010 rule changes did not sufficiently address MMFs’ structural vulnerabilities, and referenced current data on MMFs and MMFs’ experience with shareholder redemptions, sponsor support and government guarantees.<sup>3</sup>

The FSOC proposed three alternatives for structural reform of MMFs, which could be implemented alone or in combination:

1. Require MMFs to have a **floating net asset value** (NAV). The FSOC proposal states that “floating NAVs could make investors less likely to redeem *en masse* when faced with the prospect of even modest losses by eliminating the “cliff effect” associated with breaking the buck. Regular fluctuations in MMF NAVs likely would cause investors to become accustomed to, and more tolerant of, fluctuations in NAVs. A floating NAV would also reduce the first-mover advantage that exists in MMFs today because investors would no longer be able to redeem their shares for \$1.00 when the shares’ market-based value is less than \$1.00.”
2. Retain the fixed NAV, but have a **capital buffer** (of up to 1% of NAV) to absorb losses, and **redemption holdbacks** (called a “minimum balance at risk” (MBR)). The capital buffer could be funded by the sponsor, by the MMF’s retained earnings, or by the issuance of a special share class of “buffer shares.” In the event that an MMF suffers losses that exceed its NAV buffer, the losses would be borne first by the redemption holdback from shareholders who have recently redeemed. According to the FSOC proposal, this would create a disincentive to redeem and provide protection for shareholders who remain in the fund. These requirements would not apply to Treasury MMFs, and the redemption holdback would not apply to investors with account balances below \$100,000.

<sup>1</sup> The FSOC’s proposals:  
<http://www.treasury.gov/initiatives/fsoc/rulemaking/Pages/open-notice.aspx>

<sup>2</sup> <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/dodd-frank-closer-look/money-market-funds-reform.jhtml>

<sup>3</sup> MMFs have \$2.9 trillion in AUM (\$2.6 trillion in Rule 2a-7 funds). As of the end of 2011, there were 632 such funds; the top 20 MMF sponsors have funds that hold 90% of the AUM in MMFs.  
<http://www.treasury.gov/initiatives/fsoc/rulemaking/Pages/open-notice.aspx>

3. Retain the fixed NAV, but have a **capital buffer** (of up to 3% of NAV), coupled with other measures, such as **more stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements**. In its proposal, the FSOC states that it would reduce the size of the NAV buffer to the extent that it can be adequately demonstrated that more stringent investment diversification requirements (alone or in combination with other measures) complement the NAV buffer and further reduce the vulnerabilities of MMFs.

The FSOC action follows an open letter in September from Treasury Secretary Geithner making the case for structural reforms to MMFs. Notably, these are the very reforms that the SEC was considering during much of 2012, though the SEC was not able to reach agreement to propose these or other reforms for public comment, as we described in our recent *Closer Look*.

### **Other options? What about similar cash products?**

The FSOC also asked for comment on other suggestions to address MMFs vulnerability to runs, including proposals recently advanced by the industry to allow MMF boards to impose “gates” on redemptions and to require redeeming shareholders to pay “liquidity fees” to redeem during times of stress. The FSOC noted, however, that these proposals could exacerbate runs as redeeming shareholders could try to exit the fund prior to gates being imposed. This concept is not among the FSOC’s three primary alternatives as described above, and appears not to be favored by the FSOC.

In its proposal, the FSOC explicitly stated that it recognized that “regulated and unregulated or less-regulated cash management products may pose risks that are similar to those posed by MMFs and that further MMF reforms could increase demand for non-MMF cash

management products.” This concern has been expressed by many in the industry and by at least one SEC commissioner.<sup>4</sup> The FSOC’s proposal states that it and its members “intend to use their authorities, where appropriate and within their jurisdictions, to address any risks that might arise from a migration to non-MMF cash management products,” and the proposal seeks comment on possible reforms that would address such risks.<sup>5</sup>

### **The FSOC and its authority**

Created by Dodd-Frank, the FSOC’s mission is to prevent systemic risk to the financial markets. The FSOC is comprised of ten voting members (banking, securities, and commodities regulators) and is chaired by the Treasury Secretary. Any action by the FSOC requires a majority vote, which must include the Treasury Secretary.

