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Investment Companies

How the Dodd-Frank Act Should Affect Mutual Funds, Including Money Market Funds

Contributed by: David M. Geffen & Joseph R. Fleming, Dechert LLP

The Credit Crisis and Reform

Largely in response to the recent credit crisis (Credit Crisis), the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted in July 2010. The Dodd-Frank Act is an historic and wide-ranging piece of legislation and constitutes the most significant legislative change in the regulation and supervision of financial institutions since the Great Depression.

Registered investment companies and registered investment advisers (also referred to herein as "funds" and "advisers," respectively) were minor players in the Credit Crisis.[1] Nevertheless, the Dodd-Frank Act contains several provisions, rulemaking directives, and required studies that could impact funds and their advisers. The Dodd-Frank Act defers many of its effects to future studies and regulations by federal regulators, which are directed under the Dodd-Frank Act to promulgate a variety of regulations in the six to 18 months following the Dodd-Frank Act's enactment.[2] These studies and regulations have the potential to impact funds and their advisers significantly.

Today, it is impossible to predict what impacts the Dodd-Frank Act will have on funds and their advisers. However, it is not too early to set the agenda concerning the extent to which these studies and regulations *should* impact funds and their advisers. While there is no shortage of potential causes of the Credit Crisis,[3] funds and their advisers were largely unaffected by the crisis. Therefore, to determine how, if at all, funds and their advisers should be affected by forthcoming studies and regulations, it is first necessary to understand what differentiated funds from the financial institutions that did fail. It also is important to consider the regulatory regime that already applies to funds and their advisers before new regulations are added to the regime.

Finally, as described below, money market funds, especially institutional money market funds, may be distinguishable as a unique sub-class of funds that is targeted for additional regulation because they are deemed to pose systemic risk. The final section of this article describes a proposal that represents an alternative reform to those now being discussed publicly if money market funds are deemed to present systemic risk. However, the rationale for targeting money market funds for added regulation does not carry over to the remainder of the fund universe.

Why Some Financial Institutions Failed

While the last word on the causes of the Credit Crisis awaits to be written, there is a consensus that certain characteristics of the special purpose vehicles (SPVs), directly or indirectly holding subprime securities, contributed to the disaster. The complexity or opaqueness of the securities issued by the SPVs contributed materially to the Credit Crisis due to the inability of market participants to price these securities accurately. In turn, multiple entities with exposure to the SPVs were deemed uncreditworthy due to their unknown exposure to the SPV securities. Lenders fled to lower risk borrowers. Therefore, at least temporarily, the credit markets froze. In addition, the substantial leverage of the SPVs aggravated their problems when the SPVs' predicted cash flows failed to materialize.

In short, the complexity and related lack of transparency of the SPVs' issued securities combined with the SPVs' sensitivity to cash flow shortfalls to destroy the value of these securities. The effects on the originators/securitizers, warehouses/underwriters, and credit default swap protection sellers followed.

Excessive Leverage

Securities issued by SPVs backed directly or indirectly by subprime mortgage loans played a significant role in the Credit Crisis.[4] The SPVs issued mortgage-backed securities (MBSs) backed by a pool of mortgages owned by the SPV. Alternatively, an SPV would own the MBSs issued by other SPVs (or other asset-backed securities (ABSs) issued by other SPVs). This latter group of SPVs issued collateralized debt obligations (CDOs), which refers to the MBSs and other ABSs that backed the CDOs.

The SPV issuers of MBSs and CDOs underlying the Credit Crisis failed because the underlying mortgages default rate exceeded expectations, resulting in insufficient cash flows to service the holders of the SPVs' senior debt tranche. The reason for the higher-than-expected default rate is not critical to this article. Instead, what is important is that the SPVs were issuers that turned out to be excessively leveraged, as evidenced by the fact that, due to shortfalls in the anticipated revenues from subprime mortgage loans, there was inadequate cash flow from equity capital invested in the SPVs or other sources to service the debt securities issued by the SPVs.

Excessive Complexity

Securities issued by the SPVs also were excessively complex. With respect to the disclosure documents describing the MBSs and CDOs issued by the SPVs, there is a general consensus that, although the disclosure documents describing these securities satisfied federal securities laws, the disclosure nevertheless turned out to be inadequate or insufficient.[5]

For example, as noted, MBSs were typically issued through SPVs. Payment on MBSs depended upon payment of underlying mortgages, and valuing MBSs was complex because it required modeling payment of underlying mortgages (*e.g.*, default risk, prepayment risk).[6] CDOs were even more complex because CDOs' payments depended on a mixed pool of MBSs tranches and other

ABSs.

