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# Money Market Funds — What's Next?

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Even after significant regulatory reform, money market funds remain a potential target for additional oversight and regulation. This article briefly reviews the key steps taken by lawmakers and regulators since the events of September 2008. It then discusses further changes that may be proposed and offers alternative approaches in an effort to resolve the question of "What's next?"

## Introduction

On September 15, 2008, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection, causing the Reserve Primary Fund to become the second money market fund in history to break the dollar share price and triggering a widespread "flight to quality" which left many prime money market funds struggling to meet heavy redemptions. In the wake of those events, the Securities and Exchange Commission (SEC) proposed and adopted extensive amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the 1940 Act), which were designed to address many of the issues with which money market funds grappled during the weeks following the Lehman bankruptcy. Notwithstanding those amendments, however, lawmakers, regulators and industry leaders have continued to engage in a discussion about whether additional regulatory changes are necessary to address perceived issues relating to the money market fund

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industry and, if so, what form those changes should take.

The public debate about the future of the money market fund industry has taken place against the backdrop of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). While not directed specifically at money market funds, Dodd-Frank created the Financial Stability Oversight Council (FSOC), which is tasked with the responsibility for identifying and designating as systemically significant nonbank financial companies (Significant Nonbanks) and subjecting those entities to prudential regulation by the Board of Governors of the Federal Reserve System (FRB). Money market funds and their sponsors are among the non-bank financial companies that have been suggested as possible targets of FSOC consideration.

Adding fuel to the fire of the debate is the report of the President's Working Group on Financial Markets (PWG) on "Money Market Fund Reform Options" (the PWG Report). The PWG Report, which was subsequently published by the SEC for public comment, identified several perceived issues raised (or at least not addressed) by the manner in which money market funds currently are operated and regulated. Most recently, on May 10, 2011, the SEC hosted a roundtable discussion on money market funds and systemic risk where industry participants and regulators, including members of the FSOC, came together to discuss the future of money market funds.

Clearly, therefore, money market funds remain in the spotlight and additional regulatory measures (whether from the FSOC, the FRB and/or the SEC) may be forthcoming. This article will briefly review the key steps that have been taken since the events of September 2008. It will then discuss some of the regulatory and structural changes that have been proposed by industry participants and others to further strengthen the ability of money market funds to operate in the face of future crises. The purpose of the article is not to suggest that there is a "silver bullet" that can cure all of the real and imagined ills surrounding the money market fund industry. Rather, the purpose is to encourage those engaged in the debate to give serious consideration to the proposals described as they determine the next steps to be taken.

## The 2010 Rule 2a-7 Amendments

In February 2010, the SEC adopted amendments to Rule 2a-7 and other rules governing money market funds (the Amendments).[1] Key provisions of the Amendments require money market funds to:

- Comply with enhanced portfolio quality and maturity requirements;
- Comply with stringent portfolio liquidity requirements;
- Periodically "stress test" the fund's ability to maintain a stable $1.00 net asset value (NAV) per share upon the occurrence of certain hypothetical events;
- Disclose fund portfolio and other information in public Web site postings on a monthly basis;
- Electronically report portfolio and other information to the SEC on Form N-MFP; and
- Be able to process transactions at prices other than a stable $1.00 NAV no later than October 31, 2011.

The Amendments also adopted Rule 22e-3, which permits a money market fund to suspend redemptions of its shares in anticipation of the liquidation of the fund. The SEC also broadened the relief provided by Rule 17a-9, which now permits fund affiliates to purchase portfolio securities from money market funds, subject to a "claw-back" requirement that any profit realized from a subsequent sale of a purchased security (other than a security that is in default or is no longer an Eligible Security under Rule 2a-7) must be returned to the fund.

Although the Amendments were comprehensive in scope, at the time they were adopted SEC Chairman Mary Schapiro characterized them as "an important first step in our efforts to strengthen the money market regime."[2] This statement and other statements made by the SEC and its Staff indicate that additional modifications to the SEC's regulation of money market funds may yet be forthcoming.

## Implications of the Implementation of Dodd-Frank for Money Market Funds

On July 21, 2010, President Obama signed into law Dodd-Frank,[3] which made sweeping changes to the supervisory and regulatory regime governing the US financial markets. Among the most significant aspects of the new law for money market funds are: (i) the establishment of the FSOC; and (ii) a requirement to remove references to Nationally Recognized Statistical Rating Organizations (NRSROs) from SEC rules, including Rule 2a-7.