Under Section 120 of Dodd-Frank, the FSOC is empowered to issue recommendations to the “primary financial regulator” in order to apply new or heightened prudential standards

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<sup>4</sup> Statement by SEC Commissioner Luis Aguilar (August 23, 2012):

<http://www.sec.gov/news/speech/2012/spcho82312laa.htm>

<sup>5</sup> The Office of the Comptroller of the Currency recently finalized new rules for national banks’ short term investment funds (STIFs), which are pooled vehicles that also use amortized cost accounting and seek to maintain a fixed NAV. Short-Term Investment Funds, 77 FR 61229 (Oct. 9, 2012). The new rules impose tighter credit, liquidity and other standards. In its release on the new rules, the OCC notes that it will “continue to evaluate the requirements [for STIFs] in light of future policy assessments and initiatives concerning stable NAV funds, and will take such additional actions as are appropriate.” A comparison of these new rules and Rule 2a-7 by Dechert LLP is at:

<http://sites.edechert.com/10/545/november-2012/2012-11-07---occ-tightens-regulatory-requirements-for-stifs.asp?intEmailHistoryId=358572&intEmailListId=27&intEmailId=68748&intExternalSystemId=1>.

for a financial activity or practice. The FSOC is required first to consult with the primary regulator, and then to provide notice to the public and an opportunity to comment on any proposed recommendation. The primary regulator must then impose the standards recommended by the FSOC, or explain in writing within 90 days why it is choosing not to do so (the so-called “adopt or explain” approach in Section 145 of Dodd-Frank).

The limits of the FSOC’s authority over the primary financial regulators were debated during the crafting of Dodd Frank. Early legislative proposals would have authorized the FSOC to override agency action or inaction, but were rejected in light of concerns that the proposals would have resulted in a “super-agency” with authority over all financial regulators.<sup>6</sup>

As outlined in the FSOC’s proposal, the FSOC also has authority to designate entities or activities as “systemically important.” Such a designation would give the Federal Reserve broad powers to impose enhanced prudential requirements on any MMF that was designated as a Systemically Important Financial Institution (SIFI). However, when the FSOC adopted final rules for designating nonbank SIFIs, it reserved judgment on whether subjecting asset management firms to Federal Reserve supervision would mitigate any threats to financial stability or whether any such threats “would be better addressed through other regulatory measures.”<sup>7</sup>

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<sup>6</sup> Speech by Fed Governor Tarullo, University of Pennsylvania Law School (October 10, 2012): <http://www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm>

<sup>7</sup> See 77 Federal Register 21644, April 16, 2012, and our earlier *Closer Look* on money market reform: <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/dodd-frank-closer-look/money-market-funds-reform.jhtml>

In addition, individual banking agencies could impose capital surcharges on bank-affiliated MMF sponsors, or could restrict banks’ ability to sponsor, borrow from, invest in, or provide credit to MMFs that do not have protections. The FSOC’s proposal states that it and its banking members will consider these options “in-parallel,” should the SEC, as the primary functional regulator for MMFs, fail to act.

*This is the first time that the FSOC has exercised its authority to issue recommendations. It’s likely to be scrutinized closely by the public, industry, members of Congress, and other primary regulators. While the FSOC has authority to make recommendations to primary regulators, in this case the SEC, it does not have authority to mandate that the primary regulator adopt rules. Thus, its recommendations can be seen as clear interagency support for SEC action, though they are not binding on the SEC.*

*While the FSOC cannot impose rules on a primary financial regulator, its use of its Section 120 authority, and coming within weeks of Secretary Geithner’s September 27 open letter, indicates that the FSOC felt comfortable exercising its authority. In this instance, it had unanimous support of its ten members, including SEC Chairman Schapiro.*

*Despite its action, the FSOC members indicated their preference for the SEC to take action. Indeed, Secretary Geithner called that the “preferred course” and said that if the SEC was to find a majority of its commissioners to support reforms, the FSOC would suspend its consideration of the proposals and would not forward a recommendation to the SEC.*

## The reaction

Following the FSOC action, the Investment Company Institute reiterated its opposition to these reforms:

“The process that the FSOC is following is deeply flawed. The SEC is the appropriate agency to evaluate additional money market fund reforms. Only the SEC has the necessary expertise as the regulator of mutual funds. At the request of SEC Commissioners, that agency is engaged in an analysis of the Commission’s 2010 reforms to money market fund regulation. Such analysis—and a thorough examination of the voluminous public record already compiled on this issue—should be completed before any further action is taken.