The complexity, in the sense of opaqueness, that resulted from the tranching and layering of securitized debt instruments has been called by one commenter a "loss of information":

> I have argued that one problem leading to the current crisis was the loss of information. What does it mean for information to be lost due to complexity? Lost implies that the information was known at one point, and then it became lost. By lost I mean that for CDOs investors and investors in other instruments that have CDOs tranches in their portfolios, it is not possible to penetrate the chain backwards and value the chain based on the underlying mortgages. The structure itself does not allow for valuation based on the underlying mortgages, as a practical matter. There are (at least) two layers of structured products in CDOs. Information is lost because of the difficulty of penetrating to the core assets.[7]

The level of complexity of the tranched and layered securities exceeded the analytical abilities and, therefore, the risk management abilities of highly sophisticated institutions.[8] To value the highly complex MBSs and CDOs, investors, including very sophisticated institutional investors, erroneously relied on the ratings of an MBSs or CDOs provided by one or more securities rating agencies.[9]

Comparison to Registered Investment Companies

To set the agenda concerning how, if at all, funds should be affected by the studies and regulations mandated by the Dodd-Frank Act, it is important to understand the provisions of the ICA that prevent a fund's securities from taking on the complexity or opaqueness of the securities issued by the SPVs described above. The same holds true for the ICA provisions that prevent a fund from taking on a highly leveraged capital structure approaching the capital structures of the failed SPVs.

The Investment Company Act of 1940 – Underlying Principles

The ICA was the result of a four-year investigation by the SEC and report to Congress[10] that "showed fantastic abuse of trust by management and wholesale victimizing of investment company security holders."[11] Unrestricted leverage was identified as one of the major abuses by investment companies.[12] Further, the ICA's legislative history indicates a hostility to the excessive organizational complexities of fund holding companies that made it difficult for investors to understand their investments. Thus, Section 1(b) of the ICA, in pertinent part, states that the ICA is intended to combat abuses arising from excessive leverage and undue organizational complexity:

> Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission . . . and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected –
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> when investors purchase, pay for . . . sell, or surrender securities issued by

> investment companies, without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management . . .
>
> when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or . . . when investment companies operate without adequate assets or reserves.
>
> It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.[13]

How the ICA Limits Excessive Leverage

As described above, in the Investment Trust Study of 1939, the SEC staff identified unrestrained leverage as one of the leading abuses of investment companies.[14] For a fund, leverage creates an obligation, or indebtedness, to someone other than the fund's shareholders and enables an investor the right to the return on a capital base that exceeds the investment personally contributed to the fund.[15]

The legislative history of the ICA indicates that Congress intended Section 18 of the ICA to limit a fund's ability to employ leverage.[16] Open-end (mutual) funds are prohibited by ICA Section 18(f) from issuing any "senior security,"[17] except for bank borrowings. Bank borrowings are permitted, provided that, after including the proceeds of any borrowing, the mutual fund maintains an asset coverage of at least 300% of the amount borrowed. Similar prohibitions apply to closed-end funds, which are permitted to issue one class of preferred stock in addition to one class of debt securities.[18]

Section 18 thus prohibits funds from having complicated capital structures.

In addition, the SEC and its staff interpret Section 18(g)'s definition of senior security to encompass instruments, such as derivatives,[19] that create the same type of risk for a fund as the other instruments enumerated in Section 18(g). Most, but not all, derivatives create leverage for a fund. In its 1979 interpretive release (Release 10666),[20] the SEC interpreted Section 18 broadly and stated that trading practices used by funds to "accomplish leveraging fall within the legislative purposes of Section 18" because these trading practices pose a risk of loss to funds "analogous to the danger caused by leverage."