### Establishment of the FSOC

Title I of Dodd-Frank established the FSOC, a new body charged with monitoring systemic risks to the US financial system. Chaired by the Secretary of the US Department of the Treasury (Treasury), the FSOC is comprised of representatives from each of the major financial regulatory agencies and has ten voting members and five nonvoting members.[4] Under Section 113 of Dodd-Frank, the FSOC is given broad authority to designate Significant Nonbanks and to subject those companies to prudential regulation by the FRB. In addition, Section 120 of Dodd-Frank gives the FSOC the authority to recommend that a primary financial agency, such as the SEC, apply new or heightened standards and safeguards to significant financial activities (Significant Financial Activities) conducted by entities under its jurisdiction.

### Authority to Designate Significant Non-Banks

Section 113 of Dodd-Frank empowers the FSOC to determine that a "nonbank financial company" shall be supervised by the FRB and be subject to prudential standards. To make this determination, the FSOC must conclude that material financial distress at the US nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, could pose a threat to the financial stability of the United States. The FSOC's determination to designate a nonbank financial company as a Significant Nonbank is non-delegable and must be made by a vote of no less than two-thirds of the FSOC's voting members then serving, including an affirmative vote by the Chairperson. Designation as a Significant Nonbank would cause a financial company to become subject to a set of prudential standards and requirements, including heightened capital and liquidity requirements, to be developed and implemented by the FRB, either on its own initiative or pursuant to recommendations of the FSOC under Sections 165 and 166 of Dodd-Frank.

Section 113(a)(2) of Dodd-Frank sets forth ten specific factors for the FSOC to consider when determining whether to make a Significant Nonbank designation:

(1) <u>Leverage</u>. The extent to which the company's assets are or may be leveraged;
(2) <u>Off-balance-sheet exposures</u>. The extent and nature of any off-balance-sheet exposures of the company;
(3) Significant Transactions and Relationships. The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
(4) <u>Credit for Businesses and Governments</u>. The importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the US financial system;
(5) <u>Credit for Underserved Populations</u>. The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
(6) <u>Assets Under Management</u>. The extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
(7) <u>Size, Complexity, and Interconnectedness, etc</u>. The nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company;
(8) <u>Existing Regulation</u>. The degree to which the company is already regulated by one

or more primary financial regulatory agencies;

(9) Financial Assets. The amount and nature of the financial assets of the company; and

(10) Liabilities. The amount and types of the liabilities of the company, including the degree to which the company relies on short-term funding.

In addition, the FSOC may consider any other risk-related factors that it deems appropriate. Dodd-Frank does not indicate how much weight the FSOC should give to each factor in determining whether to designate a particular nonbank financial company as a Significant Nonbank.

Several recent events indicate that the FSOC may be considering money market funds as possible candidates for designation as Significant Nonbanks. For example, in early October 2010, the FSOC issued an advance notice of proposed rulemaking (the ANPR) seeking public comment on the criteria that should inform its designation of Significant Nonbanks under Dodd-Frank.[5] Certain questions in the ANPR may have been directed at money market funds. More recently, FRB Governor Tarullo suggested that a few hedge funds and mutual funds, potentially including money market funds, could be on the short list for designation.[6]

The money market fund industry has strongly opposed the notion that a money market fund should be designated as a Significant Nonbank. In its comments on the ANPR, the Investment Company Institute (ICI), the national association that represents the mutual fund industry, argued that designating a money market fund as a Significant Nonbank "would not be an appropriate tool for further strengthening the resilience of money market funds to severe market distress."[7] In particular, the ICI pointed out that money market funds are highly regulated by the SEC and are subject to stringent quality, liquidity, maturity and diversification standards. Commenters also argued that: (i) the 2a-7 Amendments have addressed the risks presented during the 2008 financial crisis;[8] (ii) money market funds are a regulatory success and are already subject to robust regulation; and (iii) the prudential standards specified for Significant Nonbanks are either already addressed more comprehensively in current money market fund regulations or would be an inappropriate fit for money market funds.[9]

## Authority to Designate Significant Financial Activities

In addition to its authority to designate Significant Nonbanks, the FSOC has the authority to provide for more stringent regulation of Significant Financial Activities conducted by a bank, bank holding company (BHC) or any nonbank financial company, if the FSOC determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of the financial activities or practices could create or increase the risk of significant liquidity, credit, or other problems spreading among BHCs and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities. If an activity is deemed by the FSOC to be a Significant Financial Activity, the FSOC is empowered to recommend that the primary financial regulatory agency or agencies apply new or heightened standards and safeguards to the activity. The FSOC's recommendations may include proscribing the conduct of the Significant Financial Activity in specific ways (such as by limiting its scope, or applying particular capital or risk management requirements to the conduct of the activity) or prohibiting the activity in its entirety. In making its recommendations, the FSOC is required to take into account the costs to long-term economic growth, consult with the primary financial regulatory agencies and provide notice to the public and opportunity for public comment on any recommendations. The FSOC must also report to Congress on any such recommendation and its implementation.