ICI and its members continue to oppose these reform concepts. When aired in the past, these concepts have elicited strong opposition for their adverse impacts on investors, issuers, and the economy from hundreds of organizations representing state and local governments, businesses, and others, as well as Members of Congress from both parties.”<sup>8</sup>

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<sup>8</sup> Statement of ICI President and CEO Paul Schott Stevens (November 13, 2012): [http://www.ici.org/pressroom/news/12\\_news\\_fso\\_c\\_action](http://www.ici.org/pressroom/news/12_news_fso_c_action). See also: <http://www.ici.org/mmfs>

## The focus now shifts to the SEC

In 2010, the SEC imposed more stringent rules on MMFs, tightening quality, duration, liquidity and transparency requirements.<sup>9</sup> Despite those changes, in early 2011, SEC Chairman Schapiro and various federal banking regulators including Treasury Secretary Geithner and Federal Reserve Governor Tarullo began to champion the need for additional reforms to stave off destabilizing runs on MMFs.

Throughout the summer, the SEC staff worked on a proposal to present to the Commission for a vote scheduled for August 2012 (a majority of the five-member Commission is needed to issue proposals or adopt rules). However, days before the August 29th vote, Chairman Schapiro announced that she did not have majority support of the commissioners to authorize issuing a proposal for public comment.<sup>10</sup> Since then, the SEC staff have been conducting an analysis of various reform options and their potential impact, as well as studying the impact of the 2010 rules on the resilience of MMFs.

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<sup>9</sup> The 2010 Rule 2a-7 changes are described in detail in our earlier *Closer Look*: <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/dodd-frank-closer-look/money-market-funds-reform.jhtml>

A recent report by Fitch tracks changes in liquidity at large MMFs during the financial crisis, after the announcement of the 2010 Rule 2a-7 amendments, and during Eurozone market volatility in 2011: [http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=695216](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695216)

<sup>10</sup> Statement of Chairman Mary Schapiro (August 22, 2012): <http://www.sec.gov/news/press/2012/2012-166.htm>

The FSOC's proposal shifts the focus back to the SEC to determine whether a majority of commissioners (3 of 5) can support one of the reform options put forth by the FSOC – or another option.

While Chairman Schapiro stated her personal view that the floating NAV option is the best and simplest option, each of the SEC commissioners has views on the need for reform and the optimal type of reforms. In August, the two Republican commissioners indicated that they were not opposed to additional reforms to MMFs, thus indicating some openness to exploring options.<sup>11</sup> Among the options, they indicated support for discretionary “gates,” coupled with enhanced disclosure to investors. One commissioner has also indicated support for a floating NAV.<sup>12</sup> Another commissioner did not rule out support for reforms to MMFs, but called for study of the entire cash management industry.<sup>13</sup>

*While the SEC has been working on MMF reform for some time, the views of the SEC commissioners may not yet be fully formed. The commissioners will be focusing on the results of the SEC's staff's study, as described above, and will be reviewing the comments submitted to the FSOC. We expect that they will make serious efforts to find common ground, in an area that is within the traditional and unique regulatory jurisdiction and expertise of the SEC. We think it likely that the SEC will propose its own set of reforms.*

*As we noted in our Closer Look, one hurdle, which the SEC is well aware of, is that in order to overcome possible court challenge, it will need to perform a cost-benefit analysis and an analysis of why additional reforms are needed, beyond the 2010 Rule 2a-7 amendments.*

## What will happen next?

- Comments on the FSOC's proposal are due by January 18, 2013 (and may be submitted to [www.regulations.gov](http://www.regulations.gov)).
- Following that, the FSOC will review the comments received and will submit its recommendations to the SEC. We would expect the FSOC to take this action fairly early in 2013.
- Thereafter, the SEC will have 90 days to adopt the recommendations or to explain why it will not do so.
- As we describe above, we think it likely that the SEC will take action on its own to put out a rule proposal for public comment. Thereafter, separate action (and another vote by the SEC) would be needed to adopt rules.

<sup>11</sup> Statement by SEC Commissioners Daniel Gallagher and Troy Paredes (August 28, 2012): “[F]urther action must be advanced on the basis of data and rigorous analysis showing that any such changes to our existing rules would be workable, would be effective in achieving their purpose, and would not unwisely disrupt the functioning of money market funds and short-term credit markets.”

<http://www.sec.gov/news/speech/2012/spcho82812dmgtap.htm>.

<sup>12</sup> <http://www.bloomberg.com/news/2012-09-27/sec-s-gallagher-calls-for-floating-price-for-money-market-funds.html>

<sup>13</sup> Statement by SEC Commissioner Luis Aguilar (August 23, 2012): <http://www.sec.gov/news/speech/2012/spcho82312laa.htm>

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