Release 10666 specifically discussed the treatment of reverse repurchase agreements, firm commitment and standby commitment agreements. However, it stated that "if an investment company were to issue a security which affected its capital structure in a manner analogous to the agreements discussed [in Release 10666], and barring other material differences, the Commission believes it would view that transaction from a similar analytical posture." In 1994, the SEC restated this analysis:

> Certain derivatives involve leverage for a fund because they create an obligation, or indebtedness, to someone other than the fund's shareholders and enable the fund to participate in gains and losses on an amount that exceeds its initial investment. . . Examples are futures, forward contracts and written options.[21]

To avoid a senior security issue, the SEC requires funds to "cover" the obligations created by derivatives by (1) segregating or earmarking liquid portfolio assets in an amount at least equal to the value of the obligations, or (2) by holding the underlying instruments or other offsetting instruments.

Most recently, in a written report, an American Bar Association section committee[22] responded to a challenge by Andrew (Buddy) Donohue, former Director of the SEC's Division of Investment Management, to address concerns about investment company use of derivatives and leverage.[23]

How the ICA Limits Excessive Complexity

The ICA's legislative history indicates a hostility to "undue organizational complexities"[24] of fund holding companies that made it difficult for investors to understand their investments.[25]

The ICA mandates detailed disclosure for funds and, as described in the previous section, regulates funds' capital structures. A multi-tiered securities ladder, which was common for CDOs, would be impermissible for a fund.

In addition, ICA Section 12(d)(1) restricts investments by one mutual fund in another. This section is called the ICA's "anti-pyramiding" provision. Section 12(d)(1) regulates any registered investment company's acquisition of securities of another registered investment company.

Funds also are required to disclose their complete portfolios each calendar quarter, which is a component of "the recurrent theme throughout [the federal securities laws] of disclosure, again disclosure, and still more disclosure."[26] The SEC has stated:

> [Commenters noted] that providing a complete [quarterly] presentation of these investments is important to investors and gives them a better understanding of the nature of the fund's investments, its hedging strategies, its use of leverage, and any potential conflicts of interest in the management of the fund. We agree with these latter commenters. Requiring a complete presentation of investments other than securities of unaffiliated issuers in shareholder reports is important in order to provide investors with an understanding of the risks and potential conflicts of interest associated with the fund's portfolio.[27]

The civil liability provisions of the Securities Act of 1933, as amended (Securities Act), apply to the prospectus of every fund. Investors who purchase shares of a fund while the fund's prospectus — which includes the fund's annual report — contains a material misleading statement or has a material omission have broad legal recourse under Sections 11 and 12 of the Securities Act. These shareholders can prevail in a lawsuit to recover any subsequent decrease in the shares' value without claiming they relied on the misleading statement or that a defendant was at fault with respect

to the misleading statement. Section 11 provides that every person signing a fund's registration statement (which, under Section 6(a) of the Securities Act, includes the fund), every director or trustee of the fund, the fund's executive officers, the auditors certifying the financial statements in the fund's registration statement and the fund's underwriter may be liable for material misstatements and omissions in the prospectus. A plaintiff can prevail under Section 11 or Section 12 without showing that there was fault (*e.g.*, any intent to deceive) on the part of any defendant with respect to the misstatements. Some courts have likened defendants' liability for a material misstatement or omission as one of one of strict liability. Notably, fund shares differ from MBSs and CDOs, which normally are not registered and offered under the Securities Act and, therefore, are not subject to the civil liability provisions of the Securities Act.

In sum, ICA provisions regulate the capital structure that funds are permitted to employ. Layering of fund upon fund generally is limited. Funds must make quarterly disclosure of their portfolio holdings, and a very stringent civil liability regime applies in the case of any fund with a prospectus or financial statements that is misleading. Taken as a whole, funds differ from the MBSs and CDOs in that fund investors normally can look through their fund's holdings to understand their investment.

Other ICA Controls

While not implicated directly in the Credit Crisis, funds and their advisers are subject to a number of legal provisions intended to assure that funds are not overreached or made party to transactions that are not in the best interest of a fund and its shareholders. Stated simply, the ICA represents a successful regulatory scheme applicable to all funds, covering fund governance and fund operations and investment limitations. In terms of its comprehensiveness, the ICA, as supplemented by applicable provisions of the Investment Advisers Act of 1940, as amended (IAA), is unique among the federal securities laws. Consider the following examples.