If the FSOC recommends that a primary financial regulatory agency imposes stricter regulations on the conduct of a Significant Financial Activity, the agency is required either to: (i) impose the standards recommended by the FSOC, or similar standards that the FSOC deems acceptable; or (ii) explain in writing to the FSOC, no later than 90 days after the date on which the FSOC issues the recommendation, why it has determined not to follow the recommendation.

## Removal of NRSRO Ratings from Rule 2a-7

Section 939A of Dodd-Frank directed the SEC to:

(i) Review its rules for any references to or requirements regarding credit ratings that require the use of an assessment of the creditworthiness of a security or money market instrument;

(ii) Remove those references or requirements; and

(iii) Substitute in place of the credit ratings in those rules other standards of creditworthiness that the SEC deems appropriate.

On March 3, 2011, the SEC proposed a set of amendments to certain rules, including Rule 2a-7 under the 1940 Act that would remove references to credit ratings issued by NRSROs (the NRSRO Proposal) and replace them with new, more subjective, standards of creditworthiness.[10]

Rule 2a-7 has long imposed portfolio quality requirements that limit a money market fund's portfolio holdings by reference to NRSRO ratings. While Rule 2a-7 has also required money market funds to conduct their own credit analysis of all portfolio investments, the use of NRSRO ratings has provided a useful "floor," limiting the universe of potential fund investments to those rated no lower than the top two rating categories. The NRSRO Proposal would remove all references to credit ratings from Rule 2a-7, impacting five elements of the rule:

(i) Determination of whether a portfolio security is an "Eligible Security;"

(ii) Determination of whether a portfolio security is either a "First Tier Security" or "Second Tier Security;"

(iii) Credit quality standards for portfolio securities with conditional demand features;[11]

(iv) Requirements to monitor portfolio securities for ratings downgrades and other credit events; and

(v) Requirement to periodically stress test a money market fund's ability to maintain a stable $1.00 NAV per share.

By eliminating NRSRO ratings from Rule 2a-7, the NRSRO Proposal would remove an objective test and replace it with a more flexible standard that arguably could allow a money market fund to invest in portfolio securities that would not qualify as fund investments under the current rule. However, in the proposing release, the SEC indicated that a money market fund could continue to look to NRSRO ratings if the fund's board concludes that the ratings establish standards that are similar to those proposed and are credible and reliable, and those determinations are reflected in the fund's procedures. Many in the industry anticipate that, if the NRSRO Proposal is adopted, money market fund boards may write the current rating requirements of Rule 2a-7 into their fund procedures, rather than foregoing the protection provided by the current ratings floor.

## PWG Report on Money Market Fund Reform Options

On October 21, 2010, the PWG released the PWG Report,[12] which was subsequently published by the SEC for public comment.[13] The PWG Report acknowledged that the SEC's adoption of the Amendments to Rule 2a-7 was an important "first-step" in making money market funds more resilient and less risky. However, the PWG Report recommended that more be done to address systemic risks and the structural vulnerabilities of money market funds to "runs." To that end, the PWG Report presented the following possible reform options for consideration by the FSOC:

- Floating net asset values;
- Privately sponsored emergency liquidity vehicles;

- Mandatory redemptions in-kind;
- Insurance for money market funds;
- A two-tier system providing enhanced protections for stable NAV money market funds;
- A two-tier system reserving stable NAV money market funds solely for retail investors;
- Regulating stable NAV money market funds as special purpose banks; and
- Enhancing constraints on unregulated money market fund substitutes.

Before the PWG Report was released some observers had expected the PWG Report to propose that money market funds be required to move away from maintaining a stable share price and adopt floating NAVs. Suggestions that money market funds should be forced to move to a floating NAV have been strongly resisted by both the money market fund industry and issuers of short-term debt, among others.[14] Although the PWG Report discussed various reform options for the FSOC to consider, the Report refrained from recommending any particular reform.