To assure that a fund is managed in the interest of investors rather than a fund's adviser, the ICA relies on a board of independent-minded directors. The ICA requires that at least 40 percent of a fund's directors must be independent. The SEC has increased this percentage further through its rule-making powers such that, today, at least 50 percent of a fund's board must be independent. In fact, almost all funds have boards with a majority of independent directors. In early 1999, the SEC held a "Roundtable" on the role of independent investment company directors. Arthur Levitt, then Chairman of the SEC, stated that the Roundtable was intended to discuss "the increasingly important role that independent directors play in protecting fund investors, and precisely how their effectiveness may be enhanced."[28]

In October 1999, in response to the recommendations made at the Roundtable, and after its own review, the SEC issued a release titled, *Role of Independent Directors of Investment Companies*,[29] along with a companion interpretive release.[30] Taken together, these two releases are intended "to reaffirm the important role that independent directors play in protecting fund investors, strengthen their hand in dealing with fund management, [and] reinforce their independence . . . ."[31]

The ICA also protects fund shareholders through broad restrictions against transactions that involve a fund and any of its "affiliated persons." ICA Section 17 ensures that a fund is operated separately from its affiliates by prohibiting most transactions between a fund and any of its affiliated persons without any showing whether a particular transaction is in the best interest of the fund and its

shareholders and regardless of whether the fund's directors, including its independent directors, have approved the transaction. The concern here is self-dealing by persons in a position to overreach a fund. The SPVs described above could not have operated lawfully as registered investment companies due to fact that the transactions that the SPVs entered into with their originators/securitizers or warehouses/underwriters would have been prohibited by Section 17 of the ICA.

Under Section 205 of the IAA, fund advisers are prohibited from charging a fund an "incentive fee," whereunder an adviser is entitled to a portion of the capital appreciation in the fund.[32] In general, a compensation scheme in which advisers share proportionally in the rewards when they succeed, but do not share proportionally in the losses when they fail, creates a moral hazard to take additional risks. Thus, incentive fees create an incentive for an adviser to "swing for the fences" — following a riskier investment strategy — in the hopes of making a quick and sizable return without a downside disincentive to avoid the losses the investors will incur if the riskier strategy proves unsuccessful. Section 205 prohibits such arrangements.

The Special Case of Money Market Funds

Various federal regulators, including the SEC, appear ready to regulate money market funds further because these funds' susceptibility to runs, analogous to bank runs, is deemed to pose a systemic risk. This section summarizes why money market funds are perceived as posing a systemic risk. An alternative proposal to mitigate this risk is offered here, as well.

Money Market Funds Deemed to Pose Systemic Risk

In 2009, the Treasury Department proposed in its *Financial Regulatory Reform: A New Foundation*,[33] that the President's Working Group on Financial Markets (PWG) prepare a report assessing changes necessary to reduce systemic risk by reducing money market funds susceptibility to runs.[34] In October 2010, the PWG published its study,[35] containing possible reforms, extending beyond those effected by the SEC in February 2010,[36] that the PWG believes could mitigate systemic risk posed by money market funds. The source of money market funds' susceptibility to runs was described in the PWG Report as follows:

> Although the run on MMFs in 2008 is itself unique in the history of the industry, the events of 2008 underscored the susceptibility of MMFs to runs. That susceptibility arises because, when shareholders perceive a risk that a fund will suffer losses, each shareholder has an incentive to redeem shares before other shareholders.
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> * * *
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> Early redeemers are . . . more likely to receive the usual $1 [net asset value] than those who wait.[37]

In November 2010, the SEC issued a request for comment on the reforms proposed in the PWG Report.[38] The SEC's request for comment is not alone. In October 2010, the Financial Stability Oversight Council (Council), established under the Dodd-Frank Act, issued an advance notice of proposed rulemaking (ANPR) inviting public comment on the criteria it should use to identify systemically important nonbank financial companies, which will be made subject to prudential regulation pursuant to the Dodd-Frank Act.[39] Comments on the ANPR were due by November 5, 2010. If the Council determines that a nonbank financial company is systemically significant, that company will be regulated, which may include capital reserve requirements, by the Federal Reserve Board and by other agencies, including the Federal Deposit Insurance Corporation.

Therefore, money market funds may face additional regulation from the SEC, as well as new regulation by federal banking regulators.

Reframing the Source of Systemic Risk

An alternative interpretation is offered here. Rather than attributing the systemic risk engendered by money market funds susceptibility to runs to the structure of money market funds, the systemic risk could be deemed to arise from institutional shareholders, which can demand liquidity when money market instruments in which money market funds invest are experiencing a period of exceptional illiquidity.