## Other Suggestions for Reform Offered by Industry Participants

Largely in response to the SEC's publication of the PWG Report for public comment, several industry participants suggested or elaborated upon various reform options. These included: (i) creating a private emergency liquidity facility; (ii) permitting a capital reserve to be maintained within a money market fund; and (iii) permitting money market funds to impose a special "redemption fee" during periods of market turbulence.

### Private Emergency Liquidity Facility

In its comments on the PWG Report, the ICI strongly supported the creation of a private emergency liquidity facility for prime money market funds (the Liquidity Facility).[15] Under this proposal, any prime money market fund that intends to maintain a stable $1.00 NAV would be required to participate in the Liquidity Facility, although Treasury and other government money market funds would be exempt from participating. Prime money market funds that do not participate in the Liquidity Facility would be required to switch to a floating NAV or convert into a Treasury or government money market fund.

The proposal envisions that, during times of unusual market stress, the Liquidity Facility would purchase high-quality, short-term securities from prime money market funds at amortized cost, thereby: (i) enabling funds to meet redemptions while maintaining a stable $1.00 NAV; and (ii) helping to protect the broader money markets by allowing funds to avoid selling into a challenging market. The Liquidity Facility would not be intended to provide credit support, but rather would assist a money market fund that requires cash by purchasing high-quality instruments from the fund. The Liquidity Facility would be designed to provide a liquidity backstop *only* after a money market fund has utilized a substantial portion of its minimum mandated liquidity positions.

The Liquidity Facility would be a state-chartered bank or trust company, and would comply with applicable banking laws. As such, the Liquidity Facility would be a member of the FRB, eligible to access the discount window in the ordinary course, and would issue time deposits that are eligible for FDIC insurance, although it is not anticipated that the facility would seek to insure those deposits. The Liquidity Facility would have two direct sources of capital. The initial capital would be provided by sponsors of prime money market funds, based on their assets under management, with an aggregated target initial equity of $350 million. The minimum contribution for the smallest money market funds or new money market funds would be $250,000 and the maximum contribution would be capped at 4.9 percent of the total initial equity. After the initial capitalization, the Liquidity Facility would require ongoing commitment fees of its member funds, which would accrue for the benefit of current and future money market fund shareholders, not the Liquidity Facility's equity holders.

A money market fund seeking to sell securities to the Liquidity Facility would be required to present its entire portfolio to the Liquidity Facility's credit analysts for review. A money market fund could only access the Liquidity Facility if the credit analysts determine that its securities are suitable for purchase by the Liquidity Facility. The Liquidity Facility would be subject to stringent asset policies to avoid absorbing credit risk and to minimize through diversification, concentration and duration risk controls the impact of any default.

In its comment letter, the ICI sought to address many of the concerns raised in the PWG Report regarding a private liquidity facility. For example, the ICI stated that requiring all stable NAV prime money market funds to participate in the liquidity facility would help eliminate both investor confusion over prime money market funds, as well as the potential for non-participating funds to benefit from the market stability that a voluntary liquidity facility would provide. In addition, the ICI stated that the proposed Liquidity Facility is being designed to address capacity concerns raised by the PWG Report and, together with the new liquidity requirements imposed by the Rule 2a-7 Amendments, would offer, during future periods of unusual market stress, the liquidity required to allow funds to withstand events similar in magnitude to those experienced during the 2008 financial crisis. The ICI also addressed the potential conflicts of interest that may arise when liquidity is in short supply, noting that the proposed independent credit function would be intended to effectively minimize losses while providing liquidity. The proposed Liquidity Facility governance structure would include a board comprised of representatives from a range of fund sizes, as well as independent directors to provide balanced oversight. Finally, the ICI sought to quell the concern of potential "moral hazards" by requiring that prime money market funds not only maintain the Rule 2a-7 mandated levels of liquidity, but also pay an access fee for using the Liquidity Facility.

## Creation of a Capital Reserve

Other parties have suggested the creation of a capital reserve within money market funds to serve as a buffer to shield the fund's ability to maintain a stable price per share (the Capital Reserve).[16] In its comment letter on the PWG Report, Fidelity Management & Research Company (Fidelity) supported the creation of a Capital Reserve that would be funded by holding back a portion of a money market fund's income similar in size to the amount funds paid for the Treasury's Temporary Guarantee Program for Money Market Mutual Funds. Fidelity maintained that this proposal would address the features of money market funds that the PWG Report argued create an "incentive to redeem shares before other shareholders," stating that the proposal would create a reserve that could absorb losses if the fund was forced to sell assets at a loss. In particular, with a Capital Reserve in place:

> (i) Investors would be less likely to redeem their shares in fear that the money market fund's liquidity would be depleted;
>
> (ii) The focus on the $1.00 stable NAV would become less of a concern for shareholders because a money market fund's market-based NAV would be above $1.00 per share on a regular basis; and
>
> (iii) Money market funds would be better equipped to handle credit and interest rate risks that may result in unrealized losses.