Beginning in the autumn of 2007, money market funds began experiencing difficulties when the problems in the residential mortgage market, for the first time, affected the portion of money market funds' commercial paper holdings that had been issued by SPVs to fund the SPVs' acquisitions of assets and liquidity requirements. Most SPVs did not have substantial exposure to *sub-prime* mortgages, but investors began to avoid all asset-backed commercial paper.[40]

Investors in non-U.S. Treasury money market funds became concerned that the funds would be unable to maintain a constant $1.00 a share net asset value (NAV), resulting in a redemption run by investors in favor of Treasury-only money market funds (*i.e.*, funds that invested primarily in U.S. Treasury instruments).[41]

Thus, in the week following September 15, 2008 — the day of the Lehman bankruptcy filing and the day before the Reserve Primary Fund broke the buck — investors redeemed approximately $300 billion from non-U.S. Treasury money market funds, much of which was reinvested in Treasury-only money market funds.[42] Most of these redemptions were made by institutional investors,[43] while retail money market funds experienced normal cash flows. Short-term credit markets froze, blocking corporate borrowers access to the short-term private debt markets.

Ultimately, the structure of money market funds, by itself, is not the source of systemic risk associated with those funds. Equally important are institutional investors — the investors that redeemed $300 billion from non-U.S. Treasury money market funds in September 2008 — that are a source of the systemic risk associated with money market funds. Viewed in this light, institutional money market funds and their investors are a classic tragedy of the commons — a situation in which independent actors, each acting rationally to maximize its own interest, deplete a shared, finite resource (*i.e.*, the limited liquidity available to their fund during a liquidity crisis), despite the fact that it is in each actor's interest to avoid the destruction of the resource.

A Proposed Solution to the Now-Reframed Systemic Risk

The PWG Report offers several reforms that individually or in combination could mitigate money market funds' susceptibility to runs and related systemic risk. These reforms include (1) mandating that money market funds have a floating NAV instead of a stable $1.00 NAV, (2) establishing private emergency liquidity facilities for money market funds, (3) regulating stable NAV money market funds as special purpose banks, and (4) mandatory redemptions in kind of large shareholders. As noted above, in November 2010, the SEC issued a request for comment on the reforms proposed in the PWG Report. None of the PWG Report's proposals, with the possible exception of mandatory redemptions in kind, focuses on the behavior of investors as a means of stopping or deterring a run on a money market fund.[44]

The alternative suggested here is that, during a period of illiquidity, as declared by a money market fund's board[45] (or, alternatively, the SEC or another designated federal regulator), a money market fund may impose a redemption fee on a large share redemption approximately equal to the cost imposed by the redeeming shareholder and other redeeming shareholders on the money market fund's remaining shareholders. For example, if redemptions in cash are expected to impact the market value of the fund's remaining portfolio securities by an estimated dollar value or percentage, then the redeeming shareholders would be entitled to receive their principal value (*i.e.*, the $1.00 NAV) minus the market impact that the redemptions have on the fund. Thus, during a period of declared illiquidity, a shareholder who insists upon making a large redemption of its shares would receive less than the full amount of its shares' NAV. As soon as the declaration is withdrawn at the end of the period of illiquidity, money market funds would no longer be permitted to impose a redemption fee on redeeming shareholders and, once again, share transactions would occur at the $1.00 NAV.

The redemption fee causes the large redeeming shareholder to internalize the cost of the negative externality that the redemption otherwise would impose on non-redeeming shareholders.[46] If the large shareholder redeems, it bears the full cost of the redemption. The "savings" to the fund arising from the fact that the large shareholder is redeemed for less than the principal value of its shares offsets the market impact of the sale of portfolio securities to satisfy the redemption.

This type of redemption fee is not unprecedented. In the 2001 Fidelity Korea Fund no-action letter,[47] the SEC staff permitted a closed-end fund that was reorganizing to an open-end fund to impose a 4 percent redemption fee on the newly reorganized fund's shares that were redeemed from the reorganized fund less than 200 calendar days after the reorganization.

In the Fidelity Korea Fund no-action letter, the fund-applicant relied on the fact that when closed-end funds, which frequently trade at a discount, are reorganized as open-end funds, arbitrageurs and other short-term traders traditionally purchase shares of the closed-end fund in anticipation of the reorganization. These short-term traders profit from the difference between the closed-end fund's discount to NAV and the proceeds received from redeeming the reorganized open-end fund's shares at NAV.