Moreover, as envisioned by Fidelity, the Capital Reserve would be mandatory, regulated, transparent, and subject to board oversight.

Although some shareholders may object to potentially lower returns due to the holding back of income necessary to create the Capital Reserve, the Fidelity proposal offers a solution that could be easily adopted and implemented by money market funds. The proposal would also be consistent with the PWG Report's recommendation that money market funds internalize the cost of risks associated with their operation. The proposal to create a Capital Reserve has received support from several industry participants. On May 5, 2011, The Charles Schwab Corporation and Wells Fargo Funds Management, LLC signed a joint letter with Fidelity expressing their support of the proposals.[17]

Regulatory and tax issues that would need to be worked out before the Capital Reserve proposal could be implemented could include: (i) allowing a fund to hold back a portion of its income notwithstanding a stated policy that all or substantially all of its income will be paid to shareholders; and (ii) ensuring that the hold back of income would not jeopardize the fund's tax status under Subchapter M of the Internal Revenue Code of 1986.

### Redemption Fees During Market Turbulence

Another approach suggested by commenters on the PWG Report to address money market funds' susceptibility to runs by investors was detailed in a comment letter filed by HSBC,[18] which maintained that the most effective means of mitigating systemic risk would be to apply a charge on redemptions that accurately reflects the cost of raising liquidity to meet redemptions and hence the realizable value of the shares being redeemed. HSBC proposed that, during a period of market stress or idiosyncratic stress experienced by an individual money market fund, the price of a fund's shares would be estimated to investors not at the stable $1.00 NAV, but rather at the variable NAV price, which would include an estimate of the sale price of any distressed asset. If an investor redeems during the period, the proceeds would be met by selling a representative portion of the money market fund's assets, including any distressed securities. The difference between the money market fund's stable $1.00 NAV and the actual value of the redeemed shares could be called a "redemption charge" or some other acceptable term, such as a "liquidity protection payment." This amount would be retained by the money market fund to prevent a drop in the fund's market based NAV per share as a result of the redemption.

HSBC noted that this proposal would provide a number of benefits, which include ensuring that: (i) shareholders carefully consider their liquidity needs before taking action to redeem; (ii) shareholders that redeem during a time of market stress are redeemed at an appropriate price of the money market fund's shares; and (iii) shareholders that do not redeem their shares will not be unfairly impacted by redeeming shareholders. HSBC suggested that some of the challenges presented by the proposal would include: (i) determining when to apply the redemption charge; (ii) avoiding the redemption charge being incorrectly perceived as a tax; and (iii) ensuring the proper accounting methodology is used to determine the amount of the charge.

## Other Suggestions and Reform Options

In addition to the suggestions discussed, there are other possible changes that could assist money market funds during times of market stress. Two possible reform options that could be considered include:

> (i) Permitting the board of a money market fund to temporarily suspend redemptions during market turbulence without requiring subsequent liquidation of the fund; and
>
> (ii) Permitting money market funds to issue a "capital" or "support" share class to the investment adviser or its affiliates.

### Temporary Suspension of Redemptions

Under Section 22(e) of the 1940 Act, the board of a money market fund generally is not permitted to suspend redemptions. However, as adopted in 2010, Rule 22e-3 permits a money market fund board to suspend redemptions of the fund's shares if: (i) the board determines that the deviation between the fund's shadow NAV and stable $1.00 NAV may result in dilution and other unfair results to investors or existing shareholders; (ii) the board has approved irrevocably the liquidation of the fund; and (iii) the fund notifies the SEC prior to the suspension. This relief would be useful to a money market fund, such as the Reserve Primary Fund, that has broken the dollar share price and needs to liquidate in an orderly manner. However, the rule provides little comfort to a fund that, unlike the Reserve Primary Fund, does not hold defaulted securities but rather finds itself (i) holding securities of creditworthy issuers that have experienced a decline in market value due to a liquidity crisis such as that which occurred after the Lehman bankruptcy and (ii) facing heavy and sustained redemptions as a result of a "flight to quality" by investors.