The applicant asserted, and the SEC staff apparently agreed, that without a redemption fee, certain costs would be borne by the new fund and its long-term investors rather than by the short-term

traders who cause the costs to be incurred by the fund and its long-term investors. Specifically, the reorganized open-end fund would incur costs from being forced to sell a substantial portion of its portfolio holdings in order to satisfy arbitrage-related redemptions. These sales would have adverse impacts on the market price of the fund's portfolio securities, especially in emerging markets where the fund invested and securities were thinly traded.

If institutional money market funds can impose redemption fees, it could be argued that such funds would be less desirable investment vehicles and that, as a result, institutional investors would invest to a greater extent in unregistered funds or other investment vehicles. On the other hand, such a redemption fee would mitigate the possibility of runs on money market funds and, therefore, could attract new investors due to the mitigation of this risk.

Money market funds are an intermediary of short-term credit to the economy. They hold over 40 percent of outstanding commercial paper and approximately 65 percent of short-term municipal debt.[48] Money market funds also manage a substantial portion of U.S. business short-term assets (24 percent as of 2006).[49] As of December 29, 2010, money market funds had approximately $2.8 trillion of assets,[50] or approximately 25 percent of all U.S. fund assets.[51] Of the $2.8 trillion in money market funds, more than $1.8 trillion was invested in institutional money market funds. If regulators ultimately determine that money market funds pose a systemic risk due to the funds' susceptibility to runs, the advantage of the redemption fee approach described here is that it focuses on the behavior of institutional investors to reduce the possibility that money market funds will suffer a run, instead of restructuring the funds to cope with runs. For this reason, it may warrant consideration along with the reforms proposed in the PWG Report that focus on fund structure.

Conclusions

Today, it is not possible to predict how the studies and regulations called for by the Dodd-Frank Act will impact funds and their advisers. This article has shown that funds differ significantly from the MBSs and CDOs issued by the failed SPVs and, thereby, contributed materially to the Credit Crisis. In particular, as mandated by the ICA and the other federal securities laws, funds do not employ excessive leverage, funds' structures are not unnecessarily complex, and the portfolio holdings of a fund are significantly easier for an investor to understand. More broadly, the ICA "generally is regarded as a model regulatory statute, one that strikes a careful balance between the need to impose uniform standards of fiduciary behavior and the desire to encourage experimentation, change and innovation."[52]

It is accurate to view funds as bit players in the Credit Crisis. This can be attributed to the success of the ICA and other existing federal securities laws. For this reason, it would be unwise to attempt to employ provisions of the Dodd-Frank Act — which, after all, is Congress' response to the Credit Crisis — to justify another layer of regulation for funds and their advisers.

Institutional money market funds' susceptibility to runs may pose systemic risk, and it is possible that the SEC's 2010 tightening of the regulations applicable to such funds does not sufficiently reduce the systemic risk. If that proves to be the case, in addition to the PWG Report's proposals that focus on restructuring funds to cope with or avoid runs, it may be worthwhile to consider the redemption fee proposal described in this article as an alternative or adjunct reform.

David M. Geffen is counsel and Joseph R. Fleming is a partner in the financial services group of Dechert LLP. Both authors practice in Dechert LLP's Boston office.

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1 Problems relating to money market funds were largely a symptom and not a cause of the financial crisis. Using its existing authority, in February 2010, the Securities and Exchange Commission (SEC) adopted amendments to certain rules that govern money market funds under the Investment Company Act of 1940, as amended (ICA). *See* SEC Release No. IC-29132 (Feb. 23, 2010) ("The amendments will tighten the risk-limiting conditions of rule 2a–7 . . . [and] are designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share.").

2 The Dodd-Frank Act mandates approximately 240 rulemakings and 67 studies.

3 There is no shortage of potential causes of the Credit Crisis: rising housing prices; too-easy credit due to the actions of the Federal Reserve and government-sponsored enterprises; lending to not-credit-worthy borrowers; borrowers who failed to realize that housing prices also can fall; predatory lending; deregulation of financial institutions and the use of certain types of securities; negligence (or worse) on the part of regulators and business persons; systemic risk from financial institutions that were too big to fail; etc. It is true that, under the Dodd-Frank Act, money market funds could be deemed to pose systemic risk and, therefore, become subject to additional capital and leverage limits or other perceived risk-reducing regulations. *See* Paul S. Stevens, Investment Company Institute, letter to Barney Frank, Chairman, Committee on Financial Services, House of Representatives (June 3, 2010) (mutual funds should not be subject to systemic risk regime, due to the different non-bank structure of such funds).