One possible measure that could help prevent a run on money market funds would be to permit the board of a money market fund to authorize the temporary suspension of redemptions of fund shares during market emergencies without requiring the board to liquidate the fund. This alternative would empower boards of money market funds to act for the protection of fund shareholders during a market crisis and allow time for the markets to return to normalcy. It could also allow time for more of the money market fund's portfolio holdings to mature, as well as time to liquidate fund assets in an orderly manner, each of which could provide the fund with additional liquidity to meet redemptions.

Section 22(e)(2) of the 1940 Act provides that a fund may suspend redemptions for any period during which an emergency exists as a result of which (i) disposal of the securities owned by it is not reasonably practicable, or (ii) it is not reasonably practicable for the company to fairly determine NAV. Section 22(e) provides that the SEC by rules or regulations shall determine the conditions under which an emergency shall be deemed to exist. In reliance on this statutory authority, the SEC could adopt a rule permitting a money market fund board to temporarily restrict or suspend redemptions of the fund's shares if the board determines that: (i) the secondary market for the securities in which a substantial portion of the fund's portfolio is invested has become illiquid, with the result that it is unlikely that the fund could sell sufficient securities to meet redemptions without realizing losses; and (ii) the fund is faced with redemption requests that substantially exceed cash and liquid assets available to meet such redemptions. If deemed necessary, the SEC could require that the money market fund either begin processing redemptions or move to liquidate within a certain period of time.

Obviously, a suspension of redemptions would be a drastic step that would be undertaken by a money market fund only as a last resort. In fact, the marketplace could be expected to prevent abuses of this rule, as investors (particularly larger investors) could be expected to move away from funds that suspend redemptions without good cause. However, allowing the temporary suspension of redemptions could provide a money market fund with enough "breathing room" during a market liquidity crisis to allow the fund's manager and board to seek solutions to the problems confronting the fund, whether through sales of securities to affiliates or otherwise, cash infusions or a merger with a more stable fund.[19]

One area of concern is that a temporary suspension of redemptions may impose hardships on investors who rely on their ability to redeem shares. Indeed, this was one of the SEC's concerns when it adopted Rule 22e-3 under the 1940 Act, and is a reason why, under Rule 22e-3, a board must irrevocably liquidate the fund in order to suspend redemptions in reliance on the Rule.[20] However, where a money market fund does not hold defaulted securities and a drop in the market-based NAV of its shares is the result of market illiquidity, a temporary suspension may make sense. Moreover, the breathing space that would be provided by a temporary suspension of redemptions could help prevent a fund from being forced to sell securities into an illiquid market, and thus go a long way toward easing any concerns that the FSOC may have regarding the systemic impact that money market funds may have on the rest of the US economy, including the short-term commercial paper market.

## Issuance of a "Capital" or "Support" Share Class

During the financial crisis and under other circumstances, certain fund advisers (or their affiliates) have provided money market funds with a capital infusion in order to increase the funds' shadow NAV. These capital infusions were simply a contribution of a sum of money to the fund, made by the adviser or its affiliate with no right to, or expectation of, future repayment. Another possible reform option would be to provide advisers or their affiliates with the ability to infuse capital into a money market fund to support the $1.00 share price through the purchase of subordinated "capital" or "support" shares (Support Shares). Support Shares would be a separate, junior class of equity security privately issued by the fund. The capital represented by Support Shares would be available to support the market-based NAV per share of the public shares of the fund that are held by individuals and institutional investors. Support Shares could be sold only to the Fund's adviser or its affiliates.

Support Shares would be subordinated to the publicly offered share classes of the money market fund and, in the event of a liquidation of the fund, the Support Shares would be entitled to receive liquidation proceeds only after the holders of the public shares have received proceeds equal to $1.00 per share. Support Shares could be redeemable, but the ability to redeem would be restricted to only those times when the shadow NAV of the public share classes of the money market fund exceeds $1.00 per share for a specified number of days and would remain at or above $1.00 immediately following the redemption of the Support Shares. Support Shares would also not be entitled to receive any dividends unless the payment of dividends is deemed necessary to avoid negative tax consequences to the fund.

Other possible characteristics of Support Shares could be that: (i) they would not pay any management fees on assets attributable to the Support Shares; (ii) they could be voting securities, but the adviser would "mirror vote" the shares (that is, vote in the same proportion as the other shares); and (iii) they would not be transferable to any other party except the adviser or its affiliates. Finally, the existence and general terms of the Support Shares would be disclosed in the money market fund's registration statement.