4 *See* Gary Gorton, *The Panic of 2007*, Yale ICF Working Paper No. 08-24 at 3 (Aug. 25, 2008), unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1255362; Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 Minn. L. Rev. 373, 378-379 (2008); Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. Ill. L. Rev. 1359, 1372.

5 *See* Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 Utah L. Rev. 1109; Securities Industry and Financial Markets Association, *Restoring Confidence in the Securitization Markets*, 22 (Dec. 3, 2008), unpublished manuscript available at http://www.sifma.org/Issues/Capital-Markets/Securitization/Housing-Finance-and-Securitization/Restoring-Confidence-in-the-Securitization-Markets-(December-2008); Gorton, *supra* note 4 at 45; Mendales, *supra* note 4 at 1381. *See also* Gregory A. Krohn & William R. Gruver, *The Complexities of the Financial Turmoil of 2007 and 2008*, 11 (Oct. 7, 2008), unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1282250 (credit problems in the opaque and complex world of structured finance led to a liquidity crisis).

6 *See* Joseph R. Mason & Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?*, 22 (Feb. 13, 2007), unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027472.

7 Gorton, *supra* note 4 at 61.

8 *See* Global Joint Initiative to Restore Confidence in the Securitization Markets, *Restoring Confidence in the Securitization Markets*, 5 (Dec. 3, 2008) (report of joint group created by the Securities Industry and Financial Markets Association, the American Securitization Forum, the European Securitisation Forum, and the Australian Securitisation Forum).

9 *Cf.* Troy Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L.Q. 417, 441-442 (2003) (people have limited cognitive abilities to process information and, consequently, people tend to economize on cognitive effort when making decisions by adopting heuristics that simplify the decision-making).

10 Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies, Pt. I at 60 (Investment Trust Study of 1939). Section 30 of the Public Utility Holding Company Act of 1935, 15 U.S. C. § 79z-4 (Supp. 1939), directed the SEC to investigate the activities and functions of investment companies, and to report to Congress with the SEC's findings. The result was the Investment Trust Study of 1939.

11 Note, *The Investment Company Act of 1940*, 50 Yale L.J. 440, 441 (1941).

12 *See* SEC Release No. IC-10666 (Apr. 18, 1979), *citing* Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. at 1029 (1940) (Senate Hearings).

13 15 U.S.C. § 80a-1(b).

14 *See* Senate Hearings at 1029 ("The conclusion to be drawn from the operation of the principle of leverage and from these statistics is that the common stock of leverage investment companies is so fraught with danger to the investor and so hazardous a commodity that it is definitely inappropriate as an offering of a public investment institution . . . .").

15 *See* Senate Hearings at 240.

16 See Senate Hearings at 1025 (memorandum titled, Provisions of the Proposed Bill Relating to Capital Structure (Sections 18, 19(b) and 21(c)).

17 Section 18(g) of the ICA defines "senior security" to include "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness, and any such stock of a class having priority over any other class as to distributions of assets or payment of dividends."

18 Sections 18(a)-(e) of the ICA permit closed-end funds to issue senior securities representing debt or preferred stock. For debt securities, like open-end funds, closed-end funds must maintain asset coverage of 300 percent. For preferred stock, asset coverage of 200 percent is required.

19 A derivative has been defined as "an instrument whose value is based upon, or derived from, some underlying index, reference rate (for example, interest rates or currency exchange rates), security, commodity, or other asset." *See* SEC No-Action Letter, Mutual Fund Use of Derivatives (Sept. 26, 1994). The term "derivative" encompasses forward contracts, futures, swaps, and options.

20 *See* SEC Release No. IC-10666 (Apr. 18, 1979). *See also* SEC Release No. IC-7221 (June 9, 1972) (Funds avoid senior security problem with respect to short sales and written options if these positions are covered with an offsetting position or with segregated cash, U.S. government

securities or high-grade debt securities).

21 Mutual Fund Use of Derivatives, *supra* note 19.

22 *See* Committee on Federal Regulation of Securities of the ABA Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage* (July 6, 2010) (Committee Report).