The framework for creating Support Shares would have to be carefully crafted in order to be permitted under the 1940 Act. Because the Support Shares would be subordinated to a money market fund's publicly offered share class(es) with respect to the distribution of assets and payment of dividends, the SEC likely would have to provide relief from Section 18(f)(1).[21] The SEC may also need to grant relief under Sections 2(a)(32), Sections 22(e), Section 22(c) and Rule 22c-1 in order to deem the Support Shares to qualify as redeemable securities and to permit the payment of redemption proceeds only under certain circumstances. Relief may also be necessary under Rules 2a-7 and 30b1-7 to permit a fund that has issued Support Shares to meet certain requirements of those rules. Accounting and tax considerations would also need to be considered.

A rule permitting (but not requiring) money market funds to issue Support Shares would encourage advisers and their affiliates to infuse capital into a fund to support the fund's ability to maintain a $1.00 share price. The amount of the capital attributable to Support Shares would be retained by the fund as necessary to support the $1.00 share price. However, in the event the market recovers and the market-based NAV of the fund exceeds $1.00 per share without taking into account the capital of the Support Shares, the adviser would be allowed to redeem the Support Shares and recover some or all of its capital contribution.

## Conclusion

There is, of course, no definitive answer to the question of "What's next?" for money market funds. Over the next few weeks and months, industry participants, regulators and others will debate what steps, if any, should be taken, as well as the merits of each of the proposals currently on the table. In addition, other proposals may be developed and debated. Nonetheless, one point is clear – there is no "silver bullet" that can, by itself, remedy the situation, prevent future problems and satisfy all parties. There are, however, a number of useful proposals that have been put forward by the industry and regulators. A combination of several of these proposals would increase available liquidity in times of market stress, provide a buffer to help preserve the dollar share price, encourage fund advisers and their affiliates to support the fund's share price and allow money market funds to continue to serve as an effective financial intermediary between short-term investors and issuers that need short-term financing.

## Post-Script – Discussions Continue

As this article was going to print, the SEC hosted a roundtable discussion, which was moderated by Director Eileen Rominger and Associate Director Robert Plaze of the SEC's Division of Investment Management. Participants at the roundtable included the SEC Chairman and Commissioners, representatives of the FSOC, academics, and professionals from the investment management industry. During the three-hour roundtable, the moderators and participants engaged in a discussion of the systemic risk inherent in the money market fund industry. The informal nature of the roundtable permitted the participants to offer their thoughts and opinions on various issues, including:

- The factors that make money market funds vulnerable to runs;
- The role of money market funds in the short-term financial markets in relation to systemic risk analysis; and
- Various regulatory options including:
    - Requiring a floating NAV;
    - Possible regulation of money market funds as banks;
    - The creation of a Liquidity Facility;
    - The creation of a Capital Reserve, and
    - Liquidity fees.

After this article goes to print, the ICI will be hosting its Money Market Funds Summit on May 16, 2011 at which industry leaders and analysts will discuss the global money market fund industry, the progress that has been made in strengthening money market funds and the current policy debates over next steps.

## Notes

1. *See Money Market Fund Reform*, SEC Release No. IC-29132 (Feb. 23, 2010) (the Adopting Release).

2. Press Release, Securities and Exchange Commission, "SEC Approves Money Market Fund Reforms to Better Protect Investors," (Jan. 27, 2010) available at *http://www.sec.gov/news/press/2010/2010-14.htm*.

3. Pub. L. No. 111-203, 124 (July 21, 2010).

4. Voting members include: (i) the Secretary of the Treasury, who shall serve as Chairperson of the FSOC; (ii) the Chairman of the FRB; (iii) the Comptroller of the Currency; (iv) the Director of the Bureau of Consumer Financial Protection; (v) the Chairman of the SEC; (vi) the Chairperson of the Federal Deposit Insurance Corporation; (vii) the Chairperson of the Commodity Futures Trading Commission; (viii) the Director of the Federal Housing Finance Agency; (ix) the Chairman of the National Credit Union Administration Board; and (x) an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise.

Nonvoting members include: (i) the Director of the Office of Financial Research; (ii) the Director of the Federal Insurance Office; (iii) a state insurance commissioner, to be designated by a selection process determined by the state insurance commissioners; (iv) a state banking supervisor, to be designated by a selection process determined by the state banking supervisors; and (v) a state securities commissioner (or an officer performing like functions), to be designated by a selection process determined by such state securities commissioners.