23 *See* Committee Report at 3. *See also* SEC Speech, Andrew J. Donohue, *Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality?* (Apr. 17, 2009).

24 *See* Senate Hearings at 238-39 (statement of David Schenker); 76 Cong. Rec. S2844-45 (Mar. 14, 1940) (remarks of Sen. Wagner).

25 *See* SEC Release No. IC–26198 (Oct. 2, 2003); Investment Trust Study of 1939, Pt. 3 at 1665, 1674-1675. *Cf.* Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 Wash. U. L.Q. 303, 325 (1941).

26 Louis Loss & Joel Seligman, 1 Securities Regulation 29 (3d ed. 1998).

27 SEC Release No. IC–26372 (Mar. 9, 2004).

28 The Role of Independent Investment Company Directors, Transcript of the Conference on the Role of Independent Investment Company Directors (Feb. 23, 1999), available at http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm (statement of Chairman Levitt).

29 SEC Release No. IC-24082 (Oct. 15, 1999).

30 SEC Release. No. IC-24083 (Oct. 14, 1999).

31 Release No. IC-24082, *supra* note 29.

32 Under a prohibited incentive fee arrangement, an adviser would be entitled to, say, 20 percent of the appreciation of the fund over the course of a fiscal year. Typically, this 20-percent fee would be in addition to an asset-based fee (say) of 1 percent of the value of the fund's assets. As noted, advisers to registered funds may not enter into incentive fee arrangements.

33 U.S. Treasury Department, *Financial Regulatory Reform: A New Foundation* (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

34 *See id*. at 38-39.

35 *See* President's Working Group on Financial Markets, *Report of the President's Working Group on Financial Markets: Money Market Fund Reform Options* (PWG Report).

36 *See* Release No. IC-29132, *supra* note 1.

37 PWG Report at 8-9.

38 SEC Release No. IC-29497 (Nov. 3, 2010).

39 *See* Financial Stability Oversight Council, *Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (Oct. 6, 2010).

40 SEC Release No. IC-28807 (June 30, 2009) (Proposing Release) at text accompanying note 38.

41 *See* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 16 (Oct. 18, 2010), unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1676947.

42 Investment Company Institute, *Report of the Money Market Working Group: Submitted to the Board of Governors of the Investment Company Institute* (Mar. 17, 2009) (ICI Report). From September through December 2008, $234 billion was redeemed from non-U.S. Treasury money market funds and there was a net cash inflow of $489 billion into Treasury money market funds.

43 *See* Proposing Release at text accompanying note 47.

44 The PWG Report concludes that mandatory redemptions in kind may be unsuccessful if the redeemed shareholder sells the in-kind distribution, and those sales depress the market value of securities remaining in money market fund's portfolio. *See* PWG Report at 26.

45 Fund boards, with assistance from fund management, are well qualified to determine whether conditions warrant the imposition of a redemption fee for a money market fund. With respect to funds that are not money market funds, pursuant to Rule 22c-2 under the ICA, fund boards already are authorized to impose redemption fees of no more than 2 percent on share redemptions. Rule 22c-2 was promulgated in 2005 to assist funds in combating market timing. *See* SEC Release No. IC-26782 (Mar. 11, 2005). Separately, as part of the 2010 amendments to the rules governing money market funds, the SEC adopted Rule 22e-3. *See* Release No. IC-29132, *supra* note 1. Rule 22e-3 permits a money market fund's board to suspend fund redemptions, provided the board has irrevocably approved the liquidation of the fund, and the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.

46 Such a "tax" on a shareholder's redemption proceeds is intended to function as a Pigovian tax, named after British economist Arthur Cecil Pigou.

47 SEC No-Action Letter to Fidelity Advisor Korea Fund (Mar. 7, 2001).

48 *See* Proposing Release at text accompanying notes 14 and 16.

49 ICI Report at 29.

50 *See* Investment Company Institute, *Money Market Mutual Fund Assets* (Jan. 13, 2011), available at http://www.ici.org/research/stats/mmf/mm_01_13_11.

51 As of September 30, 2010 total net assets of U.S. mutual funds were almost $11.3 trillion. *See* Investment Company Institute, *Trends in Mutual Fund Investing* (Oct. 28, 2010), available at http://www.ici.org/research/stats/trends/trends_09_10.

52 Matthew P. Fink, The Rise of Mutual Funds: An Insider's View, 31 (2008).

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