5. *Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (Oct. 1, 2010) available at *http://www.treas.gov/FSOC/docs/2010-25321_PI.pdf;* 75 Fed. Reg. 61653 (Oct. 6, 2010).

6. James Hamilton, "Fed Governor Says List of Hedge Funds and Mutual Funds Deemed Systematically Important under Dodd-Frank Should Be a Short One," *http://jimhamiltonblog.blogspot.com/2011/04/fed-governor-says-list-of-hedge-funds.html* (April 13, 2011) (last visited May 11, 2011).

7. Comment letter from Paul Stevens, President and Chief Executive Officer, Investment Company Institute (Feb. 15, 2011) available at *http://www.regulations.gov/contentStreamer?objectId=0900006480bf8c4b&disposition=attachment&contentType=pdf*.

8. Comment letter from John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard & Gus Sauter, Managing Director and Chief Investment Officer, Vanguard (Feb. 25, 2011) available at *http://www.regulations.gov/contentStreamer?objectId=0900006480bf887d&disposition=attachment&contentType=pdf*.

9. Comment letter from John D. Hawke, Jr., Arnold & Porter (Feb. 24, 2011) available at *http://www.regulations.gov/contentStreamer?objectId=0900006480bf767d&disposition=attachment&contentType=pdf*.

10. *See References to Credit Ratings in Certain Investment Company Act Rules and Forms*, SEC Release No. IC-29592 (Mar. 3, 2011).

11. A conditional demand feature is a demand feature that does not provide, by its terms, that it would be readily exercisable in the event of a default in payment of principal or interest on the underlying security. *See* Rule 2a-7(a)(6) and 2a-7(a)(28).

12. *See* "Report of the President's Working Group on Financial Markets: Money Market Fund Reform Options," available at *http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf*. In 2009, Treasury had proposed that the PWG prepare a report on fundamental changes needed to address systemic risk and to reduce the susceptibility of money market mutual funds to runs. *See* "Financial Regulatory Reform: A New Foundation," available at *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf*.

13. Press Release, Securities and Exchange Commission, "SEC Publishes Request for Comment on President's Working Group Report on Money Market Fund Reform Options," (Nov. 3, 2010) available at *http://sec.gov/news/press/2010/2010-211.htm*.

14. However, we note that a *Wall Street Journal* editorial suggested that, if money market funds adopt a floating NAV, investors would better understand the risks that funds can lose value. (*Taxpayers and Money Market Funds*, Review and Outlook, *Wall St. J.* (May 9, 2011)). In response to this editorial, Paul Stevens, President and Chief Executive Officer of the ICI, argued that the *Wall Street Journal* editorial ignored the progress that has been made to make money market funds more resilient to a financial crisis and failed to acknowledge the economic disruption and risks of a floating NAV. (Paul S. Stevens, Letter to the Editor, *Wall St. J.* (May 11, 2011) available at *http://www.ici.org/mmfs/snav/11_resp_wsj_mmfs* (last visited May 11, 2011)).

15. Comment letter from Paul Stevens, President and Chief Executive Officer, Investment Company Institute (Jan. 10, 2011) available at *http://www.sec.gov/comments/4-619/4619-49.pdf*.

16. Comment letter from Scott Goebel, Senior Vice President and General Counsel, Fidelity Management & Research Company (Jan. 10, 2011) available at *http://www.sec.gov/comments/4-619/4619-36.pdf*.

17. Comment Letter from Scott Goebel of Fidelity Management & Research Company, Carrie Dwyer of The Charles Schwab Corporation and C. David Messman of Wells Fargo Funds Management, LLC (May 3, 2011) available at *http://www.sec.gov/comments/4619/4619-97.pdf*.

18. Comment letter from John Flint, Chief Executive, HSBC Global Asset Management (Feb. 28, 2011) available at *http://www.sec.gov/comments/4-619/4619-84.pdf*.

19. The SEC could also add conditions restricting the ability of a fund to rely on the temporary suspension rule if the fund holds defaulted securities which accounted for more than one-half of one per centum of the fund's portfolio immediately prior to the default.

20. *See* Adopting Release, *supra* n.1, at Section II.H.

21. It should be noted that Section 18(f) contains, as a condition to the exception from the definition of senior security that permits series funds, a requirement that "the only other outstanding class of the issuer's stock consists of a common stock upon which no dividend (other than a liquidating dividend) is permitted to be paid and which in the aggregate represents not more than one-half of one per centum of the issuer's outstanding voting securities." While unclear, this statutory language arguably could be read to permit the issuance of Support Shares.